

SECTION A – CASE QUESTIONS

Answer 1(a)

The chargeability of the profits in question depends on whether the share in B Ltd. is a trading stock or a long-term investment.

In *Simmons v IRC* [1980] 1 WLR 1196, Lord Wilberforce held that trading requires an intention to trade and the question to be asked is whether this intention existed at the time of the acquisition of the asset. In the present case,

- B Ltd. started off as a shelf company with no business activity;
- it mainly relied on the mortgage loan from Bank C to finance the purchase consideration of the Building;
- by the sale of the subject share in August 2009, the Building had yet to generate any income for B Ltd. to meet the mortgage repayment; and
- the financial position of A Ltd. was also not good enough to assist B Ltd. in repaying the mortgage loan.

For the above reasons, it is difficult to contend that A Ltd. intended to acquire the share in B Ltd. as a long-term investment.

In addition, A Ltd. acquired and sold the subject share within a short period (only five months).

All these facts clearly show that the relevant share transactions were a trading venture and the profits so derived should thus be chargeable to profits tax.

Answer 1(b)

The broad guiding principle for determining the source of profits, as laid down by Lord Bridge in *Commissioner of Inland Revenue v Hang Seng Bank Ltd.* [1991] 1 AC 306 and expanded by Lord Jauncey in *Commissioner of Inland Revenue v HK-TVB International Ltd.* [1992] 2 AC 397, is “one looks to see what the taxpayer has done to earn the profit in question and where he has done it”.

In Departmental Interpretation and Practice Notes (“DIPN”) No. 39, the Inland Revenue Department (“IRD”) stated that the above principle would continue to apply in determining the source of profits earned by different types of business via electronic commerce. But as electronic commerce transactions involved less human activity and may be conducted using a server located outside Hong Kong, the IRD took the view that it was generally the location of the physical business operations, rather than the location of the server alone, that determined the locality of the profits. It would give greater weight to the underlying physical operations conducted by the taxpayer to earn the profits in question than the location of the electronic processes.

Although A Ltd. established certain representative offices in the Mainland to carry on a consultancy business via the internet, the staff members of those offices were only responsible for liaison work, whilst the servers there merely acted as a gateway for obtaining orders from and delivering the consultancy reports to the Mainland clients. All these functions were antecedent or incidental matters which did not determine the source of the consultancy income: see *Kwong Mile Services Limited v. Commissioner of Inland Revenue* [2004] 3 HKLRD 168. The effective cause of such income was the research work and it was done in Hong Kong. As such, the income should not be regarded as having a source outside Hong Kong.

Answer 1(c)

Article 1 of the Provisional Regulation of Business Tax of the People Republic of China provides that all units and individuals providing prescribed taxable services within the territory of People's Republic of China shall be subject to business tax. The prescribed taxable services include, inter alia, the business of providing services by making use of equipment, tools, sites, information or techniques. In considering whether a taxable service is provided “within the territory of People's Republic of China”, the State Administration of Taxation takes the view that the determinant is the place where the service recipient or service provider is located, not where the service is performed.

In the present case, A Ltd. provided consultancy services to the Mainland clients via servers operated in various representative offices. The services were taxable services by making use of information about the property market, and the service recipients were located in the Mainland. Therefore, the income from such a consultancy business shall be subject to business tax.

A Ltd. neither made a return nor payment for business tax in the Mainland. It appears that the non-compliance was entirely caused by the mistake of A Ltd. In the circumstances, the Mainland tax authorities may seek recourse for the business tax payment plus a surcharge.

Answer 2(a)

B Ltd. classified the Building as its fixed asset and let it to a manufacturing company for three years. Plainly, the Building was used for producing rental income and the stamp duty incurred in its acquisition can satisfy the conditions prescribed under s.16(1) of the IRO. The fact that A Ltd. intended to trade in the Building through the transfer of share in B Ltd. should have no relevance to the intention of B Ltd. towards the Building: see *Commissioner of Inland Revenue v Quitsubdue Limited* [1999] 2 HKLRD 481.

However, the Building was a capital asset. The relevant stamp duty should thus be of capital nature and be prohibited from deduction pursuant to s.17(1)(c) of the IRO.

Answer 2(b)

B Ltd. obtained a mortgage loan from Bank C to finance the purchase of the Building. The Building was a capital asset of B Ltd. which produced chargeable rental income, whilst Bank C was a financial institution. In the circumstances, the mortgage interest satisfied the conditions under ss.16(1)(a) and 16(2)(d) of the IRO and should be deductible. On the other hand, there is no evidence that the mortgage loan was secured by a deposit made by B Ltd. or its associate, or an arrangement was in place such that the interest payment was ultimately paid back to B Ltd. or to a connected person. Thus, the mortgage interest should not be subject to any restriction pursuant to ss.16(2A) or 16(2B) of the IRO.

Answer 3

B Ltd. acquired the Building, being a new industrial building, for letting to a manufacturing company. Thus, by virtue of ss.34(1) and 35(2)(a) of the IRO, B Ltd. was entitled to IBA (including initial allowance and annual allowance) in respect of the Building. As the Building was purchased from a property developer, for computing the IBA, B Ltd. was deemed to have incurred capital expenditure in relation to the Building equal to the net price paid by it pursuant to s.35B(b)(i) of the IRO.

On the other hand, B Ltd. let the Building to a manufacturing company which used 70% of the Building as a factory (a qualified trade) and 30% as office and showroom (non-qualified trade). As the non-qualified part exceeds one-tenth of the Building, by virtue of s.40 of the IRO and its provisos, only 70% of the net price should qualify for IBA. Of course B Ltd. may still claim Commercial Building Allowance in respect of the remaining 30% of the net price pursuant to s.33A of the IRO.

In view of the foregoing, the IBA which B Ltd. was entitled for the year of assessment 2009/10 should be computed as follows:

Qualified capital expenditure = (HK\$200 million - HK\$100 million) x 70% = HK\$70 million

Initial allowance = HK\$70 million x 20% = HK\$14 million

Annual allowance = HK\$70 million x 1/25 = HK\$2.8 million

Answer 4(a)

Before entering into the arrangement, Mr. X should have been assessed to salaries tax in respect of his whole salary under s.9(1)(a) of the IRO. He would also be entitled to home loan interest deduction under s.26E(1) of the IRO.

Under this arrangement, half of Mr. X's salary ("the Sum") would be converted into rental income in respect of the Property and he was provided with the Property as rent-free place of residence by A Ltd. Mr. X would no longer be assessed to salaries tax for the Sum. Instead, a rental value at 10% of the remaining salary would be included in his assessable income pursuant to ss.9(1)(b) and 9(2) of the IRO.

On the other hand, the Sum would be assessed to property tax by virtue of s.5(1) of the IRO after deduction of the rates paid by Mr. X (s.5(1A) of the IRO) and 20% allowance for outgoings and repairs (s.5(1B) of the IRO). Further, if Mr. X elected to be assessed under personal assessment, he would also be entitled to deduction of the mortgage interest paid in respect of the Property under the proviso to s.42(1) of the IRO. The amount of such interest deduction would be greater than that of the home loan interest deduction, which would have been allowed to Mr. X if he had not entered into the arrangement.

In short, the arrangement could cut down the taxable amount of the Sum and provide a greater amount of interest deduction. Mr. X's overall tax liabilities could thus be reduced.

Answer 4(b)

According to the terms of Mr. X's service agreement, his remuneration package only included a base salary. He was not contractually entitled to any housing benefit. Although Mr. X purported to have let the Property to A Ltd., the tenancy agreement between the parties was unstamped which was not admissible in evidence pursuant to ss.15(1) and (2) of the Stamp Duty Ordinance ("SDO"). Apart from such agreement, there is simply no evidence that Mr. X did let the Property to A Ltd. The Sum, which was allegedly paid to Mr. X as rent, was no more than part of his base salary, and it should be fully chargeable to salaries tax by virtue of s.9(1)(a) of the IRO.

Even if it were accepted that Mr. X had let the Property to A Ltd. which had in turn provided the Property back to Mr. X as free quarters, the arrangement would be considered as artificial within the ambit of s.61 of the IRO, having regard to the following:

- (a) The Property was at all material times owned by Mr. X. He had every legal right to use the Property for residence. There is neither need nor commercial sense for him to let the Property to A Ltd. and then get it back as free quarters.
- (b) The tenancy agreement took retrospective effect for two months before the date of execution. The rent provided thereunder also doubled the then market rent. Unlike the common requirement of paying rent in advance, A Ltd. was required to pay rent to Mr. X in arrears at the end of each month. All these terms are unusual for normal tenancy agreements between unrelated parties dealing with each other at arm's length. They highlight the artificiality of the tenancy between Mr. X and A Ltd.

As the arrangement, if left unchallenged, would reduce Mr. X's overall tax liabilities (see answer 4(a)), it should be disregarded pursuant to s.61. It follows that the Sum was not rental payment to Mr. X but part of his base salary and it should be fully chargeable to salaries tax under s.9(1)(a).

Answer 5

Having noticed the failure of A Ltd. to return the profits on sale of the share in B Ltd. and the consultancy service income from the Mainland clients for profits tax purposes, D & Co. should take the following actions in accordance with s.430 of the Code of Ethics for Professional Accountants:

D & Co. should promptly advise A Ltd. of the above irregularities and recommend that A Ltd. makes disclosure to the IRD. The firm is not obligated to inform the IRD, nor may it do so without A Ltd's consent.

If A Ltd. does not correct the irregularities, D & Co. should inform A Ltd. that it cannot continue the representation in connection with the relevant tax return and/or other related information submitted to the authorities. The firm should also consider whether continued association with A Ltd. in any capacity is consistent with its professional responsibilities and if it decides to continue with its professional relationships with A Ltd., it should take all reasonable steps to assure that the irregularities are not repeated in subsequent tax returns.

If because of the irregularities, D & Co. ceases to act for A Ltd., it should advise A Ltd. of the position before informing the authorities of it having ceased to act and should give no further information to the authorities without the consent of A Ltd., unless required to do so by law.

* * * END OF SECTION A * * *

SECTION B – ESSAY / SHORT QUESTIONS

Answer 6(a)

Under s.51(1) of the IRO, taxpayers are required to furnish return on profits tax within a reasonable time stated in the notice given by the assessor, or the time limit stipulated in the tax return.

Under s.51(2) of the IRO, taxpayers are required to inform the IRD in writing on the chargeability of profits tax not later than 4 months after the end of the basis period for that year of assessment.

Under s.51(3) of the IRO, taxpayers are required to furnish fuller or further returns.

Under s.51(4) of the IRO, taxpayers are required to provide information which may affect the tax liabilities of any taxpayers.

Under s.51(6) of the IRO, taxpayers are required to inform the IRD of the cessation to carry on any trade, profession or business within 1 month of such cessation.

Under s.51(8) of the IRO, taxpayers are required to inform the IRD of the change of address within 1 month of the change.

Under s.51C of the IRO, taxpayers are required to keep sufficient records to enable the ascertainment of assessable profits of not less than 7 years.

Answer 6(b)

Under s.52(2) of the IRO, employers, upon request, are required to furnish details of employees information and remuneration.

Under s.52(4) of the IRO, employers are required to inform the IRD when it commences to employ an individual in Hong Kong not later than 3 months from the date of commencement of such employment.

Under s.52(5) of the IRO, employers are required to inform the IRD when it ceases or is about to cease to employ an individual not later than 1 month before such individual ceases to be employed.

Under s.52(6) of the IRO employers are required to inform the IRD of an employee about to leave Hong Kong for more than 1 month. The IRD should be informed not later than 1 month before the expected date of departure.

Under s.52(7) of the IRO, employers, giving notice of departure of an employee under s.52(6) of the IRO, are required to withhold payments to that employee for a period of 1 month from the date of the notice, in case the employee has ceased or is about to cease to be employed in Hong Kong.

Answer 6(c)

The employers, upon request, are required under s.51(4) of the IRO to furnish information and payment details for persons other than employees (Form IR56M).

The employers should pay attention if independent individuals would render personal services under employment-like conditions, but have entered into service contracts in the name of service companies owned by them (s.9A of the IRO).

If the individuals performing employment-like services for employers have been regarded as "Relevant Individuals" under s.9A of the IRO, the employers are then required to comply with the notification requirements of s.52 of the IRO (Para 41 of DIPN 25, (August 1995)).

Answer 6(d)

Under s.16(1) of the IRO, commission paid or payable is allowed for deduction if the amounts are incurred in the production of taxable profits and are not capital in nature under s.17(1)(c) of the IRO.

Details of the payment including recipient information, nature of services provided, quantum of payment, etc. should be fully disclosed to the IRD in order to ascertain the deductibility of the claim.

Under Para. 6 & 7 of DIPN12 (September 2001), the IRD would accept the non-disclosure of the abovesaid details as a compromise for disallowance of the amount, except for circumstances when (i) taxpayers suffer overall operating loss, (ii) the expenses incurred do not fall into a basis period and will drop out for assessment purposes; (iii) the expenses were capital in nature.

Answer 7(a)

Property tax liabilities of Ms. Poon
Year of assessment 2009/10

	HK\$
Rent (7.5 x \$18,000) – 16 Aug 2009 – 31 Mar 2010	135,000
Premium (\$36,000 x 9/36) – 1 Jul 2009 – 31 Mar 2010	9,000
	<hr/> 144,000
Less: Rates (\$3,000 x 3)	(9,000)
	<hr/> 135,000
Less: 20% Statutory deduction	(27,000)
Net assessable value	<hr/> 108,000
Property tax @15%	<hr/> 16,200

Year of assessment 2010/11

	HK\$
Rent (\$18,000 x 4) – 1 Apr 2010 – 31 Jul 2010	72,000
(\$120,000 x 7/12) – 1 Sep 2010 – 31 Mar 2011	70,000
	<hr/> 142,000
Premium (\$36,000 x 12/36)	12,000
	<hr/> 154,000
Less: irrecoverable bad debts ([((\$7,000 x 3)+(\$18,000 x 4)]- \$35,000)	(58,000)
	<hr/> 96,000
<i>(1 Jan – 31 Mar) (1 Apr – 31 Jul) (Deposit)</i>	
Less: Rates (\$3,000 x 4)	12,000
	<hr/> 84,000
Less: 20% Statutory deduction	(16,800)
Net assessable value	<hr/> <hr/> \$67,200
Property tax @15%	<hr/> <hr/> \$10,080

Answer 7(b)

Individual deriving rental income subject to property tax is not entitled to claim mortgage loan interest expenses in calculating property tax liability.

Mortgage loan interest can only be allowed for deduction from net assessable value under personal assessment.

The amount of mortgage loan interest deduction is limited to the net assessable value.

Under ss.41(1), 41(1A) and 41(4) of the IRO, to be eligible for electing personal assessment, an individual must satisfy the following conditions:

- aged 18 or above, or below that age if both his/her parents are dead;
- either a permanent or temporary resident in Hong Kong; and
- for a married individual, the spouse is eligible to make personal assessment and must also elect personal assessment.

Ms. Poon is not eligible to elect for personal assessment as she is neither a permanent resident (ordinarily resides in Hong Kong) nor a temporary resident (stays in Hong Kong for more than 180 days during the year of assessment in respect of which the election is made; or 300 days in two consecutive years of assessment, one of which is the year of assessment in respect of which she elects for personal assessment).

Answer 8(a)

Under ss.25(7), 29C(10) and 29F(1) of the SDO, where upon the exchange of immovable property for another immovable property, any consideration paid, given, or agreed to be paid or given, for equality, the principal or only instrument whereby the exchange is effected shall be charged with the same stamp duty as a conveyance on sale for the consideration (Para.47 and 41 of SOIPN No.1 (August 2006)).

As the HK\$3 million difference in market value with respect of the two properties would be regarded as gift of immovable property or conveyance operating as a voluntary disposition inter vivos under s.27(1) of the SDO, the stamp duty liabilities for the swap is HK\$3 million x 1.5% = HK\$45,000.

Answer 8(b)

Relief on stamp duty under s.45 of the SDO is applicable to the transfer of the HK\$6M listed shares from D Ltd. to B Ltd. and therefore there is no stamp duty payable regarding the proposed transfer. This is based as the following grounds:

- A Ltd. effectively holds D Ltd. 90.25% shareholding (95% of C Ltd. x 95% of D Ltd.);
- B Ltd. and D Ltd. are associated body corporates as both companies are beneficially owned by a third body corporate (i.e. A Ltd.) of not less than 90% of the issued share capital of each of the companies;
- Place of incorporation of the body corporate is irrelevant to relief under s.45 of the SDO; and
- Mr. Fischer's 80% beneficial ownership of A Ltd. is also irrelevant to relief under s.45 of the SDO.

However, under ss.45(4)(c) and 45(5A) of SDO, if the transferor (D Ltd.) and the transferee (B Ltd.) ceased to be associated within 2 years after the date of the transfer by reason of a change in the percentage of the issued share capital of the transferee in the beneficial ownership of the transferor or a third body corporate, the relief will be revoked.

Answer 8(c)

Lease of immovable property for 1 year or less than 1 year will be subject to stamp duty of 0.25% of the total rent payable over the term of the lease.

For lease with premium and rent, the premium will be charged for stamp duty at the maximum rate for a conveyance on sales (i.e. 4.25%).

For rent stated as contingency, the maximum amount specified in the lease contract is applicable for the calculation (i.e. HK\$1,200,000 in the lease agreement).

The total amount of stamp duty for the lease contract is [(HK\$100,000 + HK\$1,200,000) x 12 x 0.25%] + (HK\$300,000 x 4.25%) = HK\$51,750.

Answer 8(d)

An assignment effecting a distribution in specie by a liquidator in relation to a voluntary liquidation is **not** a conveyance on sale within the scope of s.24 of the SDO (Para 21(g) of SOIPN 3 (September 1998)).

The taking back of the immovable property of Mr. Kam in the abovesaid way is therefore not subject to stamp duty.

* * * END OF EXAMINATION PAPER * * *