

Question 1

1) A person carrying on trade, profession or business in Hong Kong with assessable profits arising in or derived from Hong Kong from such trade, profession or business will be chargeable to Hong Kong Profits Tax for each year of assessment at the standard rate under section 14 of the Inland Revenue Ordinance (“IRO”) excluding profits arising from sale of capital assets.

Secondment

BCL seconded four members to train GAL’s production team and got reimbursed for the staff member’s salary and 10% mark-up.

Showroom and e-trading

BCL is a Chinese company and earns trading profits from e-trading of DCDs, blu-ray discs and books in Hong Kong.

An issue is whether BCL is carrying on a business in Hong Kong through a permanent establishment in Hong Kong.

According to Article 5 in the Double Taxation Arrangement between China and Hong Kong (“DTA”), facilities solely used for display of goods is not a permanent establishment. The Hong Kong showroom is for displaying copies of the products but not for sale of the products. Therefore the showroom is not a permanent establishment in Hong Kong.

Another issue is to ascertain the source of the e-trading profits.

From Hang Seng Bank case, the broad guiding principle is one to look what the taxpayer is done to earn the profits and where it has done it. It should be the place where operation of the profit-generating activities is performed.

According to Department Interpretation and Practice Note 39 (“DIPN”) of IRD, profits from e-commerce is still following the broad guiding principle. The profit-generating activities from e-trading is BCL receives orders from customers and delivery of the products, which take place in China. The profits are not sourced in Hong Kong.

Therefore, the profits from e-trading is not taxable in Hong Kong Profits Tax. The expense for renting the showroom is not deductible.

Training services

The locality of service income is the place where the service is performed. Therefore the tuition fees received by BCL has a Hong Kong source.

The issue is whether the executive training centre is treated as a permanent establishment for BCL in Hong Kong.

BCL provided training in Hong Kong for 104 days for the year concerned through a place provided by the executive training centre. The centre provided administrative and marketing service to BCL with a charge of 50% of tuition fee. Therefore BCL is treated as carrying on a business in Hong Kong through

the executive training centre. The profits (tuition fee received) is taxable in Hong Kong under section 14 of the IRO and the expense to BCL is deductible under section 16(1).

2) With reference to the adjustment, the service income will be doubly charged and become taxable in both Hong Kong and China. The double taxation issue arises.

GFPL could apply for tax credits for Income Tax in China against the Hong Kong Profits Tax payable in respect of the income in Hong Kong under section 50 of the IRO.

The credit shall not exceed the amount which would be produced by computing the income amount charged to tax at the standard rate 16.5%. Any foreign tax amount exceeding the credit should be allowed as a deduction under section 50(5).

Question 2

Trading income and royalty income

A person carrying on trade, profession or business in Hong Kong with assessable profits arising in or derived from Hong Kong from such trade, profession or business will be chargeable to Hong Kong Profits Tax for each year of assessment at the standard rate under section 14 of the Inland Revenue Ordinance ("IRO") excluding profits arising from sale of capital assets.

As LL is a Hong Kong company, it carries on business in Hong Kong. The locality of trading income depends on the place where the sales and purchase contract is effected.

Only if both the sales and purchase contract are effected outside Hong Kong will the trading income have a non-Hong Kong source. If both or either of the sales and purchase contract is effected in Hong Kong, the trading income is sourced in Hong Kong.

In this case, as LL receives trading income from Hong Kong department stores, the whole trading income has a Hong Kong source. No apportionment is allowed.

Therefore, the trading income is taxable in Hong Kong under section 14 of IRO.

For royalty income, LL obtained the right to use the brand name and sub-licensing it to other companies for royalty income. The locality of the royalty income in this case is the place of granting and concluding the sub-license contract.

As LL negotiated and concluded the sub-license to GRL in Hong Kong, the royalty income is sourced in Hong Kong.

Therefore, the royalty income is taxable in Hong Kong under section 14 of IRO.

Deductibility of royalty and promotion expenses

Outgoings and expenses incurred during the basis period for the production for chargeable profits in Hong Kong Profits tax is deductible under section 16(1) of IRO unless the expense is specifically disallowed for deduction under section 17.

LL paid royalty fee to TL for using the brand name in Hong Kong department stores. As it is incurred in the production of chargeable profits of LL as stated in the answer above and is revenue in nature, the royalty expense is deductible.

LL incurred promotion expenses for the brand name for Hong Kong and mainland China market. If the promotion expenses are incurred for the production of the royalty and trading income which are taxable in Hong Kong, the expenses are deductible.

Other related issue

The royalty fee received by TL from LL is deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong under section 15(1)(b) for right to use in Hong Kong and 15(1)(ba) for right to use outside Hong Kong. Therefore TL is chargeable to Hong Kong profits tax in respect of its royalty income. It shall be chargeable either directly or in the name of its agent (LL) and is recoverable out of the assets of TL or from LL.

According to section 20A of the IRO, LL, as the agent, shall retain sufficient amount for the royalty fee to produce the amount of the tax of TL and is indemnified against any person whomsoever in respect of his rentation.

According to section 21A of IRO, though the royalty fee is derived from TL's associate LL, the percentage 30% of the royalty fee shall be used as the assessable profits as there is no evidence that the 'Toby' brand name was at any time wholly or partly owned by any person carrying on a trade, profession or business in Hong Kong.

Question 3

WML is a Hong Kong company which involves business in manufacture and distribution of electric cars. Management of MI should consider whether and how the income of WML is chargeable to Hong Kong profits tax.

The management should consider the country of residency of Subco. If Subco is a china enterprise, the way of assessing WML's manufacturing income depends on whether the processing agreement between WML and Subco is a contract processing agreement or import processing agreement.

Contract processing agreement

In the case of the contract processing agreement, WML provides raw material, machinery (computerised production system), technical and managerial know-how to Subco and Subco provides factory premise and labour for manufacturing the electric cars. Both legal title of raw materials and finished goods remain in WML.

As WML has substantial involvement in manufacturing the products in Mainland, IRD accepts to assess the manufacturing profits and the relevant expenses in a 50:50 basis. Though the production system will be denied for depreciation allowance under section 39E(1)(b)(i) or capital expenditure on the provision of the prescribed fixed asset under section 16G as the plant and machinery is used outside Hong Kong by a leasee, IRD will accept depreciation allowance of 50% by concession.

Import processing agreement

In the case of import processing agreement, it is considered as WML sells raw material to Subco and Suboc subsequently sells the finished goods to WML. WML makes profits from the difference in purchase price of the finished goods and selling price to its customers. If WML sells to Hong Kong customers, WML's profits will be treated as trading profits and will be assessed in full.

Question 5

1a) Assume that the listed securities held for trading purposes are under the fair market value. The revaluation gain or loss booked in Profit and Loss account should be included in tax computation in the same year of revaluation (taxable for gain and deductible for loss). The net amount of \$100,000 should be deductible in this question.

1b) Compensation of \$200,000 for early termination of tenancy agreement is of revenue nature because there is no loss in the capital asset. The compensation is taxable.

1c) bad debt is deductible if it was caused in a trade receipt and in a specific provision. Additional information is needed to check whether it is a specific or general provision.

1d) The exchange loss is in capital nature and is not deductible as it is in a bank deposit which is a capital of the company.

1e) Assume that there is no change of usage for the office. Building decoration expenses of \$1 million for refurbishment of an office is deductible under section 16F of IRO under 5 equal deductions beginning from the basis year that the expenditure incurred.

The refurbishment of director's residential quarters is not deductible under section 16F because it is a domestic building. However, commercial building allowance can be allowed with annual allowance of 4% of the capital expenditure incurred beginning from the basis year of which it incurred.

2) For interest expense to be deductible, it has to pass section 16(1), section 16(2) with restriction of section 16(2A), (2B) and (2C).

For expense for \$5 million and \$15 million loan, it passed section 16(1) and section 16(2) (a) but the amount will be restricted under section 16(2A) because it is secured by a deposit with the bank in which interest income is not taxable.

Question 6

Mr Bee
Salaries Tax computation
For the year of assessment 2015/16

			\$ Note
Salary (\$100,000*12)	1,200,000		
Share award		100,000	1
Holiday journey benefit	25,000		
Share option gain	<u>50,000</u>	2	
			1,375,000
Factor for time apportionment	<u>0.54645</u>	3	
Income after time apportionment	751,366		
Add: Rental value		<u>12,404</u>	4
Assessable income		763,770	
Less: Concessionary deduction			
Mandatory provident fund	<u>(18,000)</u>		
Net assessable income	745,770		
Less: Allowance			
Basic allowance		<u>(120,000)</u>	
Net chargeable income		625,770	
Tax in standard rate		111,865	
Tax in progressive rate		94,380	
Total tax payable (\$94,380-\$20,000)		<u>\$74,380</u>	

Note:

1) Share award is an allowance fully taxable at the time of the grant. The market value on the date of award (January 2016) is used for the computation.

2) Share option gain is taxable when Mr Bee exercised the share option to purchase 5000 shares. Share option gain = $(\$20 - \$10) * 5000 = \$50,000$.

3) Mr Bee has a non-Hong Kong employment as his employment contract was negotiated, concluded and enforcement outside Hong Kong. The residency of employer is outside Hong Kong and he did not have a new employment with BL.

4) Mr Bee paid \$25000 per month for rent. He was reimbursed of \$20000 per month by OC so he suffered rent (net amount) of \$5000 per month. Rental value is calculated under s.9(1A) (c) = $(\$1,375,000 - \$50,000) * 200/366 * 10\% - (\$25,000 - \$20,000) * 12$.

5) Part-time master's degree course was paid by Mr Bee in March 2015 which belonged to year of assessment 2014/15. Assume that Mr Bee claimed deduction for self-education expense in year of assessment 2014/15 and was allowed for \$80,000 (Maximum), the reimbursement amount of \$30,000 should be adjusted in year of assessment 2014/15 by additional assessment under section 60 of IRO.

Mrs Bee
Salaries Tax computation
For the year of assessment 2015/16

Salary			\$ 96,000
Travel allowance		<u>12,000</u>	
Net assessable income		108,000	
Less: Basic allowance	(120,000)		
Total tax payable		<u>NIL</u>	

2) Mr and Mrs Bee should opt for joint assessment as Mrs Bee has unutilized allowance amount. If they opt for joint assessment, the chargeable income from employment for Mr and Mrs Bee will be added in aggregate before deducting any allowance amount. Mr Bee can pay less tax by utilizing Mrs Bee unused allowance amount of \$12,000.