SECTION A – CASE QUESTIONS

Answer 1(a)

The profits of A Ltd. may not be accepted as having a source outside Hong Kong because of the following:

The broad guiding principle for determining the source of profits, as explained in *CIR v. Hang Seng Bank Limited* [1991] 1 AC 306 and further elaborated in *HK-TVB International Limited v. CIR* [1992] 2 AC 397, is "what the taxpayer has done to earn the profit in question and where he has done it". In the present case, A Ltd. was engaged in selling audio and visual equipment. Its profit-producing activities included soliciting sale orders from customers, subcontracting the production to the Mainland entities, sourcing raw materials for production and arranging shipments of them and the finished products. As it performed all these operations in Hong Kong, the source of its profits should be in Hong Kong.

No doubt A Ltd. had a representative office in the Mainland to liaise with the contractors there. However, what it did through the representative office was merely antecedent or incidental work, not the effective cause of its profits. On the authority of *Kwong Mile Services Limited v. CIR* [2004] 3 HKLRD 168, we should not be distracted by such work when determining the source of A Ltd.'s profits.

In Departmental Interpretation and Practice Notes ("DIPN") No. 21, the IRD made it clear that profit apportionment would not be appropriate if the Hong Kong company had restricted involvement in the processing arrangement with the Mainland enterprise. Here, A Ltd. was not involved in the manufacturing operations in the Mainland, its profits should thus be fully chargeable to profits tax without any apportionment.

Answer 1(b)

S.39E(1)(b)(i) of the Inland Revenue Ordinance (IRO) denies the granting of a depreciation allowance if the plant and machinery concerned was under a lease and they were wholly or principally used outside Hong Kong by a person other than the taxpayer. S.2 of the IRO defines "lease" to include "any arrangement under which a right to use the machinery or plant is granted by the owner of the machinery or plant to another person".

In *D61/08*, (2009-10) 24 IRBRD 184, the Board of Review held that s.2 provides a broader meaning to the term "lease" than either its ordinary meaning or its legal definition in land law. An arrangement, which is not in writing and involves no consideration, suffices.

In the present case, A Ltd. provided the Mainland contractors with certain plant and machinery for production in the Mainland. Such an arrangement fell within the definition of "lease" under s.2. As the plant and machinery under that lease were used wholly outside Hong Kong by the contractors, s.39E(1)(b)(i) should be invoked to deny any depreciation allowance claim from A Ltd.

Answer 1(c)

The claim that A Ltd. has paid business tax in respect of its sale of an office unit in the Mainland is acceptable because selling immovable properties within the Mainland is a taxable service subject to business tax: Article 1 of the Provisional Regulations of Business Tax of the People's Republic of China. The business tax payable should be 5% of the business turnover.
For sale or transfer of immovable properties, the purchase price of the property or land use right can be deducted from the sale consideration in calculating the business tax payable (*Caishui* (2003) 16; *Guoshuihan* (2005) 83).

For a foreign tax to be deductible for profits tax purposes, it must be: (i) a charge on the earnings (rather than on profits) that must be borne regardless of whether or not a profit is derived; and (ii) the earnings on which the tax is imposed should be chargeable to profits tax: see DIPN No.28.

In the present case, the business tax was imposed on the sale consideration of the office unit only if A Ltd. made a profit. Also, the gain on disposal would not be chargeable to profits tax as it may be of capital and/or offshore nature. Therefore, the business tax should not be deductible.

Answer 2(a)

Though B Inc. did not carry on any business in Hong Kong, it received royalties from A Ltd. in respect of the patented technology used for the production of audio and visual equipment in the Mainland. Such royalties were deducted in ascertaining the assessable profits of A Ltd. By virtue of s.15(1)(ba) of the IRO, the royalties are deemed to arise in or be derived from Hong Kong from a trade, profession or business carried on by B Inc. in Hong Kong.

Since B Inc. is a non-resident, s.20B(2) of the IRO provides that A Ltd., who paid the royalties to B Inc., is chargeable to tax on behalf of B Inc. in respect of the royalties. As the tax so charged is recoverable from A Ltd., it should deduct from the royalties a sum sufficient to pay the tax due by virtue of s.20B(3) of the IRO.
Being the person chargeable to tax on behalf of B Inc., A Ltd. failed to report the royalty payment to the IRD. Such failure is contrary to s.51(2) of the IRO, which requires the taxpayer to inform his chargeability to tax within 4 months after the end of the basis period of the relevant year of assessment.

Answer 2(b)

A Ltd. provided Mr. D with free residence in the Mainland. It was a fringe benefit to Mr. D. However, A Ltd. failed to return such remuneration to the IRD. S.52(2) of the IRO requires every employer to furnish the remuneration of its employees, whether it is in cash or otherwise. The fact that the residence provided was outside Hong Kong would not relieve A Ltd. from reporting such housing benefit to the IRD under s.52(2).

Answer 3

S.27(1) of the Stamp Duty Ordinance (SDO) provides that any conveyance of immovable property as a voluntary disposition inter vivos shall be chargeable with stamp duty with the substitution of the market value of the property. Under s.27(4) of the SDO, any conveyance of immovable property shall be deemed to be a voluntary disposition inter vivos if the Collector of Stamp Revenue is of the opinion that by reason of the inadequacy of the consideration or other circumstances the conveyance confers a substantial benefit on the person to whom the property is conveyed or transferred.

Here, A Ltd. purchased the shop at 20% less than the market value and such a discount did confer a substantial benefit to the company. The fact that the transaction between A Ltd. and the seller was at arm's length would not prevent the imposition of stamp duty on the market value of the shop. In *Lap Shun Textiles Industrial Co. Ltd. v Collector of Stamp Revenue* 1 HKTC 880, the Court of Appeal held that the application of ss.27(1) and (4) of the SDO depended on whether the conveyance conferred a substantial benefit upon an objective examination of the factual elements, not the intentions of the parties concerned.

Therefore, by virtue of ss.27(1) and (4) of the SDO, the stamp duty on the relevant conveyance should be calculated at the market value, rather than the sale consideration, of the shop.

The stamp duty payable should be calculated as follows:

Market value of property: HK$20,000,000 / (1-20%) = HK$25,000,000
Stamp duty payable: HK$25,000,000 x 4.25% = HK$1,062,500

Answer 4(a)

Mr. D's employment with A Ltd. should have a source in Hong Kong because of the following:

(a) Mr. D was employed by A Ltd. in Hong Kong. His employment contract should have been negotiated, concluded and enforceable in Hong Kong.

(b) A Ltd. was a company managed and controlled in Hong Kong. It should be a resident in Hong Kong.

(c) Mr. D was under the payroll in Hong Kong. Save for the free residence in the Mainland, Mr. D's other remuneration should have been paid in Hong Kong.

Therefore, unless Mr. D was eligible for the exemptions provided under s.8(1A)(b)(ii), (1A)(c) and (1B) of the IRO, all his remuneration should be chargeable to salaries tax by virtue of s.8(1) of the IRO.

On the facts set out in the question, Mr. D should not be granted full exemption under s.8(1A)(b)(ii) and (1B) for the following reasons:

(a) he attended to business matters in Hong Kong. This means he did not render all the services in connection with his employment in the Mainland.

(b) he returned to Hong Kong for business purposes two days a week, which should have exceeded 60 days during each of the relevant years.

However, pursuant to s.8(1A)(c), he should be exempt from salaries tax to the extent of his income derived and taxed in the Mainland because:

(a) part of his income was derived from his services in the Mainland;

(b) he paid IIT in respect of that income in the Mainland; and

(c) IIT, being a tax assessed on employment income, is of substantially the same nature as salaries tax in Hong Kong.

Alternatively, as Mr. D's income is subject to tax in both Hong Kong and the Mainland, he may claim for tax credit in accordance with the Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income. But in general, the exemption under s.8(1A)(c) will provide greater benefit than that by tax credit.

Answer 4(b)

S.9(1) of the IRO defines income from employment to include, inter alia, the rental value of any place of residence provided rent-free by the employer. As provided under s.9(2) of the IRO, the rental value of any place of residence shall generally be 10% of the taxpayer's income from employment. However, if the place of residence is a hotel, hostel or boarding house, the rental value shall be deemed to be 8% of his income where the accommodation consists of not more than 2 rooms, or 4% of his income where the accommodation consists of not more than 1 room.

Here, Mr. D was provided with a serviced apartment for residence in the Mainland. By virtue of s.9(1)(b), the rental value of such residence should be included as his income for salaries tax purposes. The fact that the residence provided was outside Hong Kong would not prevent Mr. D from being assessed with respect to the rental value for salaries tax purposes.

As regards the amount of the rental value, a serviced apartment is not a hotel or boarding house within the meaning of s.9(2): see *D91/04*, (2005-06) 20 IRBRD 22. Thus, even if Mr. D was only provided with a 1-room serviced apartment, the rental value of such residence should still be calculated at 10% of his income from employment (after the exemption allowed under s.8(1A)(c)).

* * * END OF SECTION A * * *

SECTION B – ESSAY / SHORT QUESTIONS

Answer 5(a)

As New Ltd. is a company incorporated in Hong Kong and carrying on business in Hong Kong, it will be subject to Hong Kong profits tax in respect of profits derived from Hong Kong (s.14 of the IRO). Profits derived offshore would not be taxable. Whether profits are taxable or not would depend on the nature of profits and New Ltd.'s mode of operation. As New Ltd. is responsible for the marketing and sale of group products, if its trading operations are carried out in Hong Kong and all the relevant purchase and/or sales contracts are effected in Hong Kong, then the profits derived from its trading operation would be subject to tax in Hong Kong. For profits from contracts effected offshore, there may be grounds to claim that such profits are not taxable. However, any offshore claims must be substantiated with supporting documentation and agreed with the Assessor. The profits tax rate in Hong Kong is 16.5%. All expenses (including marketing and sales expenses) incurred in the production of assessable profits are deductible (s.16(1)) except those specifically excluded under s.17.

There is no withholding tax on dividends payable to World Corp.

New Ltd. has an obligation to notify chargeability under s.51(2)

There is capital duty of 0.1% on authorised capital, capped at HK$30,000.

Answer 5(b)

If supporting evidence clearly demonstrates that the branch maintains a separate trading operation offshore responsible for effecting purchase and sales contracts, then the profits derived by the branch should be offshore and not taxable.

If tax is payable in Country Y on the branch profits, such payments would not be deductible under profits tax as it is a foreign tax on profits rather than on earnings: see DIPN No.28.

Answer 6(a)

Costs incurred in acquiring IP are capital expenditure and are not deductible.

Under s.16E, specific deductions for patent rights or rights to any know-how which are not acquired from related companies and not for use outside Hong Kong are allowed. In the present case, the IP was acquired from a related company, therefore it is not deductible under s.16E.

The trademark is also not deductible as it is not covered by s.16E.

As the IP would be owned by Star Ltd., the royalty income from group companies would be taxable under s.14. Royalties withholding tax incurred in the various jurisdictions should be deductible.

Answer 6(b)

Such costs incurred for bringing into existence an enduring asset (IP) are capital in nature and will not be deductible.

S.16B allows deduction for research and development expenditure in the year of assessment in which it was incurred in respect of payments made to any approved research institute for research and development related to that trade, profession or business. In the present case, payments to research companies in Country Z would not be deductible under s.16B.

Answer 7(a)

It appears that Carol's total chargeable income for this year of assessment is likely to be as follows:

Salaries: HK$240,000

Commission
- (April to June: HK$20,000)
- (July to September: Nil)
- (October to December: Not yet ascertained)
- (January to March: High possibility of not meeting target due to holidays overseas – Commission: Nil)

Therefore, her annual income for this year should be around HK$240,000 + HK$20,000 + commission for the period from 1 October to 31 December = HK$260,000 plus commission for the period from 1 October to 31 December.

Carol should be reminded to check her total income (i.e. salary and commission) for the period 1 April to 31 December. If her net chargeable income for this year is less than 90% of the net chargeable income of the previous year, she should be able to request for a holdover of provisional salaries tax.

On the facts before us, she should be entitled to such a claim.

However, she should note that the deadline for applying for holdover of provisional salaries tax is 28 days prior to the due date for payment of the first installment of provisional salaries tax or 14 days after the issue date of the notice of assessment whichever is later. In her case, if she wishes to apply for a holdover of provisional tax, she must do so on or before 2 January.

The Assessor would likely take into account her total income derived for the period ending 31 December and compute her annual chargeable income as follows: (Income for period ending 31 December x12/9) for the purpose of ascertaining if Carol is entitled to a holdover of provisional salaries tax and the quantum to be held over.

The IRD may challenge and seek to impose penalty under s.80(2)(c) or s.82A(1)(c) if the actual income turns out to be more than 90% of the previous years income.

Carol could request for payments by instalments but she should also note that there will be surcharges imposed.

Answer 7(b)

Cash prize
Carol could argue that this is not related to her services under the contract of employment with ABC Co. and thus not taxable.

Prize at wedding party
This is personal in nature and not related to her employment and thus not taxable.

Travel allowance
This will be a perquisite relating to her employment and services provided and thus taxable (s.9).

Answer 7(c)

Carol

(1) Reimbursement of private expenses by ABC Co., the employer, would be taxable.

(2) However, if reimbursement of expenses paid on behalf of ABC Co., then it would not be taxable.

ABC Co.

Re (1) Above payments represent staff perquisites. These are expenses incurred in the production of assessable profits and should be deductible.

Re (2) Parking fees are deductible but fines are not deductible.

Answer 8(a)

The gain on the sale of Property A should not be taxable for the following reasons:

- Property A is the matrimonial home of John and his wife. It is not held for trading purposes.
- There is no intention to trade.
- The sale was merely the disposal of one long term investment and to deploy the capital funds to finance another long term investment.
- As there is no evidence suggesting an adventure in the nature of trade, the capital gains on disposal of Property A would not be taxable.

Answer 8(b)

On the facts before us, John should be entitled to the following allowances:

- Basic allowance (if wife is separately assessed for salaries tax) or
- Married person's allowance (if wife is not separately assessed for salaries tax)
- Child allowance (for his son)
- May be entitled to dependent parent allowance if his father /parents is/are living with him or he is supporting his father /parent financially (i.e. not less than HK$12,000 p.a.)
- Mortgage loan interest deductions under s.26E. Where a person pays during any year of assessment any home loan interest for the purposes of a home loan obtained in respect of a dwelling which is used at any time in that year of assessment by the person exclusively or partly as his place of residence, a deduction in respect of the home loan interest shall be allowable to that person for that year of assessment. The amount deductible is the home loan interest actually paid by the taxpayer in the year of assessment, subject to a maximum amount of HK$100,000, and the deduction is granted to each person for 10 years of assessment, whether continuous or not. John should be entitled to claim deductions for mortgage interest incurred on Property B subject to a cap of HK$100,000.

* * * END OF EXAMINATION PAPER * * *