Answer-to-Question- 1

1)

Hong Kong profits tax liability arises when:

a) the company carry on a trade, business or profession,

b) the company derive profits from such trade, business or profession, and

c) the profits are deriving from or within Hong Kong, with the exception to those capital income.

Rose Ltd is carrying on a trading business in Hong Kong and the source of trading profits is determined based on the contract effected test.

The contract effected test does not merely mean the execution of contract but include the process of negotiation to the conclusion of contracts. If both purchase and sales contracts are effected inside HK, then the trading profits would be onshore sourced and subject to profits tax. If either the sale or purchase contracts are effected outside of HK, the trading profits are still considered as HK sourced and subject to tax. If both sales and purchase contracts are effected outside HK, the trading profits would be offshore sourced and non-taxable.

Other than contract effeceted test, it is also important to scrutinize the operations to ascertain what and where the work is performed in order to earn the income in question.

During the year ended 31 December 2015, Rose Ltd has established 10 wholly owned subsidiaries in the PRC to promote its products to PRC customers. The PRC subsidiaries would act on Rose Ltd's behalf to negotiate and finalize trading terms with the PRC customers. Although there is no agency agreement signed between Rose Ltd with the PRC subsidiaries, it is clear that the PRC subsidiaries are acting as an agent in PRC for Rose Ltd. With reference to Mcquarie case the work done by the PRC subsidiaries are significant in earning the relevant profits from the PRC customers. Without the work performed by the PRC subsidiaries, Rose Ltd would not have earned the profits from the PRC customers. The work performed by Rose Ltd in HK e.g. placing orders with Dandillion should be considered as preparotary and auxiliary. On this basis, since the work by PRC subsidiaries are all performed in China, the sales income attributable to the PRC sales should be considered as offshore sourced and non-taxable for HK tax purposes.

When sales attributable to PRC customers are non-taxable, the relevant services fee (5% of sales) paid to PRC subsidiaries should be disallowed as a deduction.

During 2016, Rose Ltd's marketing managers would travel to the PRC to promote its business. With reference to the abovementioned contract effected test, if any contracts are concluded by these managers in the PRC, such profits could also be considered as offshore sourced and non-taxable as the managers are promoting, soliciting and concluding the contracts with the PRC customers in the PRC. Corresponding expenses e.g. salaries, travelling costs or an apportioned expenses (may be based on turnover basis) attributable to these PRC sales should also be disallowed.

Of course, when the staff of Rose Ltd negotiate and conclude contracts with HK basesd customers in HK, such profits should be onshore sourced and taxable.

2)

When PRC tax authority has adjusted upward the profist from the sale to China customers, this would mean the HK tax authority has over-charged Rose Ltd becuase the share of profits attributable to HK operations should be less according the adjustment made by PRC tax authority.

Rose Ltd can re-open the year of assessment with HK tax authority to seek re-assessment on the revised downward adjustment.

If HK tax authority does not agreement to the adjustment, Rose Ltd would also rely on the mutual agreement procedure stipulated under the HK/PRC tax treaty where this provision provide a channel for both tax authorities involved to negotiate and compromise the adjustments on the captioned income. Nonetheless, this is not guaranteed a conclusion would be reached and the procedure could be time-consuming as well.

---------DO-NOT-EDIT-THIS-DIVIDER----------

Answer-to-Question- 2

1)

According to the DTA, a HK resident company would be subject to PRC enterprise income tax if it carries on business in PRC through a permanent establishment situtated there in. [Article 7]

Permanent establishment is defined under Article 5 to 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

The term "permanent establishment" also encompasses

i) a building site, construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than 6 months

ii) the furnishing of services, including consultancy services, by an enterprise of one side in the other side, directly or through employees or other personnel engaged by the enterprise, but only if such activities continue (for the same or a connected project) for a period or perios aggregating more than 183 days within any 12-month period.

2)

BHK would grant GAC the right to use BDEES in return for a fee.

BHK would send technician to PRC in configuring GAC's computer systems to operate BDEES. Also, BHK would provide on-site BDEES technical support at GAC's Guangzhou office. In accordance with the definition of PE under tax treaty between HK and the PRC, the serivces provided by BHK in PRC would consitite a PE in China if BHK's employees furnish the services for a period more than 183 days within any 12-month period. The stay period of technican in configuring the system as well as the on-site support should be considered together as they are related to a connected project on BDEES. If BHK's employees do not stay more than 183 days in any 12-month period, BHK would not create a PE in China. If BHK's employees stay more than 183 days, BHK would have created a PE in China and profits attributable to this PE should be subject to EIT.

3)

BHK developed a computer programme BDEES in Hong Kong. In this case, the source of royalty could be deteremined based on where the programme was developed. Therefore, the income should be onshore soured and subject to HK profit tax.

Nonetheless, GAC would pay royalty to BHK for the usage of BDEES. When the payment is considered as rotyal in nature, this may imply GAC is actually paying the proprietary right in the programme BDEES. In such case, the source of the payment could arguably be determined based on the place where the programme is used and in currect context, GAC use the programme in China. Therefore, the royalty income earned by BHK should be considered as offshore sourced and not-taxable.

4)
BHK owns 50% in GAC. According to Article 10 (2)(1) of the DTA, the dividend paid by GAC to BHK should be subject to PRC withholding tax at 5% (i.e. 5% on RMB1m). BHK would received RMB950,000 from GAC.

BHK would then pay such dividend to BAL. There is no withholding tax imposed on dividends under HK tax regime. Therefore, BHK would pay RMB950,000 to BAL.

5)
Since BHK owns more than 25% interest in GAC,any gains derived from the sale of interest in GAC should be subject to PRC EIT in accordance with Article 13(1)(5).

---------DO-NOT-EDIT-THIS-DIVIDER----------

Answer-to-Question-   3

Transactions between related companies should be conducted on an arm's length basis i.e. the price should be commensuate to those charged by unrelated companies on the same services or transactions.

There are several anti-avoidance provisions under IRO which tackles situations where the trasnactions are not entered into on an arm's length basis and IRD has authority under these provision to make necessary transfer pricing adjustments.

Section 20 of IRO stipulated for transactions entered into with overseas related companies and if they are not conducted on an arm's length bais, the IRD may disregard the transaction and tax the transaction as if there was no involvement of the overseas companies.

When the company entered into artificial or fictitious trasnactions i.e. underreport income, ommiting income, Section 61 of IRO could also come in place and IRD has the authority to recompute the income level as they think appropriate.

There is also Section 61A of IRO which attack transactions where they are entered into for the sole and dominant purpose to obtain tax benefits (postponement or reduction of tax payments).

The IRD has also issued Department Interpretation and Practice Note on trasnfer pricing. Although this practice note is not legal binding, it provides acceptable transfer pricing methods for related party trasnaction and IRD's view and practice when dealing with related party transactions.

With the Base Erosion of Profit Shifting project initiatives, HK tax authority would take more stringent approach in scrutinizing transfer pricing issues and it may issue formal transfer pricing rules in the near future.

Basd on the information provided, CCL was charged at cost plus 30% mark up. IRD has indiciated for related transaction, a mark up of 12.5% may be considered as appropriate, therefore, IRD may challenge the high mark up charged by BC PRC. In particular, BC is currently enjoying a preferential tax rate of 12.5% in China which is lower than HK income tax rate of 16.5%, IRD may challenge the high mark up is to retain more profits in China which is subject to a lower tax rate. The sale by CCL to its clients in HK are transactions with unrelated companies and they will be no transfer pricing issue.

Nothwithstanding the above, CCL profits are 3 times of that of BC, this may indicate the BC may not include all related costs they incurred in the manufacturing which lead to undercharge CCL despite a high mark up has been incorporated. This is however, out of the scope of IRO.

2)

BC and CCL performance outweight competitors due to their unique strategy. Comparables may not be available and CUP may not be appropriate. When the management is concerned the profits of CCL is 3 times of BL, they may review BC costs of manufacturing process and determine whether a cost sharing agreement would be required.

---------DO-NOT-EDIT-THIS-DIVIDER----------

Answer-to-Question-   5

1)
DBC is not a financial institution.

The interest income of HKD300,000 should be taxable as it is used to secure bank loan borrowed by DBC's overseas subsidiary. Interest Exemption Order is not applicable.

Gain on revulation of staff quarter of HKD20m should not be taxable as the gains is capital in nature even it is unrealized as current practice of IRD still follow the Shakey approach.

Gain on revaluation of trading securities should not be taxable because due to the Nice Cheers case, only real gain should be subject to tax. The revaluation gain is only an ascetained and estimated amount.

2)
Gain of HK$300K on disposal of a proprietary interest in a registered product design should be non-taxable as it is capital in nature.

DBC purchase a registered trademark and it can be deducted over 5 annual instalment i.e.

HKD400,000 is deductible for year 2016/2017 even it is not yet reflected in P/L.

3)
Decoration of a product research center of HKD2m is deductible as they are relating to research and development.

4)
Bank charges associated with trading transactions. They shoud be deductible as they are incurred in the production of taxable income.

Interest expenses of HKD140,000 should be

5)
The repair expenses is for replacement of cooking equipment. They should be deductible.

6)
The write off of loan of HKD19,500 should be non-deductible. The interes portion is deductible as interest income should be previously treated as assessable.

Provision of 5% on total trade debtor's balance should be disallowed because the amount is not specific according to Section 16(1)(d) of IRO.

---------DO-NOT-EDIT-THIS-DIVIDER----------

Answer-to-Question- 7

In the past, HK company may be denied interest expenses deduction when they source funding from offshore group companies as the interest income is not subject to HK tax. This create unbalanced treatment where interest income is subject to tax (provision of credit is in HK) while relevant interest expenses is not deductible.

To promote HK as a treasury hub, HK IRD has issued new rule to provide tax incentive on

treasury company which carries on qualifying transactions as stated below:
- entering into intra-group financing transactions
- proivding corporate treasury services
- entering into corporate treasury transactions

Concessionary tax rate on treasury company is 50% of 16.5%.

1)
FL may not be benfit the new tax incentive as there is a safe habour limit. If the company carried on other transactions, the qualifying treasury transaction should reach at least 75% of the turnover/asset of the company in order to be considered as a qualifying treasury company.

2) The tax incentive is only applicable to HK incorporated company and does not extend to branch of an company. So BI's branch would not be elible for the concessionary tax rate.

3) Yes, when a new company is set up and wholly performed the above qualifying transaction in HK, it can enjoy the reduced tax rate.