Question 1

Part 1

In section 20(1)(a) of the Inland Revenue Ordinance (IRO), a closely connected person is defined as one where a person is substantially identical to another, or where the ultimate controlling person of each is owned or deemed to be owned by the same person or persons.

In s.20(1)(b) the controlling interest of a company is deemed to be owned by the beneficial owners of its shares, whether held directly or through nominees.

Essentially, where a person is a natural person, the Inland Revenue Department (IRD) would look at relatives of that person, partners of that person and any relative of that partner.

For companies, connected persons are essentially those companies that have a shareholding relationship.

If a company is holding shares on behalf of another company, the beneficial owner is the company who is the actual beneficial owner.

A beneficial owner is usually the company that has the right to receive dividends on the shares and the right to vote on those shares.

The commissioner has discretion to decide based on the facts of the case.

Part 2

Transaction 1

Proposed restructuring exercise 1 involves purchasing a supplier that has not run its business well. This supplier has substantial tax losses. It appears one motive is to utilise those tax losses by transferring a business to that entity and sell products to MGL at a higher price.

The IRO provides in s.61(B) the right to the Commissioner to prevent the set-off of losses in cases where i) there is a change in shareholding of any corporation (this is the case here) and ii) the sole or dominant purpose of that change is to utilise any loss.

Accordingly, the IRD would very likely invoke s.61B as the motive of transferring the business and raising selling prices prima facie looks as though it is intended to utilise the tax losses.

If there can be any commercial justification for the purchase of the business and restructuring, it may be possible to defend against the application of s.61B, but this would require careful planning and good documentation e.g. to prove that the selling prices should normally be higher, that the restructuring has additional commercial benefits which are unlocked by the business reorganisation.

Transaction 2

In this transaction a new company is set up in another territory (MSL) which will source products and sell products to MGL.

There are a number of important considerations with a transaction of this nature.

Firstly, the question of whether MSL can actually be considered as carrying on a trade in Hong Kong. This would be the case if in fact the staff of MGL continue to operate the new company. In this case, it may be that s.14(1) is applicable and the profits of MSL are subject to tax as it is carrying on a trade or business in Hong Kong which derives profits from a Hong Kong source (i.e. the purchase and sale of products to a Hong Kong company).

It would also be important to check the provisions of s.20 which provides that where a non-resident person carries on business with a resident person with whom he is closely connected (it is assumed that the new company is closely connected though we are not informed this is the case), and such business is structured such that the resident person derives no profits or less than ordinary profits.

If these conditions are met, the business of the non-Hong Kong person will be deemed to be carried out in Hong Kong by the Hong Kong person and the non-resident person will be taxable in the name of the resident person as if the resident person were the non-resident's agent.

We don't know whether this restructuring will produce no profits or less than normal profits for MGL. However, if it does, the IRD could use this section to tax the profits of MSL in the name of MGL.

The other provision of the IRO which are potentially relevant are s.61 and s.61A.

Section 61 gives the IRD the power to disregard certain transactions if the transaction has the effect of reducing the tax payable and the transaction is artificial or fictitious.

There is no evidence that this is the case here, however, a careful analysis of the arrangements would be needed to see whether there is any commercially artificial or unrealistic elements or disguised elements or whether the transaction is a sham to avoid or reduce tax. The definition of artificial and fictitious was considered the cases of Howe Hong KongTC936 and Seramco Ltd.

The other section that is important is section 61A which is a general anti-avoidance provision which gives the power for the IRD to reconstruct a transaction or deny any tax benefit that arises where a taxpayer obtains a tax benefit and the relevant transaction has been entered into for the sole or dominant purpose of obtaining the tax benefit.

While there is no immediate evidence this will apply to MGLs proposal, the IRD would consider firstly whether there is a tax benefit and then whether there is any motive by considering a number of factors including the Ramsey Principle, i.e. looking at the manner in which the transaction has been structured, the form and substance of that transaction and a number of other factors including whether the terms and conditions are at arm's length.

This is particularly relevant as in the Ngai Lik case, the taxpayer was subject to 61A when prices for transactions to associated persons were not at arm's length.

The IRD would generally apply the terms of DIPN46 to assess whether the selling prices to MGL by MSL were on arm's length terms, conditions and prices.

Part 3

Rental income

Hong Kong has a territorial tax system and hence only profits which arise in or are derived from Hong Kong are taxable in Hong Kong. This question of source is very important and the IRD has helpfully provided extensive guidance in DIPN21.

In Para45(a) of DIPN21, the IRD confirm that rental income has a source in Hong Kong where the location of the property is in Hong Kong.

Accordingly, the rental income of the property in Australia will not be taxable in Hong Kong as the test set out in s.14(1), that the income be sourced in Hong Kong is not met.

Interest income

DIPN 13A sets out the IRDs explanation of the deductibility of interest expenses.

Interest income is deductible for Hong Kong profits tax purposes if the provisions set out in s.16(1) (a) and s.16(2)(a)-(f) and s.16(2A), (2B) and (2C) are met.

MGL will borrow funds from a bank in Hong Kong for two purposes:

- to finance the Hong Kong operation; and
- to finance the newly expanded investment in Australia.

For the Hon Kong operation financing, it is assumed this relates to ordinary working capital and not any other purposes (e.g. the proposed restructuring operations).

In such case, the interest expense could be said to be incurred in the production of assessable profits and hence be deductible under s.16(1)(a) subject to meeting the other conditions.

We know the funds are borrowed from a bank in Hong Kong and hence the condition set out in s.16(2)(d) is met.

Accordingly, this interest is deductible if the interest is not guaranteed by a deposit that is exempt from tax (offshore deposit) (s.16(2A)) which appears to not be the case and for there to be no interest flow back (2B). Again this appears not to be the case.

For the portion relating to the investment in Australia, this will not be deductible as the investment is not made in the production of assessable profits. The income from the expenditure is on a capital asset and moreover the resulting income is not subject to Hong Kong profits tax.

The interest expense could be apportioned to work out the deductible element according to Inland Revenue Rule 2A and DIPN3.

Question 3

Part 1

Salaries tax computation for Mr & Mrs Chan (Tax year ended 31 March 2014 / Year of assessment 2014/15):

**Mr Chan**

| | |
|---|---|
| Monthly salary | |
| 100,000 x 12 | 1,200,000 |
| Less: | |
| Time apportionment (a) | |
| (non-Hong Kong employment) | |
| 226 / 365 | (456,986) |
| Taxable salary | 743,014 |
| Reimbursement of tuition (c) | 30,000 |
| Holiday journey (d) | 100,000 |
| Excess rent allowances (b) | |
| 12 x 5,000 | 60,000 |
| Net assessable income | 933,014 |
| Rental allowance | |
| 10% x 933,014 | 93,301 |
| Less: Concessionary allowances | |
| MPF (e) | (17,500) |
| Chargeable income | 1,008,815 |

Tax due
Standard rate =
1,008,815 x 17% = 171,499
Progressive rate
1,008,815 – 120,000 (basic allowance) – 120,000 x 15%
Tax due = 115,322 + 8,400 = 123,722
Progressive rate is lower, less tax rebate 75% capped at HKD10,000
Tax payable – 113,722

**Mrs Chan**

| | |
|---|---|
| Salary | 50,000 |
| Sum in lieu of leave | 1,000 |
| Less: MPF | (10,000) |
| Net chargeable income | 41,000 |
| Less: Personal allowance | (120,000) |
| Tax due | NIL |

Part 2

Secondment in Hong Kong

Time apportionment is applicable for non-Hong Kong employments according to the three tests set out in DIPN10 and following the guidance in the Goepfert case.
If an employment is with a non-Hong Kong company, or if the contract has been negotiated overseas and is enforceable overseas iii) the salary is paid overseas, the employment may be considered non-Hong Kong source.

In such a case, the taxable amount is based on the number of days (including pro-rata holiday days) actually spent in Hong Kong.

Mr Chan is employed by Bee, Inc. which is a US company and the contract of employment is with BI. No new contract was signed with the Hong Kong company to which he is assigned.

The IRD would likely treat this as a non-Hong Kong employment even if the third test is not met due to the totality of facts approach.

If there are less than 60 days, depending on the visit status of that individual i.e. whether they can be considers as visitors (may not apply if family are in Hong Kong), then the full income is exempt. A tax treaty may increase this time.

Total days in Hong Kong = 200 + 20 leave days + 6 = 226 days in Hong Kong
Leave days outside Hong Kong deemed spent in Hong Kong = 10 x (200+20/200+20+135) = 6

Rental refund

As the rent and costs are less than the rent reimbursement, the excess is considered taxable i.e. HKD5,000 is subject to salaries tax.

As there is a flat which is part of the rental reimbursement, the assessable amount is based on 10% of this value (8% due for hotel room (two rooms) and 4% for one room) under section 9(2).

Payment and reimbursement of the tuition fee

The payment of the tuition fee was made in March 2014. As this payment was made prior to the start of the current assessment year (14/15), there will be no self-education allowance available.

Normally there is a cap of HKD80,000 for such costs. If Mr Chan is due to pay salaries tax for 13/14, it may be possible to deduct this in the prior period.

The reimbursement from the employer is treated as a reimbursement of a private expense and considered as a taxable amount. Hence, this is subject to salaries tax under s.9(1).

Package tour benefit

The benefit of a holiday journey is taxable under s.(9)(2A)(c) which specifically provides this is taxable. This is even the case where s.9(1)(a)(iv) provides that payments made under an arrangement between an employer and a third party are not normally taxable. DIPN41 sets out the views of the IRD on this matter.

The benefit would be considered the portion attributable to Mr Chan's wife as the portion for him could be regarded as part of the business trip. The IRD sets out in DIPN9 that it would generally allow travel expenses to be deductible (or not taxable if paid direct by the employer).

Contribution to provident fund

DIPN9 para 41 sets out that the IRD will permit the deduction of MPF expenses subject to a cap. The cap is provided for in the IRP and updated from time to time. For 14/15, the cap is HKD17,500 and hence the deduction is restricted to this level.

Share option benefit

Share options are taxable upon exercise. However, this is only the case where the share option exercise relates to the Hong Kong employment. As the option exercised relates to the grant of an option (with no vesting conditions) in March 2013, this does not relate to the Hong Kong employment (which started in March 2014).

DIPN38 (Part 1) sets out the views of the IRD on the taxation of options exercised and para 43 deals with a non-Hong Kong employment.

As the exercise does not arise from services rendered in Hong Kong, there is no tax. If there is any gain on the actual shares when eventually disposed (after the exercise), this gain would be regarded as a capital gain and hence not taxable.

Part 3

The election for joint assessment will provide a tax benefit to the couple as under separate assessment, Mrs Chan does not make full use of her personal allowance.

By joint assessment, the full married couples allowance of HKD240,000 will be deductible from the combined income of Mr and Mrs Chan.

The overall tax payable by the couple under the progressive rates will be lower.

Joint assessment is possible if the couple are married by election under s.10(2) if both husband and wife elect at any time during the year of assessment or following the year of assessment within one month after the date the assessment becomes final.

Part 4

The Chans can elect for personal assessment since both of them were resident in Hong Kong during the year of assessment. This will be beneficial for the following reasons:

i) A deduction for home loan interest. This will be deductible in full. If the Chans paid property tax, the interest deductible would be capped at the assessable value determined under s.5B.

ii) losses from consultancy business. The adjusted loss of HKD50,000 would be deductible from the combined income, assuming that no salary was deducted from this amount.

Question 4

Part 1

A Hong Kong company is subject to Hong Kong profits tax if they meet the conditions set out in s.14(1), that:

i) there is trade or business carried out in Hong Kong;
ii) there are profits (not capital profits) from that trade; and
iii) the income arises or is derived from Hong Kong.

The third test is difficult to assess in some cases as there is no further guidance in the IRO, and we are reliant on a body of case law and the IRDs guidance in DIPN21.

If income has a source offshore, then the income is not subject to Hong Kong profits tax.

For ML, we know that it has set up a separate company to manufacture goods and to act as a sales agent.

ML is not a manufacturer in this situation as this is sub-contracted to the PRC subsidiary. Hence the apportionment of the manufacturing profit is not applicable and ML is not taxable on this. The manufacturing activity takes place wholly outside Hong Kong and by a separate company.

ML is thus a trader and the key question is how to assess whether income arising is subject to Hong Kong profits tax.

The Hang Seng Bank and TVBI cases presented us with the Operations Test, that one looks to see what has been done and where one has done it. This is of most relevant to services and operations.

Accordingly, this has been further developed into the Contract Effected test which applies specifically to trading transactions. As elaborated in the Magna case, all relevant actions carried out to earn the profits, including the solicitation of orders, negotiation, conclusion, trade finance, shipment and performance of contracts are relevant.

The actions of an agent are considered that of the principal.

In this case, we know that RL is appointed a sales agent with the right to operate within pre-defined parameters, to accept orders and to deliver goods directly. Hence one would initially presume that the actions are offshore and hence the purchase and sale contract is offshore.

However, the strategic marketing decisions and the financing are carried out from the office in Hong Kong.

Accordingly, it is possible the IRD would view that the contracts are effected in Hong Kong.

It really depends on the substance of the actual arrangement and how important each component is to the generation of the profit. It looks as though the strategic marketing and financing could be crucial which could bring the activity onshore.

Accordingly, if taxable, the whole profit generated would be subject to tax as the IRD does not agree to the apportionment of trading profits.

Part 2

A Hong Kong company trading in the PRC would be subject to tax if it creates a permanent establishment (PE) in the PRC according to Article 5 of the Hong Kong-PRC tax treaty.

There are three primary ways in which a Hong Kong business can create a PE. This includes the creation of a fixed place PE. This is generally where a Hong Kong company is operating in PRC through an office of fixed place of business and must carry on part or all of the business of the enterprise in PRC. A PE can also be created if that place of business is considered a “place of management”.

A building site or construction project can also be considered to be a fixed place PE provided that this is a continuous project which lasts more than six months in any 12 month period.

The second main way in which a PE can be created is by a Service PE. This can be triggered if employees of a Hong Kong company provide consultancy services or other services while physically located in the PRC.

If such services are provided on a connected project for more than six months in any 12 month period, then a PE can be created.

The final way in which a PE can be created is if a Hong Kong company appoints an agent in the PRC to act on behalf of the Hong Kong company. The PRC agent must be a “dependent agent” which must have the right to conclude contracts on behalf of the Hong Kong company.

There are exclusions to the above rules which could apply to a Hong Kong company and these are set out in Article 5:

- Activities of an auxiliary of preparatory character – generally activities which are not core to the overall business would not be considered a PE (the profits from these activities would still be taxable); and

- Use of facilities for storage, display or delivery of goods and maintenance of a stock of goods for processing for another enterprise.

Withholding taxes

There may also be cases where income is derived from activities in PRC. Dividend income would generally be subject to PRC withholding taxes. As dividend income will not be subject to Hong Kong tax (as it is exempt), there is no need to take a foreign tax credit under s.50(1) and s.50(5).

Income tax implications of proposed secondment arrangement

As ML will second staff to work at RLs office in product development, the question is whether a fixed place PE arises. As this activity is carried out in PRC and the staff will report directly to ML’s directors, it could be considered that a fixed place PE exists.

Accordingly, the staff will be fully subject to PRC taxes as the cost incurred (paid by RL to ML) can be considered as cost borne by a PE in PRC. The dependent services article in the Hong Kong PRC treaty provides that where services are provided by a PE, the conditions to provide for exemption from PRC taxes if the employee stays less than 183 days in the calendar year do not apply (the remuneration is borne by a PE / fixed base which the employer has in PRC)

Part 3

ML will be subject to Withholding Income Tax (Enterprise Income Tax) on the gains arising from the disposal of the shares.

The tax will be due on the gain from the disposal, with no set-off of any capital losses. Transaction costs will not be applicable.

Business Taxes may be due on the disposal in PRC.

As ML is a resident of Hong Kong (it is incorporated in Hong Kong, carries out a business here and is centrally managed and controlled in Hong Kong), it may be possible to claim an exemption from the tax due by virtue of the capital gains tax article in the Hong Kong-PRC double tax treaty (Article 13).

As the total holding in the company is less than 25%, prima facie, Article 13(5) would apply to provider a full exemption from WIT.

However, as the company in question is potentially “land rich” i.e. is a property / real estate owning company, the provisions of Article 13(4) may be applicable.

To be land rich, more than 50% of the assets (being immovable property) based on the accounts of the company at any point in the three years before the sale of the shares.

As the shares were sold in 2015, we look at the book values (per accounts) in 2014, 2013 and 2012 to assess whether a company is land rich or not:

- 2012 = Book value / total assets = 80 / 200 < 50%
- 2013 = Book value / total assets = 145 / 300 < 50%
- 2014 = Book value / total assets = 160 / 350m < 50%

As for each of the years, the 50% threshold is not met, the full gain should be exempt from PRC income taxes under the Hong Kong-PRC tax treaty.

The new Hong Kong-PRC tax treaty (not yet in force) removes the land rich requirement.

Question 6

Part 1

Berry Ltd (year of assessment 2014/15):

Basis period – year ended 31 March 2015

| | |
|---|---|
| Net profit before taxation | 3,000,000 |
| | |
| Add: | |
| Capital items / disallowable items | |
| | |
| Depreciation | 300,000 |
| Repair expenses | 100,000 |
| General provision | 10,000 |
| | |
| Less: | |
| Non-taxable items / deductions | |
| Booked profits | (4,000,000) |
| Purchase of trademark | (2,000,000) |
| Depreciation allowances | (200,000) |
| Net losses available for carry forward | (2,790,000) |

Part 2

Sales through Hong Kong agents

This is onshore sourced as the goods have been purchased from Hong Kong suppliers. DIPN21 sets out that in this case, the purchase contract is deemed effected in Hong Kong and prima facie the IRD would treat the whole profit as taxable as there is no apportionment.

Booked profits for group companies

This should be regarded as offshore sourced as the contract effected test should imply that both the contract of purchase and of sale were effected overseas in line with the principles set out in DIPN21 and the Magna case.

Revaluation of trading securities

Nice Cheer case, accounting treatment can be followed.
Assumes that trading securities would be taxable in Hong Kong if sold and not offshore sourced.

Interest on Hong Kong deposit and interest on bank loan

Under s.87 and the interest exemption order, usually interest on deposits with banks in Hong Kong are exempt from the payment of profits tax.

Per DIPN34, the IRD explain that any interest income from deposits that have been pledged as collateral is not exempt if the interest expenses incurred on the financing facilities are allowable for tax deduction.

In this case, we know the interest expense was used to purchase trading stock and it from a bank. There is no apportionment. The whole deposits will lose its exempt from payment of profits tax status if applicable.

Hence, as the conditions for deduction of the interest expenses on the loan are met under s.16(1)(a) as the interest is incurred in the production of assessable profits and s.16(2)(d) a borrowing from a bank (onshore or offshore) and also s.16(2)(e)(ii) the purchase of trading stock (assuming not connected with the vendor).

Hence, in conclusion, the deposit is no longer exempt from the payment of profits tax and is assessable accordingly. No adjustment in the tax computation is required as this amount is already included in income.

A deduction for the interest expense on the loan is permitted as the conditions outlined above are met and there is no apparent interest flow back (s.16(2A)) nor any offshore deposit guaranteeing the loan (s.16(2A).

<u>Trading design sale</u>

Section 16(E) allows a deduction for certain expenses including the costs of acquiring patent rights, trademarks or designs.

As section 16(E) has been in force since 1986, a deduction for the cost of purchase would presumably have been taken in 2009 when purchased. Accordingly the profit on the sale would be taxable under s.16E(3) which provides that where a deduction has been taken on purchase, the resulting profit would be taxable when sold. As this amount is already included in the profit and loss as income, no tax adjustment is required.

<u>Purchase of registered trademark</u>

Purchase of new trade mark. Under s.16(E), this would be deductible in the year the expense was incurred. There is no requirement that the patent must be in use in the year the expense was incurred provided that the rights are for the use in the trade of that Hong Kong person i.e. for the purposes of producing assessable profits.

As the cost was incurred in 14/15, this amount will be deductible.

<u>Purchase of new research equipment</u>

under s.16A, even though there may be capital expenditure incurred in research and development costs, this amount is allowable in full in the basis period in which the cost is incurred provided the capital expenditure is for research and development relating to the trade.

As this amount is already included in the profit and loss account, no further tax adjustment is required.

Bank charges on ordinary trading transactions

This is deductible under s.16(1) as an expense incurred in the production of assessable profits, irrespective of the fact this is in connection with a bank deposit which may be exempt from tax or exempt from the payment of profits tax.

Repair expenses

As these expenses were incurred to allow the use of a recently purchased second hand asset, this will be considered as capital expenditure and not permitted for tax purposes under s.17(1)(c).

However, s.16G provides that a deduction is available for expenses incurred on prescribed fixed assets which provides for a 100% deduction for any expenditure on machinery or plant used specifically and directly for any manufacturing process.

It is presumed that the packing machine is used in such a manufacturing process.

Bad debts

Trade debts recovered are taxable in the year of receipt as these had previously been written off. No adjustment required as already included in income.

Write off of staff loan is allowable as a cost of business under s.16(1) as cost of staff emoluments. No adjustment is required.

This will possibly be taxable on the staff member.

Provision – a deduction for specified trade debtors is allowable, but not for the general provision of 5%.