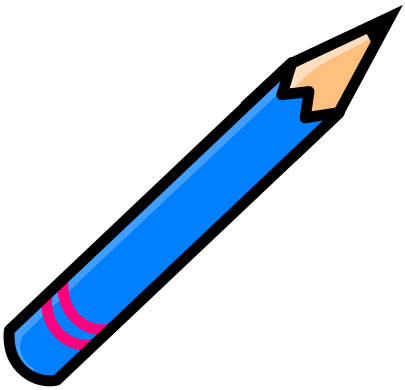
Taxation Notes



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Study Notes for Hong Kong Taxation, especially for Module D, QP of HKICPA

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The study notes are based on the author's experience as a marker of various taxation examinations for many years. They aim to provide an answer guide for answering case analysis questions, and getting marks, especially for HKICPA QP Module D Hong Kong Taxation and ACCA (HK Taxation) Examination and many public taxation exams. Based on the author's experience in marking exam papers, **Marking Points** (•) are highlighted so as to provide hints on how to answer case questions and get marks.

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Topic 1: Salaries Tax - **Source of income**

- **S8(1)(a)** states the **basic charge** of salaries tax: The **whole income** from Hong Kong sourced employment is taxable.

- **Dual employment contracts** case: Analyze each contract separately • S8(1)(a) concerns "employment" relation between an employer and an employee which is created by an employment contract • Identify who is employer • Source of employment is a totality of facts: Comment on the facts given and draw conclusion on whether it is a HK sourced employment.

- **DIPN 10** states IRD's policy on the charge to salaries tax: IRD follows Goefert decision in determining the source of employment income.

- According to **Goefert** case, the general rule for determination of source of employment concerns 3 important facts: (1) whether the employment contract was negotiated, entered into and enforceable in Hong Kong (2) whether the employer was a resident in Hong Kong; and (3) whether the employee's remuneration was paid in Hong Kong.

- Distinguish between HK employment and non-HK employment with Geofert principles • IRD puts **more weighting on (1) and (2)** because (3) the location of payment can be easily arranged by the taxpayer.

- Case analysis: Is the **employment contract** negotiated and signed outside Hong Kong? Is the **employer** an overseas resident company? Who is the real employer – HK subsidiary/associated company? or the overseas company?
- A HK **branch** of overseas company is not a "real" employer. The real

employer is the overseas company • If the taxpayer's employment is HK sourced, **S8(1)(a)** applies so that all income from the employment is taxable. Otherwise, extension of charge under **S8(1A)** applies so that only income attributable to HK service is taxable.

• Judge's reservation in **Goefert** case: "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."

• Case analysis: Does the non-HK employment case has external or superficial features? — Say, A has been working in HK for more than 2 years and he left HK frequently, mostly for holidays. In that case, IRD can challenge that the facts are superficial features and deceptive. IRD can look further into the case and apply the **totality of facts** approach as adopted under Board of Review cases • Besides, IRD can invoke **S61A** to disregard the superficial features and make an assessment to counteract the tax benefit (that is to disallow the time basis claim).

• Case analysis: The overseas employer has a subsidiary company in Hong Kong and the employee has been working with it for more than 2 years. IRD may challenge the time apportionment claim and ask Immigration Department for the employer's declaration filed with Immigration Department and the employment agreement relating to the work visa, in order to find out who is the real employer: the HK subsidiary or the overseas company?

• **DIPN 10**: Time apportionment is applicable for employees who hold overseas employment, assigned to HK temporarily, **required to work overseas** and he will be relocated back to his home country later • If the employee is not required to work outside HK, time basis is not allowed.

• **S8(1A)** states the **extension of charge** for non-HK employment cases: Assess the income in respect of the services rendered in HK only • It is called time-apportionment / **time-basis** assessment • Assessable income = Total **employment income** x no. of day in HK / no. of day of employment period in the year of assessment • If the taxpayer took annual leave, first compute the annual leave attributable to HK service: no. of annual leave day x no. of working day in HK / total no. of working day in the year of assessment. Then, add the "no. of annual leave day attributable to HK service" to "no. of working day in HK" to get the "**no. of day in HK**" • Day of arrival in HK and day of departure from HK are each counted as 0.5 day respectively • Total employment income includes share option gain • **Hardship allowance** for overseas work is not included in assessable income, see D56/91 • **Salaries tax paid by employer** is wholly taxable and it is not subject to time apportionment.

• **S8(1A)(b)(ii)** exempts an employee from salaries tax if he renders **all services outside HK** in the year of assessment • This exemption does not apply to seamen and aircrew • From case law, "services" rendered by employee in HK include: supervise junior staff, attend **business meetings**, report duties to supervisors, take part in training of staff, etc. • Case analysis: A reported duties in HK every Friday – that constitutes services rendered in HK in case law. Therefore, A is not entitled to full exemption of salaries tax under S8(1A)(b)(ii).

• **S8(1B)** states the 60-day visit rule: **Exempt** an employee who renders services in HK during **visits** not exceeding 60 days in the year of assessment. • Exemption is applicable to "visit HK" only • According to Shorter Oxford Dictionary, "visit" means a short and temporary stay • In **So Chak Kwong Jack** case, all days in HK are counted, irrespective of whether they are service day or not. Part of a day is counted as one whole day • From Board of Review cases, if the employee's **permanent base** (or work base) is in HK, his stay in HK cannot qualify as visit • Case analysis: As Chan's permanent base (his home) has been moved to mainland China, his stay in HK can qualify as "visits" even he holds a HK Permanent Resident Identity Card • A HK resident emigrates overseas in May cannot get the exemption even though his total number of stay in HK in that year of assessment does not exceed 60. • A HK resident who has moved his **work base** (the fixed place of work) to mainland China can apply for the exemption • The 60-day rule does not apply to an office holder, a seafarer or an aircrew.

• **Company director** appointed under Companies Ordinance is an **office holder** • Office is a permanent position which has an existence independent from the person filling it, see **Great Western Railway** case • According to **McMillan v Guest** case, location of director office depends on the management and control of the company • According to **D123/02**, director office of a company **incorporated in HK** is treated as locating in HK unless the contrary is proved. The board considers the following facts for management and control in HK: carrying on business in HK, having a fixed place of business in HK, recruiting staff in HK, maintaining bank account in HK, incorporation in HK, registered office in HK, **registers of members** in HK, accounts audited in HK. On a **totality of facts**, the director office is held as locating in HK • Case analysis: As Co. X is **incorporated in HK**, the IRD will

regard the director office locating in HK based on D123/02 • Case analysis: Co. Y is **incorporated in BVI**. As the company director B is a **HK resident** and he ordinarily resides in HK, IRD can regard the **management and control** of the company in HK. The director fee is apparently sourced in HK and taxable.

• D1/81: **dual capacity** of director and employee may be accepted on facts and evidence. Duties of director are statutorily laid down by the Companies Ordinance and the company's Articles of Association; whereas duties of an employee are laid down from day to day by his employer • No exemption for director fee if the director office is in HK • Location of director office is determined by the company's **central management and control**, see **McMilllan v Guest** • Director office of a HK incorporated company is in HK, see D123/02 • Employee's remuneration may get the following exemptions: (i) Exemption under S8(1A)(b)(ii) is allowed if all services outside HK (ii) Exemption under S8(1B) is granted for visiting HK not exceeding 60 days, or (iii) Exemption for the overseas service income is allowed under S8(1A)(c) if overseas income tax is paid in respect of the overseas services income. These exemptions do not apply to an office holder.

• **S8(1A)(c)** exempts income attributable to **services rendered outside HK** if such overseas service is chargeable to tax of a substantially the same nature as salaries tax (e.g. China's IIT) and the overseas tax has already been paid.
• S8(1A)(c) is not applicable if time apportionment under S8(1A)is allowed.
• In general, IRD does not simply exclude the income as assessed in the foreign tax bill from assessable income because foreign income tax may be on world wide basis • In general, IRD uses time apportionment to determine the income attributable to services outside HK, see DIPN 10 • No exemption is granted if the taxpayer does not pay overseas tax even though the overseas

income is chargeable to overseas tax • A taxpayer who did not provide services outside HK cannot get S8(1A)(c) exemption even though he paid foreign income tax • As stipulated in **DIPN 10**, a taxpayer must supply foreign tax bill to get S8(1A)(c) exemption. If foreign tax bill is not yet available, the taxpayer should object to assessment and the tax involved will be held-over pending submission of the foreign tax bill by the taxpayer.

• **Double Taxation Arrangement** with mainland China says : • A mainland resident gets **exemption** from salaries tax if he stays in Hong Kong for not exceeding 183 days in any 12-months period commencing or ending in the year of assessment; his income is not paid by Hong Kong resident employer; and the cost of his salaries is not borne by Hong Kong resident employer. • Similar exemption of IIT is granted for Hong Kong residents working in mainland – see Topic 19. • A mainland resident gets exemption of salaries tax if he visits HK for not exceeding 60 days in the year of assessment. • A mainland resident cannot apply for tax credit in Hong Kong. If he wishes to apply for tax credit, he should make the claim to China tax authority. • A HK resident who has paid IIT on the China-sourced income doubly assessed in Hong Kong can apply to HK Inland Revenue Department for a **tax credit** to set off his HK salaries tax payable. The maximum tax set off is computed on the assumption that the China-sourced income is taxed under HK Salaries Tax. The time limit for application of tax credit is within two years after the end of the year of assessment. • In general, the taxpayer should apply for S8(1A)(c) exemption first instead of tax credit because of greater tax reduction and easier to get exemption under S8(1A)(c) – see Topic 19 for more on tax credit.

Topic 2: Salaries Tax – **Taxable items, Deductions, Allowances etc.**

• **S8(1)**: **3 types of incomes** taxable in salaries tax: **employment**, **office**, **pension** • Case analysis: Refund of course fee under a government scheme is not taxable because it is not derived from employment, office or pension.

• **S9(1)(a)**: Taxable employment income includes: salary, wage, leave pay, fee, commission, bonus, gratuity, **perquisite**, and **allowance**, whether or not they are derived from employer. • Case analysis: A cash allowance 現金津貼(eg. transportation allowance) or a perquisite 非現金的福利(eg. a gift of gold bar on meeting performance target) are taxable under S9(1)(a).

• UK tax cases are applicable to tax employment benefits (**perquisite**), see **Glynn** case • A benefit having **money worth** is taxable • A benefit has money worth if it is **convertible into money** (e.g. it is saleable) or if it is involved in the **discharge of the employee's personal liability** (e.g. payment of the employee's credit card liabilities).

• Examples of **non-taxable** employment benefit — **inconvertible into money** (the liability to pay is on the employer) — include: • Corporate membership of a club allowing employees to use club facilities • Employer employs a domestic helper for employee • Employer makes contract with utility company for supply of electricity, gas and telephone to employee • Employer takes group life insurance scheme for employees • Employer provides free medical / free lunch / free transportation etc. to employees • Employer hires a car and allow employees to use it.

• If employer gives the employee a **gift in recognition of work performance**,

the **second-hand value** of the gift (i.e. the open market value at the time of giving) is taxable, see **Wilkins v Rogerson** • Case analysis: Employer gives employee ParknShop **cash coupons** —they are taxable on face value.

• **Reward for service rendered**, whether it is for **past service** or **future service** is taxable, see **Hochstrasser v Mayes** • Case analysis: Money received by employee on signing of the employement contract is taxable. **Ex gratia** (ie. non-contractual) payment is taxable if it is a service reward.

• Payment for **acting as an employee, inducement to enter into an employment** contract, and **payment in lieu of notice** for termination of employment are taxable, see **Fuchs** Walter Alfred Heinz case. • Case analysis: The **bribes** received by an employee concerning his duties are taxable because they are payment for acting as employee • Payment which is **arising out of employment contract** and forms **part and parcel of remuneration package** is taxable, see **Murad** case.

• Payment made as a **gift on a special occasion** or based on **personal relationship** is not taxable • Examples include: gifts made on birthday, New Year, marriage, death, passing examination, retirement, annual dinner etc.

• **S9(2A)(b)**: **School fee** paid by employer for education of employee's child is taxable even though the employer is liable to pay it.

• **S9(2A)(c)** concerns **holiday benefit**. The assessable amount of holiday benefit is the **actual expense paid** by employer in connection with the holiday journey of employee even though such benefit is not convertible into cash • If an overseas trip is substantially for business purpose, the whole journey is

exempt even part of the trip contains private portion • **DIPN 41**: If the private portion is significant and clearly identified, the expenses attributable to the private portion should be ascertained and taxable.

• **DIPN 41**: Payment for **relocation** of an employee to HK on commencement of employment and payment for the relocation of an employee out of HK are not taxable. These payments are **not reward for service**.

• **Compensation for loss of office** is not taxable • Case analysis: Is there **redundancy** due to **downsizing** / **closure** / **restructuring** of employer's business and **sudden termination** of the post/office **by employer**? • If the termination of office is initiated by employee or if the office is filled by a successor, there is no loss of office/employment, the compensation is taxable.

• Based on **Fuchs** principle, compensation for **work injuries** or for **damages in legal disputes** / **wrongful dismissal** of employee / **breach of employment contract** / **termination of contractual rights** / **remainder salaries** in employment contract for **unperformed services** — these payments are not taxable.

• According to **Pritchard** case, payment by a new employer for inducement of a person to **leave existing employment** is not taxable • Such payment is taxable if it is made to the person who has signed an employment contract with the new employer, see Fuch case.

• According to **Yung Tze Kwong** case, compensation for a leaving employee **not to compete with employer** is not taxable.

• **Severance** payment or **long-service** payment under employment law are not taxable, see **Tsai Ge Wah** case

• Reimbursement of **business expenses** is not taxable because it is not employee's income • Reimbursement of **private expenses** (e.g. employer refunds employee's domestic helper wages) is taxable because it is in discharge of the employee's personal liability • Reimbursement of **self-education expenses** not exceeding the statutory limit $80,000 is not taxable.

• **DIPN 9**: Reasonable **special allowances** to cover employee's travelling, accommodation and related expenses while **working away from usual base** or usual place of residence are not taxable.

• **Salaries tax paid by employer** is wholly taxable. It is not subject to time apportionment in non-HK employment case.

• **Pension** in respect of **overseas work** is not taxable. • Pension from **fund managed** and controlled outside HK is not taxable.

• **S9(2):** Rental value of **free accommodation** is computed on S9(l)(a) income after S12(l)(a) expenses deduction • Rental value (usually at 10%) is computed on the actual **S9(1)(a) income** in respect of the period in which free accommodation is provided; whereas S12(1)(a) expenses deduction are apportioned accordingly • **Rent suffered** by the employee is deducted from rental value; but the rental value cannot be negative • **S9(2)(b)**: Employee can elect for **rateable value** to be the rental value • **S9(1A)**: Free accommodation includes one provided by **associated corporation.** Income from associated

corporation is included for RV computation • **S9(6)**: Free accommodation includes one required under terms of employment whether or not he **better perform duties** • D46/87: Residence provided to employee with **restrictions on its use** is not a taxable benefit • Case analysis: As the employee's wife cannot live in the room, the residence is not taxable • If 2 employees **share a flat**, no apportionment is allowed • If employer provides **2 places of residence**, compute rental value for each • If 2 **separate employers** provide free accommodation, compute rental value for each • **Overseas residence** is taxable • **Serviced apartment** is not hotel, hostel or boarding house, see D91/04. Use 10% rate. • **Share option gain** or **contract gratuity** at termination of employment are not included in RV computation; but other taxable incomes such as **holiday benefit** and **child education benefit** are included • No deductions are made for **MPF**, **HLI**, **ERCE**, **SEE**, **ACD** in RV computation • For **non-HK employment**, first compute S9(1)(a) income less S12(1)(a) expenses deduction; then do the time apportionment to determine the HK-service income; then compute rental value; then allow **full deduction** of rent suffered from rental value • Mind the special treatment of **overseas hardship allowance** and **salaries tax paid by employer**.

• **S9(1A)(a)**: **Rent refund** by employer is not taxable income; only **rental value** is assessed • **Rent allowance** is fully taxable under **S9(1)(a)** • The question to distinguish them, as said in **Robershaw** case, is to ascertain the **intention of employer**: Whether the payment is paid as rent refund? Whether the intention of rent refund was carried out? • **Peter Leslie Page** case: Label is unimportant; the **real substance** must be considered • IRD practice: Consider whether the employer has **control** over the use of rent refund
• Case analysis: Arguments for rent refund are: (i)The employee is not free to use the money (ii)The free accommodation is provided in the **employment**

contract (iii)The free accommodation is based on **company policy**.

- In a rent refund case, if the **quarter is rented from employee** or from his relative, the **IRD may accept** the arrangement for rental value computation if: (i)The terms of lease and the rent are commercially realistic (ii)The lease is duly stamped (iii)The employer is not controlled by the employee; and (iv) The proportion of rent in remuneration package is not unreasonable, see **D14/00**.

- **S11B** : Income is assessable when it **accrues** to employee • Income accrues to a person when he becomes entitled to claim payment • Income accrued to employee in the year of assessment but **not yet received** by the employee in the year of assessment is excluded from assessment until it is received • When the employee receives the excluded income, he must inform IRD so that an additional assessment is made accordingly.

- **S11D(a)**: Income which has been **made available** to employee, or **dealt with on his behalf** or according to his direction, is deemed to be received by the employee.

- **S11D(b)(ii)**: Income received after termination of employment is deemed to be received on the last day of employment.

- **S11D(b) proviso (i)**: Lump sum paid on termination of employment or deferred pay can be related back over the related service period (max 3 years).

- **S9(1)(d)**: **Share option** gain is assessable • **S9(4)**: the gain is assessable in the year of **exercising** or selling the share option. • **Sawhney** case:

Exercising share option after cessation of employment does not affect the chargeability of share option • The gain is calculated by : no. of share exercised x (market price at exercise day – exercise price) – expenses – contribution • If the share options are sold, the net sales proceeds are taxable: sales proceeds – expenses/contribution

• **Share award** is taxable when the share is **vested** on the employee (ie. when the employee can claim ownership of the shares) • The taxable amount is based on the **market value** as at the day of the vesting (usually the grant day) • A discount (5% per year) is granted if there is a restriction period for sale of the share, see **DIPN 38** • Dividend received after vesting day is not taxable because it is employee's personal investment income.

• Payments from **MPF** scheme—if received on **retirement**, death, or incapacity—are not taxable • The portion attributable to employee's contribution is not taxable • The portion attributable to the employer's mandatory contribution is generally exempt • The portion attributable to the employer's **voluntary contribution** (the accrued benefit) is not taxable if it is paid on termination of employment with services for more than 120 months. For termination of employment with service less than 120 months, the exemption limit for the accrued benefit, called **proportionate benefit**, is defined as: accrued benefit x no. of completed month of service / 120. Any excess over the limit is taxable. **Old schemes**, such as ORSO, do not have employer mandatory contribution**.** All employer's contribution is treated as employer's voluntary contribution in computing proportionate benefit.

• Tax clearance is required for employee **leaving Hong Kong** • **S77**: A tax defaulter may be stopped from leaving HK • **S51(7)**: An **employee** chargeable

to tax must notify the IRD of his departure from HK if the departure period is more than one month. Such notice must be given at least one month before the expected date of departure. Notification is not required if he leave HK in the course of his employment at frequent intervals • **S52(6)**: Employer must notify IRD of his employee's imminent departure from HK. Notification is made in Form IR56G reporting the date of departure and the employee's income up to the date of departure. Such notice must be given at least one month before the expected date of departure. After notification, the employer must withhold payment of salary until he receives a **letter of release** from IRD. • **DIPN 38**: If the employee has outstanding **share option** as part of his taxable income, he can elect for a **notional exercise** for computing the gain on share options on the assumption that the share options are exercised on a day as chosen by the employee within 7 days before filing of the tax return. If he has left HK not exceeding 3 months, he can still elect for notional exercise of the share options as at the day of departure.

Deductions

• **S12(1)(a)**: Conditions of **expenses deduction**: not domestic nature, not private nature, not capital expenditure, and wholly, exclusively, necessarily incurred in the production of assessable income • **DIPN 9**: "wholly, exclusively" should not be interpreted narrowly. In practice, apportionment of expenses is allowed. • Ricketts v Colquhoun case: "necessarily" means "is necessarily obliged to incur **in the performance of duties**". The expenditure must be required by the job; not due to the personal reasons of the employee. • **Humphrey** case: "in the production of chargeable income" means "in the performance of duties". Expenditure not incurred in the performance of duties is not deductible under S12(1)(a).

• Case analysis: **Transportation cost** from home to office or office to home is private nature and not incurred in production of assessable income; therefore not deductible • Transportation cost from one employment to another employment is allowable because it is incurred in the production of assessable income.

• Sin Chun Wah case: **Payment in lieu of notice** made by employee to employer for quitting employment is not deductible because it is not incurred in production of assessable income. In fact, it is to end the employment and it does not concern any performance of duties.

• **Robert P Burns** case: Expenses incurred on **obtaining qualification** to get employment are not deductible because they are not incurred in production of assessable income; they are expenses before employment.

• **DIPN 9**: Annual **membership fee** paid to professional body is not incurred in the performance of duties. It is **allowed by concession** if the membership is a **prerequisite for employment** and retention of membership and keeping abreast of current development is of regular use to the performance of duties • Only one membership fee is allowed • Deduction is made for annual fee only; no deduction is allowed for the initial entrance fee.

• **S12(1)(b)**: Depreciation allowance may be granted in respect of capital expenditure on plant and machinery which is **essential to the production of assessable income** • IRD concession: Depreciation allowance may be granted for the equipment/vehicle used by handicapped employees.

Allowances and Concessionary deductions

- In general, where part of year of assessment is satisfied, full amount of allowance is granted. For example, a child born on 31 March (that is the last day of year of assessment) can get full child allowance and new born baby allowance in that year of assessment.
- **Non-HK resident child** can qualify Child Allowance〔**CA**〕subject to satisfying the age and maintainance conditions.
- Adopted child qualifies child allowance if the adoption is legal.
- Dependent Parent Allowance〔**DPA**〕is not allowed for a parent who is not **ordinarily resident in HK**. A parent holding a HK Permanent Resident Identity Card cannot get DPA if he has already emigrated overseas.
- Elderly Residential Care Expenses〔**ERCE**〕should be claimed instead of DPA if the amount of ERCE incurred (max 80,000 for 2015/16) exceed the amount of DPA allowance ($40,000 for 2015/16 & aged 60+).
- **Non-HK resident wife** qualifies Married Person Allowance〔**MPA**〕if she does not have employment income in HK.
- **Joint assessment**〔**JA**〕under S10 should be elected if the spouse's employment income is less than her basic allowance. The time limit of election is the end of the following year of assessment. Election of joint assessment can be made in their Individual Tax Returns BIR60.
- A divorced or living-apart person may claim Single Parent Allowance〔**SPA**〕under S32 if he/she provides **sole or predominant care** to the child in the years of assessment after the year of the divorce or the year of separation. Whether such care exists is mainly a question of facts. The IRD looks to whether the claimant is responsible for the **daily care** and supervision of the child.

• Case analysis: Taxpayer cannot get Disabled Dependant Allowance 〔**DDA**〕 in respect of his unhealthy child because the child is apparently not eligible to claim Disability Allowance from Social Welfare Department.

• Case analysis: Taxpayer cannot get Self Education Expenses〔**SEE**〕under S12(1)(e) for the Taiqi course because it is unrelated to employment. Moreover, it is not a prescribed course offered by an approved education institute.

• Case analysis: Taxpayer cannot get Approved Charitable Donation〔**ACD**〕under S26C(1) for the car donated to Po Leung Kuk because it is not a cash donation.

• Case analysis: Taxpayer cannot get Elderly Residential Care Expenses 〔**ERCE**〕because XXX is not a recognized elderly home.

• Case analysis: Taxpayer cannot get Home Loan Interest 〔**HLI**〕deduction under S26E in the following situations: (a) the loan is not for purchase of residence (b) the property is not the principal place of residence (c) he is not the registered owner of the property (d) the loan is not made by a recognized lender (e) the loan is not subject to a mortgage (e) the property is not located in Hong Kong (ie. not subject to rates payment in HK).

Topic 3: **Self-employment – salaries tax or profits tax**

• Case analysis: Whether Raymond's income is subject to profits tax or salaries tax? Suggested answer: It depends on whether he provides his service as an independent contractor (ie. **contract for service**) or he provides the service under an employment contract with the company (ie. **contract of service**), see **Fall v Hitchen** case.

• Further analysis: Based on **Market Investigations** case principle, the basic question is whether Raymond is performing his services as a person in **business on his own account** • An employment exists where there is a **legal relation of master and servant** • Whether it is a contract of service or a contract for service is chiefly **a question of facts** • Case analysis: Comment on the facts given in the question and then draw conclusion on whether it is a contract of service or a contract for service.

• In **DIPN 25**, IRD says the following tests should normally be used in case of tax disputes〔Refer to Topic 20 if a limited company is set up to avoid salaries tax〕

• **Control test**: Whether the person demanding service has **control** over what, how and when the services are performed, see **Yewens v Noakes**: Who decided the work to be done? Who prescribed the work schedule?
• Normally, an employer has the power to direct and control the work of an employee • The **absence of control** does not mean that the person rendering the services is in business; particularly where the work is so technical that the employer is unlikely to exercise control. • Case analysis: Comment on the facts given and draw conclusion on control test.

• **Integration test**: Whether the service provider is **part of the company**, i.e. Whether he is treated like other employees and whether he is held out by the company to the public as an officer of the company, see **Band voor Handel**
• This test also concerns the capacity of the person rendering the service: Whether he has a position in the company? • Case analysis: Comment on the facts given and draw conclusion on integration test.

• **Economic Reality test**: Whether the service provider performs the services on his own account, such as whether he has to provide his own equipment and hire his own staff; to work in his own business premises; to bear his own business risk; manage his own business; and whether and how far he has an opportunity of profiting from sound management in the performance of his task, see **Market Investigations** case. • Case analysis: Comment on the facts given and draw conclusion on economic reality test.

• **Mutuality of obligation test**: Whether there has been some form of mutual obligations between the company and the service provider, see **Poon Chau Nam** case • This test concerns: Whether the company is obliged to **pay a wage** or remuneration? Whether the service provider is obliged to **provide his work**? • Case analysis: Comment on the facts given and draw conclusion on mutuality of obligation test.

• Case analysis: Raymond was likely an employee having a contract of service with Co. X because: (i) He reported duties to the Supervisor Mr. A. (ii) He sought approval for taking leave. (iii) He attended office at regular hours. (iv) His business expenses were reimbursed by Co. X (v) He was not required to provide his own equipment. (vi) He did not hire assistants. (vii) His name card showed he had a position in Co. X. (viii) He represented Co. X when

dealing with clients. (ix) He earned commission income based on sales amount and there was no risk of making loss. Therefore, he should be liable to salaries tax instead of profits tax.

- Case analysis: Raymond was likely running a business on his own account because (i) He had other clients apart from Co. X. (ii) He worked at flexible times at his own discretion. (iii) He hired his own staff. (iv) He could arrange his staff to do his work. (v) His income was fluctuating from time to time. Therefore, he should be liable to profits tax instead of salaries tax.

- **Tax advantages** for self-employed person: In general he gets more lenient expenses deduction under profits tax than under salaries tax. For more, see Topic 24.

- **Obligations** for a self-employed person: (i) Get a business registration certificate from IRD. (ii) If no tax return is received and he makes profit, he must notify IRD of his chargeability within 4 months after the relevant year of assessment. (iii) He must keep sufficient business records either in English or Chinese. (iv) He must prepare financial accounts. (v) He must file correct tax return on time. (vi) He must pay profits tax on time. (vii) He must notify IRD change of address within 1 month after change. For more, see Topic 17.

Topic 4: **Property Tax**

- **S5(1):** Property tax is charged on **owner** of land and building situated in Hong Kong at 15% standard rate on **net assessable value (NAV)**

- **S5(1A):** NAV means Assessable Value **(AV)** less the **rates paid by owner** and a **statutory allowance of 20%** for repairs and outgoings.

- Where the rent recipient is **not an owner**, IRD may assess him to profits tax. In that case, assessable profits is computed on the actual rental income and the actual expenses incurred; there is no 20% statutory allowance under profits tax.

- "**Owner**" is defined in S2(1) to include: the person holding the property from the government (**registered owner**), mortgagor, mortgagee in possession, **joint owner**, **co-owner**, **owners' corporation**, beneficial owner, **executor** of deceased owner, tenant for life, owner with a an **adverse title**.

- **S56A** : If a joint owner or co-owner pays the tax, he can recover such tax from the person liable to pay it.

- **S2**(2011 amendment): For **common area** of a building, the owners' corporation or the person receiving rental income is chargeable to property tax

- **S5B:** Assessable value (**AV**) is the **consideration** in money or money worth **payable** to the order of and for the benefit of the owner in respect of use of land or building in Hong Kong.

• **Owner's expenses**, such as management fee, repairs, repayment of bank loans etc. paid by tenant are assessable.

• Income of a **capital nature** is assessable • **S5B(3)**: **Premium** (lump sum paid at the commencement of a lease) can be spread over the lease period with a maximum of 3 years.

• **S7C(1): Irrecoverable rent** is deductible when it is proved to be irrecoverable • **S7C(2)**: Unused irrecoverable rent can be carried backward.

• **Every owner** must file a tax return, keep **rent records** for 7 years and pay property tax • Failure to keep records is an offence under **S80(l)(c)** that makes the offender liable to a level 3 fine of $10,000 under **S80(1)**.

• **S51(2)**: If property tax is payable and the owner does not receive a return, he must inform IRD within 4 months after the end of the year of assessment. • Failure to comply with S51(2) can render him liable to penalty under S80(2): a **level 3 fine** of $10,000 plus **three times the tax undercharged**.

• **S51(6)**: If the property taxpayer ceases to be an owner, he must inform IRD within 1 month after the cessation • **S51(8)**: If he changes address, he must inform IRD within 1 month • Failure to comply with S51(6) or S51(8) can make the offender liable to a level 3 fine of $10,000 under S80(1).

• **S2(1)**: A **limited company** having rental income is regarded as carrying on business in HK • The company is subject to profits tax in respect of its rental income • Mortgage loan interest expenses are normally deductible under profits tax, according to S16(1), S16(l)(a) and S16(2)(d) • There is no

deduction of 20% statutory deduction under profits tax • All repairs and maintenance expense and other revenue expenses incurred in the production of assessable profits are deductible under S16(1) • To avoid double taxation of rental income under property tax and profits tax, the company can apply for an exemption from Property Tax under **S5(2)(a)** • If no exemption is claimed, the Property Tax paid can set off the company's Profits Tax payable under **S25** to avoid double taxation • IRD can issue a property tax assessment to a limited company, whether or not the company is chargeable to profits tax, see **Harley Development** case.

• An **individual** property owner is assessed to **profits tax** instead of property tax in the following cases: (1) rental income of **cinema**, **ballroom**, **restaurant** (2) a person owning a lot of serviced apartments i.e. **furnished letting** case (3) property dealer (4) the letting of property is incidental to or form part of trading activities (e.g. a shop owner uses the property mainly for his business and lets out a small part for rental income).

Author's advice

Practice makes perfect. Doing exercises and checking your work with suggested answers is vital. You can use past papers of ACCA and HKICPA as exercises.

Topic 5: **Personal Assessment**

• **S41(1)(b)**: To be eligible for election of personal assessment (**PA)**, an individual or an individual's **spouse** must either be a permanent resident or a temporary resident of Hong Kong.

• **S41(1)(a)**: The individual must be aged 18 or above; or if under 18, both his parents have died.

• A permanent resident means an individual who **ordinarily resides in Hong Kong** 通常在香港居住 see D57/02. • There is no definition in the Inland Revenue Ordinance on what constitutes as "ordinarily resides". In the case of Director of **Immigration v Ng Shun-loi**, “ordinarily resides” means “the person must be **habitually and normally resident** there apart from temporary or occasional absence of living or short duration” • Regular and substantial periods of visit year-by-year is relevant, see **Lysaght** case. • Maintaining a place of residence is also relevant, see **Cooper** case.

• Case analysis: Comment on whether the taxpayer or his spouse is a permanent resident of Hong Kong: Did he or she have a home (a family) or a fixed place of residence in Hong Kong? Did he or she stay in Hong Kong for on average at least 5 months from year to year? If either answer is no, then he or she is likely not a permanent resident of Hong Kong. Then, consider whether he is a temporary resident — see below.

• A temporary resident is one stays more than 180 days in the year of assessment of election; or more than 300 days in 2 consecutive year of assessment, one of which concerns the election.

• Case analysis: Count the number of day in Hong Kong of the taxpayer or his spouse in the relevant year of assessment. Every day in Hong Kong is counted (day of arrival in HK and day of departure from HK are counted as one whole day respectively). If it exceeds 180, he is a temporary resident. Otherwise, count the no. of day in preceding year of assessment or following year of assessment to see if the 2 year total no. of days exceed 200; if yes, he is a temporary resident. If no, he cannot elect for personal assessment.

• A **non-resident** can elect PA if he is **married** with a HK permanent resident in the year of assessment • Election must be made by the married couple jointly in Individual Tax Return BIR60 or in Form IR76C • No separate taxation is allowed under PA, see **Wong Tai Wai David** case.

• **Benefits** for election of PA: (1) Maximize deduction for charitable donation. (2) Claim deduction for the mortgage interest for a leased-out flat. (3) Utilize the un-used personal allowance of spouse under Salaries Tax. (4) Utilize spouse's trading losses to reduce the total assessable income.

• Only the **current year business loss** is transferred to PA • Previous-year business loss is carried forward under profits tax • If there is unused business loss under PA, taxpayer will be deemed to elect PA in the following year of assessment until the loss is fully set-off with income.

• **Mortgage loan interest** deduction is only deductible from net assessable value of let-out property under PA. No deduction is allowed for excess of mortgage interest over net assessable value.

• **Self education expense** is only deductible under salaries tax; it is not a

deduction under PA. If he/she has no assessable income under salaries tax, his/her SEE cannot get deduction under PA.

- **Concessional deductions** such as home Loan Interest, Approved Charitable Donation, MPF mandatory contribution, Elderly Residential Care Expenses are deductions under PA, not under salaries tax, if PA is elected.

- Total tax payable is apportioned between spouses according to their respective net incomes after allowable deductions (i.e. the net income before granting of personal allowances).

- Refer to past papers of ACCA and HKICPA for computation of Personal Assessment.

Topic 6: Profits Tax - **Source of profit**

• **S14(1)**: Profits tax is charged on a person who carries on a business in Hong Kong in respect of his **profits arising in or derived from Hong Kong**
• Carrying on a business in Hong Kong is largely a **question of facts**, see **Magna Industrial** case. See topic 9.

• **S2(1)**: "profits arising in or derived from HK" includes profits from business transacted by an **agent** • A company incorporated in HK engages a secretarial firm to handle purchases and sales is liable to profits tax • A non-resident who appoints a HK company (the agent) to sell goods on its behalf is carrying on business in HK and is liable to pay profits tax in respect of the goods sold by the agent • Case analysis: Did the **non-resident** company appoint any person in HK to do things on its behalf? If yes, that person is an agent; then consider whether the profits earned by the agent is assessable under S14(1). For more on "agent", see Topic 10.

• Whether a **non-resident** is carrying on business in HK depends generally on whether he has a **permanent establishment**〔**PE**〕in HK. See Topic 10.

• Even though a person carries on a business in HK, the **profits sourced outside HK are not taxable** under S14 • Case analysis: What are the profits? Where are the profits earning activities? —The **nature of activities** generating profit must be identified: trading? service? manufacturing? interest income? royalty income? rental income? profit from sale of shares? or other?
• Then, depending on the nature of profits/activities, apply the following applicable tax principles.

• **DIPN 21** states the **IRD's policy** on sources of profits: • No apportionment is allowed for **trading** activities • If either sales or purchases. or both, are **effected in HK**, the profits are fully taxable • Allow 50:50 apportionment for contract processing cases — see next page.

• **Magna Industrial** case: This principle is applicable to **trading** (buy and sell) transactions • Source of profits is determined by **totality of facts**: • the place where the contracts for purchase and sale are **effected**? and other factors: • How are the goods procured and stored? • How are the sales solicited? • How are the orders processed? • How are the goods shipped? • How is the financing arranged? • Are the operations of buying and selling goods carried out in HK? • Are the purchase and sales contracts signed and concluded in HK? • Are after-sale services provided in HK? • Case analysis: Comment on each factor with the facts given in the question and then draw conclusion on taxability of the trading profit based on totality of facts.

• **Operation test** was used in **Whampoa Dock** case • If the operation generating the profit is done outside Hong Kong, the profit is not taxable • This tax principle is applicable to "operation cases 特殊行動及任務" • Case analysis: Was an operation done for earning the profit? Was the operation done outside HK? If yes, allow offshore claim based on operation test.

• **Broad guiding principle** was used in **Hang Seng Bank** case: "One looks to see what the taxpayer has done to earn the profit and where he has done it" • Profit from **rendering service** is derived from the place of rendering service • Profit from manufacturing is derived from the place of manufacturing • This principle is applicable to work, service and manufacturing cases 涉及工作、服務、或生產的個案 • Case analysis: Does the question concerns

work or services or manufacturing or human activities? Where is the work? If it is done outside HK, allow offshore claim. • If work is done by various parties in various places (some in HK and some outside HK), then apply the "effective cause principle" below, **after using** the "broad guiding principle".

• DIPN 21: **Contract processing** gets 50:50 apportionment of profits • Contract processing is an arrangement between a HK Co. and a mainland China entity with the following terms: The HK Co. does not have a license to carry on business in China. It enters into a processing arrangement with the China entity under which the HK Co. provides raw materials, machinery, know-how, management, money etc. **Finished goods belong to the HK Co**. • Contract processing has been phased out and is largely replaced by Import Processing arrangement nowadays — see below.

• According to DIPN 21, if a HK company has only **restrictive involvement** in a processing arrangement, the profits are fully assessable without apportionment • Restrictive involvement means HK company's role in the mainland processing is limited, for example HK company only assigns staff in the supervision of the mainland factory while all other things of the factory belongs to the China entity • This principle is applicable to cases involving **subcontracting** out the manufacturing process by a HK company to a mainland entity • Allow deduction for contract fee, costs of staff and other expenses incurred by the HK company for the manufacturing as they are incurred in the production of assessable profits.

• DIPN 21: No apportionment of profits is allowed for **Import Processing** cases because the arrangement is trading nature • Import processing is a trading arrangement between a HK Co. and a mainland China entity with the

following terms: A **legal enterprise** is set up in China for the processing. The legal enterprise runs the business on its own account. The enterprise owns the finished goods and pays CIT. • The processing fee paid to the China enterprise is deductible. • **Datatronic** Ltd / **C G Lighting** case: As the HK company does not have the ownership of raw materials and finished goods, apportionment of profits is not allowed.

• If the China entity and HK Co. are **closely connected** and the subcontracting fee is excessive, transfer pricing issue can arise and IRD may invoke **S61A** to counteract the tax benefit or invoke **S20(2)** to assess the HK Co. for the tax undercharged of the less than ordinary profits. For more on anti-avoidance, see Topic 20. • Case analysis: Whether a separate legal entity (e.g. a subsidiary) is set up in mainland China? Whether the HK Co. or the China entity owns the finished goods? Is it an import processing case - if yes, no apportionment is allowed based on C G Lighting case.

• **Orion Caribbean** Ltd. case: Source of interest income (taxpayer is not a financial institution) is determined by **provision of credit**: The place where the money is made available to the borrower • Case analysis: Interest received from bank deposits at an overseas bank is offshore and not taxable.

• **Kwong Mile Service** Ltd. case: "To grasp the reality of each case, focusing on **effective cause** without being distracted by **antecedent or incidental matters**" • As regards profit from underwriting agreement, the assumption of risk did not generate profit; it was the **marketing activities** that generated the profit • This principle is applicable to cases involving **activities done both within and outside HK** • Case analysis: Distinguish the effective cause and the antecedent or incidental matters. Disregard the location of antecedent/

incidental matters. If the effective cause in HK, the profit is assessable.

• **Li & Fung (Trading)** Ltd. case: Service income relating to sourcing of goods from overseas suppliers is not taxable because the effective-cause of the income, the sourcing activities were done by the taxpayer's **overseas affiliates** outside HK. • Managing and **supervision** of the overseas affiliates done by taxpayer in HK are regarded as antecedent or incidental matters.
• Case analysis: Does the HK company appoint overseas affiliates to handle the overseas work? Is the overseas work the effective cause of the profit? If yes, allow the offshore exemption based on Li & Fung (Trading).

• HK-**TVB International** Ltd. case concerns acquisition of **rights** for films produced in HK and granting the rights to overseas TV stations. These acts were regarded as being done in HK because the company had no overseas office • This principle is applicable where profit is earned from granting of right/license/intellectual property (IP) and such **IP** is owned by a HK company.
• Source of royalty income is determined by the place of **acquisition** and **granting** of the right according to DIPN 21 • **DIPN 49**: If the IP was developed by a HK company, the income from use of the IP outside HK is still regarded as HK sourced and taxable. If a taxpayer purchased an IP outside HK and licensed it to another party for use outside HK, the royalty income derived will be regarded as non-HK sourced and not taxable.

• **Wardley Investment** case: "it is only the taxpayer's operations, not anybody else's, that are relevant" • Overseas activities done by **independent parties** were ignored • The income in question was derived from the performance of **fund management services** which were done by the taxpayer in HK: therefore the income is taxable.

• **International Wood Product** case: Source of **commission income** is determined by the place where the service is rendered to earn the income.
• In the case, the income was not taxable because the service was done by a **dependent party** outside HK • Case analysis: Is the overseas party doing the work on its own account as an independent party? or Is the overseas party doing the work under the instruction of HK Co. (then it is a dependent party)? Can the work of the overseas party be ignored in considering the offshore claim? If the work of the overseas party is ignored, does the HK Co. has overseas work done by itself to justify the offshore claim?

• **ING Bearing Securities** case: Activities done by overseas brokers **on the taxpayer's behalf and under his instruction** were considered • Case analysis: Any activities done by the taxpayer outside HK? and if done by other parties, are the overseas activities done on the taxpayer's behalf or under its instruction? If they are done on the taxpayer's behalf or under the taxpayer's instruction, then such overseas work can be considered in the offshore claim based on the decision of ING Bearing Securities case.

• **Kim Eng Securities** (HK) Ltd. case: If taxpayer **employs** an employee to act for him, his profit is earned at the place where the employee carry out his instruction • Activities of a member of **group companies** cannot be ascribed to another group company • Bringing together the need of the overseas brokers and their clients was done by the taxpayer in HK: no matter how little it did in HK, where the profit derives from what it did in HK, the profit is fully taxable • This principle is applicable to cases involving dealings between a HK company and its overseas associated companies • Case analysis: Disregard the activities done by the overseas holding/subsidiary company in offshore

claim • Case analysis: A company set up in HK to bridge the trading needs of an overseas company can attract profits tax liability because the bridging function is executed in HK — Does the HK company has a **bridging role** for overseas related company? If yes, the profits earned from such role/function in HK can be taxable, based on Kim Eng Securities case.

• **Exxon Chemical** case: Taxpayer purchased goods from a group company and sold the goods to another group company. Goods did not pass through HK.
• Profit arising from what it did in HK: the **matching of orders**, is taxable.

• **Euro Tech** (Far East) Ltd. case concerns **re-invoicing** centre: Activities for bringing together the needs of buyer and seller were done in HK: The profit therefrom is taxable • Roles played by an overseas **independent** party cannot be considered in the offshore claim as they are not done by the HK taxpayer • **Profit can arise in HK even though the activities in HK are minimal** • Case analysis: What are the roles played by the overseas company? Is the overseas company an independent party? Should the overseas company's roles be ignored in the offshore claim? If such roles are ignored, will the offshore claim be disallowed by IRD?

• **Consco Trading** Ltd. case concerns a HK company having **purchases in China**, **sales to overseas customers**, and goods without passing HK • The court rejected offshore exemption based on a **totality of facts**: pre-contract negotiation, making of purchase contracts, making of sale contracts, processing of shipping documents, financing, opening of letters of credit, payments etc. • Case analysis: Does the taxpayer purchased goods from mainland and sell it to overseas customers? Does the taxpayer have such activities as those mentioned in Consco case in HK? — If yes, based on a

totality of facts, the profits should arise in HK and be taxable.

• DIPN 39 concerns **electronic commerce** • Location of server is not important in determining source of profit • Conventional tax principles apply: Look to the activities and people doing the profit generating operations.

• Case analysis: Does the question concern E-Commerce and computer server outside HK? If yes, point out **DIPN 39**: IRD should focus on the physical operations of the company in HK and pay no regard to the location of the computer server and the electronic activities. Then, make analysis on the physical operations of the company by means of the conventional tax principles such as effective cause, totality of facts, Hang Seng Bank case, Magna case, DIPN 21 ... etc.

Author's advice

Offshore profits questions often carry many marks (say 8 to 15). In order to get good marks, you should base your analysis on **a number of principles**, rather than just quote one principle or one tax case. In your answer, you may comment on the general principles first, e.g. S14, DIPN 21, board guidng principle…, and then followed by elaborating the specific principles, rules and IRD practices. Of course, the depth of your analysis should be commensurate with the marks given.

Topic 7: Profits Tax - **Sale of property / shares / other assets**

The following principles apply generally to sale of various kinds of assets; whereas **sale of landed property** is more likely to be examinable.

• **S14(1)**: Profits tax is charged on a person who carries on a **trade** or **business** in Hong Kong • **S68(4)** puts the onus of proof on taxpayer in case of objection to an assessment: He must supply evidence to prove that he did not carry on a business or a trade of selling property • Case analysis: P bought a flat for $3M as his residence. After 3 years, he sold it for $5M. The profit is not taxable because P did not carry on a trade of property dealing.

• In **Lee Yee Shing** case, the court upheld the **Smith v Anderson** principle that carrying on **business** implies a **repetition of acts** • **Calkin** case: Business is the exercise of an **activity in an organized and coherent way** directed to an end result • Case analysis: Are there any repetition of acts? Is the activity done in an organized and coherent way? Then draw conclusion on whether the taxpayer is carrying on a business or not.

• **S2(1)**: A **trade** includes every **adventure** in the nature of trade • An **occasional sale** of property can constitute a trade and its profit is taxable.
• **Six badges of trade** were summarized by Royal Commission on Taxation of Profits and Income: • Subject matter of sale • Length of ownership
• Frequency of similar transactions • Supplementary work done
• Circumstances leading to sale • **Motive** (intention at **acquisition**)

Case analysis: • Property for **own use** is not a trading stock • Property acquired for **re-development** is trading stock • Short period of ownership

(less than 1 year) suggests trading • Leasing out property for more than 2 years suggests **long term investment** • Frequent sales suggest trading • Just **one sale** in the year of assessment can be trading because it can be **an adventure** in the nature of trade • Renovation making it more attractive for sale suggest trading • Excessive and long period of renovation or **decoration for personal use** suggest no trading • Taxpayer appoints a property agent to sell property shortly after purchase suggests trading • After purchase for 1 year, taxpayer is approached by an estate agent with a very high price can be an argument for no trading intention at the time of purchase • Taxpayer's argument that he needs a bigger residence after marriage is unconvincing because he should know that when he buy the property • Taxpayer sells the property because of liquidity problem can be an argument for a **change of circumstances** occurring after purchase and therefore no trading • Sale of property due to a **compelling reason** (e.g. serious illness, business failure, loss of major customer, **financial difficulties**, unusual high price offered by a customer) is a good argument for no trading.

• The principles mentioned in **Marson v Morton** are: • A transaction **relating to the trade** carried out by taxpayer is likely part of the trade • **History of similar dealing** suggests a trade • **Short-term borrowing** suggests a trade • Items broken down into **saleable parcels** suggest a trade. • A **resale contract before purchase** suggests a trade • An item for **personal enjoyment** is no trading.

• **S14(1)**: Assessable profits exclude profits from sale of **capital assets** • **Capital gain is generally not taxable**; whereas revenue gain is generally taxable • **Ammonia Soda** case: **Capital is what the owner turns to profit by keeping it in possession** • Tools, apparatus or assets used by the

business to make profits are **capital assets** • Premises, plant, machinery, tools etc. are capital assets because they form **permanent structure** of the business • **Profit from sale of a capital asset is not taxable under S14(1)** • Property held for own use (e.g. director quarter, staff quarter, office etc.) is capital nature and profit from sale is not taxable • Case analysis: Is the asset a profit-making tool? Is it kept for earning income? Does it form part of the permanent structure of the business? — If yes, it is a capital asset; as such, by S14(1) profit from sale is excluded from assessable profits.

• **Long–term investment** is capital asset because it is **held for income on long term basis**, see Ammonia Soda Company case: Capital is what the owner turns to profit by keeping it in possession • Profit from sale of a long-term investment is not taxable because it is a capital gain.

• **Trading stock** is revenue nature because it is to be sold • Classification in balance sheet as a fixed asset is one of many factors to consider • From IRD perspective, classification as a fixed asset is usually not a strong argument for capital asset because that is only an accounting treatment by taxpayer • The question of whether it is a capital or revenue gain depends on a **totality of facts** • A property acquired for an **ongoing recurring income** is likely a long term investment • If the taxpayer carried on a property dealing business, any similar transactions by his name or by a company under his control will be assessed to profits tax based on the history-dealing principle in Marson case.

• Case analysis: Argument points for buying a shop as a **long-term investment** may include: • Taxpayer's business is "Property Investment" and its **major source of income is rental income** • Buying the shop for rental income is consistent with the nature of the business carried on by taxpayer •

Taxpayer has **no history of trading** in property • If the shop is trading stock, the taxpayer should have offered it for sale immediately after the purchase. In fact, one year after the purchase the estate agent approached the taxpayer with a good offer • Taxpayer made **extensive renovation** to the shop lasting for 5 months. Such renovation might not fit common buyers and it caused long delay in selling • Soon after the purchase, the taxpayer appointed an estate agent to lease out the shop • Taxpayer used a **long term loan** to finance the purchase • Taxpayer's income level was capable of holding the shop on long term basis • The shop was leased out at market rent and the rental income was a reasonable return on investment.

• **Quitsubdue** case: **Change of shareholder**/ownership of company is not trading; profits tax assessment cannot be made on the company because there is **no sale of property** by the company • For similar reasons, **change of use** of an asset by a company cannot generally give rise to tax liability because **a person cannot trade with himself** – the court says **Sharkey v Wernher principle is not generally applicable in HK** • If change of shareholder is used to avoid tax [for example, an individual taxpayer use a limited company to hold the property and he sells all his company shareholding to make profits], IRD may invoke **S61A** to assess the shareholder/owner to profits tax for the tax benefit concerned. See Topic 20.

• **Lionel Simmons** Properties case: To determine whether trading stock or long-term investment, the intention of the purchaser **at the time of acquisition** is important • Case analysis: Determine the intention at the time of purchase. If it is for sale, profit from sale is assessable. If original intention is not for sale, then consider whether there is any **change of intention** to sale; change of intention may cause the profit from sale taxable, see **HK Sheng**

Kung Hui case • **Wing On Cheong Investment** case: Change of intention after acquisition is proved by the party claiming for the change. See below.

• **All Best Wishes** case: Intention is determined on the **whole of evidence**, including the **objective facts** and circumstances • If the IRD issues an assessment and the taxpayer objects to it, the onus of proof is on the taxpayer, see **S68(4)** • **Real Estate Investment** case: It is the intention at acquisition**.** Such **intention must be supported by evidence**. The length of ownership is less important • Case analysis: If the property has been held for use or for income for over 2 years, it is likely a capital asset. By S14(1), profit from sale of capital asset is excluded from assessable profits.

• **HK Oxygen & Acetylene** Co. Ltd. case: Taxpayer **changed its intention** from investment to trading before the property was transferred to its subsidiary. The proceeds received from the property developer are taxable • IRD must prove there is such a change, see **Wing On Cheong Investment** Ltd. In practice, IRD requires taxpayer to provide evidence (e.g. architect's development plan, company minutes on redevelopment, company meetings with property developers etc.) • For change of investment to trading stock, the market value (if available) at the time of change can be taken as cost of good sold. The increase from original cost to market value at the time of change is capital gain and not taxable • Case analysis: If money is received for development of property (which has been held as a fixed asset before), the money is taxable because of the change of intention/use from investment to trading, see HK Oxygen & Acetylene case.

• **HK Sheng Kung Hui** case: Redevelopment of an orphanage site is a change of intention to start a trade • Tax exemption under **S88** fails for the

trading activities done by a charity • Property was held as non-trading stock for a long time; but subsequent redevelopment made it a trading stock and the profit from the redevelopment was taxable. • **S88**: **Charitable body** is **generally exempt** from profits tax • However, if it carries on a trade or business, the profits will be exempt only if they are applied solely for **charitable purposes** and **not expended outside HK** and either (a) the trade or business is exercised in the course of the objects of charity, or (b) the work is done by the persons for whose benefit such charity, is established. • Case analysis: Comment on the requirements of S88 with the facts provided: Is it a charitable body (see Pemsel case below)? …doing charitable activities? …profits used for charitable purpose? …profits mainly expended for HK people? …trade done by the people for whose benefit such charity is established? — Then, draw conclusion on whether the profits are taxable based on HK Sheung Kung Hui case. • **Pemsel** case: **Charitable purposes** mean: (1) relief of poverty (2) advancement of education (3) advancement of religion, or (4) other charitable purposes beneficial to public community. • Case analysis: Comment on the facts given: Can the objectives of the institution qualify as "charitable purposes" with Pemsel principle? If no, S88 exemption is not allowed. If yes, go on to further analysis on S88 as above.

Author's advice

Whether gain from sale of property/shares/asset is taxable is a hot topic for examination. Don't elaborate too much on what are the Six Badges of Trade because copying from textbook gets low marks! Rather, do detailed analysis on the facts given, quoting the relevant principles from case law and then you will get high marks.

Topic 8: Profits Tax — **Capital nature** and revenue nature

• **Ammonia Soda** case : • Capital is what the owner turns to profit by keeping it in possession • Premises, plant & machinery, tools etc. are **capital assets**. They form the **permanent structure** of the business • **Circulating capital** is what he makes profit of by **parting with it** and letting it change masters • An asset acquired **in the ordinary course of business** is circulating capital (**revenue assets**) • Land acquired for **development** is revenue asset (trading stock) and profit from development/sale is taxable.

The **general principles** regarding Capital and Revenue Nature are:

- Capital gain is generally not taxable in case law.
- Revenue gain is generally taxable in case law.
- Capital expenditure and capital loss are not deductible under **S17(1)(c)**.
- Revenue loss is generally deductible subject to the provisions in Inland Revenue Ordinance, such as **S16(1)** and **S17(1)(b)**, and the various established principles from **case law**.
- Profit from sale of capital asset is not taxable under **S14(1)**.
- Profits from disposal of revenue asset are taxable.
- Income/compensation of capital nature are generally not taxable.
- Income/compensation of revenue assets are generally taxable.
- Generally accepted accounting principles〔**GAAP**〕adopted by the taxpayer are followed for taxation unless they are overruled by a specific legislation or a decided case law principle, see **Secan** case.

Characteristics of **capital nature** are: • once and for all • large amount • enduring asset/benefit • profit earning tool • permanent structure • classified in Balance Sheet as a fixed asset.

Characteristics of **revenue nature** are: • recurring • small amount • short-term benefit • bought for resale • circulating item • charged to Profit and Loss account as an expense.

• Case analysis: Comment on **each characteristic** mentioned above and draw conclusion based on a **totality of facts**: for example, the acquisition cost of **5-year licence** to sell Product X is capital nature because (i) the cost $1M is large as compared to normal business expenditure (ii) it is incurred once for 5 years; it is not a recurring expenditure (iii) it has long-term benefit (iv) the licence is a profit earning tool for the business.

Below are some **important tax cases** on capital/revenue nature.

- Compensation received for loss of **trading receipts** is revenue nature and taxable, see **London & Thames** Haven Oil case • Case analysis: Since trading income was lost because of the XXX damage, the compensation received is revenue nature and therefore taxable.

- Compensation received for **loss of trading contracts** or trading items in ordinary course of business is revenue nature, see **Short Bros** case.
  • Case analysis: Do the receipts concern a trading transaction? If yes, they are revenue nature and taxable.

- Compensation for **temporary loss of usage of a fixed asset** is revenue nature and taxable, see **Burma Steam Ship** case. But compensation for **permanent loss of a fixed asset** is capital nature and not taxable, see **Glenboig Union Fireclay** • Case analysis: Distinguish whether it is a temporary loss or a permanent loss of fixed asset. For example, a truck

was damaged in an accident: If it can be repaired, the compensation received is revenue nature and taxable. If it is destroyed, the compensation received is capital nature and not taxable; in accounting such compensation is treated as disposal proceeds in the computation of loss on disposal of the truck. See Topic 14.

- Loss concerning the **permanent structure** of business is capital nature, see **Fleming** case • Case analysis: The **factory/office/aircraft/franchise** was the permanent structure of Co. X. As it was destroyed, the compensation received is capital nature and not taxable.

- Lump sum paid for the **nuclear fund of a retirement scheme** for its staff is capital nature because it creates an **enduring asset**, see **Helsby Cables v Atherton** case: This is only the general principle; nevertheless there is a specific provision in Inland Revenue Ordinance regarding deductibility of contribution to retirement fund, see Topic 11 • Case analysis: Comment on **whether an enduring asset is created** by a large-amount expenditure. If yes, it is capital expenditure and not deductible under **S17(1)(c)**.

- Payment for obtaining a **guarantee from staff not to work in the same industry** is capital nature because it creates an **enduring benefit**: it is not deductible under **S17(1)(c)**, see **Associated Portland Cement** case.
  • Case analysis: Comment on whether an enduring benefit is created by the payment. If yes, it is capital expenditure and not deductible under S17(1)(c).

- Payment for **getting rid of a permanent disadvantage or onerous**

burden of a **long-term lease** is capital nature, see **Mallett** case.

- Payment for terminating a disadvantageous agency contract is revenue nature because the agency contract is not a capital asset but a **trading arrangement**, see **Anglo-Persian Oil** case • Case analysis: Comment on **whether it is a trading arrangement**. If yes, it is revenue expenditure. Then, if it satisfies **S16(1)** requirements, especially the test of "in the production of assessable profit", it can be deductible.

• Case analysis: Compensation received for early termination of the lease of the **company office** is capital nature because the office is the company's permanent structure as it refers to the company's operating structure, see Fleming case. As the compensation is capital nature, it is not taxable.

• Case analysis: Compensation received from cancellation of **tenancy contract** of rental income of an office. The office is the company's only property leased out for rental income. Cancellation of the tenancy is a trading arrangement. According to Anglo-Persian Oil case, amount generated from a trading arrangement is revenue nature and taxable. Besides, there is no destruction of capital asset because a new tenant can be found. Therefore, the cancellation of tenancy contract is not capital nature.

Author's advice

This is a frequent topic of examination. But it often carries not many marks. So, spending too much time on it seems not effort effective. Anyway I hope the above points help you get good marks on the topic.

Topic 9**:** Profits Tax – **Chargeable incomes** and profits

• In **Hang Seng Bank** case, the judge says there are **3 conditions** under **S14** for a profits tax charge: (1) a person carry on a business/trade in HK; (2) he earns profit from the business/trade; (3) only profits arising in or derived from HK are taxable. This is often called the **basic charge of profits tax**. For simplicity sake, hereafter, business/trade are called business.

• **S14 applies to both HK residents and non-residents** • In general, a non-resident company without a **Permanent Establishment** (**PE**) in HK is not liable to profits tax — see Topic 10 • Case analysis: A Macau company setting up a branch in HK to sell cakes. Even though the company is managed and controlled outside HK, its HK sourced profits are taxable.

• According to **Egytian Hotels** Ltd case, whether a person carries on a business in HK is largely **a totality of facts**, taking into account the location of **capital**, employment of **staff**, **business activities** • Case analysis: As X Corp employs staff in HK and its business activities are mainly in HK, X Corp is carrying on a business in HK, based on Egyptian Hotels Ltd case.

• **Bartica Investment** Ltd case: The court rejected the view that a business was carried on where the business decisions were made; instead, the court focused on whether the company **directors were based in HK**, whether **business records kept in HK** and whether **bank accounts operated in HK**.
• Case analysis: Co. Y is carrying on a business in HK because its directors are residing HK, its business records are maintained in HK and it operates a bank account in HK, based on Bartica Investment case.

• According to **DIPN 13**, mere **placing deposit at a bank** situated in HK without business operations in HK does not constitute carrying on business in HK • Case analysis: As the foreign enterprise has no operations in HK, it is not carrying on a business in HK even though it has a bank account in HK.

• A **company incorporated in HK** is generally regarded by IRD as carrying on a business in HK: This is because setting up a company in HK indicates an **intention to do business in HK** unless the contrary is proved. • **Lam Soon Trademark** case: A company **incorporated outside HK** whose management and control is in HK (because the **company directors are based in HK**) is held as carrying on a business in HK • Case analysis: X Ltd. is carrying on a business in HK because it is incorporated in HK; its directors are HK residents and they mainly reside in HK • Case analysis: Although Y Inc. is incorporated in Singapore, it is carrying on a business in HK because it is managed and controlled in HK—the company directors are ordinarily resident in HK.

• As stipulated in **IRR5**, a **non-resident company** having a permanent establishment (**PE**) **in HK** is deemed to be carrying on a business in HK— see Topic 10 • Case analysis: USA Inc. is not carrying on a business in HK because it is incorporated in USA; its directors are not HK residents; and it has no permanent establishment in HK. So, it is not liable to profits tax under S14.

Interest income (taxpayer is not a financial institution) and **dividend** income

- **Interest Income Exemption Order 1998**: Interest on **HK bank** deposit is exempt from payment of Profits Tax under **S87** • Case analysis: Bank interest is a deduction in the Profits Tax Computation — see Topic 14
  • No exemption is allowed if the deposit is used as a security for a

borrowing and the interest expense of the borrowing is deductible under **16(2)(d)** • The interest exemption order is not applicable if the deposit is made with an **overseas bank**. Nevertheless, the interest is still not taxable because of offshore nature – see following.

- Source of interest income is determined by **provision of credit** test. **Offshore interest** is not taxable under S14 — see Topic 6.
- Interest **received by a HK business** from persons other than a bank/financial institution is taxable: under **S15(1)(g)** for partnership/sole-trader; under **S15(1)(f)** for corporation.
- Interest in respect of **overseas trade debt** is taxable as it is derived in the ordinary course of business. It is **on-shore** nature because it forms an **integral part of sales**, see **DIPN 13**.
- Interest on **qualifying debt instruments** issued by major institutions such as MTR, LINK, HKMCL, Airport Authority, HSBC etc. gets exemption. For **medium-term** debt (3-7 year maturity), allow 50% exemption under **S14A**; for **long-term** debt (>7 year maturity), full exemption is granted under **S26A(1)(h)**.
- Profit on sale of / interest on **exchange fund debt instrument** are exempt under **S26A(1)(c)** / **S26A(1)(d)** respectively.
- Interest on **Tax Reserve Certificate** is exempt under **S26A(1)(a)**.
- **Dividend** from a company incorporated in HK is **exempt** under **S26(a)** • Dividend from an overseas company is exempt because of offshore nature (it is not derived from HK).

Income from use of TV, film, sound recording in HK

• Money received by a person from exhibition or use in HK of TV, film, sound recording in HK is taxable under **S15(1)(a)**. This section applies only if S14 is

not applicable〔e.g. he is a non-resident not carrying on business in HK〕.

• If S14 is applicable〔e.g. the recipient is carrying on business in HK〕, the money is fully assessable under S14 and there is no need to invoke S15(1)(a).

• If S15(1)(a) applies, the assessable profit of the money is deemed to be 30% thereof; or 100% if the payer and the recipient are associated companies.

• Case analysis: H Co. pays $100,000 to non-resident B Inc. for use of a TV drama in HK. B does not have a permanent establishment in HK. So, B is liable to profits tax under S15(1)(a). H, being the payer of the money, must deduct tax (100,000 x 30% x 16.5% = 4,950) before payment to B; withhold the tax; and report tax and pay tax to IRD on behalf of B.

Financial assistance received by a HK business

• **S15(1)(c)**: Money received by a person carrying on business in HK by way of grant, subsidy or similar financial assistance is taxable unless it is in connection with capital expenditure • If the recipient does not carry on a business in HK, there is no tax charge under S15(1)(c). • Case analysis: Financial assistance received from suppliers for **launching of a new product** is taxable because it is received in the ordinary course of the business.

• Case analysis: **Waiver of loan** due to holding company is not taxable because it is not a business receipt in the ordinary course of business.

• Case analysis: The government subsidy for **purchase of trucks** is not taxable under S15(1)(c) because it is in connection with capital expenditure. However, no depreciation allowance is allowed for the trucks as their full cost is subsidized by the government.

Income from use of movable property in HK

• Income from use of **movable property** (machine/equipment/sculpture etc) in HK is taxable under **S15(1)(d)** • The tax charge arises whether or not the owner of the movable property has a permanent establishment in HK • Case analysis: Overseas Inc. (a non-resident company), being the owner of a machine, is liable to profits tax in respect of the hiring fee because the machine is used in HK. Overseas Inc. can claim depreciation allowances, repair costs and other costs incurred for the hiring income. Overseas Inc. must file a profits tax return or notify IRD of its chargeability of profits tax in case no profits tax return is received for the year of assessment concerned. Failure to do so can render Overseas Inc. to penalty — see Topic 16. On the other hand, H Ltd., being the lessee, has no reporting obligation to IRD and no withholding responsibility for the tax liability of Overseas Inc. ⪡If H Ltd pays Overseas Inc. usage fee for using a patent in HK, H Ltd will have reporting and withholding obligation for Overseas Inc. — see following paragraph ➢

Income from use of Intellectual Property

• S14 is the basic charging section of intellectual property (IP) income involving trademark, copyright, design etc. • Case analysis: B Ltd has royalty income from C Ltd. Both B and C carry on business in HK. Then, B's royalty income must be included in its assessable profits, as reported in its profits tax return. • If S14 is applicable, the source of IP income is determined by the **place of acquisition** and the **place of granting** of the IP, see TVB International case and DIPN 49 (see page 33). • Case analysis: Does the recipient carry on a business in HK? — If yes, use S14 so that all income is taxable. • If the recipient is a company incorporated outside HK, consider

whether it has a permanent establishment in HK? and whether Lam Soon Trademark principle is applicable? —If yes, use S14 so that all income is taxable. • If the recipient is a company incorporated outside HK and it does not carry on business in HK, then S14 is inapplicable; then consider whether the deemed trading receipts provision in S15(1) is applicable—see below.

• If S14 is inapplicable (e.g. **the recipient does not carry on business in HK**), the income can still be chargeable to tax under **S15(1)(b)** or **S15(1)(ba)**. • **S15(1)(b)** applies if the **IP is used in HK** • Case analysis: M Inc. (a unrelated non-resident without carrying business in HK) is the owner of trademark "MM". Co. P used the trademark for sale of goods in HK. P paid M Inc. $1M for use of trademark in Y/A 2012/13. P must withhold tax 1,0000,0000 x 30% x 16.5% = 49,500 and pay the tax on behalf of M Inc. • **Emerson Radio** case: **Apportionment of profits** was made between 'HK use' and 'non-HK use' • A trademark is regarded as "**use in HK**" in the following situations: (1) the trademarked goods is **manufactured in HK**; (2) the trademark goods is sold in HK; or (3) the affixing of the trademark is done in HK • Case analysis: E Ltd (a HK company) pays trademark usage fee to K Inc. (a Singaporean company). E affixes the trademark on the goods manufactured in HK. Following the Emerson Radio principle, the trademark is used in HK. So, **S15(1)(b)** applies so that E must report and withhold tax for K Inc. in respect of the payment of trademark fee.

• **S15(1)(ba)**: For **use of IP outside HK**, the income concerned is taxable if the payment is **tax deductible** on the part of the payer • This is to counteract taxpayer using the Emerson principle by payment of licence fee of IP to reduce tax: The payment is deductible as it is incurred in the production of assessable profits of the HK taxpayer; but the non-resident recipient is not liable to tax

because the IP is used outside HK • Case analysis: H Co. paid F Inc. (a French company without carrying business in HK) for use of F's trademark in the manufacturing of motor parts at a Shenzhen factory. The motor parts were used for H's business in HK. F Inc. was not chargeable to tax under S14 because it did not carry on business in HK. The payment of trademark usage fee was deductible by H because it was used for H's business. In this case, S15(1)(ba) is applicable. Then, H must withhold tax from the payment to F Inc. and report such to IRD within 4 months after the end of the year of assessment under S51(2). Then, IRD will send a profits tax return to "H for F Inc." and H must file the tax return as if it were the "agent" of F Inc. When H receives the tax assessment, it must pay tax for F Inc.

Income connected with business operations is taxable

• Various incomes/receipts **connected with business operations** are taxable — see IRD pamphlet pam57e • Examples are rental income from sub-letting, rebate/kickback from supplier or customer, forfeiture of trade deposits, compensation of trade disputes, compensation from employee. • Receipts not connected with business operations are not taxable • Case analysis: Money received by a company from its director is not taxable because it is not **a receipt in ordinary course of business**. • Case analysis: Ms. Y, a flower shop owner, received $500,000 from her boyfriend as business fund. This money is not taxable because it is not connected with the business operation • Case analysis: Co.X sued a former employee about business fraud and got $1M compensation. The compensation is taxable because it is a receipt in the ordinary course of business.

When is income taxable?

• There is no provision in Inland Revenue Ordinance regarding when income is taxable • According to **Secan** case, generally accepted accounting principles [**GAAP**] should apply unless they are in conflict with law: • Financial accounts must be prepared on **accrual basis**, not cash basis • Income accrued to a person when he is **legally entitled to claim** it. • According to **Willingale** case, **anticipated gain matured after balance sheet date** is excluded from assessable profits • Case analysis: Chan sold goods with a credit period of 2 months. Sales income was booked only when sales money was received. Upon field audit by IRD, profits of the last 6 years were revised on accrual basis. Chan was liable to penalty, apart from payment of the tax undercharged previously • By **prudence basis**, profits should not be taken into profit and loss account until they are earned. So, future profits or anticipated profits are not taxed • Case analysis: Ms. L ran a learning centre. Course fee was received before commencement of a course; it would be returned to students in case the course fell through. By prudence concept, L can defer such course fee received before balance sheet date which was in respect of a course commenced after the balance sheet date.

• **DIPN 42**: **Unrealized gains** recognized in Profit and Loss Account in accordance with **generally accepted accounting principles** cannot be excluded from assessable profits • **Nice Cheer Investment Ltd** case: **Revaluation surplus of securities** is not assessable because it is not actual profit • Case analysis: Co. Z buys and sells shares in stock market. In its profit and loss account, a revaluation surplus $4M of shares was booked. Based on Nice Cheer Investment case, the revaluation surplus is a deduction in the profits tax computation when computing Z's assessable profits.

• When **goods are delivered** or when **services are done**, the customers are legally bound to pay. So, the sales revenue must be recognized as "receivables" in accounts even though their payments are received later.

• **Arthur Murray** case: Where a **deposit** is received in advance of rendering service, it can be deferred for taxation purpose until it is recognized in profit and loss account.

• **Interest** on fixed deposit: the day of accrual is the maturity date of the deposit because the depositor cannot claim it before that day • Interest on savings account: the interest accrues to the depositor on a day-to-day basis and so it should be apportioned throughout the period concerned. • For taxability of interest income, see page 49.

• Sale of property by **instalments**: If profits on sale are taken in accounts on a pro-rata basis, such basis should be adopted for tax purpose, see **Montana Lands** case.

• For property developers, profits on sale of property arise when sale and purchase agreements are executed. • According to **DIPN 1**, as far as **property under construction** is concerned, profits will not be assessable until occupation permit is issued by Building Authority.

• Understatement of income means **incorrect tax return**. That causes penalty if the taxpayer has no reasonable excuse. The penalty is a fine of $10,000 plus 3 times the tax undercharged in case of prosecution under S80(2). See topic 16 for more on penalty.

Whether a trustee or a nominee is liable to profits tax?

• As stipulated in **S14(1)**, a person carrying on business in HK is liable to pay profits tax in respect of his assessable profits arising in or derived from HK. • As stipulated in **S2(1)**, a "person" includes a trustee. • In law, the profits tax liability of trustee is not very clear. • In practice, a trustee is liable to pay tax on "his profits" from **running the business**. • In D37/93, it is held that if a trustee being a nominee does not run the business, he is not liable to profits tax. • Case analysis: Comment on whether the "trustee" or "nominee" takes part in running the business with the facts given in the question. If yes, he is liable to pay profits tax based on D98/99. • If no, he is not liable to pay profits tax based on D37/93.

Author's advice

The points mentioned in this topic are part of the analysis on chargeability of profits/income. In examinations, as well as in practice, we have to consider other factors such as nature of income, offshore profit exemption, capital versus revenue nature, anti-avoidance law … etc. To get good marks in an examination, students are advised to watch carefully the facts and requirements in the question, then consider what are the relevant points at issue, then do the analysis with the facts provided and the principles concerned.

Topic 10: Profits Tax - **Non-resident**

• **S14(1)**: Every person carrying on a business/trade in HK is chargeable to Profits tax • This **basic charge** is applicable to both resident and non-resident. 〔Hereafter, "business/trade" is called business〕

• The tax can be assessed directly on the non-resident company under **S14** or on its **agent for the non-resident** company under **S20A(1),** or on the **payer in HK** under **S20B(2)**.

• In practice, IRD issues a profits tax assessment to the HK company who is deemed to be the **agent** of the non-resident company under **S20A(1)** or to the **HK company who makes payment** to the non-resident company under **S20B(2)** • Tax can be collected from the HK agent or from the HK payer • Pursuant to **S20A(2)**, the HK agent/payer must retain sufficient sum to pay non-resident's tax and he is indemnified against claim from the non-resident • According to **S20AA**, **stockbroker** is not an "agent" for his share dealings with non-resident and he is not required to withhold tax for non-resident.

• The Inland Revenue Ordinance does not define what is a non-resident. • According to **DIPN 17**, a non-resident **person** is one who has no permanent **business presence** in HK • From case law, a non-resident **company** has a place of residence outside HK • Place of residence of a company is mainly based on facts • The place of **residence of a company** is generally located at the place where the **central management and control** is exercised, see **De Beers Consolidated Mines** case • Central management refers to **top management** • A company is normally resident at the place where the **board**

of directors normally meet and where they carry out their duties • In practice, IRD looks to whether the company **directors mainly resides in HK** and whether they **conduct business meetings in HK**.

• Case analysis: Co. A is **incorporated in HK**. All directors are HK residents and they mainly reside in HK. All board of directors meetings were held in Macau. As the directors normally meet in HK, they should carry out their director duties in HK. Apparently, Co. A is a HK resident company as its management and control is in HK.

• Case analysis: Co. B is **incorporated in BVI**. All directors are HK residents and they ordinarily resides in HK. As the company's management and control is exercised in HK, Co. B is a HK resident company.

• Case analysis: U Inc. is a non-resident company because its central management and control is in USA, not in HK. U is not liable to profits tax because (1) It does not have any shop, branch, office or management in HK. (2) The services in HK are performed by an **independent agent** who run his business on his own account. (3) The agent is not a permanent establishment in HK because the **agent** has no general authority to negotiate and conclude contracts for U. (4) The agent does not maintain any **stock of merchandise** for U in HK.

• "**Agent**" is defined in **S2(1)** to include (a) **agent**, attorney, factor, receiver or manager in HK; and (b) any **person through whom the non-resident is in receipt of the profits** • "Agent" in S2(1) does not apply to a HK company who makes payment to a non-resident on **principal-to-principal** basis, see **ATV** case.

• After ATV case, **S20B** was enacted to assess the HK payer company who pays a non-resident company for the income assessable under S15(1)(a), S15(1)(b) and S15(1)(ba). For these kinds of payments, the HK payer company must withhold tax from the amount payable to the non-resident under **S20B(3)** even though the payment is made on principal-to-principal basis.

• Case analysis: Comment on whether the HK company is an agent of the non-resident in S2? Whether principal-to-principal basis exists? Whether the income received by non-resident is deemed chargeable under S15(1)(a), S15(1)(b) or S15(1)(ba)? — If yes, S20B is applicable, and HK company must withhold tax under S20A or S20B and report that to IRD within 4 months after the end of the relevant year of assessment under S51(2). IRD will then issue a tax return to the HK company who will file the tax return and pay tax for the non-resident. Failure to do that can make HK company liable to penalty under S80(2).

Inland Revenue Rule **IRR5 (2)**: the assessable profits of a non-resident company can be determined as follows:

- Where the local accounts reflect the true HK profits, assessment is based on the **local accounts**.
- Where the local accounts does not reflect the true HK profits, HK profit is computed by: HK Turnover / World wide turnover x Total worldwide profits, with appropriate tax adjustments to the **worldwide profits**.
- Where these two methods are not practicable, the HK profit is determined by a **fair percentage of the HK turnover**.

• If a non-resident has a permanent establishment in HK and he has profits sourced in HK, he is liable to profits tax under S14. In that case, his

assessable profit is normally based on its local accounts in HK.

• Inland Revenue Rule〔**IRR5 (1)**〕: **permanent establishment** (PE) means a branch, management or other place of business. It does not include an agent unless the agent has and habitually exercised 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.

• Case analysis: Whether the non-resident company has a branch? a management? a place of business? or an agent in HK? — if there is an agent in HK, does he have general authority to make contracts on behalf of the non-resident or does he keep a stock of merchandise in HK? — Then, draw conclusion on whether the non-resident has a permanent establishment in HK; and whether he carries on a business in HK; and then whether S14 can be used to assess the non-resident to profits tax.

• **Transfer pricing** is not a usual problem for transactions with non-resident because **HK's tax rate is usually lower** • However, in case a **non-resident** and a **closely connected** HK resident undergo transfer pricing arrangement under which the HK resident makes no profit or **less than ordinary profits**, the transactions done by the non-resident are deemed to be business carried on in HK and the transactions are chargeable to tax in name of the HK resident as if he were the agent of the non-resident, see **S20(2)** • It is necessary to look to the ultimate **controlling interest** of the parties concerned. Nominee shareholding is ignored and beneficial ownership must be ascertained, see **S20(1)(b)**. For transfer pricing, see Topic 21.

Payment for **use of IP** (patent, design, trademark, copyright, secret process or formula, knowledge etc.) **:**

~ If the **recipient carries on a business in HK**, the royalty income is taxable under S14, see **Lam Soon Trademark** case • If the recipient is a non-resident company, then consider whether it carries on a business in HK which is mainly a question of facts • A non-resident having a permanent establishment in HK is generally regarded as carrying on business in HK and is chargeable to tax under **S14**.

~ Royalty income received by a **non-resident without PE in HK** for use of a trademark etc. in HK is taxable under **S15(1)(b)** • Whether the use of trademark etc. is in HK is a question of facts • In **Emerson Radio** case, use of trademark was outside HK because the product was manufactured outside HK and sold outside HK • If the trademark is used outside HK and the payment is deductible by the payer under profits tax, the royalty income of the non-resident is taxable under **S15(1)(ba)** • Whether the payment is deductible in profits tax of the payer depends on whether the payment is incurred by the HK payer in the production of his assessable profits • The tax chargeable under S15(1)(b) or under S15(1)(ba) is generally paid by the HK payer for the non-resident recipient although IRD can make direct profits tax assessment on the non-resident recipient.

~ Assessable profits are generally deemed to be 30% of payment • The payer must **withhold tax** and pay tax to IRD on demand • Tax thereon = payment x 30%x 16.5% • If the payment was made to an **associated company** and the IP was **previously owned by a HK business**, then 100% of payment is deemed to be assessable profits, see **S21A(1)**. • In such case, tax thereon = payment x 100% x 16.5%

~ Payment for use of copyright of **software** in HK is a deemed trading

receipt under 15(1)(b) • Examples of "use of software" are: the right to make copies for distribution to public, the right to prepare derivative programs, the right to make a public performance of the program and the right to publicly display the program • For pre-packed software or downloading software via internet, as the user does not have the right to reproduce, modify or adapt the software, S15(1)(b) is inapplicable, see **DIPN 39**. So, no withholding tax is required.

• **Consignment** Tax: A local person who **sells goods in HK on behalf of a non-resident** is required to furnish **quarterly returns** to the IRD, see **S20A(3)**. • When he submits the quarterly return, he should pay to IRD a sum equal to 1% of the sales proceeds or such lesser sum as accepted by the Revenue. In practice, only **0.5 %** of the sales proceeds is demanded • The HK person must withhold the tax amount from the sales money • In consignment cases, ownership of the goods belongs to the non-resident, not to the local person who sell the goods for the non-resident.

• Non-resident **sportsman** & **artiste** making **public performance** in HK are chargeable to profits tax under S14 and S20B • Since they normally stay in HK for a few days, the procedures of issuing tax returns before making of assessments will not be followed, see **DIPN 17**. Instead, the HK promoter of the performance (the agent) will submit a **Form IR623** to IRD stating name of the performer, the gross income and tax withheld. • Then, an estimated assessment under S59(1) proviso and S59(3) will be issued to assess the agent and collect the tax withheld • Tax withheld by the HK promoter = Gross income x **2/3** x tax rate 15% (for individual performer). • Case analysis: M paid a mainland artiste $10,000 who performed at annual staff dinner. M need not withhold tax from the payment because it is not a public performance.

Offshore fund: exemption for non-resident trading in HK stock

• **S14(1)**: Every person carries on a business in HK with profit arising in or derived from HK is liable to profits tax • Carrying on a business is a question of facts. The motive of profit making is unimportant. Relevant facts include whether the activities are carried out in a organized and coherent manner – see Topic 7 • Speculation activities of securities by an **individual** do not normally constitute carrying on a business or trade, see **Le Yee Shing** case • An economist speculates on share dealing is not carrying a trade or business, see **Chang Liang-jen** case • A **company** engaged in buying and selling shares will normally be regarded as carrying on a business of **share dealing** and liable to profits tax because a company has presumably a motive to make profits • Profit from securities dealing in **overseas market** is offshore and exempt • Profit earned in HK stock market is sourced in HK and taxable, see **DIPN 21**.

• Reasons for **exemption of non-resident** company trading in HK stock include: (i) development of offshore funds in the HK market; (ii) helps maintain HK's international financial centre; (iii) benefit supporting services including brokers, accountants, bankers and lawyers, see **DIPN 43**.

• **Non-resident company** has central management and control outside HK. Location of central management and control is mainly a question of facts. In general, management and control is normally exercised by the directors in board meetings • Case analysis: Co. X is a non-resident company because the board of directors usually holds meetings in UK.

• **S20AC**: Only non-resident's profits from **specified transactions** through or

arranged by **specified persons** are exempt.

- **Specified person** means a licensed company or an authorized financial institution under Securities and Futures Ordinance. A **licensed stockbroker** doing share dealings in a stockmarket is a specified person.

- **Specified transactions** include transactions in listed securities (but exclude shares/debentures of private company) as specified in **Schedule 16** of IRO as: (i) securities (ii) future contracts (iii) foreign exchange contracts (iv) deposits (v) foreign currencies (vi) trade commodities.

- The exemption also covers profit from transactions **incidental** to the carrying out of the specified transactions provided that the trading **receipts from the incidental transactions** (for example interest, commission) do not exceed **5%** of the total trading receipts from both the specified transactions and the incidental transactions, see S20AC.

- Exemption is for non-resident person only. A resident person who: (i) alone or jointly with his associates, holds direct and/or indirect beneficial interest of 30% or more in a tax-exempt offshore fund or (ii) any percentage if the offshore fund is the resident person's associate, is deemed to have derived assessable profit in respect of the trading profit earned by the offshore fund from specified transactions and incidental transactions carried out in HK, see **S20AE**. • Case analysis: Co. H is deemed to have assessable profits earned from the offshore fund because the offshore fund is 50% owned by Co. H which is a resident company. According to **DIPN 43**, Co. H has the legal obligation for filing of tax returns, notifying chargeability of tax and paying tax under Inland Revenue Ordinance.

Topic 11: Profits Tax – **Deduction** of expenditures

- The basic rule of deduction is **S16(1)**: whether the expenditure is **incurred in the production of assessable profits**?
- The test for S16(1) is: Whether the expenditure is incurred in the **ordinary course of business** - Swire Pacific case.
- Payment to get workers back to work to **avoid damages caused by strike** is deductible even though it does not generate any profit - **Swire Pacific** case.
- An **indirect nexus** between payment and derivation of profit is sufficient - Swire Pacific case. Case analysis: Advertising expenditure for sales of a new product is deductible even though the sale turns out to be unsuccessful.
- Only **immediate and direct purpose** are relevant. Indirect or subsequent purpose are ignored.
- Expenses for earning **future profit** are deductible - **Mutual Investment** case.
- **Redundancy** / severance payment to employees before cessation of business is deductible because such payment is a necessary condition / statutory requirement for hiring of employees to provide services - **Cosmotron** case.
- Expenditure relating to **employee's fraud** is in the ordinary course of business and deductible - **D128/01**.
- Payment for protecting or **defending an asset** used for production of assessable profits is deductible - **Morgan** case.
- **Fine** paid for breaking law is not deductible because it is not incurred in the **ordinary** course of business. In fact, it is for punishment of the wrongdoer - **Chu Fung-chee** case.

- Expenditure with a view to **obtaining a tax advantage** even though they may give rise to assessable profits is not deductible - **D44/92**.
- Interest incurred on **construction of building for own use** is capital nature and not deductible - **Tai On Machinery Works** case
- Interest on **redevelopment of property** for rental income before completion is capital nature and not deductible- **Wharf properties** case.
- Expenditure to establish, replace, or enlarge the business's **capital structure** is capital nature and therefore not deductible - **Sun Newspapers** case.
- Money spent on **improving the asset** or making it more advantageous is capital expenditure and not deductible, see **Tucker** case.
- **Generally accepted accounting principles** adopted by taxpayer is followed unless it is in conflict with law, see **Secan** case.
- Interest absorbed into **cost of stock** is deductible only when the stock is sold - Secan case.
- **Prepaid** expenditure which has been carried forward to next year is not deductible - **DIPN40**.
- **Exchange loss** is deductible if the related item is revenue nature and incurred in the production of chargeable profits. Loss on trading receipt deposited at bank is capital nature and not deductible - **Li & Fung** case.
- Deductibility of **legal expenses** depends on the nature of the related transaction • Legal expense for collection of trade debt is deductible • Legal expense for **first lease of company office** is not deductible because of capital nature; whereas legal expense for **renewal of lease** is deductible • Legal expense for **tax appeal** is not deductible because it is not incurred in the production of assessable profits.
- **Rent** (if not excessive) paid to proprietor's spouse is deductible; rent paid to proprietor is not deductible • Rent paid to a partner or his spouse is

deductible under **S16(1)(b)**.

- **Property tax** paid by corporation set off its profits tax liability under **S25**.
- **Foreign tax** on profits or **earnings** is not deductible. Foreign **turnover tax** (e.g. BT and VAT of mainland) and foreign royalty tax paid are deductible if (a) the tax is paid regardless of whether or not a profit/earning is derived and (b) the relevant earning is taxable, see **DIPN28**.

Non-deductible expenditures under **S17** are:

- domestic or **private** expenses - **S17(1)(a)** e.g. business owner's travelling expenses between home and office
- expenses **not for production of assessable profits** - **S17(1)(b)** e.g. for earning offshore profits
- **capital** expenditure - **S17(1)(c)** e.g. issue of company shares, setting up a new branch, purchase of a fixed asset
- cost of **improvement** - **S17(1)(d)** e.g. renovation of office
- any sum recoverable under **insurance** or contract of indemnity - **S17(1)(e)**
- salary, interest on capital, voluntary contribution to MPF for the **sole-proprietor** or his spouse; or salary, interest on capital, voluntary contribution to MPF for a **partner** or his spouse - **S17(2)**.

• Mandatory contribution to MPF for the proprietor or partner is deductible subject to a statutory limit [18,000 for 2015/16] • Mandatory contribution to MPF for the proprietor's **spouse** or the partner's **spouse** is not deductible.

• S16(1) allows deduction of expenses "**to the extent**" that they are incurred in the production of assessable profits • For excessive expenditure, IRD can apply "**commercial considerations**" principle and limit the deduction of the

expense to a **commercially realistic level**, see **So Kai Tong Stanley** case.

• According to **DIPN 3**, expenses should be **apportioned** between "deductible" and "non-deductible" wherever applicable. Apportionment is required in dual nature cases involving **private use**, **offshore claim**, **excessive** and **unreasonable** amount.

• Apportionments required by **Inland Revenue Rules**:

(a) Where profits are derived partly within Hong Kong and partly outside: disallow expenses directly attributable to the **profits derived outside HK**: apportionment based on sales amounts, see **IRR 2A**

(b) Where profits are derived from trading (taxable) and also from **dividends** (non-taxable): (i) interest incurred for financing the investment producing dividends: not allowable, see **IRR 2B**: (ii) management cost of investment: no apportionment in general; if substantial cost is involved, disallow 1/2% on cost of investment, see **IRR 2C**.

• S16(1) says expenses '**incurred**' during the basis period are deductible. An expenditure is incurred when the claimant has a **definite or committed liability** to pay and the amount can be a**scertained on an accurate basis**, see **Lo & Lo** case • Provision for **contingent** liabilities, **transfer to a general reserve** against future expenditure or future loss is not deductible because the future expenditure/loss/liability has **not yet** been incurred.

• **Commission** expenditure: IRD requires **separate disclosure** of commission expenditure, see **DIPN 12** • The separate disclosure is made in a **schedule** annexed to the tax computation showing: (i) name, address and identity card number or business registration number of the recipient; (ii)

relationship with the taxpayer; (iii) amount of the payment; (iv) details of services rendered • Failure to disclose can lead to disallowance of the expenditure or imposition of penalty for not keeping sufficient business records or prosecution in tax evasion cases • Case analysis: IRD may assess Co. HK as if it were the agent for the overseas company in respect of the commission payment under **S20(2)** because the two companies are **closely connected** and the payment made Co. HK producing **less than ordinary profits**.

• **Bad debts**: **S16(1)(d)** sets out conditions for deduction: It must be a **trade debt** (i.e. included in assessable profits before) which is **proved to be bad** • Taxpayer must provide evidence to prove the company has taken actions to recover the debt • **General provision** for bad debt is not deductible • Case analysis: The bad debt arising from the loan due from fellow subsidiary is not deductible because Co. A is a trading company and no information suggests that it carried on a **money lending business**. Even if Co. A carried on a money lending business, it has to prove that the loan was lent in the ordinary course of money lending business. As the loan is made to its fellow subsidiary, IRD will examine under what circumstances the loan was granted, including the terms of repayment, the security provided by the borrower etc.

• **Valuation of stock**: **DIPN 1** says • First-in-first-out is acceptable • Standard cost is acceptable if the standards are frequently revised to reflect actual cost • Adjusted selling price is acceptable if it gives reasonable approximation of historical cost • **Last-in-first-out** is unacceptable • **S51C** requires **sufficient business records** for valuation of trading stock in Profit and Loss Account • **Stocktaking records** must be maintained: (a) a list of each type of stock and its value (b) who did the stock-taking (c) how the stock-taking was done (d) date of stock-taking and (e) basis of valuation.

• **Repair & Replacement** expenditure: • Expenditure on **repair** to premises, plant, machinery, implements, utensils or articles used in earning assessable profits are deductible under **S16(1)(e)** • Repair expenditure is distinguished from **improvement** expenditure because the former is deductible whereas the latter is not deductible under S17(1)(d) • "Repair" means **reverting the asset to its original capability** or function; whereas "improvement" means a **new function** or a **significant enhancement** is made to the original asset
• Expenditure on **replacement** of implements, utensils or articles used in earning assessable profits is deductible under **S16(1)(f)**.

• **Refurbishment** expenditure on a **commercial building** is capital nature but it is deductible under **S16F** by 5 equal instalments over 5 years of assessment • If such expenditure does not qualify S16F, it may qualify for **commercial building allowance** under S33A • Case analysis: Expenditure for improving the building is capital nature; whereas expenditure on repair is revenue nature. The question of improvement or repairs is largely a question of facts and degree. As the renovation results in substantial alteration of the building, it is capital expenditure; it may qualify for deduction under S16F or CBA • S16F deduction does not apply to a **domestic building**; and a domestic building does not include a **hotel**. So, renovation for hotel gets S16F deduction although a hotel involves domestic/residence nature.

• **Removal** expenditure: Whether or not removal expenditure is deductible 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 be regarded as capital nature and therefore not an allowable deduction. Nevertheless, in that case, the part of the expenditure in relation to dismantling, transporting 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 revenue nature and therefore allowable.

- Case analysis: The removal is **forced by circumstances** beyond the control of the company – it was caused by the termination of lease by the landlord. The whole cost of the removal is deductible: Not only the transportation cost, but also the dismantling and the erecting cost of plant and machinery, are also deductible.

- **Environmental protection** expenditure〔vide **S16H** to **S16K**〕: Environmental protection machinery includes: **low-noise** construction machinery; **air pollution** control machinery; **waste treatment** machinery; **wastewater** treatment machinery; and **environment friendly vehicle.**
- Purchase cost of machinery/plant/vehicle for environmental production is fully deductible • For **installation cost**, allow 20% deduction in each of the 5 consecutive years of assessments.

- **Technical education**: Payment to an approved institute **relating to the trade** gets full deduction, see **S16C** • Whether or not the employee studying at the approved institute does not affect S16C deduction.

- **Research and development**: Under general rules, expenditure on R&D is not deductible because of **capital nature**. This is because R&D creates an enduring benefit/asset (a long-term competitive advantage) • **S16B(1)(b)** grants full deduction for expenditure on R&D which is **related to the trade** except expenditure on **building** • Expenditure on building gets **Industrial Building Allowance** under S40 • Expenditure on **P&M** qualifies for full deduction; **sales proceeds** of such asset is deemed trading receipt under

S16B(3) • **DIPN 5**: R&D relating to the trade includes any activities for extension of knowledge in **natural science** and **applied science**, business research; R&D for new product, new materials, new devices, new process; improvement of technical efficiency of the trade, medical research for workers in the trade • Case analysis: Comment on whether the expenditure qualifies R&D in DIPN5 • S16B(1)(a): Payment to an **approved institute** for R&D relating to the trade also gets full deduction. • Case analysis: Donation to HKU for research in the taxpayer's industry gets full deduction.

• Purchase cost of **prescribed fixed assets** - **computer** hardware and software and **manufacturing machinery** - for producing assessable profits is deductible under **S16G** • Where the prescribed asset is sold, the **sales proceeds** is deemed taxable receipts • Assets **used outside HK** are regarded as held on lease under S2. They are **excluded assets** under S16G(6) and do not qualify S16G deduction • S16G is not applicable for assets acquired on hire purchase. They get depreciation allowance as a usual hire purchase asset – see Topic 13. .

• **Employees'** expenditures: Almost all kinds of expenditure for the benefit of employees are deductible as they are incurred in the ordinary course of business • In practice, IRD regards **director of private company** not an ordinary employee, but a business owner • **Small gift** to employee on marriages is deductible because it can promote good relationship • **Large gift** to employee may not be deductible because it is likely made out of personal reasons • **Curtis** case: Loss caused by embezzlement or misappropriation by employee is deductible because it is arising out of and incidental to the carrying of the trade • Excessive remuneration paid to **relative of business owner** who worked for the company may be challenged by IRD that it is not

incurred for producing assessable profits • If the so-called employee did not work, IRD will disallow the expenditure and take penalty action including criminal prosecution.

• Contribution to **approved retirement schemes**: Special contribution, including **initial contribution** to set up the fund, is allowed by spreading equally over 5 years of assessment under **S16A(2)** • **Regular contributions** made by employer are deductible up to a 15% limit: deduction for **each employee** is restricted to **15%** of his total income. No deduction is allowed for excess contribution • Regular contribution consists of the employer's mandatory and voluntary contribution under MPF Scheme • Refund of contribution to employer from the scheme is taxable up to the limit of the amount previously allowed, see S15(1)(h).

• Purchase of **patent/know-how** is fully deductible under **S16E** • Purchase cost of **copyright/design/trademark** is deductible by equal instalment in **5** years of assessment under **S16EA** • Make apportionment if the intellectual property (IP) is partly used for production of assessable profit • No deduction is allowed if the IP is **purchased from an associate**, see **DIPN 49** • S16E(4): patent, design and trademark must be registered • S16E(4): Patent means the right to do anything; doing without this right is an infringement of a patent • Purchase cost include related legal expenses and valuation fee • Only **outright purchase** of legal and economic ownership is deductible • S16E(9) & S16EA(13): No deduction for acquisition of a "licence" for use over a long period • **Registration cost** of trademark, design is deductible under **S16(1)(g)** • Payment for **use of IP** is deductible if it satisfies S16(1) for producing assessable profits. If the payee is an overseas company, the HK payer must withhold tax from such payments. See Topic 10.

• **Donation** expenditure: In general, it is **non-deductible under S16(1)** because it is not incurred in production of assessable profits • If it is incurred in the ordinary course of business, that is for producing assessable profits, it is deductible under S16(1) and there is no need to consider S16D • **S16D** grants exemption for donation made to an **approved charitable institution** subject to a 35% limit and the aggregate donation payments not less than $100 • Buying something higher than its market price from charity cannot get tax relief under S16D, see **Sanford Yung Tao Yung** case.

• Case analysis: Donation to **overseas charitable organization** is not deductible under S16D because it is not an approved charitable organization under S88. Besides, the donation cannot satisfy S16(1) for deduction because the donation is unrelated to the trade and so, it is not incurred in the production of assessable profits. For discussion on S88, see Topic 7.

• Payment of **service fee** / **management fee**: Following the general principle, such expenditure is deductible under **S16(1)** because it is incurred in the production of assessable profits • However, owing to some taxpayers using the payment to avoid tax, IRD may disallow or restrict deduction of such expenditure. For more, see topic 20.

Author's advice

Almost every exam paper on taxation has questions on deduction of expenditures in profits tax. To get passed, study this topic hard and do exercises on profits tax computation. As a practice, try the Mock Exam Question 5 in Part B and then check with the suggested answer.

Topic 12: Profits Tax - **Interest deduction**

• **S16(1)** allows interest expense **to the extent** they are incurred in the production of chargeable profits • If only part of the interest expenditure satisfies S16(1), make **apportionment** accordingly • Case analysis: Co. X was a trader of commodities. It borrowed money from a bank and then lent the money to a supplier. The interest payment is not deductible because it is not incurred in the ordinary course of business (X is not a money lender).

• Only **direct and immediate purpose** of the loan are considered • Case analysis: Andy borrowed a bank loan to finance his residence. He argued that without the residence he must live at the business place and since his moving to the residence, he had a bigger place to do business and earned more profits and so the loan is in effect for business use. His argument is not acceptable because the direct and immediate purpose of the loan is to buy a residence - it is a private and domestic expenditure, not for production of assessable profits - it must be disallowed by S17(1)(a) and S17(1)(b).

• Interest incurred on money borrowed for purchase of **trading stock**, **plant & machinery** satisfy S16(1) • According to **Zeta Estate** case. money borrowed for financing **working capital** after payment of dividends satisfies S16(1) • **S16(1)(a)** stipulates that not only S16(1), but also **S16(2)** must be satisfied • Case analysis: Co. Y borrowed $10M from the wife of company director to purchase trading stock. The interest payment is not deductible because it fails to satisfy any condition of S16(2) – see below.

• **S17(1)(b)** disallows those expenses that are **not for producing assessable profits** 〔 Candidates should mention this point in addition to

S16(1) requirement to get more marks〕 • No interest deduction is allowed if the loan is for: financing **offshore** exempted activities / director **private use** / advances to **related companies** / purchase of **private shares** as investment • **IRR2** requires apportionment of interest expenditure between deductible and non-deductible. See topic 11 for more.

• **S17(1)(c)** disallows expenses of a **capital nature** • Interest for **purchase of fixed asset** before it is ready for use is capital nature and disallowed. If the fixed asset is **ready for use** upon purchase, interest is revenue nature • **Tai On Machinery Works** case: The interest incurred on **construction of building** for own use is capital nature. When the building is completed and ready for use (e.g. occupation permit is granted), the interest expenditure becomes revenue nature. • **Wharf Properties** case: The interest incurred on redevelopment of property for rental income **before completion** is capital nature. When the property is ready for use or ready for letting out (when Occupation Permit is obtained), the interest becomes revenue nature.

• **S16(1)(a)** requires satisfying **one of S16(2)** conditions, subject to the restrictions under S16(2A), S16(2B) and S16(2C) • These are **anti-avoidance** measures • S16(2)(c) and S16(2)(d) concern who is the lender • S16(2)(e) concerns the purpose of the loan • S16(2)(f) concerns issue of debentures.

• **S16(2)(d)** is applicable where money is borrowed from a **bank** (or a financial institution) • Then, consider whether the restriction under S16(2A) or S16(2B) is applicable? — see below.

• **S16(2)(c)** is applicable if money is borrowed from a person **other than a financial institution**〔A bank is a financial institution〕 • Interest is deductible

if the **lender pays profits tax** on the interest income • If the lender does not carry on a business in HK, his interest income is not taxable and then S16(2)(c) fails • If the lender carries on a business in HK and provides money provided outside HK, his interest income is not taxable and then S16(2)(c) fails • If the lender carries business in HK and the money provided in HK, his interest income is taxable and then S16(2)(c) is satisfied • If satisfied, consider whether the restriction under S16(2A) or S16(2B) is applicable?

• **S16(2)(e)** condition is satisfied if money is borrowed for purchase of **trading stock** or for purchase of **plant and machinery** for business use • S16(2)(e) fails if the lender is an **associate** under **S16(3)**. 〔Candidates should mention this point after doing analysis on S16(2)(c) or S16(2)(d) to get more marks〕 • Case analysis: S16(2)(e) is not applicable because the loan is not used to finance purchase of trading stock or plant & machinery〔Candidates should mention this to get marks〕 • Case analysis: S16(2)(e) fails as the lender (being the company's director) is an **associate under S16(3)** • Case analysis: S16(2)(e) fails because the loan is provided by its holding company which is an associate defined in S16(3).

• **S16(2A)** is **secured loan test**: Restriction of deduction is made if money borrowed is **secured by a deposit** generating interest **not chargeable to tax** and the deposit is provided by the borrower or its associate • Case analysis: The deposit is provided by the company director and the interest income received by the director is not taxable. So, S16(2A) restriction is applicable. • Case analysis: The deposit is provided by subsidiary which carries on a business in HK. The interest income is chargeable to tax under S14 and S15(1)(f). Therefore the S16(2A) restriction is not applicable.

• **S16(2B)** is the **interest flow-back test**: Restriction of deduction is made if interest is flowed to a **connected person** and not chargeable to tax • Case analysis: If money is borrowed from a connected person or through an interposed person, consider whether the interest income chargeable to tax? — If chargeable to tax, S16(2B) restriction is not applicable. — If not chargeable to tax, S16(2B) restriction is applicable.

Money borrowed by issue of debentures

• **S16(2)(f)** is applicable if money is borrowed by issue of **debentures** in a **recognised** financial market (including overseas stock market) • Case analysis: Co. H issued debentures in Singapore. The debenture interest expenditure satisfies S16(2)(f). • Restriction under **S16(2C)** is applicable if debentures are bought by an associated company of the taxpayer • **S16(2G)** is **Market Maker Exemption:** S16(2C) restriction will not apply if the debentures are bought by a market maker. Market maker means a **licensed stock broker**.

Author's advice

Interest deduction is a hot topic for examination. You should study this topic well. For computation of the amount of interest deduction and restriction, you can refer to DIPN 13A.

Topic 13: Profits Tax - **Depreciation allowances**

Plant and machinery (P&M)

• **IRR 2** sets out a list of P&M: **10%** pool includes air-conditioning plant, electric cable, lift, escalator, water main, sprinkler; **20%** pool includes furniture, room air-conditioner, electrical appliances and any other **unclassified items**; **30%** pool includes motor vehicles. • The list of P&M under IRR 2 is not exhaustive. An unclassified asset can be accepted as a P&M (belonging to 20% pool) if it satisfies the case law principle • Refer to **DIPN 7** for examples on computation of P&M depreciation allowance.

• **Yarmouth v France**: Plant is an apparatus for permanent employment in his business: the **functional test** • Case analysis: A store-keeper buys dogs to safeguard his goods. Dogs are animal; not apparatus; so they cannot attract deprecation allowance • Case analysis: A painting at a barrister's office is not "plant" because the painting has no trade function, see **D52/04** • Case analysis: A painting in a high-class restaurant is "plant" because it has **trade function**: It can create atmosphere and ambience for the business, see **Scottish & Newcastle Breweries** case.

• **S37(1)**: Capital expenditures incurred on provision of P&M **for production of assessable profits** qualify depreciation allowance • Case analysis: No depreciation allowance is granted for the yacht bought for private use because it is not for production of profits • **S37(1)**: Purchase cost includes related expenses and installation cost • Case analysis: The **legal expenses**, **delivery charges** and **installation costs** for purchase of machinery are added to the purchase price for computation of depreciation allowances.

• As P&M are normally **ready for use** on purchase, the **interest on loan** for the purchase is revenue nature and deductible – see Topic 12.

• **Aberdeen Restaurant** case : Plant should be distinguished from building and structure – this is called **business setting test** • Fixture or electrical wiring forming **integral part of the building** or structure are not plant • Case analysis: Is the asset a building/structure? or part of the building? Is the asset detachable from the building? — If it is part of the building (not detachable), it cannot qualify P&M depreciation allowance.

• **Display platform** and **signboard** are plant because they have **trade function** • Surgical equipment, **kitchen utensil**, **carpet**, **curtain**, **loose tool** are not plant; they are "implements, utensils and articles": their **initial purchase** costs are not deductible because of capital nature; their **replacement** costs are deductible under **S16(1)(f)** and their **repair** costs are deductible under **S16(1)(e)**.

• P&M on **hire purchase** is not pooled • Deprecation allowance is separately computed for each HP asset under the old rule • Interest on hire purchase is deductible • **Initial Allowance** is granted for the **down payment** and the **capital portion** of monthly instalment payment • **Annual Allowance** is provided on the **Written Down Value** which is computed on the cash price less initial allowances and annual allowances.

• P&M **partly for business use** are not pooled • For **private assets brought into business**, no initial allowance is allowed and deduct **notional annual allowances** for each year of private use.

• **S38A**: Where a lot of assets are acquired at a single price, CIR can allocate a price to each asset • **S38B**: Where a P&M is **sold between connected parties**, CIR can use open market value instead of the sales price.

• **S39D(4)**: On **cessation** of business, if P&M is **put out of use** without sale, the P&M is deemed to be sold at market value • **S39B(7)**: If the P&M is taken over by another business or by a successor, the residue of the pool is transferred to the new business and no balancing adjustment is computed.

S39E denies depreciation allowance to lessor under 3 types of lease

(1) P&M **used outside HK**, see S39E(1)(b)(i) • A P&M is regarded as held under a **lease** even though no rental is charged • Under S2 a 'lease' includes an arrangement under which a right to use the machinery is granted by the owner to another, see **D61/08** • Case analysis: Co. H bought machinery which was used by a Shenzhen factory to manufacture goods for sales by Co. H. No depreciation allowance is granted by S39E(1)(b)(i) • Case analysis: If 50:50 apportionment of profits is allowed in contract processing case (see page 31), IRD will allow 50% deprecation allowance for those assets used outside HK.

(2) **Sale and lease back**, see S39E(1)(b)(ii), except that the lessee has not claimed depreciation allowance and the price paid by the lessor is not more than the original price, see S39E(2)(a).

(3) Acquisition of P&M is wholly or predominantly **financed by non-recourse debt**, see S39E(1)(b)(ii) • Non-recourse debt means the rights of the creditor is restricted to the P&M alone.

Industrial Building (IB) and Commercial Building (CB)

• **DIPN 2** sets out IRD's policy and **examples** on computation of Industrial Building Allowance (**IBA**) and Commercial Building Allowance (**CBA**).

• A building used for a **trade** consisting of - (i) manufacturing, (ii) subjection of goods or materials to a process, (iii) storage of goods or materials used in manufacturing or in processing - qualify an IB, see **S40** • A building used for **scientific research** qualify an IB, see S40 • A warehouse used by a **retailer** for storage of goods is not an Industrial Building • **Tai On Machinery Works** case: to get IBA, "part of the trade qualify" is not sufficient; the whole trade of taxpayer must qualify • Case analysis: A warehouse owned by a supermarket for storing groceries cannot get IBA because the taxpayer's trade is retailing, not warehousing.

• **Cooking** in restaurant is not subject of goods or material to a process • Restaurant is "service" industry which is not a qualifying trade, see **Aberdeen Restaurant** case.

• Taxpayers should **separate the cost of P&M** (e.g. central air-conditioning, lift) from cost of construction of the building because P&M can attract more generous depreciation allowances.

• Only **cost of construction** of the building qualifies IBA or CBA • Interest and architect fee for construction are included in the cost of construction • Cost of land, levelling ground and demolition of old building are excluded from the cost of construction.

• For **purchase of IB from property developer**, the price attributable to the cost of construction is allowed • In practice, IRD allows **1/2 of the first purchase price** paid to the property developer as the cost of construction for IBA or CBA. 〔This is based on the assumption that the other half of purchase price approximates the cost of land and therefore it is excluded.〕

• Expenditure on office, retail shop, showroom, quarter is not qualifying expenditure. It should be excluded from the cost of construction for IBA. • CBA is granted on such excluded expenditure • Nevertheless, if the expenditure on the **non-qualifying parts** do not exceed **10%** of the total construction costs, all expenditure on the building is treated as qualifying expenditure for IBA.

• Where a IB/CB is **sold to a related person/company**, the open market value is deemed to be the sale price, see S38B.

• Balancing charge/allowance is computed on sale of IB/CB • No balancing charge or allowance is made if an IB/CB is **demolished for redevelopment** • Case analysis: Co. Z rented an office for 5 years. Before moving in, Z incurred $5M as decoration expenditure. Z could claim CBA of 5M x 4% = 0.2M from year 1 to year 4. In year 5, as Z moved out, it could claim balancing allowance of 5M – 0.8M = 4.2M.

• CBA or IBA are not granted for buildings **in mainland China** because they should constitute a permanent establishment (PE) in China. Under the DTA with mainland, the PE in China is liable to CIT in respect of the profits earned in China. The HK company can therefore apply for offshore profits exemption or tax credit under the DTA. For more, see Topic 19 on page 115.

Example of Profits Tax Computation for 2015/16.

Net profits per Profit and Loss Account for the year ended 31.3.2016		700,000
Add: Depreciation	100,000	
Legal costs for tax appeal	200,000	
Loss on disposal of old computers	100,000	
Sales proceeds of old computers	100,000	
Sale proceeds of patent (restricted to cost)	100,000	
Private portion of entertainment	30,000	
Provision for bad debts	50,000	
Donation	120,000	800,000
		1,500,000
Less: Profit on disposal of patent	100,000	
Bank interest	20,000	
Medical research for workers in the trade	200,000	
Approved charitable donation	10,000	
Gain on disposal of UK listed shares	100,000	
Depreciation allowance	200,000	630,000
Assessable profits **before loss set off** for 2015/16		870,000
Less: Loss b/f set off from 2014/15 under Section 19(c)		570,000
Assessable profits after loss set off		300,000
Profits tax thereon @16.5%		49,500
Less: Provisional tax paid for 2015/16		40,000
Balance of tax payable for 2015/16		9,500
Add: Provision tax for 2016/17		49,500
Tax to be payable in **Demand For Tax**		59,000

Basis Periods

Commencement of business

- No assessment is made for the **year of commencement** if first accounting date falls in the 2nd year, see S18C(2).
- **Pre-commencement expenditures** are, strictly speaking, non-deductible because they are not in the production of profits • By **concession**, IRD allows deduction for the expenses incurred before commencement in the first accounting period if such expenditure can qualify for deduction after commencement (e.g. office rent, electricity).

Cessation of business

- Trading receipts received after **cessation** are taxable, see S15D.
- Expenditures incurred during **dormant** period or after business **cessation** are not deductible because they are not incurred in the production of profit, see **Overseas Textiles** case.
- **S15D**: Expenses incurred before cessation and paid after cessation are deductible in the last year of assessment if such expenditure could qualify for deduction before cessation.
- S18D(1): Basis period for the **last year of assessment**: The last basis period is from the previous accounting day to the business cessation day (applicable to businesses commenced after 1.4.1974). This is to ensure all profits during the whole life of the business are fully assessed.
- On cessation of business, if **trading stock** is sold to another person carrying on a business in HK, the sales proceeds is taken for assessment, see S15C(a). In other cases, the trading stock is deemed to be sold at open market value, see S15C(b) • For disposal of plant & machinery on cessation of business, see Topic 13.

Change of accounting day

- S18E(1): IRD has **discretion** in deciding the basis periods for the **year of change** and the **preceding year**
- **Double taxation of profits** can arise if the change gives an accounting period of less than 12 months
- Assessment of **profits** for more than 12 month is made if an accounting period of more than 12 month is created
- Losses in any accounting periods can never be allowed twice.

Loss of limited company

- **S19C(1):** If loss is agreed by the IRD, it can be carried forward to set off future assessable profits**.**
- There is no set-off of tax loss between companies within a **group**.
- There is **no time limit** on loss carried forward to set off future profits.
- If the company is **dormant**, the tax loss can set off its future profits when the company is reactivated.
- If the company is **liquidated**, the loss will lapse forever.
- If there is **change of shareholding**, the tax loss to set off the company's future profits may be challenged by IRD under **S61B** • If there are commercial reasons for the change and the sole or dominant purpose of the change is not for tax avoidance, the tax loss can set off the company's future assessable profits • Commercial reasons include company business did not change substantially after change of shareholding • Case analysis: As the company's business after change of shareholding is different, IRD can treat the change of shareholding as having tax avoidance and use S61B to disallow the loss set-off. Refer to Topic 20 for more.

• **Case selection** for audit and investigation: • qualified audit report (particularly records not reliable) • low turnover • low profit margin • incomplete records • persistent late tax returns • non-compliance with IRD's query, risk-bearing items reported in tax return (e.g. offshore claim, payment to non-resident company) • reports by informer • high-risk business (e.g. cash sales) • project case for selected industry • random selection

• **Remind client**: • File correct tax return promptly • Notify IRD chargeability in case no return is received • Inform IRD change of address • Keep sufficient business records • Provide information to IRD timely • Seek professional assistance early.

• Most **features** of Field Audit and Tax Investigation are same • recovering back taxes • levying penalties for breaking IRO • done by assessors in accordance with IRO • educating public for compliance • deterring non-compliance • Differences are as follows: • Field Audit focus on 1 year of assessment (the audit year) and then make projection for other years based on findings • Tax Investigation is done in serious cases and it covers all years under review • Field audit aims at quick settlement; whereas tax investigation is in-depth and may result in criminal prosecution • Due to revenue collection efficiency, most are Field Audit cases.

• **Procedures** of audit / investigation: • IRD makes preliminary review of taxpayer • IRD send letter to taxpayer to fix a date and the place of interview • During the interview, IRD officers ask for information about the business, examine accounting records, conduct audit work, confirm with taxpayer for who signed the tax returns, remind him of tax penalty and take away

documents • After the interview, the taxpayer can make a proposal of settlement and the IRD will give a proposed computation of the tax undercharged based on findings of investigation • Final basis of settlement is based on compromise with taxpayer and findings from investigation • Work target is 3 months. Complicated cases last for months.

• Methods for **computation of tax undercharged**: (i) Bank Deposit method to determine omitted sales. (ii) Make adjustments on expenses charged to P&L account. (iii) Reject exemption claims based on audit findings. (iv) Project income by Gross Profits Ratio or Sales to Expenditure Ratio. (v) Estimate cash sales and living expenses. (vi) Use Asset Betterment Statement (ABS) to estimate total omitted profits. • In practice, IRD uses a combination of methods. • ABS is seldom used for settlement basis nowadays because it is very time consuming and it is difficult to find out all the overseas assets.

• **Bank Deposit method**: Omitted incomes are determined by analysis of bank statements (including business and private bank accounts) • Compile a list of bank deposits for each account, excluding non-business receipts such as transfer from other accounts, returned cheques, loans from relatives • Estimate cash sales not deposited into bank. • Add up bank deposits and cash sales. • Determine business profits with adjustments for opening and closing balances of account receivables.

• **Roles of tax representative**: • Provide professional advice on the procedures of field audit/tax investigation • Accompany taxpayer to attend interviews with IRD • Protect the interests of the client in handling questions from the IRD • Conduct preliminary review of the taxpayer's business records and tax computations • Prepare replies to the IRD's enquiries and settlement

proposal • Identify mitigating circumstances to reduce penalty • Assist taxpayer to improve future compliance.

• **Advice to client**: • Provide correct and timely reply to IRD • Cooperation with IRD for quick settlement in order to avoid prosecution and reduce penalty.

• **Penalty**: Filing an incorrect return or failure to notify IRD chargeability without reasonable excuse is an offence under S80(2). It can lead to a fine of $10,000 of plus 3 times of the tax undercharged in case of prosecution. • IRD may compound the offence under S80(5) • In wilful tax evasion case, IRD may take criminal prosecution under S82 • Instead of prosecution, the CIR may invoke S82A to impose a penalty up to 3 times of the tax undercharged. • Tax representative's role: Ask IRD to reduce the penalty on reasonable grounds. • For more on penalty, see Topic 16.

Author's advice

Tax investigation is a hot issue in practical tax work. It is also a frequent topic for group discussion in learning HK Taxation. But it is seldom examined in depth in written examinations due to the difficulties in setting questions and awarding marks. In examinations, as well as in practice, tax investigation questions often come with penalty issues – see next topic for more. So, I suggest students should study these two topics altogether at the same time.

Topic 16: **Penalty**

(1) **General cases** e.g. omission of income, incorrect stock valuation, false hold-over of provisional tax, etc.

• Case analysis: Mr X's omission of the commission income (say $50,000) in ledger is an offence under **S80(2)** if he does not have a reasonable excuse. Maximum penalty is level 3 fine of $10,000 plus an additional fine of up to 3 times the tax undercharged. If Mr X has reasonable excuse, he is not penalized. • What constitutes a reasonable excuse depends on the circumstances of each case. In **D13/85**, the Board of Review says **reasonable excuse** is what one would expect a reasonable person to do in all of the circumstance. A reasonable person is not a perfect person, but an average person using the reasonable skill and care in handling his tax affairs which one would expect to see from an average person.

• Case analysis: It is a **criminal offence** under **S82** if Mr X did it wilfully with an **intent to evade tax**. Penalty under S82(1) is, on summary conviction, level 3 fine $10,000 plus additional fine of 3 times the tax undercharged and imprisonment for 6 months. If Mr X is convicted on indictment, the maximum penalty is level 5 fine $50,000 plus additional fine of 3 times the tax undercharged and imprisonment for 3 years.

• Instead of prosecution under S80(2) or S82, IRD can issue additional tax assessment under **Section 82A**. Maximum amount assessed under S82A is **3 times the tax undercharged** • In its penalty policy, IRD says offences that do not involve wilful tax evasion are generally dealt with by S82A • For administrative convenience, IRD can **compound** an offence under S80 by

S80(5) or compound an offence under S82 by S82(2). Compounding offence means the taxpayer signs an agreement with IRD for the penalty amount as imposed by IRD in accordance with the penalty policy.

- **Penalty policy** is published by IRD on its website stating that penalty is determined according to the offender's culpability and cooperation. There are **3 categories of culpability**: intentional disregard, recklessness, absence of reasonable care. There are **4 categories of cooperation**: voluntary disclosure, disclosure on challenge, belated disclosure and disclosure denied. The levels of penalty rates are set out in a table with these categories of culpability and cooperation • Downward or upward **adjustment** of penalty up to 25% may be granted by CIR in circumstances warranted.

(2) Serious cases e.g. omission of large sales for years, supplying false information to IRD, etc.

- **S80(2)(a)** provides that any person who without reasonable excuse makes an incorrect return by omitting or understating income commits an offence. The maximum punishment is a level 3 fine $10,000 for each charge and a further fine of 3 times the tax undercharged. The Commissioner may compound these offences and settle for a monetary penalty under S80(5).

- In case of **willful tax evasion**, criminal prosecution may be taken under S82(1) which can lead to **imprisonment** in addition to the usual fine. The IRD must prove that the taxpayer has fraud or willful intention to evade tax. In practice the proof is difficult. If proof is strong, criminal prosecution can be taken on the following offences: (i) omission from a return. (ii) false statement or entry in a return. (iii) give false answer to IRD's enquiry (iv) false statement

in a claim for a deduction or allowance (v) sign an incorrect tax return.

• Case analysis: In Mr. Bad case, in view of the magnitude of the understatement (about 60% income omitted) and the recurrent omissions over six consecutive years, it is likely that Mr. Bad has a willful intention to evade tax. IRD can take prosecution under S82(1) against him. The maximum punishment under S82 is a level 5 fine $50,000 **for each charge of offence**, plus an additional fine of 3 times the tax undercharged, and an imprisonment of three years. It is possible that Mr. Bad has committed **multiple offences** under S82(1) because the omission of sales can lead to an omission from tax return or a false entry or statement in a return. The IRD can compound these offences with a money penalty under S82(2). If no prosecution under S80(2) or 82(1) are taken, the IRD can assess Mr. Bad under S82A with a maximum fine of 3 times the tax undercharged. Section 82B gives Mr. Bad right of appeal to the Board of Review against the S82A penalty • Illiteracy and reliance on bookkeepers are not good defenses in criminal prosecution. Furthermore, they are not reasonable excuses as far as S80 or 82A are concerned. However, Mr. Bad's co-operation with IRD and his voluntary disclosure during investigation can be mitigating factors for reducing the penalty. But the long delay of disclosure and the large amount of understatement are aggravating factors for increasing the penalty.

(3) Business fails to keep sufficient business record

• Every person carrying on a business in HK must keep sufficient records in English or Chinese for 7 years, see **S51C**. Records include books of account, receipts and payments, income and expenditure, together with vouchers, bank statements, invoices, receipts and other documents for verification of the

accounts. It also includes records of assets and liabilities, goods purchased and sold, details of sellers and buyers, records of stocktaking and services rendered.

• Any person without reasonable excuse fails to keep sufficient business records as required by S51C commits an offence. The offence can lead to a **level 6 fine** of max. $100,000 and a court may order to do the acts he failed to do, see S80(1)(A). The IRD can compound the offence with a money penalty under S80(5).

• Any person who has no reasonable excuse fails to **notify IRD** his chargeability to tax under S51(2) is liable to prosecution under S80(2) • If a tax return is issued to a person under S51(1) and that person does not **furnish the tax return** within the time specified, he is liable to prosecution under S80(2) • Maximum penalty for S80(2) offence is level 3 fine of $10,000 plus an additional fine of up to 3 times the tax undercharged.

(4) Failure to notify chargeability

• Failure to **notify IRD chargeability** of tax, where no return has been issued, is an offence under S80(2). It can lead to a max fine of $10,000 and 3 times the tax undercharged upon prosecution • Failure to **submit a tax return** within the time specified is an offence under S80(2). Upon prosecution, it can lead to a maximum fine of $10,000, plus 3 times the tax undercharged and a court order for filing the tax return under S51(1) • IRD can **compound** the offence with a money penalty under S80(5) • Besides, the IRD can issue a **S82A** assessment on the tax undercharged. The maximum fine is 3 times the tax undercharged.

(5) Procedures of S82A penalty assessment

• Before issuing a **S82A penalty**, the IRD must issue a written notice to the taxpayer setting out the particulars of the offence and the intention to raise S82A assessment. The taxpayer can submit written representations within 30 days of the written notice • A taxpayer assessed by S82A assessment can **appeal to Board of Review** within one month of date of the S82A assessment or at such longer time as the Board may allow • According to S82B, the notice must be accompanied by a copy of the notice of assessment, a statement of the grounds of appeal, a copy of the IRD's written notice, and a copy of any written representations made under **Section 82A(4)**.

(6) S80(1) offence

- Taxpayer fails to comply with: • S51(3) for fuller return • S51(6) to report business cessation • S51(7) to report leaving HK • S51(8) to report change of address
- Taxpayer fails to provide information on objection under S64(2).
- Limited company with exemption from property tax fails to notify change of ownership within 30 days under S5(2)(c).
- Property owner fails to keep rent records under S51D.
- Employer fail to comply with S52(1) or S52(2) to report employee's full remuneration of income.
- The **penalty under S80(1)** is level 3 fine $10,000 plus a court order for the taxpayer to do the act which he has failed to do.
- IRD can **compound** the offence under S80(1) by means of a monetary penalty by **S80(5)**.

(7) Tax representative's obligations and ethics

• **S80(4)**: Any person who aids, abets or incites another person to commit an offence is deemed to have committed that offence and is liable to penalty under S80 • **S82(1)**: Any person assists any other person to evade tax commits an offence under S82 • As required by professional ethics, tax representative should not inform IRD of client's offence because he has a fiduciary relationship with his client • Tax representative should advise his clients to comply with law, not to do things in contravention of law, make full voluntary disclosure as soon as possible, and cooperate with IRD • Tax representative should resign if his client does not follow his advice • Under no circumstances should the tax representative take part in any offence committed by his clients. • Case analysis: A tax representative cannot submit false information to IRD because doing so is an offence under S80(4) or a criminal offence under S82. He should advise his client to comply with the law and make voluntary disclosure of the wrongdoings in order to minimize the penalty. If his client fails to follow his advice, he should resign immediately.

Author's advice

The above classification of penalties is to help students to answer questions on tax penalties in examinations. In theory, IRD officers can take whatever actions as permitted by the Inland Revenue Ordinance against a person who commits a tax offence and that is why you should mention all the relevant sections of IRO in your answer in order to get high marks. Of course, in practice, IRD should normally take only one action that deems most appropriate in the circumstances of the case.

Topic 17: **Tax administration**, Objection, Section 70A claim. Hold-over of provisional tax, etc.

Taxpayer's obligations: • File correct tax return within time limit, see S51(1) • Pay tax on time, see S71(1) • Notify IRD chargeability of tax within 4m after end of year of assessment in case no tax return is received, see S51(2) • Inform IRD change of address, see S51(8) • Notify IRD within 1m after cessation of business, employment, property income, see S 51(6) • For a salaried taxpayer and sole proprietor leaving HK permanently, inform IRD one month before departure, see S51(7) • Answer IRD's enquiry, see S51(4) • Keep business records for 7 years, see S51C • Keep rent records for 7 years, see S51D • Penalty for non-compliance, see Topic 16.

IRD's **power of enquiry**: • Issue a tax return and require taxpayer to complete it within the time specified, see S51(1) • Ask taxpayer for fuller and further return (including further information), see S51(3) • Ask any other person for information about the taxpayer, see S51(4)(a) • Search for taxpayer's records with a search warrant from magistrate if the taxpayer fails to supply information, see S51B.

Assess first Audit Later **AFAL**: • Majority of tax returns is assessed quickly with minor or no adjustments. • Thereafter, IRD uses computer program to select some cases for detailed examination or desk audit.

According to DIPN 11, IRD adopts a **3-tier audit** system: (i) **Desk audit**: cases selected by computer program for checking; handled by Unit 1 or Unit 2. (ii) **Field Audit**: large amount of tax undercharged involved; handled by Unit 4. (iii) **Tax investigation**: serious tax evasion cases; may involve criminal

prosecution; handled by special teams of Unit 4.

IRD's power to **issue assessment**: • An assessor can issue an assessment to a taxpayer after the time limit of a return if he has an opinion the taxpayer is chargeable to tax, see S59(1) • An assessor may issue an assessment at any time if the taxpayer is about to leave HK or for any reason it is expedient to do so, see S59(1) proviso • An assessor may assess the taxpayer according to the tax return, see S59(2)(a) • An assessor may not accept the tax return and makes an estimated assessment, see S59(2)(b) • An assessor may make an estimated assessment if the taxpayer does not file a return within the time limit, see S59(3) • An assessor may issue an assessment or an additional assessment within 6 years after the end of the year of assessment; the time limit of 6 years can be extended to 10 years in case of fraud or wilful tax evasion, see S60(1).

Validity of assessment for want of form: • An assessment containing a mistake or omission in describing the person assessed is valid if the assessment is made in accordance with the intent and meaning of IRO, see S63 • In Hong Kong Flour Mills v CIR, an assessment omitting "limited" in describing the taxpayer is held valid.

Service of notice: • Every notice of assessment is valid if the name of officer is duly printed, see S58(1) • Service of the assessment is valid if it is sent to taxpayer's last known address, see S58(2) • The assessment is deemed to be duly served on the succeeding day in the course of ordinary post unless the contrary is proved, see S58(3) • Case analysis: The taxpayer cannot use non-receipt of the assessment as an excuse for not paying tax because: (i) The taxpayer's name as shown in the notice of assessment is correct. (ii) The

assessment was sent to the last known address as informed by the taxpayer's employer. (iii) The taxpayer did not inform IRD of change of address. (iv) The assessment was deemed to be duly served under S58(3) as no information shows it has been returned to IRD on non-delivery. (v) The assessment has become final and conclusive under S70 because no valid objection was received by IRD within 1 month after the issue date of the assessment. (vi) The taxpayer cannot make a claim under S70A because the assessment was estimated according to the assessor's judgment in the absence of a return.

Finality of assessment: • According to S70, an assessment is final and conclusive in the following situations: (i) No valid objection or appeal to Board of Review or to court has been lodged within the time limit; (ii) The objection has been withdrawn or dismissed by Board of Review; (iii) A revised assessment has been agreed under Section 64(3). • Section 70 cannot prevent an assessor from making an assessment or additional assessment under S60 which does not involve re-opening any matter which has been determined on objection or appeal.

Requirements for **valid objection** under S64(1) are: (i) A written notice of objection is addressed to CIR; (ii) It is received by IRD within 1 month after issue of the assessment; (iii) It states precisely the grounds of objection; and (iv) It is supported by a tax return in case of an estimated assessment without a return.

Late objection may be accepted by IRD if the taxpayer has been prevented from lodging a valid objection owing to absence from HK, sickness or other reasonable cause, see S64(1) proviso. • Reasons of "too busy" or "too old" are not reasonable causes for late objection, see Lam Ying Bor Investment

case • If the objection is made against an additional assessment, no revision will be made to the original assessment • If the objection is made against a Personal Assessment, no revision will be made to its composite assessments

A **Statement of Loss** is not an assessment, see Yau Lai Man case • Case analysis: As the Statements of Loss is not an assessment, the time limit for issue of additional assessment under S60 is not applicable. The IRD can revise the Statements of Loss without being subject to the time limit under S60. • The taxpayer has no right to object the revised Statements of Loss under S64. However, he can object to the assessment for the year of assessment in which the assessable profit exceeds the amount of the revised loss brought forward.

• Where a taxpayer's objection is valid, IRD will inform the taxpayer by a letter ordering the amount of tax to be **held over**, if any, pending the result of the objection. The taxpayer must pay all the tax on or before the due date unless and until the CIR orders otherwise. • If tax is held over **unconditionally** and the taxpayer loses the objection, the taxpayer will be required to pay tax plus interest. The interest rate is based on the prevailing judgment rates of law courts. • If CIR orders **no hold-over** of tax and the taxpayer wins the case at last, the tax overpaid will be refunded to the taxpayer without interest due to the taxpayer. • An **unconditional** holdover will generally be granted where it is obvious IR that the objection should be allowed in principle • IRD may grant a **conditional holdover** for purchase of Tax Reserve Certificate (TRC) for the tax in dispute If TRC is purchased, interest is only allowed if the tax is ultimately held not to be payable and the TRC is surrendered for cash. If it is used in settling the tax ultimately due, no interest is allowed.

The **onus of proof** that an assessment is incorrect or excessive is on the taxpayer, see **S68(4)** • To process the objection, IRD may ask taxpayer to supply information include books or documents in his custody, see S64(2) • After gathering all relevant information, IRD may allow the objection, or propose a revised assessment, or ask for a withdrawal of objection • If there is no agreement from the taxpayer, the case will be submitted to CIR who will determine the objection: CIR may confirm, reduce, increase or annul the assessment • If the taxpayer disagrees to the CIR determination, he can appeal to the Board of Review.

• According to **S66**, the requirements for **appeal to Board of Review** are: (i)The notice must be in writing to the Clerk of BoR. (ii) The notice must be given within one month after CIR determination. (iii) The notice must be accompanied by a statement of grounds of appeal and a copy of CIR determination. (iv) The taxpayer must send a copy of the notice of appeal to IRD • Board of Review is an independent body for hearing tax appeals. It comprises legal experts and prominent public figures appointed by the Chief Executive • The Board hearings are informal as compared with court. The taxpayers can appear in person without legal representative • Because of the low costs involved, many cases are heard by the Board every year • To deter taxpayers from lodging vexatious or trivial appeals, the BoR may impose cost not exceeding HK$5,000 on the taxpayer • Selected hearings are published with the identity of the taxpayers concealed • In general, 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 court on a question of law.

• **S70A claim** is applicable where it is proved to the satisfaction of the assessor that the tax charged for any year of assessment is excessive by

reason of (i) an error or omission in any return or statement submitted in respect thereof; or (ii) an arithmetical error or omission in the calculation of the amount of the assessable profit assessed or in the amount of tax charged • It must be claimed by taxpayer within 6 years after the end of the relevant year of assessment or 6 months after the date of the relevant assessment, whichever is later • No S70A claim for an assessment made in accordance with the then prevailing practice, see S70(1) • An error is something that happens inadvertently and it excludes a deliberate act, see Extramoney case. • Case analysis: IRD does not accept S70A claim for estimated assessment because it is made in the absence of a return and therefore there is no error made in a return. There should be no error by the assessor because it is an estimate that does not coincide with an amount that would have been assessed had the assessor been in possession of a return, see Sun Yau Investment case. • Where an assessor rejects a S70A claim, he should issue a notice of rejection under S70A(2). Then, the taxpayer can object to the notice under S64(1). The objection can only concern the taxpayer's right to make the claim under S70A and no other grounds will be entertained.

Payment of tax in default is deemed to occur at the close of business on the due date. • Where the first instalment of provisional tax is in default, the second instalment will become immediately due and recoverable. • IRD can take civil jurisdiction action in District Court to recover overdue tax. The taxpayer will then be liable to the costs incurred including court fee, fixed costs and interest on the judgment sum in addition to unpaid tax and surcharge. If a judgment sum remains unpaid, an execution may be levied on the defaulter's movable property or a charging order be applied against his immovable property. Bankruptcy proceedings may be taken against the taxpayer. • Case analysis: As the Profits Tax demanded is not paid by the due date, the tax (the

first and second instalment) is deemed to be in default. The IRD can take actions to **recover tax** from Co. P including surcharge on the late payment. • A 5% is imposed at once on the total amount of tax outstanding. • A further 10% will be imposed on any outstanding amount after 6 months from the due date • The IRD can issue recovery notice to third parties including employer, bank, tenant, debtor, director and anyone who owes or holds money due to Co. P. The person receiving the notice must pay over the money to IRD, if any, not exceeding the amount of tax in default held on account of the defaulter within a specified time. If the person fails to do so, that person will become personally liable for the tax.

IRD can accept **payment of tax by instalments**, see S71(6) • It will not be granted unless the taxpayer can show why he cannot pay tax on time with good reasons • He needs to supply payment proposal, bank statements for the last 3 months, the latest management accounts, cash flow position and business forecast • He must pay surcharge for late payment of tax • In general, IRD accept no more than 6 monthly instalments.

Departure Prevention Order: If an individual has unpaid tax and he intends to leave HK or he has left HK, IRD can apply to District Court for a direction to prevent the person from leaving HK, see S77(1) • A copy of the direction is served on the taxpayer if he can be found • The taxpayer can appeal to Court of First Instance, see S77(9).

Time limit for **hold over of provisional tax**: at least 28 days before due day or within 14 days of issue of assessment; whichever is the later • Common reason for holdover of **Salaries Tax**: Net Chargeable Income is likely less than 90% of that assessed in provisional assessment. • Case analysis: compute

the estimated 12 month Net Chargeable Income with the data given. Assessor will project the12 month income based on the actual income for 9 month.

• Common reason for holdover of **Profits Tax**: Actual profits are likely less than 90% of the provisional assessable profits assessed. Taxpayer must provide certified management accounts covering at least 8 months of the basis period. Assessor will project 12 month profits based on the profits shown in the management accounts (multiplied by12/8). • **Penalty** under S80(2) or S82A may be imposed if actual income for the year of assessment does not fall below the 90% benchmark.

A **dormant company** must submit audited accounts unless it is a dormant company under **S663** of Companies Ordinance • Such company may pass a special resolution authorizing its directors to make a statutory declaration that the company has become dormant –**S5** of Companies Ordinance • The company is deemed to be a dormant company on delivery of the statutory declaration to Companies Registry.

A private company which has ceased its operation for at least 3 months and is **solvent** may apply to the Companies Registry under S750 and S751 of Companies Ordinance for **deregistration** with a Notice of No Objection issued by IRD under S88B of IRO: IRD application fee is $270. Use Form IR1263. • Case analysis: Co. X cannot get **Notice of No Objection** from IRD if: (i) it is insolvent; or (ii) it has outstanding tax liabilities; or (iii) it has not disposed of all its trading stock (because further tax liabilities may arise later).

Profits tax return (BIR 51) of a limited company must be supported by audited accounts, profits tax computation, and supporting schedules of capital expenditure, refurbishment, service income, rent payment, management fee,

interest expenditure, offshore claim, bad debt, change in valuation of stock etc.

• A **small company** need not submit audited accounts with the return. Nevertheless, the company must do audit and tax computation as usual. They are submitted to IRD as required. • A small company means its gross income for the basis period does not exceed **$2,000,000**. • It excludes one makes payment to a non-resident within the meaning of S15(1)(a), (b) or (ba) • For a limited company, the director, secretary, manager, liquidator can sign the tax return. If no such person ordinarily resident in HK, the company must inform IRD an individual ordinarily in HK to do it, see S57.

Employer's obligations are: • IRD's power for employers' return is under S52(1). Every employer must submit employers' return reporting employees' name, residential address and their **full amount** of remuneration, see S52(2) • Employer notify IRD of a new employee who is chargeable to Salaries Tax in IR56E within 3m of employment day • Deliver BIR56A & IR56B annually to IRD for every employee chargeable to salaries tax and all part-time employee • Notify IRD termination of employment in IR56F at least 1m before termination • Notify IRD in IR56G when an employee is about to leave HK for more than 1m unless the employee frequently travels in and out HK during his course of employment. • Failure to comply with S52(1) or S52(2) is an offence under S80(1) for which the penalty is level 3 fine of $10,000 • Report payment to a self-employed person: file IR56M if annual payment > $50,000 • Report payment to a subcontractor: file IR56M if annual payment > $200,000 (not required if subcontractor is a limited company).

Block extension for filing of profits tax returns for represented cases: • Tax returns are usually sent to thousands of companies in early April every year. In the tax return a normal time limit is set • Representatives of taxpayer can ask for an extension of the time limit if the company's accounting date falls in the categories "M" and "D". • "M" cases mean the accounting date falls in the period of 1 Jan to 31 Mar and for active cases (reporting assessable profits), the extended time limit is usually on 15 Nov. "D" cases mean the accounting date falls in the period of 1 December to 31 December and the extended time limit for active cases is usually on 15 Aug. In other cases ("N" cases), no extension of time limit is allowed. • Refer to Topic 24 for more.

Advance ruling: • S88A and Schedule 10 empower IRD to make advance ruling • S88A(8) exempts IRD from any liability to anyone for using a tax ruling • DIPN31: Rulings of public interest are published for reference • Ruling is not made on matter involving penalty, correctness of tax return, prosecution and tax recovery • A ruling is binding on IRD in relation to the person it is granted unless and until it is withdrawn • Case Analysis: Co. X wants to know with certainty about the chargeability of offshore operation under S14. It can apply to IRD by submitting Form IR1297 for an advance ruling. Application fee is $30,000 (more for complicated case). Co. X needs to provide address, file number, background information about the transaction involved, applicable law, legal/professional opinion sought, draft ruling etc. • For advance ruling on tax avoidance cases, see Topic 20.

Author's advice

Tax administration is a straight-forward and easy topic in case analysis questions. Study it well to get good marks!

Topic 18: Introduction to **China tax**

(1) Corporate Income Tax 企業所得稅

• **CIT** 〔also known as **EIT**〕is a tax paid by an enterprise (i.e. an economic organization set up in accordance with law) on their **world-wide** income from production and business operation.

• A **HK company** having a **PE** in China is taxed in respect of its **income effectively connected to PE**.

• A HK company, whether it has a PE in China or not, receives dividend, interest and royalty from a China enterprise is subject to withholding tax at the following rates: dividend at 10% for at least 25% shareholding, 5% for other cases; interest at 7%; royalty at 7%.

• CIT is chargeable on taxable income after allowable deductions in a tax year at standard rate of **25%** subject to certain reductions and exemptions.

• Tax year is from 1 Jan to 31 Dec • CIT is usually payable on quarterly basis based on quarterly financial statements • Tax is paid within 15 days of the quarter end • Yearly tax returns for the tax year must be submitted within 5 months after the year end and balance of tax liability, if any, must be paid accordingly.

• Taxable incomes include business income, production income and other incomes. • Other taxable incomes include dividend income, interest income, rental income, sale of fixed assets, and income from royalty, trademark or technology. • Most government subsidies are exempt.

• Allow deduction for reasonable business expenses, charitable donations and depreciation on fixed assets and intangible assets at prescribed rates.

• Non-deductible items include dividend payment, CIT, tax penalty and expenses not for production of taxable income.

• Business loss can be carried forward to set off future profits subject to a limit of 5 years.

• Certain types of enterprise enjoy lower tax rates or exemption： • High-tech enterprises and **foreign enterprise** in Special Economic Zone are taxed at 15%. • **Small enterprises** are taxed at 20% • **Foreign enterprises without permanent establishment** in China having China sourced income (e.g. **agency fee**) are taxed at 10% to 20% in respect of the China sourced income
• Certain government encouraged activities such as scientific research, exploration of energy, development of transportation etc. are exempt.

(2) Individual Income Tax 個人所得稅

• An individual who has **domicile in China** pays **IIT** on his **world-wide** taxable income.

• An individual **without domicile** in China is taxed according to his length of stay in China; for 1 to 5 years: world-wide income referring to the amount paid in China; for **more than 5 years**: world-wide income covers both paid in China and paid outside China are taxable; for **stay of less than 1 year**, only income derived from China is taxable.

• Full exemption of IIT for **HK resident** under Double Taxation Arrangement if (i) he stays in China for not exceeding **183** days in 12 month starting or ending in the year concerned; (ii) the income is paid by an employer who is not a resident in China; and (iii) the income is not borne by a permanent establishment in China.

• To prove the HK resident status, he needs to obtain a **Certificate of HK Resident Status** from HK IRD. • An individual who has moved his permanent base to China cannot qualify a HK resident – see Topic 5 for definition of HK resident.

• For a HK resident **rendering services both in HK and China**, only his income sourced in China is subject to IIT. The income sourced in China is computed on time basis. If he stays in China not exceeding 183 days in the calendar year concerned, only the income paid in China is included in the time basis apportionment. If exceeding 183 days, all incomes including those paid outside China are included in the income for **time apportionment.** All days of presence in China are generally counted. Nevertheless, the taxpayer may ask HK IRD to raise the issue with China tax authority if he is also assessed under HK salaries tax with double counting of days. See Topic 19.

• For a HK resident **rendering services in China only**, all income sourced in China is taxable: **No time apportionment** is allowed.

• Taxable income includes wages, salaries and allowances. It is reported by the employer to tax authority on **monthly** basis. • A **fixed amount of deduction** is allowed. Tax is calculated by applying the applicable progressive

rate to the taxable income after deduction of expenses deduction and other allowable deductions.

Computation of IIT

- Taxable Income = Gross **Monthly** Salary – Social Benefit Contribution – Expenses Deduction **¥3,500**
- A **HK resident** having no domicile in China can get Expenses Deduction **¥4,800**.
- IIT = Taxable Income x Tax Rate – Quick Deduction

Monthly taxable income ¥	Applicable tax rate	Quick deduction
1 – 1,500	3%	0
1,501-4,500	10%	105
4,501-9,000	20%	555
9,001-35,000	25%	1,005
35,001-55,000	30%	2,755
55,001 - 80,000	35%	5,505
80,001 and above	45%	13,505

Example: Mr. Chan, a Hong Kong resident, worked as a factory supervisor in China. He did not work in Hong Kong. In Oct 2015 his monthly salary was ¥50,000 (tax borne by employee). Assuming he does not have domicile in China, he gets deduction of ¥4,800. So, his taxable income in June is 50,000 – 4,800 = 45,200, giving an IIT of 45,200 x 30% – 2,755 = ¥10,805. The IIT is paid by his employer in China to local tax authority within 7 days after the month end (that is on or before 7 Nov 2015).

Other incomes subject to of IIT

IIT is also levied on income from solely owned business, rental income, royalty income, dividend and interest income:

- Income from **solely owned business** is taxed at a separate set of progressive rates from 5% to 35%
- **Rental income**, **royalty income**, **dividend income** are taxed at standard rate of **20%**.
- Individual's working income such as **writer's fee** attracts an expenses deduction (20% deduction for payment over ¥ 4,000, ¥ 800 deduction for payment under ¥ 4,000) and then the balance is taxed at 20%.
- **Interest income** is taxed at 5%, tax deducted by payer. This tax deduction has been suspended since 9.10.2008

Reporting obligations of individual taxpayer

- An individual earning **income without deduction of IIT** must file a tax return with local tax authority within 7 days of the following month and pay IIT accordingly.
- An individual having an annual income of **¥120,000** must file an annual tax return to tax authority within 3 months after the year end.

(3) Value Added Tax 增值税

• Any enterprise and individual engaged in **sales of goods**, provision of services of processing, repairs and replacement must pay VAT • **Exporters** of goods are exempt and may apply for refund of VAT for input tax.

Necessities such as food, water, natural gas, books, newspapers, magazines etc.	13%
All other goods; services of processing, repairs and replacement	17%

• **General taxpayers** need to separately calculate the output tax and the **input tax** for the VAT period. Then the difference is the actual amount of VAT payable.

Tax payable = Output tax payable for the VAT period − Input tax for the VAT period

Output tax payable = Sales in the current VAT period (excluding VAT) × Applicable tax rate

• For purchase of goods, the input tax is the VAT in the VAT special invoices received from suppliers • For **importation of goods**, the input tax is the VAT in the tax certificates issued by Custom Authority • Input tax for **transportation cost** of goods is computed at 7% on transportation cost • No input tax deduction is allowed for purchase of **fixed assets**.

• **VAT period** may be 1 day, 3 days, 5 days, 10 days, 15 days, 1 month or 1 quarter as set by the tax authority. Usual VAT period is 1 month and for these taxpayers VAT must be paid within 5 days after the month end.

• **Small-scale taxpayers** are taxed on the revenue from sales of goods or provision of taxable services by applying 3%. Small-scale taxpayers are those engaged in sales of goods with annual turnover <¥ 800,000; or engaged in

production of goods with annual turnover < ¥ 500,000. VAT payable = Sales amount (excluding VAT) × 3% • Exemption of VAT is granted for small taxpayer whose monthly sales do not exceed ¥30,000.

• **Exempt** items include contraceptive medicines and devices; antique books; instruments and equipment imported for scientific research, experiment and education; articles imported for the disabled etc.

• **Mixed sales**: Sales activity involves both goods and services. Mixed sales arising from manufacturing, wholesaling and retailing are deemed to be sale of goods and subject to VAT. In any other cases, Business Tax is payable instead of VAT.

• **VAT special invoice** sets out the VAT and selling prices separately.
• Enterprises involved in printing and using invoices are subject to control by tax authority • For goods sold to consumers, the invoices need not show the VAT separately • Small-scale taxpayers are not required to issue VAT special invoices.

(3) Business Tax 營業稅

• Taxpayers of Business Tax include all enterprises and individuals engaged in provision of **service** (transportation industry 3%, culture industry 3%, service industry 5%, entertainment industry 5% -20%), transfer of **intangible asset** (5%) or transfer of **immovable property** (5%), see PRBT Article 1 • Items taxed under BT are not chargeable to VAT • For transfer of immovable properties, the purchase price of the property or land use right can be deducted from the sale consideration.

Tax payable = [Turnover (including expenses reimbursement & excluding BT) in BT period – Allowable deductions] × Applicable tax rate

BT period may be 5 days, 10 days, 15 days, or 1 month as set by the tax authority. Usual BT period is 1 month and for these taxpayers BT must be paid within 5 days after the period end.

• BT may be **exempt** for schools, medical organizations, handicapped services, cultural services, religious activities etc. • Exemption is granted for small taxpayer whose monthly sales do not exceed ¥30,000.

• **Concurrent activities**: Where the turnover of goods and services is accounted separately, enterprises pay VAT or BT separately as verified by tax authority • Case analysis: The catering and lodging revenue of hotel is subject to BT whereas its merchandise sales revenue is subject to VAT
• Where the turnover of services and goods cannot be accounted separately, the total revenue is subject to VAT.

(5) Consumption Tax 消費税

• Every enterprise and individual engaged in the **production** and **importation** of **consumer goods** (e.g. tobacco, alcoholic drinks, cosmetics, jewel, fireworks, gasoline, diesel oil, tires, motorcycles, automobiles) may pay Consumption Tax, see PRCT Article 1 • The tax is computed on sales price or sales volume.

• **Exporters** are exempt and may apply for refund of VAT for input tax. • If an enterprise purchases consumer goods from a producer for further

production, the CT paid by the producer can be deducted from the total CT on the final taxable consumer goods. Deduction is based on the amount of the consumer goods used in the further production during the relevant CT period.

• **Taxable goods** include tobacco products, alcoholic drinks, cosmetics, skin-care products, gold and jewel, firework, gasoline and diesel, motor-car, motorbike, car-tyre etc. • Tax rates vary from **3% to 56%** according to the types of consumer goods. Refer to CLP for details.

Tax payable = Turnover in CT period × Applicable tax rate;
or = Quantity sold in CT period × Applicable tax rate

• CT period may be 1 day, 5 days, 10 days, 15 days or 1 month as set by the tax authority. Usual CT period is 1 month and for these taxpayers CT must be paid within 5 days after the month end.

(6) Tax Administrative Review 稅務複議

• Where a taxpayer believes that his legitimate rights were infringed by a tax officer, he can request for a tax administrative review by a higher authority.
• If the taxpayer is not satisfied with the review, he can take legal proceedings in Peoples' Court.

Author's advice

China tax is a big topic. But it only attracts a few marks in HKICPA taxation examination. Students should allocate their time of study accordingly.

Topic 19: **Double Taxation Agreement with China (DTA)** - see DIPN 32

(1) Tax implications for HK company stationed in China

• A **company incorporated in HK** is generally accepted as a HK resident company (hereafter called **HK company**) unless its management and control is proved to be outside HK • A **company incorporated outside HK** is regarded as residing in HK if it is managed and controlled in HK • **Management** refers to the top management of company and the implementation of management decisions • **Control** refers to the control of the whole business at the top management from time to time • Case analysis: P Ltd. is incorporated in HK and all directors are mainland residents. P has a wholly owned subsidiary company C in mainland China. The dividends received from C are not taxable under profits tax because of offshore exemption. Dividends received by a mainland resident are generally subject to a withholding tax of 20% (see page 110); but if C is controlled by a HK company, the dividend withholding rate can be reduced to 10%. To apply for the 10% reduced rate, L must submit a **Certificate of Residence Status** to the mainland tax authority: For this, L submits **Form IR1313A** to IRD and if required, L has to provide evidence of directors' stay in HK and copy of directors' minutes to prove L's central management and control in HK.

• China tax authority may impose CIT on a HK company if it has a permanent establishment (**PE**) in China. • The HK company is subject to CIT in respect of the **profit effectively connected to the PE in China** • Profit earned by HK company outside mainland China is not chargeable to CIT.

• **PE** 〔常設機構〕means **a fixed place of business**. It includes a place of

management, a branch, an office, a factory or a workshop. It excludes facilities for the storage and delivery of goods or a buying office for the HK company. A representative office of a supportive nature is not a PE. • A HK company has a PE in China if it appoints a **dependent agent** to act on its behalf in China and the agent habitually exercise an authority to conclude contracts in the name of the HK company. • A HK company has a PE in China if it provides services in China for over 6 months in any 12-month period or it has construction work in China continued for over 6 months.

• No double taxation for **rent derived from China** property, dividend from a China company or interest from a China company (if the loan is made available outside HK) because such incomes are not taxable in HK.

• HK company receiving **dividend** or **copyright income** from China company is subject to withholding China CIT at **reduced rates**: dividend is taxed at 10% (if HK company has controlling interest of 25% or above); 5% (other cases); copyright right income taxed at 7%.

• In general, a HK company should apply for **off-shore exemption** for the profit sourced in China. If the claim is successful, the profit is exempt and therefore there will be no double taxation. • For the **income sourced in HK**, no tax credit is allowed because tax credit is only available for China-sourced income taxed again in HK. • If **turnover tax** (VAT, BT) is paid on sales in China, the turnover tax is allowed as an expense/deduction in Profit and Loss Account and therefore no tax credit is allowed – see DIPN 28.

• **Conditions for tax credit**: A HK company paying CIT and Profits Tax on the same income can apply for tax credit to set off its Profits Tax liability. The

amount of tax credit cannot exceed the amount of profits tax payable in respect of that income. • The total amount of the tax credit allowable for a year of assessment cannot exceed the total amount of Profits Tax payable for that year of assessment. • If no Profits Tax is payable for that year of assessment, no tax credit is allowed. • The HK company must supply CIT receipts to IRD and the claim must be made within 2 years after the end of that year of assessment. • The claim can be submitted with the tax return for that year of assessment or be made separately in writing. • Computation of tax credit for profits tax is similar to that for Salaries Tax: see next page.

• **Disclosure of IRD information** to Chain tax authority: S4 requires IRD officers to take oath of secrecy to preserve confidentiality of taxpayer's information. IRD cannot release such information except by specific legal requirements or administration of duties under IRO • With the enactment of IR(A)O on 12 March 2010, supplying of tax information to China tax authority in accordance with EoI Article under a CDTA does not contravene S4, see DIPN 47 • HK's policy on the exchange of information is restricted to **exchange upon request** and will not engage in automatic or spontaneous exchanges of information • Before passing information to China tax authority, IRD must inform the taxpayer who may, within 14 days, request for a copy of the information and ask IRD to amend the information.

Tax implications for HK employee stationed in China

• A HK resident is **exempt from IIT** if: (i) he stays in China **not exceeding 183** days in any 12 month commencing or ending in the tax year, and (ii) his remuneration is not paid by a China enterprise, and (iii) his remuneration is not borne by a China enterprise.

• A **HK resident** means: (a) a person ordinarily resides in HK; or (b) a person who stays in HK for more than 180 days during the relevant year of assessment or for more than 300 days in 2 consecutive year of assessment (one of which is the year of assessment concerned). • A person ordinarily resides in HK is one who has a **permanent home** in HK and he pays **regular visits of long period** to HK from year to year.

• For a HK resident **rendering services both in HK and China**, only his income sourced in China is subject to IIT. The income sourced in China is computed on **time apportionment**. If he stays in China not exceeding 183 days in the calendar year concerned, only income payable in China is included in the time basis apportionment. If exceeding 183 days, all incomes including those payable outside China are included in the income for time apportionment.
• If a taxpayer travels between China and HK and provides services in both sides on that day, he would be counted as being present in China for 0.5 day for the time apportionment. If he only provides services in China on that day, then one whole day in China is counted for the time apportionment.

• Any person paying IIT on income for services in China can apply for **Section 8(1A)(c)** exemption to exclude such income from Salaries Tax. In general, this exemption gives **greater tax benefit** than the tax credit.

• If an employee renders **no service in China**, Section 8(1A)(c) will fail. Tax credit is not allowed because tax credit is only applicable for the income in respect of services in China. No tax credit is allowed for HK service income according to the allocation of tax rights under the Double Taxation Agreement.

• A HK resident who has paid IIT can apply for **tax credit** to set off his HK

salaries tax • The maximum tax set off under tax credit is computed on the assumption that the **relevant China income** is taxed under Salaries Tax. • The conditions of application for tax credit are similar to those applicable to HK companies: see page 116.

Example of computation of HK tax liability with tax credit under Simplified method 〔A complex method giving same result is provided in DIPN 32〕
Y/A 2012/13, HK sourced salaries $3,000,000, China sourced salaries $1,000,000, Total salaries $4,000,000
HK Salaries Tax: 4,000,000*15%= 600,000; China IIT on HK$1,000,000, say HK$350,000
HK effective tax rate: 15%. Max tax credit = H K tax rate * China sourced income = 0.15 * 1,000,000 = 150,000
HK ST payable with tax credit allowed = 600,000 - less IIT as restricted to credit limit 150,000 = 450,000

• **Director fee** is taxed according to the location of residence of the company. • The director's period of stay in HK is irrelevant • No 183 days exemption is allowed for director-office holder • The director fee of a HK registered company is taxable in HK only and not in China • The director fee of a China company is taxable in China only, not in HK • So, there is no double taxation of director fee and it does not attract any double taxation relief.

Author's comment

HK has entered into many DTAs with different places/countries – see IRD website. Indeed DTA is a difficult topic. It takes a lot of time and effort to study.

Topic 20: **Tax Avoidance**

- Ramsay principle: Disregard **circular or self-canceling transactions** which are for the sole or dominant purpose of tax avoidance • **DIPN15** says IRD can adopt '**purposive interpretation**' to the facts realistically (the substance of the arrangement) and **Ramsay principle** can co-exist and operate alongside the general anti-avoidance provisions of IRO • Case analysis: S bought goods for $50M from W. Two months later, S sold the goods to W at $30M, making a loss of $20M. The loss is not deductible because the buying and selling transactions are circular and self-canceling; they are without commercial reasons but tax avoidance.
- Furniss v Dawson principle: Look at the end result of **a series of preordained transactions** that are entered into under an avoidance scheme. This principle can treat bridging loans under an avoidance scheme as a sham. Case analysis: Co. X sold goods to its overseas subsidiary S for $10M and 1 week later S sold the goods to a USA customer for $30M. Following **Furniss principle**, IRD can look at the end result and treat S having a sales at $30M, instead of $10M.
- Sharkey v Wernher principle: **Goods taken for owner's use** is treated as sales at open market price • Case analysis: In tax investigation, IRD found that a shopowner took goods away. IRD would treat the take-away goods as omitted sales at market price • The use of **Sharkey principle** in HK is doubtful in view of the comments in Quitsubdue case, see Topic 7 • Nevertheless, IRD can use S61A and Tai Hing Cotton Mill principle in case of a transfer of asset is made between associates – see below.
- Petrotim Securities principle: IRD can adopt open market value for **transactions between related companies**. This principle is adopted in Tai Hing Cotton Mill case, with the application of S61A. .

• **S61** disregards 3 kinds of **tax-reduction** transactions: (1) artificial transactions (2) fictitious transactions (3) dispositions not given effect • **Artificial** transactions are those **not motivated by commercial reasons**, not documented, and fixed in retrospect, see Rico International case. • **Fictitious** transactions are those n**ever being intended to be carried out**, see Douglas Henry How case • The **motives** must be considered. If payment is not one which a businessman can reasonably be expected to make in the circumstances, it is artificial and fictitious, see **Kum Hing Land Investment** case • Case analysis: Does the transaction cause tax reduction? Does it have commercial motive? Is it artificial? Is it fictitious? Then, draw comments on whether IRD can **disregard** it under S61 and discuss the tax effect.

• **S61A** applies where a person carries out a **transaction** for sole or dominant **purpose** of enabling a person to obtain a **tax benefit** • The person can be assessed as if the transaction had not been carried out, see **S61A(2)(a)**, or in such other manner as appropriate to counteract the tax benefit, see **S61A(2)(b)** • CIR's power under S61A(2)(b) must be exercised on the basis of a reasonably postulated hypothetical transaction which produces an assessment designed rationally to counteract the tax benefit, see **Ngai Lick Electronics** case • IRD determines taxpayer's intention of obtaining tax benefit by **7 specified matters**: including (i) form and substance, (ii) manner of being carried out, (iii) result achieved, (iv) financial position of taxpayer, (v) financial position of other parties (vi) whether on arm-length basis, (vi) whether non-resident party is involved, see **S61A(1)** • 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 tax assessment, see **Tai Hing Cotton Mill** case.

• **DIPN15**: S61A should only apply to blatant or contrived **tax avoidance arrangement** • Case analysis: IRD can invoke S61A because the sale of goods from H to S caused reduction of H's profits tax liability. The profit transferred to S is not taxable because S has tax losses brought forward. So, a tax benefit is conferred on H and S. The following facts suggest there was a sole or dominant purpose to obtain a tax benefit: (i) H is the holding company of S. As decided in Tai Hing Cotton Mill case, they are "the same enterprise under the same direction in economic terms" and they are not dealing at arm's length. (ii) The selling price was much lower than the open market value: so it was not on arm-length basis. (iii) The price was not determined by usual commercial terms and negotiation. (iv) The terms for payment were not commercially realistic. It is unusual for companies to enter into such an agreement if they were dealing on arm's length basis. (v) The purpose of the transaction was to appropriate profits between the two related companies. (vi) In consequence, large amount of H Co.'s profit becomes not taxable. • To counteract the tax benefit, IRD can adopt the market value for the sale of goods with the authority of **Tai Hing Cotton Mill** case and disregard the selling price as adopted by H and S. • DIPN 15: **Penalty** is imposed for submission of incorrect returns or giving incorrect statement or information without reasonable excuse. Criminal prosecution may be taken in case of willful tax evasion cases.

• **Section 61B**: Where there is a **change in shareholding** in a company which has **tax losses**, the tax losses brought forward cannot be used to set off its future profits under S19C if the IRD is of the opinion that (1) the future profits is a direct or indirect result of the change in shareholding and (2) the sole or dominant **purpose of the change** in shareholding is for utilizing the loss to avoid tax liability • Case analysis: Is it a sale of loss company? What

is the purpose of the purchase of the shareholding? Are there any commercial reasons for the purchase (e.g. reliable supply of materials, improved sales outlets, reduced purchase cost, etc.)? Is there any change of business after the purchase? Can IRD disallow the loss set off on the grounds that the dominant purpose of the purchase of the shareholding is to reduce tax?

• **Disguised employment** (Type I case) is targeted in **DIPN 25** • To avoid **Salaries Tax,** a service company is used to disguise an employment relationship • **S9A** is applicable if the service fee is paid to a service company, which is usually a **limited company,** under a **service agreement** for **personal service** provided by an individual who **controls** the company, see DIPN 25 • The service fee will then be treated as employment income of the individual, see **S9A(c)(iii)** • To avoid double taxation, the service company or the individual will not be chargeable on the service fee again, see S9A(5) • S9A will not apply if all the **6 conditions** listed under S9A(3) are satisfied. These conditions are **characteristics of a contract for service**, namely (i) the agreement does not provides for annual leave etc (ii) the individual also carries out services for other persons (iii) the individual is not subject to "employer-type" control (iv) the remuneration is not paid on a basis commonly used under employment (v) the individual does not have the right to terminate the services like an employee and (vi) the individual is not held out to the public to be an employee • CIR has **discretion** under **S9A(4)** not to apply S9A(3) if he is satisfied that the carrying out of the services under the agreement is not substantially in the nature of an employment • If S9A applies, the payer of service fee must fulfil all the obligations of an employer • Refer to Topic 3 for self-employed person cases which do not involve setting up a limited company.

• **Management / service fee** (Type II case) is targeted in **DIPN 24** • Avoidance of **profits tax** is done by payment of management fee to a sole-proprietor business or a **partnership** business • **DIPN 24** sets out a formula to limit the deduction of management fee to "service company" to **112.5%** of the total costs of "qualifying services" incurred by the service company **plus** salaries to professional staff and partners • The **legal base** for DIPN 24 includes (i) S16(1): to allow expense to the extent it is incurred in the production of chargeable profits; (ii) S17(1)(b): to disallow expenses not for production of chargeable profits, (iii) S61: to disregard the management fee if it is artificial or fictitious; (iv) S61A to counteract the tax benefit derived from the management fee; (v) the tax principles in D153/01 and So Kai Tong Stanley case to restrict the amount of deduction to a commercially realistic level • **Qualifying services** are the non-professional services that provide the infrastructure in which the business operates. Examples are salaries and benefits for office staff, office rent, periodicals and updates, lease of equipment, office supplies, etc. • **Non- qualifying expenses** include director's salaries and benefits and solicitor's fee • For the service company receiving management fee, there is **no corresponding downward adjustment** of service income if DIPN24 applies • Case analysis: management fee 2,000,000, total qualifying costs of service company 1,000,000, professional staff salaries 200,000. For the payer company, allow deduction of 1,000,000 x 112.5% =1,125,000 plus 200,000 equal to 1,325,000, instead of the 2,000,000 booked in Profit and Loss Account. For the service company, assess management fee income 2,000,000 • If the management fee is **paid to unrelated person on arm-length basis**, IRD normally allows the full payment, see DIPN 24.

• **Transferring out rental / royalty** income: The receipts are deemed to be trading receipts under **S15(1)(m)** and S15A(1) even though they are capital nature, see **S15A(1)** • The receipts are not assessable if the underlying asset is transferred out, see S15A(3) and **Aviation Fuel Supply** case • If the receipts before transferring out is not chargeable to profits tax, then S15(1)(m) will not apply , see S15A(4) • Case analysis: A non-resident company is in receipt of royalty income for a copyright used in HK. The income is taxed under S15(1)(b) – see Topic 9 and Topic 10. When the non-resident company sells out the right to royalty income without selling the copyright, the disposal proceeds is deemed to be taxable under S15(1)(m) and S15A(1) even though the sales proceeds is of a capital nature.

• **Advance Ruling** on tax avoidance arrangements is provided by IRD. The application fee per case is $10,000 • **DIPN 31** set outs procedures. See Topic 17 for more. • In S61 case, IRD requires taxpayer's submission that there is no misuse of IRO provisions • **DIPN 15** sets out the information required in S61A and S61B cases whereas **DIPN 25** sets out the information required in S9A cases • Refer to the relevant DIPNs for details of the information required by IRD for advance ruling.

Author's advice

Nowadays, tax avoidance is a hot topic in advanced taxation examinations. In exams, as well as in practice, tax avoidance issues often go hand in hand with transfer pricing – see Topic 21. So, students are advised to study these two topics altogether at the same time.

Topic 21: **Transfer Pricing**

• Transfer pricing concerns **cross-border transactions** between **related parties** for transfer of goods, services and intangible property • Related parties mean one party participates in the management, control or capital of the other party. • Case analysis: Co. X is resident in HK whereas Co. Y is resident in USA. Y is wholly owned by X. The trading transactions between X and Y can cause transfer pricing disputes under profits tax.

• **DIPN 46** states that IRD follows **OECD**'s guidelines and adopts **Arm-Length Principle** • The transfer price should be that charged by an independent party in an uncontrolled transaction in comparable circumstances. • It should be close to the open market price and produce **a reasonable allocation of profits** between the related parties • The issue is whether the pricing of the transactions reflects open market value so that it can produce reasonable profits to the HK resident company • Case analysis: Since the price of the goods sold by Co. X (HK resident company) to Co. Y (non-resident company) is lower than the open market value, X's profits will decrease and thus give less profits tax payable. IRD can invoke **S61A** to make an assessment on X so as to counteract the tax benefit or can follow Tai Hing Cotton Mill principle to substitute the transfer price by the open market price in the determination of X's assessable profits.

• The arm-length principle should take into account of the commercial and functional roles of the related parties involved. If the related parties are **trading in open markets**, it may be necessary to conduct a **functional analysis** • In Asia Master Ltd. case, the judge said that the **transfer pricing report** should include an analysis of the assets, functions and risks of all parties involved

• Case analysis: In tax investigation, IRD required Z Ltd to provide the group consolidated accounts so as to determine the group's total profits. The group's total profits will be adjusted and allocated between every company in the group based on their assets, functions and risks. This method can serve as a yardstick for computing Z's assessable profits.

• **DIPN 46** provides a number of methods for transfer pricing: (i) traditional methods such as **CUP** Comparable Uncontrolled Price method, **Cost Plus** method, Resale Price method and (ii) transactional profit methods such as Profit Split method and Transactional Net Margin method (based on Return on sales or Return on costs). • OECD says CUP method is the most direct and reliable way to apply the arm's length principle. It should be used where CUP can be found • Case analysis: CUP method should be used because the commodity is traded in open markets and its open market value can be found from published trading statistics • Case analysis: CUP cannot be used in this case because there is **no open market** for the products/service concerned. So, Cost Plus method should be used • Case analysis: A Ltd (HK resident company) owned 50% shares of C Ltd (mainland enterprise). C charged A $10M for manufacturing of the goods sold by A. IRD may require A to supply C's management accounts to find out the total costs of manufacturing and then add 10% profit margin to determine the transfer price • Case analysis: Taxation is only one of the many concerns of Co. X for the transfer pricing arrangements. Other concerns include market share, government policies and exchange control. • Case analysis: Hong Kong's profits tax rate is generally lower than other places. If Company HK received greater profits under the pricing arrangement, IRD would tax the profits accordingly and would not accept any claim for downward adjustment unless IRD is obliged to make an appropriate adjustment under the **Associated Enterprises Article**.

• Case analysis: As there is no information to show that the China tax authority has made an upward adjustment on the related Co. C in mainland China under Associated Enterprises Article of Comprehensive Double Taxation Agreement, there should be no downward adjustment of profits tax assessment of Co. HK. So, double taxation of profits can arise. See topic 19 for Double Taxation Agreement with mainland China • Case analysis: Where an adjustment per Double Taxation Agreement country under Associated Enterprise Article is **accepted by IRD**, the relevant assessment of the HK company will be **revised** in accordance with the relief provisions of the Double Taxation Agreement. In that case, **refund of tax** can be made under S79, see **DIPN 45**. In practice, normally, IRD use the transfer pricing methods in DIPN 46 to re-assess the HK company's profits tax.

• **DIPN 48**: HK company can ask IRD to make an advance ruling under **Advance Pricing Arrangement**. The threshold for application is $80M for sales and purchases in each year; or $40M for services income; or $20M for transfer of intellectual property. The application is free of charge.

• If a non-resident carries on a business in HK, **S14** should apply to assess it to profits tax • **S20(2)**: If a HK resident and a **closely connected** non-resident undergo transfer pricing arrangement under which the HK resident makes no profit or less than his ordinary profits, the transactions done by the non-resident are deemed to be business carried on in HK and such transactions are chargeable to tax in name of the HK resident as if he were an agent for the non-resident • See topic 10 for discussion on non-resident.

Author's advice: Transfer pricing is an advanced topic of taxation. The above notes are for examinations only. For more, read DIPN 46 on IRD's website.

Topic 22: **Partnership, Joint Venture**, **Club**

Partnership

• **S3 of Partnership Ordinance**: "partnership" is the relation subsists between persons carrying on a business in common with a view of profit.
• Whether a partnership exists is mainly a question of facts • Case analysis: Arguments for existence of partnership include: (i) contribution of capital (ii) sharing of profit and loss (iii) joint management and control of business (iv) partnership agreement (v) legal documents (including Business Registration Certificate)

• **S2(1)** : Partnership is **a legal person for tax assessment** • **S22(1)**: Profits tax assessment is made in the name of the partnership • **S22(2)**: The **precedent partner** is responsible to file a Profits Tax Return (BIR 52) and pay tax • **S2(1)**: Precedent partner is the one first named in the partnership agreement. If there is no such agreement, he will be the first named in the usual partnership name or in any statutory document such as Business Registration Certificate • **S22(4):** 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 is jointly and severally liable** to do it (including payment of tax of other partners).
• **S56(1)**: Any partner receiving a notice addressed to him as precedent partner cannot deny responsibility unless he can prove another partner is the precedent partner • Case analysis: IRD made an estimated assessment on the partnership XY. No objection was made in the statutory objection period. IRD should recover tax from the assets of the partnership first and if unsuccessful, from the personal assets of every partner.

• If a partner is a **corporation**, its share of profits will be taxed at the corporation rate 16.5% • If the partnership makes losses, the corporation's share of losses can set-off its trading profits, see **S19C(4)**, subject to a limit of the corporation's contribution to the partnership at the end of the relevant year of assessment, see **S22B** • Case analysis: In 2014/15 partnership P&Q made a tax loss of $2M. P is an individual partner. Q is a corporation partner and has assessable profits $3M under its name in 2014/15. Each partner has contributed $4M to the partnership capital and they have equal P&L sharing ratio. With S19C(4) set off, Q's net assessable profits will be $3M minus $1M loss set off equal to $2M • Case analysis: Partnership A&B made an adjusted tax losses of $20M in 2015/16.Then, C Ltd joined the partnership with a capital injection of $10,000. With an agreed P&L sharing ratio, C Ltd got a share of losses at $18M from the partnership. If not for S22B, C Ltd would have gotten a loss set-off of $18M to reduce its own tax liability. Now, given S22B, C Ltd could only get a loss set off of $10,000 (restricted to the capital balnce) instead of $18M. The unused loss set off of $17,990,000 attributable to C Ltd will be carried forward under partnership to set off C Ltd's future share of profits.

• If there is a **change of partner** (e.g. death of partner, retirement of a partner, admission of new partner), the change must be reported to Business Registration Office within one month • For tax purpose, the partnership is treated as going on as long as there is at least one partner remains in the partnership after the change, see **S22(3)**.

• Normally, the Revenue will issue the **first tax return** about **18 months** after a person registers his business • But if he has assessable profits for the year of commencement, he should inform IRD within 4 months after

that year of assessment • Case analysis: Partnership B&C started business on 1 Apr 2015. It made profits in the year ended 31 Mar 2016. The precedent partner must inform IRD of chargeability to profits tax not later than 31 Jul 2013 under S51(2). Failure to do so can cause penalty under S80(2).

• A single Profits Tax **assessment** is issued to the partnership to assess its assessable profits • Tax payable is computed at standard rate 15% on the partnership's assessable profits • If a partner elects for Personal Assessment (PA) and such election can reduce his total tax liabilities, then allocation of profits is made so that his share of profits is transferred to PA and is not required to pay tax in the partnership's Demand for Tax • If a partnership makes profit, no **allocation of loss** to any partner will be allowed; such loss will be re-allocated to other partners, see S22A • Only current-year loss is transferred to Personal Assessment • Partner's share of loss will lapse if he withdraws from partnership and does not elect for Personal Assessment • **Allocation** of profits/loss must be done where a partner elects Personal Assessment, or where the partnership makes a loss, or where a partner is a corporation. Refer to CLP and past exam papers for examples on allocation of profit/loss of partnership.

Joint Venture

• **Joint Venture** is a commercial structure in which the joint parties shared the risk, obligation and profits • Joint Venture is not a legal person for taxation • Share of profits is taxed in each joint-venture party's own name with other sources of income • Case analysis: Arguments for joint venture include: (i) There is no contribution of capital from the parties concerned.

(ii) It is only for a short term project. (iii) Each party is only responsible for his own work. (iv) Each party is not responsible for other party's of risk. (v) Limited companies are involved.

Club

- If **not less than half of the gross receipts** on revenue account (including subscriptions and entrance fees) are received from its voting members, the club will be deemed as not carrying on a business in Hong Kong and hence it is not subject to profits tax, see S24(1) • The test is done for **each year** and a club can be liable to pay profits tax in one year but not in another year • If the club is the owner of its premises and it receives rental income, it will be subject to property tax • If the club is liable to profits tax, the rental income will also be included in its assessable profits, but the property tax paid can set off against its profits tax payable under **S25**.

- Case analysis: A letter to Club's chairman advising on tax liabilities:

Dear Mr. Chairman Mao,

Estimated tax liabilities for the year ended on 31 Dec 2016

With reference to your letter dated xxx, I would like to advise you that under S24(1) if not less than half of the gross receipts on revenue account (including subscriptions and entrance fees) are received from its voting members, the club will be deemed as not carrying on a business in Hong Kong and hence not subject to profits tax. All members of your club have voting rights at the general meetings. This test is done for each year and a club can be liable to

pay profits tax in one year but not in another year. Besides, since the club is the owner of its premises and it earns rental income, it will be subject to property tax. Where the club is liable to profits tax, the rental income will be included in its assessable profits, but the property tax paid can be set off against the profits tax payable. As shown below, in the year ended 31 Dec 2016, less than half of the total receipts are received from members. Therefore, the whole of the profits from both members and non-members including entrance fees and subscriptions are chargeable to profits tax.

	Members	Non-members	Total
Subscriptions	100,000	0	
Entrance fee	20,000	0	
Snack bars	20,000	10,000	
Rental income	0	200,000	
Total	140,000	210,000	350,000
% of total receipts	**40%**	60%	
Less: total expenses			124,000
Assessable profits			226,000
Profits tax at 16.5% (**corporation tax rate**)			37,290
Less: property tax paid (S25 set-off)*			24,000
Net profits tax payable			13,290

*Property tax set-off: rental income 200,000 x 80% x 15% = 24,000

Yours sincerely,
Raymond Yeung Tax Consultant

Topic 23: **Deceased person**

S54(c): All tax assessments on the deceased must be made **within 3 years** from the end of the year of assessment in which the death occurs.

S54: The **executor** of a deceased taxpayer's estate is responsible to handle the deceased's tax affairs • He is obliged to file tax returns and supply information to IRD and pay tax in relation to the deceased's tax affairs.

S51(6): If the deceased taxpayer has any income chargeable to tax, the executor must write to inform IRD within one month after the death. The executor should supply personal particulars of the deceased including date of death, particulars of the income sources and a copy of the death certificate.

Penalty will be imposed on the executor if the executor personally furnished incorrect tax return for the deceased. Such penalty is personal to the executor and can be recovered from the personal assets of the executor • Penalty cannot be imposed after day of death for the offence committed by the deceased • Penalty imposed on the deceased before death can only be recovered from the deceased person's estate.

Salaries Tax

If the deceased taxpayer has **salaries** income only, the executor must report the income before death in the deceased's tax return BIR60 in the capacity of executor acting for the deceased's estate.

Property Tax

For **property tax**, until the legal title of the property is transferred to the beneficiaries, the executor has the obligation to file tax returns and pay tax on the rental income • **Solely-owned** property: Rental income from the deceased's solely-owned properties before death forms part of the deceased's estate and it must be reported in the deceased's tax return BIR60. Although rental income after death belongs to the beneficiaries, it must be reported by the executor in BIR60. Property tax on **after-death rental income** is paid by the **executor** until the beneficiaries of the estate are ascertained and legal title is transferred • **Jointly-owned** property: Death of one owner will not affect property tax because the surviving owner must do all the tax obligations.

Profits Tax

If the deceased operated a **sole-proprietorship** business, the business would be regarded as ceased on death. The executor must report the assessable profits for the period from the last accounting day to the day of death in the deceased's tax return BIR60 • If there is a successor to the business, the **successor** is treated as operating a **new business** under the same business name. The successor must apply for a new business registration certificate and get a new business registration number.

A **partnership** business will not cease on the death of a partner. The deceased partner is treated as retiring from partnership. Profits of the partnership should be reported as usual when a Profits Tax Return (BIR52) is received.

Topic 24: **Tax Planning** and **Roles of Tax Representative**

Tax Planning

Tax planning tactics for **business owners** include: • Make payment of director fee/salaries to take advantage of personal allowances and lower tax rates under salaries tax • Provide non-cash benefits to director • Payment of management fee/consulting fee/subcontractor charges to overseas related companies • Write off obsolete stock • Write off bad debts • When approaching year end, postpone sales to next year • Next year's purchase of plant & machinery is done in current year to get depreciation allowances • Review offshore operations, capital gain, capital expenditures, borrowing arrangements & interest expenditures, transfer pricing arrangements etc. to get lawful tax mitigation • Arrange timely accounting and audit to avoid delay in filing of tax return and penalty • Refer to Topic 11 for more on profits tax and Topic 20 for tax avoidance.

Tax planning tactics for **local employment** include: • Employer provides employee with free accommodation / rent refund. Tax representative should caution his client that IRD can invoke S61 to disregard artificial transactions or S61A to counteract the tax benefit if (i) the employer and employee are closely related (ii) there is no rent agreement, or the rent agreement is not duly stamped (iii) the rent is excessive (iv) the employee has no salary or the salary is unreasonable low (v) the so called "rent payments" are effected by accounting entries (vi) the employer has no control over the employee's use of rent refund • Employer provides tax-free benefits to employee, e.g. free medical, free transportation, free meals, corporate membership of leisure clubs • Employer makes contracts with utility companies to supply

electricity, gas, telephone, internet service etc. to employee • Employer hires domestic helper, driver, assistants etc. for the employee • Employer pays salaries tax for the employee. Although such benefit is taxable under S9(1)(a), the employee will not suffer from that as the tax involved is borne by the employer • See Topic 2 for more

Running a sole-proprietorship **business** versus working as an employee:

- Business expenses (including employee benefits) are generally deductible
- Depreciation allowance can be claimed on equipments purchased
- Equipments installed at home are generally not eligible for depreciation allowances under Salaries Tax; but apportionment of depreciation allowances for business use may be allowed under profits tax • Registration of business is required • Audit is not requried for unincorporated business • Business losses can set off other incomes under Personal Assessment.

Setting up a **limited company** in Hong Kong: • A limited company is a separate legal entity and liable to profits tax on its own account. Its shareholders and directors are not liable to pay the company's tax • Company director may be personally liable to penalty if he personally commits an offence under IRO, e.g. sign an incorrect tax return or provide false information to IRD • Under S14(1), only profits arising in or derived from HK are assessable • Business expenses are generally deductible • Directors' fee and salaries, if not excessive, are generally deductible • Depreciation allowances can be claimed for equipments used in HK • Registration of business • Audited accounts required; audit fee is deductible • No stamp duty is payable on authorized share capital and issue of new shares • Losses sustained by a limited company can be carried forward to set-off its own future profits.

Setting up an **overseas branch**: • Consider whether offshore exemption is applicable • Whether the branch activities are clearly separate from the HK company • Whether the branch carries on a trade as a separate business entity • Whether the branch has full authority to conclude its contracts of purchases and sales • Whether the branch keeps independent ledger separate from HK • Whether both the purchases and sales of the branch effected outside HK - IRD will not accept offshore claim if either purchases or sales are effected in HK, according to DIPN 21, see Topic 6 • If overseas profits tax is paid by the overseas branch, such tax is not deductible under HK company's profits tax, according to DIPN 28.

Setting up a **branch** or **subsidiary** in Hong Kong: • Both are liable to profits tax under S14(1) if they carry on a business in HK • Tax problems may occur for branch if its accounts do not reflect the true profits in HK. Then, IRD may use IRR5 to assess the branch profits based on its share of the global profits or based on a percentage of HK turnover • A subsidiary is a separate legal entity. Its account is audited and more likely to be accepted by IRD • A subsidiary may claim deduction for management fee paid to overseas parent company if the management fee is properly documented and commercially realistic • A branch is difficult to claim deduction for the expenses incurred by the overseas head office for the branch • In general, the risk of tax dispute for a branch is greater than a subsidiary.

Sale of business on business cessation: • Profits arising from sale of **capital assets**, including goodwill, patent, business tools etc. are not taxable under S14 • Sale proceeds of patent, trademark, patent are taxable if S16E or S16EA deductions have been granted • Sale proceeds of computer hardware and software are taxable if S16G deductions have been granted • Profits

(sales proceeds less cost) from sale of revenue assets, e.g. trading stock, trade debts, are taxable • Balancing charge or balancing allowance may arise on disposal of plant and machinery • **S15C(1)**: The purchase cost of trading stock claimed by **successor** in profits tax is taken to be the sales proceeds even though it is different from the market value.

Purchase of business: • If it is a loss company, IRD may disallow loss set-off under S61B – see Topic 20 • Purchase cost of trading stock is deductible even though the purchase price is excessive, see Ngai Lik case • Purchase cost of patent and trademark are deductible under S16E and S16EA respectively • Purchase cost of computer hardware and software are deductible under S16G • Purchase cost of plant & machinery attracts depreciation allowance • Tax representative should advise clients to determine the aforesaid costs in order to get deductions or depreciation allowances • Purchase cost of trade debts must be deducted from the amounts collected from the debtors; any bad debts therefrom are not deductible because such debts are not trade debts and their sales amounts have not been included in assessable profits • If the purchase price of the business exceeds the total cost of assets acquired, the excess being goodwill is capital expenditure and hence not deductible under S17(1)(c).

Roles of Tax Representative

Tax advisory service for **new clients**: • Check any outstanding enquiries from IRD • Check any outstanding objections and S70A claims • Check any outstanding tax payment, surcharge and penalty • Evaluate whether offshore exemption is applicable • Review accounting policies, deduction and classification of expenses • Review depreciation allowances claimed

• Review stock valuation methods and stock-taking procedures • Review company financing and whether S16(1) & S16(2) conditions are satisfied • Review transfer pricing arrangements and whether they are tax efficient.

Tax representatives' service for **filing tax return**: • Follow IRD's circulars published on internet • Obtain written authorization from client to act as representative and make declaration of that in the application form for block extension • Refer to Topic 17 for the time limits of block extension of active "M" and "D" cases • Mind the time limits for application of block extension and the time limits for filing of tax returns because late filing can cause penalty on clients • A further extension of 2 weeks is allowed for filing electronic tax returns • A further extension up to end of January is granted for "M" cases reporting losses.

Tax representative service for **clients under tax investigation**: • Obtain written authorization to act as representative from clients and send a copy to IRD • Refer to Topic 15 regarding the roles of representative in investigation and field audit cases.

Tax **advisor's ethics**: • Act honestly in accordance with law • Uphold professional standards and put forward best advice • Observe integrity and objectivity • Mind client that tax advice is for reference only and it may be challenged by IRD • Advise client that legal responsibility for filing correct tax return is on the client • Caution clients of tax penalty

In **letters to IRD**, tax representative should say that he acts on behalf of the client and under the client's instruction. When providing information to IRD, tax representative should say: "As instructed by our client, we reply to your letter

dated XXX and supply on behalf of our client the following information …" Such wordings make it clear that tax representative acts an agent for his client and can be relied on as an exemption clause to relieve the tax representative from any penalty action taken against the tax representative in case of incorrect information submitted to IRD. Tax representative should pass a copy of the letter to client and say this in the letter to IRD to show approval has been obtained from his client for the information supplied. • Below are two examples of letters to IRD used by tax representatives.

Example of **holdover** application letter to IRD

2 Dec 2014

Dear Commissioner of Inland Revenue,

Our client: A B C & Co. Ltd.

Holdover Provisional Profits Tax for 2014/15 with due date 1 Jan 2015

We are the authorized representative of our client. On behalf of our client and as instructed by our client, we apply for holdover of the provisional profits because our client made business losses of $1,000,000 for the period 1 Apr 2014 to 30 Nov 2014 and our client is prepared to cease business on 1 Jan 2015. In support of our application, we enclose a management Profit and Loss Account for 1.4.2014 to 30.11. 2014 certified by the company director. We look forward to receiving your reply before the due date of tax payment.

Yours faithfully,

[Signed]

ABC & Co., Certified Public Accountants

c.c. Client

Example of **objection** letter to IRD

1 Oct 2014

Dear Commissioner of Inland Revenue,

Our client: A B C & Co. Ltd.

Objection to Profits Tax Assessment for 2013/14 issued on 8 Sep 2014

We are authorized representative of the captioned client. On behalf of our client and as instructed by our client, we object to the assessment on the following grounds:

(1) The assessment is incorrect and excessive, and

(2) It is estimated in the absence of a tax return.

Enclosed are a duly completed tax return, supported with audited accounts, and profits tax computation with supporting schedules of depreciation allowance, management fee and interest expenditures. Please revise your assessment accordingly.

Please hold-over the tax in dispute unconditionally pending the result of our client's objection to the assessment. Thank you.

Yours faithfully,

[Signed]

PQR & Co., Certified Public Accountants

c.c. Client

Topic 25: **Stamp Duty**

• Fundamental rule: Stamp duty is levied on **instruments** (written document). Where no document is executed for the transaction, e.g. leasing of property for 6 months, no stamp duty arises.

(1) Leasing of land & building

• In land law, a lease for 3 years or more must be in writing. • If a written lease is executed, SD must be paid within 30 days of the execution.

• SD for leasing of immovable property is charged under **Head 1(2)** to SDO.
• S16(2): An agreement for a lease is chargeable as if it were a lease.
• S17: A document executed to increase rent is chargeable in respect of the additional rent charged.

• The exemption available under transfer of shares or transfer of land and building (see below) does not apply to leasing of landed property.

• A duty of $5 is payable on duplicate lease複本, see **Head 4** to SDO.

• SD = SD rate x Yearly rent全年租金; plus 4.25% of premium if rent is also payable under the lease • SD rate varies with the length of lease. 1 yr. or less: 0.25%; 1 – 3 yr : 0.5%; more than 3 yr: 1% • Yearly rent = Total monthly rent under the lease / no. of months under the lease x 12 • Case analysis: A lease for 2 years with monthly rent $10,000. Yearly rent = 10,000 x 24 / 24 x 12 = 120,000. SD = 120,000 x 0.5% = 600. In law, either the landlord or the lesee must pay the whole duty $600. In practice, each party pays half $300.

• **Delay** in stamping causes penalty: delay less than one month: penalty is two times the SD; delay 1 to 2 months: penalty is four times the SD; delay more than 2 months: penalty is ten times the SD • Collector has discretionary power to waive the whole or part of the penalty.

• Consequences of **no stamping**: • Collector may take legal action to recover unpaid duty. • Any dutiable instrument which is not stamped is not admissible as evidence in legal proceedings except criminal proceedings or recovery action by IRD. • Assignment of property unstamped cannot be registered with Lang Registry. • Unstamped contract note of share transfer cannot be used to effect the change of shareholder • Landlord cannot use an unstamped lease to take action against the default lessee.

• **Contingency principle** applies when consideration depends on a future event • If consideration cannot be ascertained, no stamp duty is payable • If a maximum amount is specified, use the maximum amount • If only a minimum amount is specified, use the minimum amount • Case analysis: A shop is let out for 2 years at a monthly rent of between $400,000 and $300,000 depending on monthly sales. SD is $400,000 x 12 x 0.5% =$24,000.

(2) Transfer of land & building

• In land law, assignment of landed property must be done by deed; transfer of an interest in land must be evidenced in writing. Penalty for delay and legal consequence of non-stamping is same as those for leasing • SD = SD rate x consideration樓價

• If **a series of transaction** can form one bigger transaction, such transactions are dutied as one single transaction and SD is computed on the total consideration of the series of transactions - see **SOIPN 1** • Case analysis: Mr. C sold a flat for $20,000,000 and a car park for $500,000 in the same development estate to Miss D on 20 Feb 2012. Two separate sales transactions were executed for the sale. Total SD payable is $20,500,000 x 4.25% = 871,250 according to SOIPN 1: IRD regards the two transactions are one single transaction per se for stamp duty.

• S24(1): Consideration includes **waiver of debt** • Case analysis: The consideration of the transfer of property as stated in the Sale and Purchase Agreement is $10,000,000. In addition, the purchaser is required by a separate agreement to pay off the outstanding bank loan $3,000,000. Therefore, the total consideration for stamp duty is $13,000,000.

• SD rate varies with **consideration**樓價〔ad valorem〕 • **Marginal relief** computation for excess of consideration slightly over marginal band-rate. For New AVD cases, the marginal duty is 20% on the excess. For Old SD cases, the marginal duty is 10% on the excess.

• From **23 Feb 2013**, New **AVD** should apply; Old SD is still applicable to the purchase of residential property by a Hong Kong permanent resident who does not own any other residential property in Hong Kong at the time of purchase • New AVD is also called Double Stamp Duty (**DSD**) because the rates are generally double the Old SD (see below).

• New **AVD** rates apply from **23 Feb 2013**: consideration below $2,000,000 SD rate 1.5%; $2,000,001 to $3,000,000 SD rate 3%; $3,000,001 to

$4,000,000 SD rate 4.5%; $4,000,001 to $6,000,000 SD rate 6%; $6,000,001 to $20,000,000 SD rate 7.5%; $20,000,001 and above SD rate 8.5%

• **Old SD** rates apply to purchase of residential property by HK permanent resident without residential property in HK: consideration below $2,000,000 SD $100; $2,000,001 to $3,000,000 SD rate 1.5%; $3,000,001 to $4,000,000 SD rate 2.25%; $4,000,001 to $6,000,000 SD rate 3%; $6,000,001 to $20,000,000 SD rate 3.75%; $20,000,001 and above SD rate 4.25%

• From **27 October 2012**, any **residential property** acquired by any person (including a limited company) **except a Hong Kong Permanent Resident** will be subject to the **Buyer Stamp Duty** at 15%, on top of the existing stamp duty and the special stamp duty if applicable.

• For a residential property purchased between 20 November 2010 and 26 October 2012 and sold within 24 months, Special Stamp Duty is charged at old rates as follows: 15% for sale within 6 months; 10% for sale within 6 to 12 months; 5% for sale within 12 to 24 months.

• For a residential property purchased on or after **27 October 2012** and sold within 36 months, **Special Stamp Duty** (**SSD**) is charged at **new rates** as follows: 20% for sale within 6 months; 15% for sale within 6 to 12 months; 10% for sale within 12 to 36 months.

• New AVD or Old SD are payable within 30 days of the execution of Sale and Purchase Agreement • A duty of **$100** is payable within 30 days of the execution of Assignment Deed • No SD is payable on Provisional Sale and Purchase Agreement.

Sections of Stamp Ordinance **applicable to both** transfer of landed property and transfer of shares

- **S27(4)**: If property (or share) is transferred at lower than market value, the transfer is deemed as a **voluntary disposition inter vivo** and the value for calculating the duty is based on the **market value** rather than the stated consideration. This section applies even though the transaction is not made between related parties.
- **S11(1)**: **Disclosure of full information** for stamp duty is required.
- **S11(2)**: Non-disclosure can lead to criminal prosecution with level 6 penalty and 1 year imprisonment.
- **S13(1):** A person may upon payment of an adjudication fee of $50 request Collector to adjudicate whether an instrument is chargeable with stamp duty.

Exemptions of stamp duty applicable to transfer of landed property

- Full exemption for the transactions with government and Housing Authority
- Full exemption for gifts made to charitable institution.
- No SD is payable if marriage is the consideration for the transfer of property
- No SD is payable if there is **no change in beneficial interest** e.g. declaration of trust
- $100 SD is payable on the "change of ownership" document made for spouse or child before execution of the assignment deed. No SD is charged on the consideration – Note 4 and 5 to Head 1(1A)
- **S45** exemption is granted for transfer of property between associated companies – see below.

(3) Transfer of Hong Kong Stock

- Transfer of **shares listed in Hong Kong stockmarket**: SD for transfer of shares is charged under **Head 2** on bought note and sold note of the shares. The SD rate for the bought note and the sold note is 0.1% on the value of each transaction. SD for instrument of transfer is $5.
- Transfer of shares of a **private company** (whose **share register** is kept in Hong Kong): SD is 0.2% on the value of the shares transferred payable within 2 days of the execution of the contract note and $5 for the instrument of transfer.
- Value of the shares transferred refers to their **market value** of the transaction – see **S27(4)**. • In practice, the Collector of Stamp charges stamp duty based on the stated consideration • If the Collector subsequently opines that the stated consideration is less than the market value, he will raise a further assessment of stamp duty • **S14(1)**: A dutypayer can appeal to District Court within one month of the date of stamp duty assessment if he is dissatisfied with the assessment.
- **S24(1)**: Consideration for transfer of shares includes injection of fund.
- **S45** exemption is granted for transfer of shares and property between associated companies – see below.

(4) S45 Exemption

- S45 exemption is available for intra-group **transfer of shares** and **transfer of property** between **associated companies**.
- S45 exemption does not apply to transfer of property from a shareholder/director to a limited company or vice versa.

- **Adjudication** for S45 exemption is compulsory. The Collector's decision is final and conclusive.
- **S45(2)**: An associated company means one is the beneficial owner of at least **90%** of the issued share capital of the other, or if a third company is the beneficial owner of at least 90% of the issued share capital of each.
- **S45(5A)**: The associated relationship must remain for at least **2 years** after the transfer. If there is a change of shareholding, the dutypayer must inform IRD and then IRD will withdraw the exemption and raise an assessment of Stamp Duty accordingly.
- **Arrowtown** Assets case: **Beneficial ownership** is determined by substance. B shares without voting rights cannot qualify for S45 exemption. Case law principles of anti-tax avoidance is applicable to stamp duty.

• Case analysis: Co. A holds 90% shareholding of Co. B; whereas Co. B holds 90% of Co. C. Therefore, A has 90% x 90% = 81% shareholding in C. If a property of A is transferred to C, no S45 exemption will be allowed because the effective % shareholding is less than 90% threshold shareholding.

Author's advice

Beware, almost in every HKICPA Module D paper, there is a stamp duty question carrying about 4 to 6 marks. That means, you need 2 to 3 marks to get it passed. That means, every marking point in your answer counts. So, study hard and you will get passed with flying colours!.