THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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PAPER 2.04 – HONG KONG OPTION

Suggested Solutions

PART A

Question 1

Part 1

According to the China-Hong Kong Double Taxation Arrangement (DTA), the profits of a mainland China enterprise shall be taxable only in the mainland unless the enterprise carries on business in Hong Kong through a permanent establishment (PE).

If the mainland China enterprise carries on business through a PE in Hong Kong, the profits of the enterprise may be taxed in Hong Kong but only to the extent of those attributable to that PE.

The term 'PE' means a fixed place of business, which may include:

- a place of management;
- a branch;
- an office;
- a factory;
- a workshop;
- a mine, an oil or gas well, a quarry or any other place of extraction of natural resources; or
- an agency with general authority to conclude contract.

For consultancy services, if the services have been furnished in one side for the same project or a connected project for a period or periods exceeding in the aggregate 183 days in any 12-month period, the provision of services will be treated as a PE in that side.

PE does not cover facilities or a fixed place of business for:

- storage, display or delivery of goods;
- purchasing goods;
- advertising, collecting information or other preparatory or ancillary activities; or
- belonging to the enterprises.

Analysis for the secondment arrangement

It was highly likely that the secondment arrangement was in fact a service provision arrangement. The staffs did not sign separate employment contracts with GAL. They were reported to and under the supervision of BCL's management in mainland China. BCL charged GAL on a cost-plus-mark-up basis, which would be regarded by the Hong Kong Inland Revenue Department (IRD) as a charge of service fee rather than actual salaries expenses. For provision of service, a PE would exist if the servicing period was more than 183 days within any 12-month period commencing or ending in the taxable year.

The servicing period is as follows:

- Staff 1 – 1/7/14 to 30/9/14 (92 days)
- Staff 2 – 1/10/14 to 30/11/14 (61 days)
- Staff 3 – 1/5/15 to 30/6/15 (61 days)
- Staff 4 – 1/12/15 to 31/12/15 (31 days)

For BCL's case, the first 12-month period is from 1/7/14 to 30/6/15, where the actual days of services were 214 days. This 12-month period commenced in the taxable year (Hong Kong profits tax) in 2014/15 and ended in 2015/16. This would render BCL being regarded as maintaining a PE in Hong Kong for both years 2014/15 and 2015/16. The last 12-month period ran from 1/1/15 to 31/12/15, where the actual days of services were just 92 days. However, this fact would not affect BCL's PE status for both years 2014/15 and 2015/16.

If BCL is treated as a having a PE in Hong Kong in this regard, BCL will be subject to profits tax in respect of profits attributable to the PE if such profits were arising in or derived from Hong Kong. As the services were provided in Hong Kong, the service fee would be regarded as derived from Hong Kong under the operation test (DIPN 21 and Hang Seng Bank case: one looks to see what the taxpayer has done to earn the profit in question and where he has done it).

Hong Kong showroom and e-trading

If the Hong Kong showroom just displayed books and discs of BCL, it might not be regarded as PE. However, if the showroom has done any activities outside the exemption scope (storage, display or delivery of goods; purchasing goods; or advertising, collecting information or other preparatory or ancillary activities), then the showroom would be regarded as a PE.

Moreover, if the showroom had stored goods/equipment for any entities other than BCL, it would also be regarded as a PE. If the showroom is regarded as a PE, all profits attributable to it should be subject to profits tax in Hong Kong if such profits were arising in and derived from Hong Kong. As the showroom had occasionally stored equipment of GFPL, it may be treated as a PE of BCL in Hong Kong. However, it seems the sales orders were not accepted in Hong Kong, the related trading profits were not derived from Hong Kong and hence the profits would not be subject to profits tax in Hong Kong.

As there is no PE for e-trading, profits derived from e-trading should not be subject to profits tax in Hong Kong.

Training services

For the training services provided at the training centre, BCL would be regarded as having a PE notwithstanding the servicing days were less than 183 days in total. It is because the training centre is a fixed place of business at the disposal of BCL, notwithstanding that BCL did not rent or purchase it. Consequently, all BCL's profits attributable to the training services would be subject to profits tax.

Part 2

When the Chinese tax authority makes the adjustment to increase the income attributable to the services done in mainland China, GFPL would be subject to a juridical double taxable if there is no corresponding adjustment (additional offshore profits) made by the IRD.

To avoid this juridical double taxation, GFPL could lodge a claim to the IRD to revise the offshore profit attributable to the mainland services. The relevant claim should be made under the "Business Profits Article" and section 79. The time limit for invocation of section 79 is six years after the end of the relevant year of assessment.

CIR would only be obligated to make corresponding adjustments up to the extent to which he agrees that the tax adjustments made by the Chinese tax authority represent the arm's length principle. If the Commissioner does not fully agree with the adjustment of the Chinese tax authority, it is expected that the two authorities would communicate with each other so as to resolve the issue (DIPN 45).

GFPL can also formally invoke the "Mutual Agreement Procedure Article" of the mainland-Hong Kong Double Taxation Arrangement (DTA). GFPL has to initiate the procedure with the IRD within three years from the time of the first notification is made to it by the Chinese tax authority in respect of the transfer pricing adjustment.

The IRD will then consider and resolve the case on its own if possible or where necessary, endeavour to resolve the issue with the Chinese tax authority (however without the obligation of necessarily reaching agreement with the competent authority of mainland) (DIPN 45).

Question 2

LL's tax position

There are two major questions relating to the royalty income and royalty expenses. First, whether the royalty paid to TL of HK$16 million and HK$4M is deductible and brand name promotion expense of HK$400,000 and HK$100,000 are deductible. Second, whether the royalty income of HK$5 million received from GRL is taxable.

Based on the general tax deduction rule under Section 16(1), LL would be able to deduct the royalty expense paid to TL if it was incurred in the production of assessable profits to LL. The royalty fee of HK$16M was paid for the purposes of running LL's department store business in Hong Kong and HK$4M was paid for sub-licensing the right to GRL in return for royalty income. The profit derived from the Hong Kong department stores are sourced from Hong Kong and hence taxable. Hence, the associated royalty expense of HK$4M would be deductible. The next issue is whether the royalty income received by LL from GRL is taxable. If the royalty received from GRL is assessable to LL, LL would be able to deduct the royalty expense of HK$4M paid to TL.

Whether the royalty income received by LL from GRL is taxable depends on whether the income is arising in or derived from Hong Kong.

Under DIPN No. 21 and DIPN No. 49, the Inland Revenue Department (IRD) mentions that the source of a royalty other than those deemed chargeable under Section 15(1)(a), (b) or (ba) is "place of acquisition and granting of the license or right of use" . Such approach is derived from the TVBI case. In TVBI case, the taxpayer acquired rights to show films by contracts negotiated and entered into in Hong Kong. It then licensed such rights to its clients outside Hong Kong. The Privy Council decided that the royalties paid by the overseas licensees were derived from Hong Kong and hence chargeable to Profits Tax under Section 14.

On the basis of DIPN No. 21 and No. 49, the source of the royalty income from GRL would be determined by looking at the place where the TL-LL license contract and LL-GRL sub-license contract are effected. If both contracts are effected in Hong Kong, i.e. LL acquired the right and granting the right in Hong Kong, the royalty would be regarded as sourced from Hong Kong. If either one contract is effected in Hong Kong, it is likely that the IRD will also regard the royalty is sourced in Hong Kong. It is only when both contracts are effected outside Hong Kong, could the related royalty income be regarded as offshore and non-taxable.

The ING Baring case states that in determining the source of profits, it should identify the critical operation responsible for the generation of profits. Accordingly, in the case where either one of the contracts is effected outside Hong Kong, if LL can substantiate that the one effected outside Hong Kong is more critical in generating the royalty income, the royalty income could be considered as sourced outside Hong Kong.

The sub-license contract with GRL was negotiated and concluded in Hong Kong. There is no evidence indicating the license contract with TL was effected outside Hong Kong. In the circumstances, LL's royalty income received from GRL of HK$5 million is likely to be arising in and derived from Hong Kong and hence taxable.

If the royalty income derived from GRL of HK$5M is assessable, the corresponding royalty fee paid of HK$4M would be deductible.

LL has incurred promotion fee of HK$100,000 and business tax in the Mainland of HK$250,000 (HK$5 million x 5%) in the production of the royalty income from GRL. LL has also paid income tax in the Mainland of HK$350,000 (HK$5 million x 7%). As the royalty fee would also be taxable in Hong Kong, income tax paid the mainland would be creditable, subject to the credit limit of Hong Kong tax payable.

The net Hong Kong tax payable of LL after allowance of credit limit is calculated below:

	HK$	HK$
Assessable income (royalty): HK$5,000,000 – 4,000,000 – 100,000 – 250,000)		650,000
Tax payable before allowance of tax credit @16.5%		107,250
Less: tax credit		
Income tax paid in China or	350,000	
The tax credit limit	107,250	
		107,250
Tax payable after tax credit		0

In accordance with section 50(5), tax paid in the Mainland which is not allowed as a tax credit, i.e. $290,719 ($350,000 – $59,281), can be allowed as a deduction as shown in the detailed computation below:

	HK$	HK$
Mainland tax paid		350,000
Net income from the Mainland after tax (grossed up at effective Hong Kong tax rate): HK$300,000 x [100%/(100% - 16.5%)]	359,281	
Less: Net income from the Mainland after deduction of tax	300,000	
Less: Tax credit limit for tax paid in the Mainland		59,281
Tax paid in the Mainland not allowed as a tax credit		290,719

	HK$	HK$
Hong Kong tax payable before tax credit: HK$650,000 – 290,719) x 16.5%		59,281
Less: Tax credit limit for tax paid in the Mainland		59,281
Hong Kong tax payable after allowance of tax credit		0

PART B

Question 3

The following profits tax and reporting issues need to consider in the acquisition of WML:

- Whether the profits tax returns in the past seven years have been filed properly and timely, the potential penalty for late or incorrect filing of the profits tax returns.

- Whether the employers' returns in the past seven years have been filed properly and timely, and the potential penalty for late or incorrect filing of the employers' returns.

- Whether WML has been keeping proper accounting books and records for ascertainment of its profits tax liability.

- Any tax objections outstanding, the issues in dispute and the tax exposure.

- Any outstanding queries from the IRD.

- Any tax payment outstanding and surcharge exposure, any penalty exposure.

- Offshore claim: Review WML operation and check if it is entitled to the 50:50 offshore basis as outlined in DIPN 21 in view of its involvement in the production process in the mainland.

- 50:50 apportionment basis should be entitled where a PRC party provides the factory premises, land and labour for a processing fee while WML will provide know—how, management, production skills, design, skilled labour, training and supervision.

- 50:50 basis is not applicable if it is merely a sub-contracting arrangement that is the PRC entity was carrying its production process independently, even though WML has involvement in the mainland production and such involvement was commercially essential to WML. (Datatronic case and CG Lighting case).

- Check if the above offshore claim has been agreed with the IRD and if not, why not.

- Once it is agreed, then unless the mode of operation has changed, the above benefits should remain after acquisition.

- Review deductibility of expenses and in particular the expenses apportionment claim.

- Review depreciation allowance and the basis for apportionment. There should be no deduction of depreciation allowance in respect of the machines provided by WML to the PRC entity under a sub-contracting arrangement (section 39E). However, if WML is entitled to 50/50 claim on its profit, it is also entitled to deduct 50% of the depreciation allowances of the machines used by the PRC entity in the mainland.

- Review mode of financing and whether the conditions under Section 16 are satisfied.

- Consider transfer pricing arrangements and see if the transfer price is not at arm's length and hence section 20 is applicable such that the non-resident is deemed to carry on business in Hong Kong and be assessed on its Hong Kong sourced profit.

- Inland Revenue Department may disregard transfer pricing transaction under section 61 (artificial or fictitious transactions) or section 61A (any transaction, where the sole or dominant purpose is for obtaining tax benefit).

PART C

Question 4

Hong Kong Stamp Duty is chargeable on the transfer of Hong Kong stock currently at 0.2% on dutiable value, which is generally determined, based on the net asset value of the stock being transferred. However, the Collector of Stamp Revenue (CSR) may revalue the assets of the company being transferred based on the relevant market value at the time of transfer, if the transfer value is not at arm's length. TL is incorporated in Hong Kong and its share register must be kept in Hong Kong. Therefore shares in TL are Hong Kong stock.

Part 1

This part involves the transfer of Hong Kong stock in TL to BL. The dutiable value would be the total consideration of HK$1,000M rather than just HK$900M. It is because under section 24(3), consideration for stamp duty purpose includes debts guaranteed. In this case, BL has signed an agreement with HS Bank to replace AL as the guarantor of the bank loan of HK$100M. Even though the sum of HK$100 million would not be received by AL, it is a consideration of the transfer. However, if the market value of the shares of TL to be transferred is higher than HK$1,000M, the dutiable value would be the market value because it would be a voluntary disposition (section 27(1)).

Under section 45, a transfer of stock within a corporate group where the transferor and transferee are associated corporations, may be exempted from stamp duty. Two corporations are associated if one is the beneficial owner of not less than 90% of the issued share capital of the other, or a third corporation is the beneficial owner of less than 90% of the issued share capital of each corporation. In this case, AL and TL are associated corporations. HL held 90% shares of AL. HL held 98% shares in BL (80% directly plus 18% shares indirectly through AL (i.e. 90% x20%)). The transfer of shares between AL and BL would be exempt under section 45, subject to the application of exception to such exemption, as discussed below. Adjudication is required for claiming the exemption under section 45.

However, exemption under section 45 will not be available if as part of the arrangement, the transferor and transferee cease to be associated by reason of change in the percentage of the issued share capital of the transferee held by the transferor or a third corporation (section 45(4)(c)). Even if such arrangement is not in existence at the time of transfer, if the transferor and transferee cease to be associated within two years, the stamp duty exemption previously granted will be "clawed back" and duty becomes payable. The transferor and transferee shall notify the CSR of that change of association within 30 days after the date of cessation (section 45(5A)).

Part 2

The issue of new shares to an independent third party will not result in cessation of the association relationship as BL was still 93.1% held by HL (directly: 76% + via AL: 90% x 19%) . Hence section 45(4)(c) is not applicable.

However, under section 45(4)(a), if the consideration of the transfer or any part of the consideration, where exemption is sought, was to be provided by a person other than a body corporate which was associated to the group, the exemption shall not apply.

The independent third party, DL subscribed new shares of BL. Therefore, section 45(4)(a) would apply to deny the exemption. Stamp Duty payable would be $1M (=HK$500M x 0.2%) (on the sale note and purchase note) plus $5 (on instrument of transfer).

Question 5

Part 1

A year-end revaluation gain of $200,000 and revaluation loss of $300,000 on listed securities held for trading purposes

A year-end revaluation gain on trading securities would not be taxable because it was not realized. According to section 14, no anticipated profits is taxable. Only profits that were realized, received or accrued should be taxable. (Nice Cheer Investment case).

However, a year-end revaluation loss that was regarded as a permanent diminution in value and material in nature for audit purposes would be deductible. For the purpose of section 16(1), a loss of an asset was incurred at the time the asset was bought (Nice Cheer Investment case).

For tax reporting purposes, subsequent to the judgment of the Nice Cheer Investment Limited, the IRD has agreed, as an interim administrative measure while pending review, to accept 2013/14, 2014/15 and 2015/16 profits tax returns in which the assessable profits are computed on a fair value basis.

The IRD agrees to re-compute the 2013/14, 2014/15 and 2015/16 assessable profits computed on a fair value basis if the taxpayers subsequently adopts the realisation basis. However, any request for re-computation should be made within the time limits laid down in sections 60 or 70A of the Inland Revenue Ordinance.

Compensation of $200,000 received for early termination of the tenancy agreement for a retail shop

Compensation received for early termination of the tenancy agreement of a retail shop would be a non-taxable capital gain if such tenancy represented the entire or a substantial part of Lion's operating structure. If this was the only retail shop of Lion and the tenancy agreement was still has many years to run, the compensation should be regarded as made for loss of the entire operating structure of Lion and hence capital nature. On the other hand, if it was just one of many short term tenancy agreements, and hence the cancellation did not significantly affect Lion's entire operating structure, and it was made to compensate the loss of profit as a result of temporary loss of usage of the shop, arguably, the compensation would be on trading account and hence taxable.

A bad debt of $200,000, representing a write-off of a Hong Kong bank account in which Lion had deposited trade receipts

The write off of bank deposit is not deductible under section 16(1)(d). Section16(1)(d) states that to qualify for deduction, it must be a bad debt either in respect of a trade debt previously assessed or money lent in the ordinary course of a money lending business carried on in Hong Kong. Once the trade receipt was placed in the bank deposit, its nature was changed to an investment asset. There is no evidence that depositing money is a normal money lending business of Lion. Accordingly, the write off is not deductible under section 16(1)(d).

An exchange loss on year end conversion of a Japanese yen-denominated bank deposit representing trading receipts from customers in Japan

Exchange loss on year end conversion of bank deposit of trade receipt is of capital nature and hence not deductible. The trade receipt became an investment asset when it was deposited at bank, re: Li and Fung v CIR [1980] HKTC 1193.

Building decoration expenses of $1 million for refurbishment of an office, and $200,000 for refurbishment of a director's residential quarters

According to section 16F(1), expenditure paid on building refurbishment though capital in nature would be deductible over 5 years, each year 20% on the expenditure, starting from the year the expenditure was paid. However, section 16F(1) is not applicable to a domestic building or structure. Therefore, the redecoration expense on the office should be deductible over 5 years, each year 20% on the expense whereas, the redecoration expense on the director quarter should not be deductible under s.16F(1). Such expense instead would be qualified for deductible commercial building allowance at 4% on the expense.

Part 2

Main points include:

- The loan of $5M was borrowed for purchase of machine. The interest expense related to this loan was incurred for the purpose of producing assessable profits and hence section 16(1)(a) is satisfied. However, the interest expense on the $15M loan was incurred for construction of a research centre and hence capital in nature and ranked for industrial building allowance.

- For the $5M loan for purchase of machine, both section 16(2)(e) (which requires the lender is not associated to the borrower and the loan is for purchase of trading stock or plant and machinery) and (2)(d) (which requires that the lender is a financial institution) are satisfied.

- As the $5M loan (interest expense of $500,000) was secured by $4M offshore loan which generated tax-free interest (provision of credit outside Hong Kong), the deductible interest expense should be reduced by $300,000 (non-taxable interest income), giving rise to deductible interest expense of $200,000.

Interest expense capitalized as cost of construction of research centre of $1.5M should be qualified for industrial building allowance. According to section 40, a building used for research and development purpose could be qualified as an industrial building. The secured loan test, which restricts deduction of interest under section 16(2A) is not applicable to this loan as the corresponding interest expense is not deductible under section 16(1)(a). Instead, an industrial building allowance (IBA) would be allowable. An initial allowance would be granted at 20% on construction cost incurred during the year, whereas an annual allowance at 4% on the qualifying expenditure would be granted starting from the year the building is completed and put into use.

<u>Question 6</u>

<u>Part 1</u>

	$
Mr. Bee's salary ($100,000 x 12) (1)	1,200,000
Refund of course fees (2)	30,000
Share award (3)	100,000
Holiday journey benefit (4)	50,000
	1,380,000
Apportioned income (200/365)	756,164
Rental value in excess of rent paid (($756,164 x 10%) - ($25,000 - $20,000) x 12) (5)	15,616
Assessable income	771,780
Less: Mandatory provident fund contribution (6)	18,000
Personal allowance	120,000
Net chargeable income	633,780
Tax payable at progressive rates: [($633,780 - $120,000) x 17% + $8,400] = $95,742 Tax payable at standard rate [($771,780 - $18,000) x 15%] = $113,067	95,742
Less: tax rebate at 75%, subject to limit of $20,000	20,000
Salary tax payable of Mr. Bee	75,742
Mrs. Bee's salary and allowance ($96,000 + $12,000)	108,000
Less: Mandatory provident fund contribution	5,400
Personal allowance	120,000
Net chargeable income	0
Tax payable	0

Notes:

- Mr. Bee was employed by OI. His employment with OI is likely to be a non-Hong Kong employment because OI is not a Hong Kong resident company and his employment should have been negotiated, concluded and enforceable outside Hong Kong. The place of payment being in Hong Kong would not affect the offshore position of the employment with OI. Therefore, time-apportionment is applicable.

- This is part of Mr. Bee's income and is assessable under section 9(1)(a). It accrued to him in 2015/2016, i.e. when his employer agreed to the refund, and is assessable in that year. The course fee was paid in 2014/2015 and is only deductible as a self-education expense in that year to the extent of $80,000 (section 12(1)(e)).

- The share award was derived from employment and hence taxable. On exercising the share option in April 2016 (i.e. 2016/17), the taxable amount is the market price of the shares less the cost of exercising, HK$50,000 [5,000 x (20-10)]. There is no taxable gain on granting the option.

- The amount taxable under section 9(1)(a) is the cost to the employer (section 9(2A)(c)).

- The rental value is computed based on the apportioned income, whereas the net rent borne by Mr. Bee is the overall yearly net rent borne by him (Williamson case).

- The amount deductible is restricted to the mandatory contribution and a maximum of $18,000.

Part 2

	$
Mr. and Mrs. Bee's total income ($771,780 + $108,000)	879,780
Less: Mandatory provident fund contribution ($18,000 + $5,400)	22,900
Personal allowance	240,000
Net chargeable income	616,880
Tax payable at progressive rates [($616,880 - $120,000) x 17% + $8,400]	92,869
(Note: Tax payable at standard rate ($879,780 - $22,900) x 15% = $128,532)	
Less: Tax rebate at 75%, limit at $20,000	20,000
Salaries tax payable	72,869

Mr. and Mrs. Bee should elect for joint assessment which would result in tax saving of $2,958 (75,827 – 72,869).

Question 7

Part 1

Deduction of trademark acquisition costs

With effect from 2011/12, cost incurred on acquisition of proprietary interest of a registered trademark is deductible over five succeeding years or the protection period, whichever is shorter, on a straight-line basis starting from the year of purchase (section 16EA(3).

However, deduction under section 16EA(3) would not be allowed in the following circumstances:

- If the relevant trademark was acquired from an associated party (section 16EC(2)).

- If at a time when the relevant trademark is owned by the taxpayer, a person holds right as a licensee of the relevant trademark, and the relevant trademark was, before it was purchased by the taxpayer, owned and used by that person (section 16(EC(4)(a)). Section 16EC(4)(a) does not apply if (a) the relevant trademark was purchased by the taxpayer from the end-user with a consideration not more than the consideration paid by the end-user to the supplier for purchasing the relevant trademark from the supplier, (b) the purchase referred to in (a) by the end-user from the supplier occurred on or after 16 December 2011, and (c) no deduction under section 16EA has been allowed to the end-user in respect of the relevant trademark at any time before the purchase of the relevant trademark by the taxpayer (section 16EC(5)).

Taxation on royalty payment

Income for the use or right to use in Hong Kong a trademark is deemed to be income arising in or derived from Hong Kong from a trade or business carried on in Hong Kong (section 15(1)(b)). The assessable profits of the recipient of sums chargeable under section 15(1)(b) are deemed to be 30% of the sums received normally. However, the assessable profits would be 100% of the sum if the recipient is an associate of the payer and the trademark has been owned by any person carrying on business in Hong Kong before (section 21A).

Part 2

Trademark “Amigo” transaction

DL acquired “Amigo” from an associated party and hence there would be no deduction under section 16EC(2).

Trademark “Bold” transaction

DL would not have any deduction in respect of the acquisition price of “Bold” (HK$1.5 million) because section 16EA has not yet been effective in the year 2009 and the acquisition cost should be capital in nature and not deductible under section 17(1)(c).

The sales proceed of “Bold” would be non-taxable because it should be capital in nature and not deemed as a taxable trading receipt under section 16EB(2).

The payment of royalty by DL to BL (HK$100,000 per annum) was incurred in the production of assessable profits and hence deducible under section 16(1).

BL did no carry on business in Hong Kong. Hence the royalty payment would not be taxable under section 14. However, the royalty payment was made for the right to use “Beta” in Hong Kong and would be deemed as a taxable trading receipt under section 15(1)(b). BL and DCL were associated companies. “Beta” had been owned by DCL which carried on business in Hong Kong. Therefore, the assessable profits of BL would be 100% of the royalty sum (section 21A). DCL would be obliged to withhold and report profits tax for and on behalf of BL. The profits tax to be withheld should be HK$16,500 (=HK$100,000 x 16.5%).

Trademark “Growth” transaction

It was a “sale and lease back” transaction. Section 16EC(4)(a) would apply to deny the deduction under section 16EA to LL unless the exception provision under section 16EC(5) applies.

There are 3 condition to be fulfilled altogether in order to apply section 16EC(5). The first condition was not satisfied because the purchase price of LL (HK$1.1 million) was higher than the price which DL paid to the supplier (HK$1 million). The second condition was satisfied because DL purchased “Growth” after 16 December 2011. The third condition that there was no deduction to the end-user was also satisfied because DL had never used “Growth” since acquisition. DL would not be entitled to any deduction under section 16EA. Notwithstanding the last two conditions were satisfied, the exception rule under section 16EC(5) would not apply because the first criterion was not met. Therefore, LL could not claim deduction under 16EA on the purchase price of “Growth”.

The sale proceeds of “Growth” would not be taxable to DL as it should be capital in nature and not deemed as a taxable trading receipt under section 16EB(2), which limit the taxable amount to the deduction allowed before.

DL could claim deduction on the royalty payment under section 16(1) as it was incurred in the production of assessable and such royalty would be a taxable business income to LL under section 14.