Chartered Institute of Taxation
Excellence in Taxation

# THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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# PAPER 2.04 – HONG KONG OPTION

## ADVANCED INTERNATIONAL TAXATION (JURISDICTION)

Suggested solutions

## Question 1

### Part 1

Under s. 20 of the IRO, a person is closely connected with another person where the Commissioner in his discretion considers that such persons are "substantially identical" or that the ultimate controlling interest of each is owned by the same person or deemed to be owned by the same person or persons and the controlling interest of a company shall be deemed to be owned by the beneficial owners of its shares, whether held directly or through nominees, and shares in one company held by or on behalf of another company shall be deemed to be held by the shareholders of the last-mentioned company.

### Part 2

There are two general anti-avoidance provisions in the IRO, namely s.61 and s.61A. S. 61A is applicable when the sole or dominant purpose of a transaction is to enable a person to obtain a tax benefit. In applying s.61A, the Commissioner can assess the taxpayer as if the transaction had not been entered into or in such a manner as the Commissioner thinks appropriate to counteract the tax benefit. S. 61 is applicable when the transaction is artificial and fictitious. In applying s.61, the Commissioner can disregard the transaction. In the absence of any commercial reasons and that the main purpose of MGL was to for tax efficiency, s.61 and s. 61A should be applicable to the proposed transactions, Other than s. 61A, specific anti-avoidance provisions are also applicable as outlined below.

*Restructuring 1 – acquisition of WKL*

Pursuant to s. 61B of the IRO, the commissioner shall disallow the set-off of any-loss or balance of loss if he is satisfied that:

- Any change in the shareholding in any corporate, as a direct or indirect result of which profits have been received by or accrued to that corporation during any year of assessment, has been effected by any person after 13 March 1986; and
- The sole or dominant purpose of the change was for the purpose of utilizing any loss or any balance of any loss sustained in a trade, profession or business carried on by a corporation, in order to avoid liability on the part of that corporation or any other person for the payment of any tax or to reduce the amount thereof.

Based on the information provided, it seems that the intention of MGL for the acquisition of WKL, which is a tax loss company, is to transfer its sourcing department to WKL and thus mitigate tax liability. If the tax reason outweigh the commercial reason, which may include pre-flotation restructuring and vertical integration to save operating costs, S. 61B of the IRO is applicable. Consequently, Commissioner would disallow the utilization of tax loss of WKL to set-off its future profits.

*Exercise 2 – setting-up MSL*

With regard to s. 20 of the IRO, where a non-resident person carries on business with a resident person with whom he is closely connected and the course of such business is so arranged that it produces to the resident person either no profits which arise in or derive from Hong Kong or less than the ordinary profits which might be expected to arise in or derive from Hong Kong, the business done by the non-resident person in pursuance of his connection with the resident person shall be deemed to be carried on in Hong Kong, and such non-resident person shall be assessable and chargeable with tax in respect of his profits from such business in the name of the resident person as if the resident person were his agent, and all the provisions of the IRO shall apply accordingly.

Under the proposed arrangement, after interposing the new company between MGL and the suppliers, part of the profit now earned by MGL would be transferred to MSL and hence reduce the tax liability of MGL and the whole group as well, because the income tax rate of MSL is 5%, which is lower than that in Hong Kong. In this regard, s. 20 should be applicable.

Part 3

The basic charging s. s.14 will be applied to ascertain the taxability of the rental income. Though MGL carries on a business in Hong Kong, the rental income derived from the property in the Australia will not be taxable in Hong Kong. It is because under the situs test, any income derived from the immovable property in Australia should be offshore in nature.

Interest expenses attributable to the production of assessable profit should be deductible under s.16(1)(a) if any one condition under s.16(2) is satisfied and the deduction restriction under s.16(2A), (2B) and (2C) is not applicable.

After MGL acquired the property in Australia, part of its profits will not be taxable and hence part of its funding costs attributable to the production of the offshore non-taxable property income should be non-deductible.

There are no clear rules to apportion interest deductibility.

The principle in Inland Revenue Rule 2A applies.

MGL may use a simple method to calculate non-deductible interest, based on an agreement they negotiate with the Inland Revenue Department ("IRD"). This method may involve applying a ratio to MGL's total interest expense to determine the non-deductible portion. The ratio would usually be determined in one of the two ways:

- Using an income basis – i.e. the amount of non-assessable income divided by MGL's total income; or
- Using an asset basis – i.e. the amount of assets that generate non-assessable income divided by MGL's total assets.

Whichever method is used, the IRD would expect consistency and would be likely to seek a detailed explanation for any change in the method.

## Question 2

### Chargeability of the rental income

Under s. 14, Mr Ford would be subject to profits tax in Hong Kong if he carried on a business or trade in Hong Kong and derived profits from Hong Kong from such business or trade. However, profits of capital nature would not be taxable. Under S. 2 of the IRO, "business" is defined to include agricultural undertaking, poultry and pig rearing; the letting or sub-letting by any corporation to any person of any premises or portion thereof; and the sub-letting by any other person of any premises or portion of any premises held by him under a lease or tenancy other than from the Government. Such definition is not exhaustive and the elements listed in the S. 2 are only illustrations.

In practice, the term "business" is considered as having a wider meaning than that of "trade". "Business" usually connotes activities of a commercial character. Whether a business is being carried on in Hong Kong is a matter of fact. It will depend on the nature and extent of the activities of the person.

In general, letting of property in Hong Kong by an individual would not constitute "business" or "trade" unless the letting activity is carried out in an organised manner. Hence, the rental derived from the Hong Kong would not be subject to profits tax.

Property tax would be charged on rental income derived from a property located in Hong Kong (s.5) at standard tax rate of 15%.

Under property tax regime, deduction of expenses is limited. Only rates paid by landlord, as agreed under the tenancy agreement and 20% statutory deduction (i.e. 20% on the assessable value, which is the rental income received and receivable less rates paid by landlord) would be allowable for deduction. Interest on mortgage loan, property management fee and decoration costs of the property would not be deductible.

If there is no property tax return received from the Inland Revenue Department (IRD), Mr Ford is required to inform the IRD within 4 months after the end of the basis period during which he commences to rental income and hence become chargeable to property tax. He is also obliged to complete and file the annual property tax return issued by the IRD within the stipulated time limit. Mr Ford will commit an offence under S. 80(1) and be liable to pay the penalty thereof if he, without reasonable excuse, fails to notify the IRD of his chargeability to tax. The Commissioner may compound the offence.

Mr Ford would not be entitled to elect personal assessment, under which mortgage interest is deductible, as he is not a resident in Hong Kong.

### Chargeability of the disposal gain

Capital gains derived from realisation of a long-term investment are exempted from profits tax, but profits from trading of properties are taxable. The question of whether a person is carrying on a trade or not is a question of fact. It is always necessary to consider all the relevant circumstances objectively and examine the person's intentions in carrying out the activities.

The Royal Commission on the Taxation of Profits and Income has identified "six-badges of trade", which are the factors normally used for determining whether a transaction or a series of transactions will constitute a "trade" or "an adventure in the nature of trade. The six factors are:

1. Subject matter
   The nature or characteristic of the asset, which is the subject matter of the issue, may give indication as to the purpose of holding by the owner. An asset which does not give an owner an income or personal enjoyment is likely purchased for trading purpose.

2. Length of period of ownership
   In general, a long period of holding between the acquisition of an asset and its disposal may show an intention that the holding is for investment purpose. A short period of holding may reflect the intention to acquire the asset(s) for speculation or trading purposes.

3. Frequency of similar transactions
   A repetition of similar activities by the same person would indicate that the person is carrying on a trade in those activities. However, in some situations, a stand-alone activity may still be regarded as an adventure in the nature of trade.

4. Supplementary work done
   If special efforts were made to enhance the value of the property, or to increase its saleable value, or to secure its saleability, it could be considered as evidence of trading intention.

5. Circumstances responsible for the sale
   If it can be proved that the sale of the asset is for reasons other than profit making, there is a better chance to argue that the asset was not held for trading purposes.

6. Motive
   There must be motive in carrying out a transaction and this motive is usually determined objectively by surrounding circumstances and by reference to the other factors listed above collectively. The existence of a profit-making motive is a clear indication but not always conclusive.

Apart from the six badges of trade, other factors include:

- Method of financing
  The financial capability of the person who claimed that the asset is held for long term investment purpose is always relevant. A person who borrows short term finance to acquire an asset and sells it within a short period is likely carrying on a trade in the asset.

- Destination of proceeds of sale
  The way the sale proceeds were put into use may indicate the purpose for sale and thus the intention of the person carrying on such a business. For example, whether the sale money was retained for use in a similar activity or for another form of investment.

Based on the facts given and applying the badges of trade, Mr Ford is likely to be regarded by the IRD as carrying on a trade in property in Hong Kong because:

- The subject matter in this case is the property located in Hong Kong. It is true that a property can always give the owner income/personal enjoyment through living in it or letting it out for income earning purpose. However, property in Hong Kong has been generally accepted as an asset which may be acquired for trading or speculative purposes. Involvement in property transactions is always under close scrutiny by the IRD to ascertain whether a trade has been carried on or not.
- From the given facts Mr Ford has no settled intention on holding the property as long term investment. He would put the property for selling and leasing.
- Mr Ford has decorated the property with an intention to make it more attractive to buyers.
- In addition, the reason for the acquisition of the property was the anticipation of increase in property price in the short run.

If Mr Ford is subject to Profits Tax on the gain on the disposal of the property, he will be required to notify the IRD within four months after the end of the basis period if he does not receive a Profits Tax Return for that year (S. 51(2)). Mr Ford will commit an offence under S. 80(1) and be liable to pay the penalty thereof if he, without reasonable excuse, fails to notify the IRD of his chargeability to tax. The Commissioner may compound the offence.

<u>Treatment of provisional property tax</u>

Mr Ford's property tax liability for the year of assessment 2014/15

| | $ |
|---|---|
| Rental income | 1,200,000 |
| Less: rates | 50,000 |
| Assessable value | 1,150,000 |
| Less: 20% statutory deduction | 230,000 |
| Net assessable value | 920,000 |
| Property tax @15% | 138,000 |

The management fee paid by the tenant to the property management through Mr Ford is not a consideration for the right to use the property, hence is not chargeable to property tax (paragraph 16 of the Departmental Interpretation and Practice Notes No. 14 (Revised)).

The property management fee, rental collection fee, mortgage loan interest, and decoration costs are not deductible expenses for the purposes of computing the property tax liability (sections 5 and 7).

The notice of provisional property tax demanded property tax payment of $900,000, which is due on 14 March 2015. The assessable value of such notice as estimated by the IRD should be $6,000,000. (i.e. $900,000 ÷ 15%). The actual assessable value as computed above is only $1,150,000, which is less than 90% of the amount provisionally assessed. This a valid ground for lodging a claim to holdover part of the provisional tax demanded. Hence, Mr Ford should lodge a claim to holdover provisional tax demanded of $762,000 ($900,000 - $138,000).

The holdover claim should be made in writing, supported by valid ground, which must be received by the Commissioner of the Inland Revenue not later than the later of:

- 28 days before the due date of payment of the provisional tax (i.e. 14 February 2015); or
- 14 days after the date of the notice of payment of provisional tax (i.e. 15 February 2015).

Today is 10 February 2015, hence Mr Ford should submit the claim before the due date of 15 February 2015.

## Question 3

### Part 1

*Mr Chan's Salaries Tax Liabilities (year assessment 2014/15)*

| | Notes | $ |
|---|---|---|
| Salary ($100,000 x 12) | | 1,200,000 |
| Excess of rental refund over rent and management fee incurred ($40,000 - $30,000 - $5,000) x 12 | 1 | 60,000 |
| Refund of course fee | 2 | 30,000 |
| Holiday journey benefit | 3 | 100,000 |
| | | 1,390,000 |
| Rental value ($1,390,000 x 10%) | | 139,000 |
| Assessable income before time-apportionment | | 1,529,000 |
| Time-apportionment factor: [200 + (20 +10) x 200/335] 365 | 4 | 0.5970 |
| Assessable income based on time apportionment | | 912,813 |
| Less: | | |
| Mandatory provident fund contribution | 5 | 17,500 |
| Basic allowance | | 120,000 |
| Net chargeable income | | 775,313 |
| Tax payable at progressive rates | | 119,803 |
| Tax payable at standard rate 15% ($912,813– $17,500) = $134,296 | | |

*Mrs Chan's Salaries Tax Liabilities (year of assessment 2014/15)*

| | $ |
|---|---|
| Salary | 50,000 |
| Sum in lieu of leave | 1,000 |
| | 51,000 |
| Less: | |
| Mandatory provident fund contribution | 10,000 |
| Basic allowance | 120,000 |
| Net chargeable income | Nil |

### Part 2

Mr Chan was still employed by BI for the year of assessment 2014/15 as he did not sign any new employment contract with the Hong Kong subsidiary. BI was a US based company and hence is a non-Hong Kong resident for salaries tax purposes. Probably his employment contract with BI was negotiated, concluded and enforceable outside Hong Kong. Accordingly, he is having an offshore employment and should be subject to salaries tax on a time-apportionment basis (s.8(1A)(b)).

Excess of rental refund over the actual rent and building management fee paid was cash allowance to Mr Chan and should be taxable and subject to the computation of rental value.

Refund of private expense of Mr Chan is taxable in the year the amount was paid to Mr Chan, i.e. year of assessment 2014/15. The course fee was paid by Mr Chan in March 2014, i.e. in the year of assessment 2013/14, and hence it should be deductible as self-education expense for the year of assessment 2013/14, if Mr Chan has already commenced his secondment. The maximum deductible amount is $80,000 (s.12(1)(e)).

Half of the package tour fee was paid for Mr Chan's business trip and hence was not a benefit to him. The other half of the package tour benefit was provided to Mrs Chan and hence is taxable. The amount taxable is the cost to the employer in providing the benefit, i.e. $100,000 (s.9(2A)(c)).

Maximum deductible amount for mandatory provident fund is $17,500 per year.

The share option gain was granted to Mr Chan before his commencement of Hong Kong secondment and hence was not attributable to any Hong Kong services during the year 2014/15. The gain derived from exercising the share option is not taxable in Hong Kong. The gain on subsequent disposal is also not taxable as it was not derived from employment.

Part 3

There are unutilised allowances for Mrs Chan. By electing joint assessment, the unutilised allowances can be absorbed by Mr Chan's income and hence overall tax liability of the couple can be reduced.

Part 4

They can elect for personal assessment, as both Mr and Mrs Ch Chan stayed in Hong Kong more than 180 days during the year 2014/15 and they are temporary residents in Hong Kong.

The following are benefits for electing personal assessment:

- Deduction of interest expense incurred in the production of the rental income. Interest deduction is limited to the relevant net assessable value of $131,200 [= ($14,000 x 12 - $1,000 x 4) x 80%].
- Business loss of $50,000 can be used to set-off other income.

## Question 4

### Part 1

*ML's trading operation in China*

If the operation in the Mainland is carried out through a fully accredited agent, the operation of the agent (RL) on behalf of ML should be considered as part of the operation of ML. All income and expenses of the agent related to the operation done for and on behalf of ML will be aggregated to ML's account. For Hong Kong profits tax purposes, if the Inland Revenue Department ("IRD") is satisfied that the profit attributable to the operation in the Mainland is sourced outside Hong Kong, the profit will not be subject to Hong Kong profits tax. If the profit is not subject to Hong Kong profits tax, the expenses incurred in the production of the profit will not be deductible (S. 16(1)).

The IRD expresses its view on determining the locality of profits in its Departmental Interpretation and Practice Notes (DIPN) No. 21. The general principle is the "operation test" (F.L. Smidth & Co. v Greenwood) which asks the question "where did the operation take place from which profits in substance arise?" According to the Hang Seng Bank case, the broad guiding principle is that one looks to see what the taxpayer has done to earn the profit in question and where he has done it.

As ML is engaged in a trading business, the IRD would generally regard the determining factor as where the contracts for purchase and sale are effected. Moreover, relying on the Magna's decision, the IRD expresses in DIPN 21 that "the totality of facts must be looked at in determining what the taxpayer did to earn the profit".

It is the IRD's practice that if either the purchase contract or sale contract is effected in Hong Kong; the initial presumption will be that the profits are fully taxable. Where the commodities are purchased from a Hong Kong supplier or manufacturer, the purchase contract will usually be taken as having been effected in Hong Kong.

The IRD takes the view that there is no apportionment of trading profit, which is either wholly taxable or wholly non-taxable.

DIPN 21 states that normally the activities of a fully accredited agent are accorded the same weight as that done by the principal itself if it can show that the agent has full authority to conclude contracts without reference to the business in Hong Kong. The agency contracts and other documentary evidence will be necessary to support the claim.

As regard to the case, as ML would purchase goods from RL with purchase orders to be placed from ML's office, the IRD will take view that the purchase contracts are effected in Hong Kong. Also, the strategic marketing function and financing are to be carried out in Hong Kong. On this basis, the trading profit derived from the sales made by the agent in the Mainland would be regarded as sourced from Hong Kong.

RL may rely on the Magna case to argue that the sales activities done by the agent in the Mainland are more important in generating the trading profit or on the ING Baring case that the activities done by the agent are more critical in generating the trading profit. However, it may be hard to convince the IRD to accept this argument because the IRD mentions in its DIPN 21 (2009) that it applies "the totality of facts" approach to ascertain source of profits. It explains that the term "totality of facts" should mean no more than having regard to all the relevant factual "operations" of a transaction to decide the locality of the source of profits.

In addition to Hong Kong Profits Tax, there may be PRC income tax exposures. The activities done by the agent in the Mainland for RL are likely to be regarded as a "permanent establishment" in the Mainland (Mainland – Hong Kong Double Taxation Arrangement (DTA), DIPN No. 44) and hence the relevant trading profit is likely to be subject to Income Tax in the Mainland. Nonetheless, if both Hong Kong Profits Tax and PRC income tax are payable, tax credit is generally available under the Mainland-Hong Kong SAR Double Taxation Arrangement (DTA) and S. 50.

*ML's secondment of manager to RL*

The secondment arrangement should be regarded as provision of services because the manager would report to ML and ML would receive a fee for the service provided.

As the services would be provided outside Hong Kong, it should be regarded as sourced outside Hong Kong.

*ML's dividend from RL*

As RL is an offshore company, its profits generally would not be taxable in Hong Kong. Hence, the dividend would not be exempt under s.26.

However, the dividend would be regarded as sourced outside Hong Kong and hence not taxable under s.14.

Part 2

*ML's income tax exposures in the Mainland*

ML's secondment of manager to RL:

- A Hong Kong company carrying on business in the Mainland of China will not be subject to income tax in the Mainland unless the Hong Kong company carries on business in the Mainland through a permanent establishment [Article 7 of the DTA ].
- According to Article 5 of the DTA, a "permanent 'establishment" (PE) includes 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, a building site, a construction, assembly or installation or connected supervisory activities lasting more than six months, the furnishing of services, including consultancy services totaling more than six months within any 12-months period commencing or ending in a taxable year. According to the Second Protocol (the Second Protocol) to the DTA signed in January 2008, "six months" is changed to "183 days". The Second Protocol is effective from 11 June 2008.
- A "permanent establishment" does not include the use of facilities or the maintenance of a fixed place of business solely for the storage, display, or delivery of goods, the purchase of goods, advertising, collecting information or other information or other preparatory or ancillary activities. However, if a person, other than an agent of independent status, habitually exercises an authority to conclude contracts on behalf of an enterprise in Other Side, the enterprise will be regarded as having a "permanent establishment" in that Side.
- If the manager is to be reported to ML, it would be regarded as provision of services by ML to RL. As the services are to be provided at RL's office, there would be a fixed place of business of ML in relation to the provision of the services and hence a PE exists.
- If ML provides the services through a PE, the profit attributable to the PE would be subject to income tax in the Mainland.

ML's dividend from RL:

- ML being a non-resident company for the purpose of China income tax would be subject to withholding tax on the dividend.
- The withholding tax rate would be reduced to 5% as RL is wholly owned by ML according to the Mainland-Hong Kong Double Tax Arrangement.

Part 3

According to the Second Protocol of the Avoidance of Double Taxation Arrangement between the mainland of China and Hong Kong (Mainland-HK DTA), gain on disposal of shares of a Chinese company would be subject to income tax in China if the assets of the company being disposed of comprised mainly of immovable property or the Hong Kong company is holding more than 25% of shares in the Chinese company (Article 13 of the mainland-HK DTA). Both the mainland tax authority and the Hong Kong IRD take 50% as the benchmark in determining whether the assets of a company

are comprised “mainly” of immovable property. Where the value of immovable property is not less than 50% of the value of the total assets of a company, the assets of that company will be deemed to be comprised mainly of immovable property. In calculating the value of the total assets of a company, debts of that company (including liabilities secured by mortgages on the relevant immovable property) must not be deducted. The calculation of the value of assets of the company would be made by reference to the book value at the end of the 3 taxable years prior to the alienation. According to the year-end accounts for 2012 to 2014, the assets of BL were not at any time comprised mainly of immovable property (less than 50% in all 3 years) as computed as below:

| | Immovable property at book value (RMB) | Total assets at book value (RMB) | Percentage of immovable property to total assets at book value |
|---|---|---|---|
| 2011 | 60,000,000 | 100,000,000 | 60% |
| 2012 | 80,000,000 | 200,000,000 | 40% |
| 2013 | 145,000,000 | 300,000,000 | 48.33% |
| 2014 | 160,000,000 | 350,000,000 | 45.71% |

ML was holding only 10% shares in BL.

Therefore, ML should not be subject to income tax in China under Article 13(4) of the Mainland-HK DTA.

## Question 5

### Part 1

A foreclosure order is specifically included in the definition of 'conveyance on sale' in section 2(1). Therefore, the assignment to the purchaser (Mr A) must be stamped under Head 1(1) at the appropriate rate of 3.75%.

Notwithstanding that the transaction between the mortgagee (B Bank) and the purchaser (Mr A) was at arm's length, the Commissioner has power to treat this as a voluntary disposition (re s. 27(4) of the Stamp Duty Ordinance and the *Lap Shun Textiles* case).

The assignment should be stamped on a consideration equal to the fair market value of $10 million. Stamp duty: $10 million x 3.75% = $375,000.

New ad valorem duty (Scale 1) does not apply because Mr A is a Hong Kong permanent resident and did not own any other property at the time of sale.

A sale of property by a mortgagee is exempt from special stamp duty (s. 29CA(11)(b)(iv)) and buy's stamp duty (section 29DB(8)(c)).

The mortgage debt is included in the consideration for stamp duty purposes – s. 24(1).

The total consideration agreed by the parties ($7 million) was ignored as the conveyance is at an undervalue. A substantial benefit was derived by the transferee (re: s.27(4) and the *Lap Shun* case).

For valuation purposes, the Collector can adopt the value of the property as at the date of the first binding contract for sale and purchase ($7.5 million) and not the value as at the date of the assignment ($8 million) (re: *Zung Fu* case).

The sale and purchase agreement was stampable under Head 1(1A) on $7.5 million. Stamp duty payable was: $7.5 million x 7.5% = $562,500. The subsequent assignment attracts a nominal duty of $100. The new ad valorem duty (Scale 1) applies because Miss C owned 2 other flats in Hong Kong when she purchased the subject property.

Buyer's stamp duty does not apply because Miss C is a Hong Kong permanent resident.

Special stamp duty does not apply because the vendor purchased the property ten years ago.

On 14 December 2011, M Ltd owned 98.05% of the issued share capital of K limited (100% x 80% + 95% x 95% x 20%) and 90.25% (95% x 95%) of the issued share capital of L Ltd.

K Ltd and L Ltd were therefore associated companies under s. 45(2) of the Stamp Duty Ordinance.

The relief of s. 45(1) applied to the transfer of the factory premises from K Ltd to L Ltd and no stamp duty was chargeable.

The transfer value and the market value were irrelevant. However, adjudication was required under s. 45(3) for this exemption.

Following M Ltd's disposal of 15% of the share capital of N Ltd to Q Ltd, M Ltd owned 86.05% of the share capital of K Ltd [85% x 80% (through N Ltd) + 95% x 95% x 20% (through P Ltd and L Ltd)], and 90.25% of the share capital of L Ltd [95% x 95%].

K Ltd and L Ltd were then no longer associated companies on 1 December 2013. However, such cessation of association relationship was not due to change in shareholding of the transferee in the factory premises transfer transaction, i.e. L Ltd. Therefore the exemption was still valid as s. 45(4)(c) was not applicable to deny the exemption under s. 45.

Part 2

The time limit for stamping a conveyance on the sale of immovable property in Hong Kong is thirty days after execution.

When an instrument which is chargeable to stamp duty is not stamped within the time specified, it can thereafter be stamped upon payment of the duty owing and a penalty.

For delays not exceeding one month, the penalty is two times the amount of duty payable.

For delays of more than one month but not exceeding two months, the penalty is four times the amount of duty payable.

For delays over two months, the penalty is ten times the amount of duty payable.

The Collector has the discretionary power to remit the whole or any part of the penalty.

Appeal against assessment procedures:

Pursuant to s.14 of SDO, any person who is dissatisfied with the assessment made by the Collector of Stamp Revenue after adjudication may:

- Within a period of one month from the date on which the assessment is made or within such further period the Court may allow if the Court, on application made by the person, is satisfied that the person was prevented by illness or absence from Hong Kong or other reasonable cause from bringing the appeal within the time limit;
- Subject to any order of the Court, on payment of the stamp duty in conformity therewith or where payment of the stamp duty or any part thereof is allowed to be postponed, on payment of the part (if any) of the stamp duty, the payment of which is not thus allowed to be postponed; and
- By notice served on the Registrar of the District Court; appeal against the assessment.

## Question 6

### Part 1

*Berry Ltd*
*Profits Tax computation for the year of assessment 2014/15*

Basis Period: Year ended 31 March 2015

| | | HK$ | HK$ |
|---|---|---|---|
| Net profit before tax | | | 3,000,000 |
| Add: | | | |
| | Depreciation | 300,000 | |
| | Initial repairs expense | 100,000 | |
| | Write off of a staff loan (principal) | 19,000 | |
| | General provision for bad debts | 10,000 | |
| | | | 429,000 |
| | | | 3,429,000 |
| Less: | | | |
| | Unrealised gain on revaluation of trading securities | 900,000 | |
| | Profits on sale of product design | 300,000 | |
| | 1/4 of trademark cost | 500,000 | |
| | Depreciation allowance | 200,000 | 1,900,000 |
| Assessable profits | | | 1,529,000 |
| Profits Tax @16.5% | | | 252,285 |
| Less: Tax rebate | | | 10,000 |
| Profits Tax payable | | | 242,285 |

Part 2

Explanations:

1. Applying the operation test, the trading profits of sales made through Hong Kong agents should be regarded as arising in Hong Kong. It is because both the purchase contracts and sales contracts were effected in Hong Kong. Though the sales orders were received outside Hong Kong, they were accepted and confirmed in Hong Kong, i.e. the sales contracts were concluded in Hong Kong (*Hang Seng Bank* case, DIPN 21).

2. The "booked" profits should be regarded as arising in and derived from Hong Kong. Though the trading terms were negotiated and concluded outside Hong Kong, the contracts were concluded in Hong Kong as BEL received and issued invoices here. Also, the operation of BEL in Hong Kong was to overcome the legal trade restriction in respective countries. Applying the operation test, the operation from which in substance BEL derived the profits was carried out in Hong Kong. Hence the profits would be taxable (*Kim Eng* case).

3. Fixed term bank deposit interest is exempt from payment of profits tax under the Interest Exemption Order. However, there will be no exemption if the deposit has been used to secure for borrowing and interest expenses on such borrowing is deductible by virtue of section 16(1)(a) and section 16(2). As the deposit in the case has been used to secure for a bank loan for purchase of trading stock. The bank loan interest should be deductible (see (8) below) and hence the deposit interest is still taxable.

4. Unrealised revaluation gain on trading securities is not taxable. Anticipated profits should not be assessable under section 14 (*Nice Cheer* case).

5. A product design acquisition cost is NOT deductible under section 16E before 2011/12. The sale proceed of the product design was hence not taxable.

6. Registered trademark acquisition cost is deductible under 16EA since 2011/12 over 5 succeeding years on a straight-line basis (section 16EA(3)) or the protection period (section 16EA (4)), whichever is shorter, in this case 4 years. Hence the deductible amount for the year is $2,000,000 ÷ 4 = $500,000.

7. Product research expense including the cost of research equipment is deductible under Section 16B.

8. Bank charges on trading transactions are deductible under section 16(1).

9. Interest on bank loan for purchase of trading stock is deductible under section 16(1)(a), 16(2)(d) and (2)(e). Restriction under section 16(2A) is not applicable as the loan is not secured by deposit generating non-taxable interest. Also section 16(2B) does no apply because there is no flow-back of non-taxable interest income.

10. Write off of staff loan (principal portion) is not deductible under section 16(1)(d) as it was neither a trade debt previously taxed nor money lent in a money lending business carried on in Hong Kong. The interest should have been included as taxable receipt previously and hence written off of the interest should be deductible.

11. Bad debt recovered is taxable in the year of recovery under section 16(1)(d).

12. General provision for bad debts is not deductible under section 16(1)(d) because it cannot be proved to have become bad.

13. Specific provision for bad debts is made based on specific evidence which can prove the debts to have become bad and hence deductible under section 16(1)(d).

14. Initial repairs expense to bring as asset back to operable condition would be capital in nature as it was incurred to bring into existence of an asset for the enduring benefit of BEL and it was

incurred “once and for all” (*The Law Shipping Ltd* case and *British Insulated & Helsby Cables Ltd*. case).

## Question 7

### Part 1

*Profits Tax obligations*

According to section 51(2) of the Inland Revenue Ordinance, every person chargeable to tax for any year of assessment shall inform the Commissioner in writing that he is so chargeable not later than 4 months after the end of the basis period for that year of assessment unless he has already been required to furnish a return under the provisions of section 51(1). In the case of PL, the company should have informed the IRD of its chargeability of Profits Tax on or before July 31 2014.

*Potential penalties*

In accordance with section 80(2), if the company has not complied with sections 51(1) and (2), the Company is guilty of an offence and is liable to a Level 3 fine (i.e HK$10,000) and a further fine of treble the amount of tax which would have been undercharged in consequence of the failure to comply with sections 52(1) and (2).

Under section 82A, the commissioner may choose to impose an additional tax, if no prosecution under section 80(2) has been instituted on the same facts, of an amount not exceeding treble the amount of tax which has been undercharged in consequence of the failure to comply with section 51(2).

*Employer's obligation*

According to sections 52(1), (2),(3),(4),(5) & (6) of the IRO, PL is obliged to notify the IRD of any employees that the Company employs in relation to their commencement, termination and departure from Hong Kong if any, and their annual earnings from the company.

Form IR56E – on commencement of employment. The form should be filed not later than 3 months after the date of commencement of the employment.

Form IR56F – on termination of employment. The form should be filed no later than 1 month before the cessation date of the employment of the individual.

Form IR56G – on departure of an individual who is about to leave Hong Kong for more than 1 month. The form should be filed no later than 1 month before the intended departure date.

Form BIR 56A and IR56B – on annual earnings paid to the employees. The forms would normally be filed one month after the date of issue.

*Potential Penalties*

In accordance with sections. 80(1) (a) and 80(1)(c), the company shall be guilty of an offence by failing to comply with these s.s and shall be subject to Level 3 fine (HK$10,000) and the court may order the company within a time specified in the order to do the act that he has failed to do.

### Part 2

PL can lodge an objection against the estimated assessment under s. 64(1) of the Inland Revenue Ordinance. A written notice must be submitted to the Commissioner within one month after the date of the notices of assessment i.e. by 1 June 2015. The objection must state precisely the grounds of objection to the assessment and must be supported by:

- The Profits Tax Return for the year of assessment 2013/14 and the supporting Profits Tax computation;
- The audited financial statements; and
- Any other relevant information.

Part 3

Under section 76(1) of the IRO, the Commissioner may recover tax from a debtor of a taxpayer if it appears to the Commissioner to be probable that any other person:

- Owes or is about to pay money to such person;
- Holds money for or on account of the taxpayer;
- holds money on account of some other periods for payment to the taxpayer; or
- Has authority from some other person to pay money to the taxpayer.

The Commissioner must give the third party notice in writing requiring him to pay sch moneys not exceeding the amount of tax in default or charged, or as the case may be, to the officer named in the notice. The notice shall apply to all such moneys which are in the third party's hands or due from him or about to be paid by him at any time within a period of 30 days thereafter.

Since the company owes Mr Leong HK$400,000, the Company is obliged to comply with the notice issued by the Commissioner and pay the full HK$400,000 to settle the tax liabilities in accordance with section 76(1).

If the company does not comply with the request and does not respond in writing within 14 days of the expiration of the period of 30 days from the date of receipt of the notice, the Company will be liable for the whole of the tax which he was required to pay, and such tax may be recovered from the Company by all means provided in the IRO for the recovery of tax from a person who has made default in payment.

If the company makes the payment is pursuance to section 76(2), the Company shall be deemed to have acted under the authority of Mr Leong and is therefore indemnified in respect of such payment against all proceedings, civil or criminal notwithstanding the provisions of any written law, contract or agreement.

Part 4

Mr Sam had a non-Hong Kong employment at the time of the grant, thus the gain will have a non-HK source and is not chargeable unless it is derived from services in Hong Kong: section 8(1A)(a).

The right is subject to a vesting period of 2 years from 1.1.2013-31.12.2014 during which Mr Sam rendered services in Hong Kong, part of the gain will be attributable to services in Hong Kong and taxable.

In taxing an appropriate portion of the gain representing services rendered in Hong Kong, regard must be given to the terms of the contract. A time-apportionment will generally be equitable.

During the year of assessment 2013/2014, Mr Sam only rendered services in Hong Kong for 50 days. Assuming that he did not visit Hong Kong for more than 60 days in that year of assessment, he will be exempt from Hong Kong salaries tax for that year and the days will not be counted in computing the taxable gain.

The fact that the option is exercised after cessation of employment or outside Hong Kong is irrelevant. The gain is taxable in the year in which the option is exercised. Section 11D does not apply to tax the gain as accrued on the last date of employment.

As Mr Sam is leaving Hong Kong for good, he needs to clear his tax before his departure from Hong Kong. IRD will allow the liability to be ascertained on the basis of a notional exercise of the option.

The gain is calculated as if the option has been exercised on the day before the submission of the tax return in the year of assessment in which he permanently departs from Hong Kong.

Taxable gain from the option is apportioned on the basis of 148 days (85+63) / 730 days (365+365).

If the gain from actual exercise is less than the amount assessed, IRD will favourably consider the application for re-assessment.