(f) Tax administrative penalty made by tax authority.

(g) Failure to handle cases or reply in accordance with law by the tax authority.

(h) Disqualification of VAT general taxpayers by tax authority.

(i) Notification to the border control authority by the tax authority to prevent taxpayers from departure.

(j) Other specific administrative actions done by tax authorities.

4.3 Tax administrative prosecution

In a tax dispute, a taxpayer, withholding agent, or tax payment guarantor should normally pay the tax first including any surcharge for overdue tax payment or provide guarantee in the first place and then apply for an administrative review.

The taxpayer or the withholding agent may apply to the tax authorities at the superior level for an administrative review within 60 days from the date on which the taxpayer was informed of the tax administrative measures taken by its governing tax authority or the date on which the tax and surcharges in disputes were settled or guaranteed.

The superior tax authority should make a decision within 60 days from the acceptance of the review application.

Should the party concerned still not be satisfied, legal proceedings may be instituted with the People's Court (*TARR, Article 6*). The judge will decide on the legitimacy and justice of the specific tax administrative actions of the tax authority. The scope is basically in line with that of the tax administrative review.

5 Business tax

Topic highlights

Business tax (BT) is a type of turnover tax imposed on provision of taxable services, assignment of intangible assets and the sales of immovable property within China.

As such, if a service fell within the scope of "taxable services", it would be subject to Business Tax and not VAT (refer to **section 8**).

5.1 Taxable scope

According to the *Provisional Regulations of Business Tax of the People's Republic of China* (*PRBT*), Article 1, all units and individuals providing prescribed taxable services, transferring intangible assets, or selling immovable properties (together called 'taxable services') within the territory of People's Republic of China are subject to business tax.

The prescribed taxable services include transportation service, construction industry, financial and insurance industry, post and telecommunications industry, culture and sports industry, entertainment industry and certain service industries (like hotel, catering, tourism, storing, leasing, advertising etc.) (*Detailed Rules for the Implementation of the Provisional Regulations of the People's Republic of China on Business Tax (PRBTIR), Art 2*).

Before 1 January 2009, It should be noted that provision of taxable services, transfer of intangible assets, or sale of immovable properties have to be 'within the territory of People's Republic of China' to be subject to business tax.

With effect from 1 January 2009, the most significant change on Business Tax was the change on the levying principle from where the taxable service is performed to where the service receiving or providing entity or individual is located. In other words, if either the service recipient or the service provider is located in the PRC, the service provider (i.e. income recipient) would be subject to Business Tax.

Nevertheless, pursuant to a tax notice, *Caishui* [2009] 111, jointly issued by the Ministry of Finance and the State Administration of Taxation, certain services that are provided wholly outside the Chinese territory will not be subject to Business Tax. These services include cultural and athletic activities, entertainment, hotel and catering, storage and other services such as the hairdressing, laundering and dyeing, mounting, transcription, engraving, photocopying and packing services.

The Ministry of Finance and the State Administration of Taxation have jointly issued Announcement No. 65 which, amongst other things, sets out in more detail the criteria to determine chargeability to business tax.

Prescribed taxable services	Service recipient or service provider is located in the Mainland
Transfer of intangible assets (excluding land use rights)	Transferee of the intangible assets (or the right to use) is located in the Mainland
Transfer of land use rights	Land is located in the Mainland
Selling or leasing of immovable properties	Immovable property is located in the Mainland

5.2 Specific taxable scopes

The specific taxable scopes for business tax are:

(a) **Transportation industry**

The scope of the item includes:

- overland transportation
- waterage
- air carrier
- pipeline transport
- loading and unloading transportation, toll charges of expressway; and
- various services related to transportation businesses, such as general aviation operation, air-ground service, salvage service, tallying of cargoes, piloting service, mooring and unmooring service, etc.

(b) **Construction industry**

The construction industry refers to construction and installation engineering projects. The taxable scope of this item includes:

- civil engineering construction
- installation of wire ways, pipeline, equipment and machinery
- repair and maintenance of buildings, decoration and
- other engineering operations

(c) **Financial and insurance industry**

(i) Finance refers to the operation of the business of monetary funds accommodation activity, including the following operations:

- Loans, including ordinary loans and re-lend of foreign exchange
- Financial leasing
- The transfer of financial commodities
- Trust business and financial brokerage, etc
- Domestic and overseas financial institutions engaged in offshore business such as deposit of foreign exchange, loan, inter-bank foreign exchange, international settlements, foreign exchange guarantee, consultation, attestation pertaining to providing taxable services within the territory of China

(ii) The taxable scope of insurance industry includes various insurance businesses.

(d) **Postal and telecommunications industry**

Postal and telecommunications industry refers to the businesses of specially handling information transmission. The taxable scope of this tax item includes postal and telecommunication services.

(i) Postal service refers to the business of delivering physical information, including:

- the delivery of letters or parcels
- postal remittance
- the distribution of newspapers and magazines
- the sales of postal articles; and
- other postal business

(ii) Telecommunications service refers to the business of using telex equipment to transmit electronic signals so as to deliver information, including:

- telegraph
- telex
- telephone
- telephone installation
- the sale of telecommunications articles; and
- other telecommunication businesses

(e) **Culture and sports service**

Culture and sports undertakings refer to the business engaging in culture and sports activities.

(i) Cultural undertaking includes:

- performances
- broadcasting on television, except televising of advertisement; and
- other cultural undertakings

(ii) Sports undertaking refers to the business of holding various sports competitions and providing sites for sports competitions or sports activities.

(f) **Entertainment business**

Recreational undertaking refers to the business of providing sites and services for recreational activities. The chargeable scope of this tax item includes:

- business of operating song-performing halls
- dance halls
- karaoke song and dance halls
- music saloon
- billiards
- golf course and bowling alleys
- amusement parks
- internet bar
- video-game halls,
- services provided for customers' recreational activities in the places of recreations.

(g) **Service industry**

Service industry subjected to business tax refers to the business of providing services for society by making use of equipment, tools, sites, information or techniques. The chargeable scope of this item includes:

- agency
- hotel service
- catering industry
- tourist industry

- warehouse and storage service
- leasing industry
- advertising; and
- other services

Moreover, commission charges received by the selling agent, except welfare lottery institutions for selling the welfare lottery and trustee of social security funds for engaging in management activities of social security funds, shall be levied business tax in terms of taxable service.

(h) **Transfer of intangible assets**

The transfer of intangible assets refers to the transfer of the ownership and right of use to intangible assets. The chargeable scope of this tax item includes the transfer of land-use right, exclusive right to trademark, patent right, non-patent technology, copyright and goodwill, subject to some exemptions.

(i) **Selling immovable properties**

The marketing of immovable property refers to the behaviour of transferring ownership of the immovable property with compensation. The chargeable scope of this item includes the sale of buildings and other land attachments.

5.3 Special rules for tax items

5.3.1 Mixed sales activity

A sales activity that involves both taxable services and goods shall be deemed to be a '**mixed sales activity**' *(PRBTIR, Article 6)*. The tax treatment of mixed sales activities is as follows:

(a) Mixed sales activities of enterprises, enterprise units or individual business operators engaged in production, wholesale or retail of goods shall be classified as sales of goods. Business tax shall not be levied on such sales. Mixed sales of other units and individuals shall be classified as provision of taxable services, and business tax shall be levied thereon, subject to certain exceptions. *(PRBTIR, Article 6)*

The term 'enterprises, enterprise units or individual business operators engaged in the production, wholesale or retail of goods' includes enterprises, units with an enterprise nature and individual business operators engaged principally in the production, wholesale and retail of goods, and also engaged in taxable services. *(PRBTIR, Article 6)*

There is no definition of entities "engaged principally in the production, wholesale and retail of goods, and also engaged in taxable services" under the PRBTIR. However, reference could be taken from the VAT regulation (*PRVATIR, Article 28*): "an entity or an individual is considered to be principally engaged in the production, wholesale or retail of taxable goods as its main business if the annual sales value from sales of goods and taxable services exceed 50% of the operator's total annual sales value, while the sales value of non-taxable services makes up less than 50%."

Some examples of mixed sales are as follows:

- Postal departments distributing press and selling philately commodities are liable to business tax. But the production and selling of philately commodities by entities and individuals other than postal departments are subject to value added tax.
- Telecommunications entities by themselves selling telecommunication articles and providing clients with related telecommunications services are liable to pay business tax; value added tax is levied on those who purely sell telecommunication articles, but do not provide relevant telecommunications services.
- For precast concrete components, other structural components or building materials produced at the construction sites by an infrastructure construction entity and enterprise, and used for construction projects of that entity or enterprise, business tax shall be levied. But for precast concrete components self-produced and used directly

on construction projects of that entity or enterprise, value added tax shall be levied at the time when the products are transferred for use.

Article 7 of PRBTIR provides that for the following mixed sales activities, the turnover of taxable services and the sales amount of goods shall be accounted for separately and business tax shall be paid for the turnover of taxable services. Where the turnover of taxable services and the sales amount of goods are not accounted for separately, the competent tax authority shall assess the sales amount of the taxpayer's taxable services:

- Activities of selling self-produced goods while providing construction services;
- Other circumstances specified by the Ministry of Finance and the SAT.

5.3.2 Concurrent activities

A concurrent activity usually refers to taxpayers engaged in the sale of goods, which is subject to value added tax, as well as the supply of taxable services, which is subject to business tax. For example, catering and lodging revenue of hotel accounted separately is subject to business tax, and the revenue of merchandise department of the hotel accounted separately is subject to VAT.

From 1 January 2009 onwards, there are new provisions on concurrent activities; taxpayers should account for the taxable turnover and non-taxable value separately, and the taxable turnover shall be taxed at business tax; otherwise the competent tax authority shall verify the taxable turnover. *(PRBTIR, Article 8)* And this means that the taxpayer shall pay VAT and BT respectively according to the turnover verified by tax authorities.

5.3.3 Deemed sales

(a) The sale of a newly constructed building by the entity or individual who built the building is also regarded as a taxable service subject to business tax, and it shall pay business tax for the building industry as well as transferring of immovable property.

(b) Transfers of limited property rights, or permanent rights, and transfers by entities of immovable properties by way of gifts to others, shall be regarded as sales of immovable properties and are subject to business tax.

(c) No business tax is levied on the behaviours of investments with immovable property and intangible assets under the joint profit sharing and joint obligation of investment risks. The investor shall be liable to pay business tax if they will not share investment risks with the invested. And no business tax is levied in light of interest transfer in the future.

5.3.4 Agency business

(a) **Selling goods on a commission basis**

Selling goods on a commission basis means the operating activities by which the consignee sells the consignor's goods in line with the requirements of the consignor, and collects commission charge. In regard to the sales of goods, it is subject to VAT, but in regard to agency business, the commission charge received is subject to business tax.

(b) **Purchasing goods on a commission basis**

Purchasing goods on a commission basis means the activities by which the consignee purchases goods in accordance with agreement or the requirements of consignor, and settles with the consignor according to the purchase price indicated on the invoice. As the consignee involved in the agency business provides agent service, the commission charges received are subject to business tax. The activities are regarded as purchasing activities on a commission basis if they meet three conditions:

- The consignee does not advance funds for the consignor;
- The goods seller gives a VAT invoice to the consignor, and the consignee passes the invoice on to the consignor;
- The consignee settles the account of consignment with the consignor in accordance with the sales value and VAT actually collected by the seller, and charges commission additionally.

6 Business tax rate and calculation

Topic highlights

Business tax adopts a different flat rate based on different industries, setting nine tax items, two unified proportional tax rates and one amplitude proportional tax rate.

6.1 Tax rate

(a) Tax rate of 3% is applicable to the following:

- Transportation industry
- Construction industry
- Post & telecommunications industry
- Culture and sports industry

(b) Tax rate of 5% is applicable to the following:

- Financial and insurance industry
- Service industry
- Transfer of intangible assets
- Sale of immovable properties

(c) Tax rate of 5%-20% is applicable to the entertainment industry

(The people's government of the province, autonomous region or municipality directly under the Central Government could choose the applicable tax rate according to local economic circumstances within the extent of 5% to 20%.)

Billiards and bowling halls are taxed at 5% in any region.

6.2 Calculation of tax liability

Topic highlights

Business tax is usually levied on the gross turnover of a business, including additional fees collected by the taxpayer. However, a special formula applies under certain circumstances to give the 'deemed turnover' or taxable value.

Business tax is usually levied on the gross business turnover, including additional fees collected by the taxpayer for the provision of the taxable service. 'Additional fees' include service charges, handling fees, subsidies, fund raising fees, fees collected on someone else's behalf, fees paid on someone else's behalf and various other additional charges received from purchasers. Such additional charges shall be included in the taxpayer's business turnover for the purpose of computing the business tax liability regardless of the accounting methods.

Article 5, of the PRBT states that the taxable turnover shall be the total consideration and all other charges receivable from the payers for the provision of taxable services, transfer of intangible assets or sales of immovable properties by the taxpayers, except for the following:

(1) For taxpayers who subcontract their transport work to other units or individuals, the turnover shall be the balance of the total price and other charges less the payments made to other units or individuals.

(2) For taxpayers engaged in tourism, the turnover shall be the balance of the total price and other charges less the accommodation fees, food fees, travelling fees and ticket fees paid to other units or individuals on behalf of tourists as well as payments made to other subcontract tourism enterprises.

(3) For taxpayers who subcontract construction work to others, the turnover shall be the balance of the total price and other charges less the payments made to the sub-contractors.

(4) For transaction of foreign currencies, marketable securities, futures and other financial products, the turnover shall be the balance of the selling prices and the buying prices.

(5) Other situations as regulated by the competent public finance and tax departments under the State Council.

For entertainment business, the turnover consists of various charges collected from audience including on-stage fees, song dedication fees, charges on cigarettes and drink, tea, flower, snacks and other charges collected in the course of the entertainment business operations. *(PRBTIR, Article 17)*

For sales of a second-hand property or land use right, the turnover is the total selling price less the purchase price of the property or land use right. (Article 3(20) of *Caishui* (2003) 16 and Article 3 of *Guoshuihan* (2005) 83.)

The transfer of all or part of the tangible assets of an enterprise, along with associated receivables, debt and workforce to other units in an asset restructuring transaction via a merger, division, sales or asset exchange, does not fall within the scope of business tax. The transfer of immovable property and land use rights in the course of such transactions also fall outside the scope of business tax (*Bulletin* [2011] No. 51 issued by the PRC State Administration of Taxation on 26 September 2011.)

6.2.1 Calculation using gross business turnover

The formula is:

Tax payable = Business turnover × Tax rate

Self-test question 1

A karaoke bar attained ticket sales of RMB 50,000 in February. The revenue of beverages, tobacco, and alcohol were RMB 100,000. The bar charged fees for presenting flowers of RMB 10,000, and collected fees for karaoke of RMB 150,000. The applicable business tax rate of entertainment is 10%.

Required

Calculate the business tax liability of the bar in February.

(The answer is at the end of the chapter)

6.2.2 Calculation not using gross business turnover

The formula is:

Tax payable = (Business turnover – Allowable adjustments) × Tax rate

Self-test question 2

A travel company organised a 50-person tourist group to travel abroad in August 2009, charged RMB 3,000 per tourist, paid fares of RMB 1,500, hotel expenses of RMB 750, and admission fees of RMB 100 for each tourist.

Required

Calculate business tax payable of the travel company.

(The answer is at the end of the chapter)

6.2.3 Calculation using composite taxable value

The formula is:

Tax payable = Composite taxable value × Tax rate

$$\text{Composite taxable value} = \frac{A \times (1+B)}{(1-C)}$$

Where:

A = cost of business operations
B = profit rate on cost
C = applicable business tax rate

This method may be used by the tax authority where the gross business turnover is obviously undervalued, or in deemed taxable activities without turnover.

7 Payment of Business Tax

7.1 Timing of tax liability

Business tax liability arises on the date which the taxpayer provides taxable services, transfer intangible assets or sells immovable property and the business proceeds are received or the date on which the taxpayer obtains documentary evidence of the right to collect business proceeds.

Where a taxpayer transfers land use rights or sells immovable property, and receives payments in advance, business liability arises on the date on which the advanced payments are received.

7.2 Tax periods

According to PRBT, the time period for paying business tax shall be 5 days, 10 days, 15 days, one month, or one quarter. Tax that cannot be assessed in regular periods may be assessed on a transaction-by-transaction basis.

7.3 Location of payment

Locations for the payment of business tax vary depending on the types of business conducted by the taxpayers:

(a) Taxpayers providing taxable services, transferring intangible assets and selling/leasing immovable properties should report and pay tax to the local tax authorities in-charge where their business establishment or the immovable property is located;

(b) Taxpayers providing construction services should report and pay tax where the taxable services are provided;

(c) Taxpayers transferring or leasing land use right should report and pay tax to the local tax authorities in-charge where the land is located.

8 Introduction to Value Added Tax

Topic highlights

Value Added Tax (VAT) is one of the most important turnover taxes in China. Two important pieces of legislation on VAT include the *Provisional Regulation on Value-added Tax of the People's Republic of China (PRVAT)* and the *Detailed Rules for the Implementation of the Provisional Regulation on Value-added tax of the People's Republic of China (PRVATIR)*.
The SAT also issued *Provisions for the Use of Special Invoices of Value-added Tax (VATIP)* to regulate the use of VAT invoices.

8.1 Basic principle of tax computation

VAT is a tax on turnover rather than on profits.

All units and individuals who are engaged in the sales of goods, the provision of processing, repair and replacement services, or the importation of goods, within the PRC territory, are subject to VAT.

As the name suggests, it is charged on the value added. VAT is collected bit by bit along the chain of manufacturing, wholesaling and retailing. Though VAT is levied on turnover, it is levied only on the value appreciation of every part of the chain, to prevent from double taxation. The value appreciation can be regarded as price difference, that is the balance of turnover received from providing taxable goods (excluding VAT paid by the purchaser of the goods and services) deducting the purchase price of the goods and services (excluding the VAT paid for purchasing the goods).

As mentioned in **section 5**, the provision of 'taxable services' would be subject to Business Tax and not to VAT.

Example: Tax computation

There are two manufacture chains: the first chain is to produce material A into product B, the second chain is to continuously process product B into product C. The following purchase price and selling price are both tax-exclusive price and the VAT tax rate is 17%:

chains		*Purchase price RMB*	*Selling price RMB*	*Appreciation value RMB*	*VAT payable RMB*
material A →	product B	100	200	100	100 × 17% = 17
product B →	product C	200	400	200	200 × 17% = 34

The first chain: The operator bought material A to manufacture and sell product B. It paid tax of RMB 17 to the suppliers (called input tax) in addition to the purchase price of RMB 100, therefore the total payment was RMB 117. When product B was sold, its customer was charged RMB 234, of which RMB 200 was the selling price, RMB 34 was the tax (named output tax). So that VAT payable of this chain was calculated as follows:

VAT payable = appreciation value × applicable tax rate = 100 × 17% = RMB 17, or
VAT payable = output tax – input tax = 200 × 17% – 100 × 17% = RMB 17

The second chain:

VAT payable = appreciation value × applicable tax rate = 200 × 17% = RMB 34, or
VAT payable = output tax – input tax = 400 × 17% – 200 × 17% = RMB 34

We assume that the operator is a general taxpayer for VAT purposes in the above example. (Please see definition of a general taxpayer for VAT purposes below.)

8.2 VAT payable and input credit

VAT payable = Output VAT – Input VAT

Output VAT = applicable VAT rate (generally 17%) × Sales

Input VAT = VAT paid on purchases

Input VAT paid on purchases of raw materials, fuels and powers such as electricity, heat and gas, low-value and non-durable equipment can be claimed and set off with the output VAT.

Starting from 1 January 2009, input VAT paid on fixed assets can be claimed and creditable.

8.3 VAT special invoices

The SAT issued Provisions for the Use of Special Invoices of Value-added Tax (VATIP) to regulate the use of VAT invoices. VAT is indicated on VAT special invoice issued by the merchandiser. This reduces the taxpayers' workload of calculating input tax greatly and makes tax deductions more accurate.

Key term

'VAT special invoice' means the invoice which indicates the selling price and output tax respectively when issued to the purchasers, and the VAT on the invoice is the output tax to the sellers but the input tax to the buyers.

However, where selling goods in retail chain or supplying service to the final consumers, the price and tax would not be separately indicated.

9 The scope of VAT

Topic highlights

VAT and business tax are mutually exclusive. A service or activity cannot be subject to both taxes.

9.1 Scope of VAT

PRVAT Article 1 provides that all units and individuals engaged in the sale of goods, the provision of processing, repair and replacement services and the importation of goods within the territory of the People's Republic of China are subject to VAT

'Goods' include food grains, edible vegetable oils, tap water, heating, air conditioning, hot water, coal gas, liquefied petroleum, natural gas, methane gas, coal/charcoal products for household use; books, newspapers, and magazines, feeds, chemical fertilisers, agricultural chemicals, agricultural machinery and covering plastic film for farming purposes; other goods specified by the State Council. (*PRVAT, Article 2*)

Immovable properties such as land, housing and other buildings are excluded. The loading port of the goods sold is considered to be within the territory of China.

9.2 Deemed sales

In general, the collection of VAT is on the premise of transferring the ownership of goods for compensation (*PRVATIR, Article 3*). However, in actual business activities, the following three situations often occur: first, transferring goods without transferring property rights; second, although changes have taken place for the property rights of goods, the transfer of goods is not in the form of a direct sale; third, the property rights of the goods does not change and the transfer of goods has not yet taken the form of sales, but the goods are used for other purposes similar to sales. The aforementioned three special circumstances are also subject to VAT; they are called deemed sales, and can be divided into the following types (*PRVATIR, Article 4*):

- Consignment of goods to others;
- Sales of consigned goods under consignment;
- Transferring goods from one establishment to another and across cities or counties for sales by a taxpayer who adopts consolidated tax filing;
- Applying self-manufactured goods, or processed goods for non-taxable items;
- Providing self-manufactured goods, processed goods or purchased goods to other entities or individual business operators as a form of investment;

- Distributing self-manufactured goods, processed goods or purchased goods to shareholders or investors;
- Applying self-manufactured goods, processed goods for staff welfare or personal consumption;
- Donating self-manufactured goods, processed goods or purchased goods as free gifts.

Self-test question 3

Company ABC, a general taxpayer engaged in car selling, purchased ten cars in the current month, and obtained VAT special invoice specifying sales value of RMB 800,000 and tax of RMB 136,000 respectively. In the same month it distributed four of the cars to the shareholders and one car as reward to a salesman. The exclusive price of each car is RMB 130,000. In the above activities, what is the sales value of the company ABC?

(The answer is at the end of the chapter)

9.3 Mixed sales

Key term

An economic activity that involves sales of goods as well as the provision of non-taxable labour services is referred to '**mixed sales**'. In other words, a mixed sales is a single sales transaction which involves both the supplies of goods, the provision of taxable services for VAT purpose and the provision of non-taxable services for VAT purpose (those services would fall within the scope of charge of business tax).

According to *PRVATIR, Article 5*, mixed sales are regarded as taxable supplies of VAT if entities or individuals who principally engaged in the production, wholesale or retail of goods as their main business. Mixed sales conducted by other entities or individuals are regarded as sales of non-taxable services which are subject to business tax instead of VAT.

An entity or an individual is considered to be principally engaged in the production, wholesale or retail of taxable goods as its main business if the annual sales value from sales of goods and taxable services exceed 50% of the operator's total annual sales value, while the sales value of non-taxable services makes up less than 50%. *(PRVATIR, Article 28)*

Self-test question 4

A general taxpayer of sales enterprise is responsible for goods delivery in a trade, and collected tax-exclusive sales price of RMB 200,000 for the selling goods, and freight fees of RMB 30,000. To complete the transportation, the enterprise purchased petrol and obtained VAT invoice indicating tax paid of RMB 1,000. Calculate VAT payable for the business.

(The answer is at the end of the chapter)

9.4 Concurrent activities

Concurrent activities have to be distinguished from mixed sales. In both cases, the taxpayers are involved in the sale of goods and supply of non-taxable services for VAT purposes. For mixed sales, there is a single business involving both taxable and non-taxable supplies, and the two supplies are connected to each other and are not distinguished in the sales value. However, for a concurrent activity, the two supplies do not form a single business but two different activities, and the sales values are often accounted separately.

PRVATIR Article 7 stipulates that a taxpayer engaged in non-taxable services as a sideline shall account for the values of goods and taxable service and non-taxable service separately. Without separate and accurate computations, the tax authority has the power to verify or determine the taxable sales values.

10 VAT taxpayers

Topic highlights

The payers of VAT are divided into general taxpayers and small-scale taxpayers. The general taxpayers adopt tax deduction method to calculate VAT payable; the small-scale taxpayers adopt a simplified system to calculate VAT payable.

PRVAT Article 1 provides that all units and individuals engaged in the sale of goods, the provision of processing, repair and replacement services and the importation of goods within the territory of the People's Republic of China are subject to VAT. 'Units' are defined under *PRVAT Article 9* as enterprises, administrative units, public institutions, military units, social organisations and other units. 'Individuals' are defined widely to include individual business operators and other individuals.

In practice, taxpayers adopt different methods of calculating VAT according to their scale of operations. The taxpayers are divided into two categories: the general taxpayer, who adopts the tax deduction method; and the small-scale taxpayer, who adopts a simplified calculation method.

10.1 General taxpayer and small-scale taxpayer

Generally, the taxpayers are in two categories, the general taxpayer and small-scale taxpayer. The general taxpayers are enterprises or other entities whose annual taxable sales value exceeds the threshold stipulated for small-scale taxpayers. Small-scale taxpayers also include those who have unsound accounting and auditing systems and thus have no ability to render relevant tax information accurately according to provisions.

'Unsounded accounting and auditing system' is a system which is incapable of accurately accounting for output tax, input tax and VAT payable in accordance with the accounting regulations and requirements of the tax authorities.

10.1.1 Small-scale taxpayer

According to *PRVATIR Article 28*, a small-scale taxpayer is:

(a) A taxpayer engaged in the production of goods or provision of taxable services that have annual taxable sales value below RMB 500,000 (including RMB 500,000) starting from 1 January 2009.

(b) A taxpayer engaged principally in the production of goods or provision of taxable services that have annual taxable sales value below RMB 500,000 (including RMB 500,000). The term 'taxpayer engaged principally in the production of goods or provision of taxable services' means that the sales amount of goods produced or taxable services provided by the taxpayers annually accounts for more than 50% of the annual taxable sales amount.

(c) A taxpayer engaged in the wholesaling or retailing of goods, which have annual taxable sales value below RMB 800,000 (including RMB 800,000) starting from 1 January 2009.

10.1.2 Special rules

There are special rules for general taxpayers, for example:

(a) If a head office and its branch office adopt consolidated tax filing, and the annual taxable sales value of the head office exceeds the threshold stipulated for small-scale taxpayers, but the sales value of the branch office itself does not exceed, the branch office may apply for general taxpayer status under certain circumstances.

(b) Enterprises engaging in tax-free items need not go through the application procedures for general taxpayer.

(c) Gas station of petroleum products shall be a general taxpayer whether the sales value exceeds the threshold or not.

The following are some special rules for the small-scale taxpayer:

- individuals except the individual business operators;
- non-enterprise entities; and
- enterprises who do not regularly engage in taxable activities of VAT.

Such taxpayers can choose to be small-scale taxpayers whether or not their annual taxable value exceeds the levels for small-scale taxpayers since 1 January 2009.

11 VAT tax rate

The current tax rate of VAT is divided into three classifications:

- lower rate of 13%
- basic rate of 17%; and
- zero rate which only applies to export goods.

11.1 Reduced VAT rates

The lower rate is applicable to these supplies:

- Food grains, edible vegetable oils and fresh milk;
- Tap water, heating, air conditioning, hot water, coal gas, liquefied petroleum gas, natural gas, coal/charcoal products for household use;
- Books, newspapers and magazines;
- Feed, chemical fertilisers, agricultural chemicals, agricultural machinery and plastic film for agricultural purposes;
- Audio-video products, such as sound recording tapes, videotapes, gramophone record, CD and VCD, which are published officially;
- E-journals;
- Diethyl ether;
- Other goods stipulated by State Council.

Note that, from 1 January 2009 onwards, there is an adjustment to the tax rate, and the metallic mineral and non-metallic ore products are subject to the basic rate of 17%.

11.2 Basic rate

The basic tax rate of 17% is imposed on sales or imports of goods (except the goods subjected to lower rate and export goods), and on the taxable services of processing, repair or replacement [*PRVAT, Article 2 (1)*].

For example, a commercial enterprise which sells household appliances which are subject to a tax rate of 17%, as well as fertilisers and agricultural chemicals which are subject to a reduced tax rate of 13%, shall pay VAT in the following manner.

For a taxpayer dealing in goods or taxable services at different rates, the turnover of the sales of goods and taxable service at different tax rates shall be computed separately. If the turnover of sales is not computed separately for different rates of VAT, then the highest rate shall be applicable.

If the enterprise computes the turnover separately, the sales value of household appliances is subject to the tax rate of 17%, and the sales value of fertilisers and agricultural chemicals is subject to the tax rate of 13%.

If the turnover of sales are mixed together and cannot be separated accurately, the sales value of household appliances and fertilisers, agricultural chemicals are both subject to tax rate of 17%.

11.3 Zero rate

Zero rate is applicable to the goods declared to export. The export goods qualify for the zero rate or tax-exempt except those restricted from exportation.

The zero rate means the taxpayers have no output tax while exporting goods. This is different from the exemption to selling goods. The tax effect is different:

(a) When a taxpayer qualifies for zero rate for its business activities, its

Tax payable = sales value × 0% – input tax = – input tax

which shall be refunded when goods are exported. Hence, zero rate means 'tax refund for exportation'.

(b) However, if the goods are tax-exempt instead of qualifying for zero rate, the output tax is zero. However, the related input tax cannot be deductible. The purchasers cannot obtain the VAT special invoices because the sellers have no output tax, and sellers cannot issue special invoices for their sales because of enjoying tax exemption.

11.4 VAT rate for small-scale taxpayers

For small-scale taxpayers, the applicable VAT rate is 3% on the sales value. No input VAT can be claimed for deduction.

Prior to 1 January 2009, a tax rate of 4% is for the small-scale taxpayer who is engaged in trading business.

Prior to 1 January 2009, a tax rate of 6% is for other business except for trading business.

11.5 Import VAT calculation

The VAT payable on goods imported by a taxpayer is calculated by applying the applicable VAT rate to the composite taxable value of the imported goods.

Composite taxable value include (a) transaction value on which customs duty is paid (b) customs duty and (c) consumption tax (where applicable) (For consumption tax, please see below.)

12 VAT exemptions

12.1 Exemptions

The following items are exempted from VAT (*PRVAT, Article 15 and PRVATIR, Article 35*):

- Agricultural products sold by agricultural producers ('agricultural producers' are primary products from crop-farming, poultry breeding, forestry, animal husbandry and aquatic products industries);
- Contraceptive drugs and devices;
- Antique books (defined as ancient books and second hand books purchased from the public);
- Imported instruments and equipment used directly for scientific research, experiment and education;
- Imported materials and equipment, which are as free aid provided by foreign governments and international organisations;
- Equipment and machinery imported for contract processing, assembly and compensation trade;
- Articles imported directly by organisations for the disabled for specific use by the disabled;

- Second-hand goods, which have been used and sold by the individual sellers (other than yachts, motorcycles and motor vehicles on which consumption tax had been paid; this exemption does not apply to sales of second hand goods by individual business operators).

13 Payment of VAT

13.1 Timing of tax liability

The timing at which VAT liabilities arises upon the sales of goods or taxable labour services is influenced by the method of settlement or payment modes as follows:

(a) For selling taxable goods, the tax periods shall be decided by the following conditions:

- Sales of goods by direct payment – on the date when the sales consideration is received or when documentary evidence of the right to collect the sales consideration is received.
- Sales of goods on credit or payment by instalment – on the agreed date of collection according to the written contract;
- Sales of goods with payment received in advance – on the date when the goods are delivered;
- Sales of goods with settlement through collection with the debtor's acceptance and entrusts the bank for the collection – on the date when the goods are delivered and the collection procedures are completed;

(b) Taxable goods for self-use – the date on which the goods are delivered to use.

(c) Taxable labour services – the date on which the labour services are provided and the consideration is received, or the documentary evidence of the right to collect the considerations is obtained.

(d) Taxable goods of importation – on the date of declaration of customs entry.

(e) "Deemed sales" – the date on which the goods are transferred**.**

13.2 Timing of input tax credit

General VAT taxpayers who purchase goods or taxable labour services can apply for input tax credit only when the electronically-produced VAT invoice has been verified by the tax authority within 180 days from the date the invoice is issued.

13.3 Tax periods

According to PRVAT, the time period for paying VAT shall be 1 day, 3 days, 5 days, 10 days, 15 days, one month, or one quarter. Tax that cannot be assessed in regular periods may be assessed on a transaction-by-transaction basis.

13.4 VAT Grouping

The Ministry of Finance and the SAT jointly issued *Caishui [2012] 84* on 31 December 2012 which sets out the framework under which head offices and branches may be eligible for VAT grouping. In other words, the head office of a taxpayer calculates the VAT payable both by itself and its branches. The VAT on a grouped basis is paid by the head office to the SAT at the location where the head office is located.

14 VAT Reform Pilot Programme

The PRC Ministry of Finance and the State Administration of Taxation jointly issued tax notices, *Caishui [2011] 110 and Caishui [2011] 111* on 16 November 2011. The reform will result in a merger of VAT and business tax.

Caishui [2011] No. 110 outlines the general principles for the VAT reform pilot programme to be implemented in the Mainland in Year 2012. It stipulated that the VAT reform pilot programme will be carried out in two phases. The first phase will be applicable to specific sectors in Shanghai. The second phase will be rolled out as pilot programmes to other regions for specific sectors.

Caishui [2011] No. 111 sets out the specific pilot programme to be implemented in Shanghai since 1 January 2012. Under the pilot program, service providers will be classified as 'general VAT payers' and 'small-scale VAT payers'. A taxpayer with annual taxable service turnover of at least RMB5 million should apply for the status of a general VAT payer.

Based on the two tax notices:

The applicable VAT rates for the general VAT payers (service providers) will be as follows:

Leasing of movable property and tangible goods	–	17%;
Provision of transportation and construction services	–	11%;
Provision of other specific 'modern services'	–	6%

'Modern services' are defined in *Caishui [2011] No. 111* to include research and development and technology services, information technology services, design services, intellectual property services, advertising services, meeting and exhibition services and certification services.

The VAT rate for small-scale VAT payers (service providers) will be 3%.

Taxpayers covered by the pilot programme should pay VAT at the location where the enterprise is located. Business tax paid in other regions can be deducted when calculating the VAT payable.

The Ministry of Finance and the SAT jointly issued *Caishui [2012] No. 71* which stipulated that the following eight areas would follow the implementation rules of the Shanghai VAT reform pilot programme.

Beijing	Since 1 September 2012
Jiangsu and Anhui	Since 1 October 2012
Fujian (including Xiamen) and Guangdong (including Shenzhen)	Since 1 November 2012
Tianjin, Zhejiang (including Ningbo) and Hubei	Since 1 December 2012

The Ministry of Finance and the SAT jointly issued *Caishui [2012] No. 53* on 29 June 2012 which stipulated that a foreign entity or individual that does not have a business establishment in China but provides international transportation services to Chinese domestic enterprises would be subject to VAT at a rate of 3% with retroactive effect from 1 January 2012.

The Ministry of Finance and the SAT issued *Caishui [2012] No. 86* which clarifies the categorization or tax treatment of certain services. Amongst all, transportation services provided between China and Hong Kong/Macau/Taiwan and within Hong Kong/Macau/Taiwan by taxpayers registered in the pilot areas are subject to zero VAT rate. *Caishui [2012] No. 86* became effective from 1 December 2012.

On 10 April 2013, the PRC State Council announced that the VAT pilot programme will be expanded nationwide on 1 August 2013. The State Council also announced that the scope of "modern services" will be expanded to include the production, broadcasting and publication of radio, films and television programme.

15 Introduction to consumption tax

Topic highlights

Consumption tax is a turnover tax levied on all units and individuals who manufacture taxable consumer goods, commission the processing of taxable consumer goods, or import taxable consumer goods within the territories of PRC.

15.1 The concept of consumption tax

Consumption tax is one of the most important turnover taxes in China. It is levied on manufacturers and importers of certain consumer goods, mostly luxury goods such as tobacco, liquors, cosmetics, jewellery and so on.

16 Consumption tax taxable scopes and tax rate

Topic highlights

Consumption tax can be imposed along with value-added tax on taxable consumer goods.

The major legislation governing Consumption Tax includes the *Provisional Regulations on Consumption Tax of the People's Republic of China* (PRCT) and the *Detailed Rules for the Implementation of the Provisional Regulations on Consumption Tax of the People's Republic of China* (PRCTIR).

Consumption tax may be charged on flat rate or fixed tax basis, depending on the particular taxable goods. Typical tax rates are listed below. However, the tax rates change from time to time. Practitioners should check with the tax authority for the latest rates.

Table of taxable consumer goods and typical tax rates (figures are effective from 1 May 2009 and for an indication only).

Taxable items			Tax unit	Tax rate/amount
I	Tobacco			
	1	Cigarettes,	50,000 Cigarettes	RMB 150
		Cigarettes, category A	RMB 70 or higher for 200 cigarettes	56%
		Cigarettes, category B	Less than RMB 70 for 200 cigarettes	36%
	2	Cigars		36%
	3	Cut tobacco		30%
II	Liquor and alcohol			
	1	White spirits made from cereals and potatoes		20% + RMB0.5 per 500 grams
	2	Yellow wine	Tonnage	RMB 240
	3	Beer	Priced RMB 3,000 per ton or higher (the price including packaging and packaging deposit, excluding VAT)	RMB 250
			Priced less than RMB 3,000 per ton	RMB 220
			Manufactured by catering business and entertainment industry	RMB 250

Taxable items		Tax unit	Tax rate/amount
	4 Other alcoholic drinks		10%
	5 Alcohol		5%
III	Cosmetics		30%
IV	Expensive ornaments, pearls, jewellery and jade		5% or 10%
V	Firecrackers and fireworks		15%
VI	Petroleum products	Petrol, naphtha, Solvent oil, Lubricant	RMB 1.0 per litre
		Aviation kerosene, fuel oil, diesel oil	RMB 0.8 per litre
		Leaded gasoline	RMB 1.4 per litre
		White gasoline	RMB 1.0 per litre
VII	Motor vehicle tires		3%
VIII	Motor cars	The rate is determined according to cylinder capacity	1%, 3%, 5%, 9%, 12%, 25%, 40%,
IX	Motorcycle		3%, 10%
X	Golf balls and golf instruments		10%
XI	Luxury watches	RMB 10,000 or higher per one	20%
XII	Yachts		10%
XIII	Disposable wooden chopsticks		5%
XIV	Hardwood flooring		5%

17 Consumption tax taxpayers

Topic highlights

The chargeable persons under consumption tax are given under *PRCT Article 1* and elaborated under *PRCTIR Article 2.*

PRCT Article 1 provides that all units and individuals who manufacture, subcontract the processing of, or import and sell taxable consumer goods are chargeable to the consumption tax.

'**Units**' are broadly defined in *PRCTIR Article 2* to mean enterprises, administrative agencies, public service units, military units, social organisations and other units.

'**Individuals**' include individual business operators as well as other individuals who engage in activities in relation to the taxable consumer goods subject to consumption tax.

Hence the taxpayers of consumption tax are all entities and individuals who engage in the manufacturing, retailing, processing and importation of taxable consumer goods within the territory of China.

18 Calculation of consumption tax liability

18.1 *Ad valorem* fixed rate method

Under the *ad valorem* fixed rate method, the consumption tax liability is subject to sales value and the applicable tax rate. The formula is:

Consumption tax liability = Sales value × Applicable tax rate

18.1.1 Taxable sales value

'Sales value' is defined under *PRCT Article 6* as the total consideration and other charges receivable from a purchaser on the sale of taxable consumer goods. 'Other charges' is defined in *PRCTIR Article 14* as meaning other service charges, subsidies, funds, fund raising charges, profit returned, penalties, late fees, interest on deferred payment, damages, charges withheld, advances, packaging fees, rentals of packaging, storage fees, quality charges, freight and loading and unloading charges, and charges of any other nature which are in addition to the price charged but excluding certain items like advance freight and government funds.

Tax treatments of packaging:

(a) If the packaging is sold together with the taxable consumer goods and a deposit is received and the taxpayer has not returned the packaging in the prescribed time, that **deposit** shall be included in the sales value for taxation at the applicable rate of consumption tax.

(b) When deposit of packaging is received together with the sale of liquor products (except yellow wine and beer) sold by a manufacturer of liquor products, the deposit should be included in the sales value for taxation at the applicable rate of consumption tax, no matter whether the deposit is returned and which accounting method is used by the taxpayer.

18.1.2 Conversion of 'sales value' from the inclusive value to exclusive value

While the taxable consumer good is subject to consumption tax, it is also subject to value added tax, like general goods. Under *PRCTIR*, the 'sales value' does not include the VAT collected from the buyers. If the taxpayer acquires the taxable consumer goods without separating the output tax from the sales value or for have no separate VAT invoices, the consumption tax can be calculated using the sales value excluding VAT. The conversion formula is:

Sales value of taxable consumer goods = A ÷ (1 + B)

Where:
A = Sales value including VAT
B = VAT rate or collection rate

When using the conversion formula, the VAT rate or collection rate should be applied according to the taxpayer's specific circumstances. If the taxpayer of consumption tax is a general taxpayer, VAT rate of 17% or 13% applies; if the taxpayer of consumption tax is a small-scale taxpayer, a collection rate of 3% applies since 1 January 2009.

18.1.3 Import of taxable consumer goods

For the imported taxable consumer goods, consumption tax is calculated based on the composite taxable value of the goods.

$$\text{Composite taxable value} = \frac{\text{(Value on which customs duty is paid + customs duty)}}{\text{(1 – applicable consumption tax rate)}}$$

Example: Calculation of consumption tax liability

A cosmetics manufacturer is a general taxpayer of VAT. It sold cosmetics to a shopping mall on 10 August 2009, and issued a special invoice, at a sales price (excluding VAT) of RMB 400,000 and output tax of RMB 68,000. The manufacturer also sold cosmetics to another company at a sales price of RMB 58,500 (including VAT), and issued a general invoice on 15 August.

Required

Calculate the consumption tax liability on the above businesses of the cosmetics manufacturer in August.

Solution

Consumption tax rate for cosmetics is 30%;
The taxable sales value of cosmetics = RMB [400,000 + 58,500 ÷ (1 + 17%)] = RMB 450,000
Consumption tax payable = 450,000 × 30% = RMB 135,000

Deduction of consumption tax paid

In order to avoid double taxation, current law provides that, if the purchased taxable consumer goods and consigned processing taxable consumer goods are used for further production of taxable consumer goods for sales, the consumption tax paid is allowed to be deducted from total the consumption tax liability of the final taxable consumer goods.

When calculating the consumption tax liability of the final taxable consumer goods, the tax law prescribes that the deduction for tax paid shall be calculated according to the amount used in the production during the relevant assessment period.

The formula for calculating the amount of tax paid as above is:

Deductible tax paid on taxable consumer goods purchased from other sources in the current period = deductible purchase price of taxable consumer goods purchased from other sources in the current period × applicable consumption tax rate

Deductible purchase price of taxable consumer goods purchased from other sources in the current period = purchase price of opening balance of taxable consumer goods purchased externally + purchase price of taxable consumer goods purchased from other sources in the current period - purchase price of closing balance of taxable consumer goods purchased from other sources

Self-test question 5

For a cigarette manufacturing enterprise, the value of opening balance of cut tobacco purchased externally was RMB 200,000 in March. The purchase of cut tobacco in March was valued at RMB 500,000 (excluding VAT) from other sources. The value of closing balance in March of cut tobacco was RMB 100,000.

Required

Calculate the deductible consumption tax of cut tobacco for March.

(The answer is at the end of the chapter)

19 Consumption tax relief and tax refund on exports

19.1 Tax abatement

To protect the environment and encourage replacement of high pollution vehicles, tax incentives are given for certain low emission vehicles, and the consumption tax liability may be lowered by 30%. The calculation formula is:

Tax abatement = Consumption tax payable computed at statutory rate × 30%

Tax payable = Consumption tax payable computed at statutory rate – Tax abatement

Example: Calculation of consumption tax liability

A car manufacturing enterprise, which is a general taxpayer, produced and sold 300 cars in June at VAT-inclusive price of RMB 175,500 each (VAT at 17%). The applicable consumption tax rate of 9%. The tax authority agreed that the cars produced by the enterprise met the national standard for tax abatement.

Required

Calculate consumption tax payable of the enterprise for June.

Solution

Tax payable before tax abatement = RMB175,500 ÷ (1 + 17%) × 300 × 9% = RMB 4,050,000

Actual tax payable after tax abatement = RMB 4,050,000 × (1 – 30%) = RMB 2,835,000

19.2 Consumption tax refund

19.2.1 Scope of tax refund for export

Certain taxable consumer goods are qualified for a tax refund. The policies for tax refunds are as follows:

(a) **Tax exemption and refund (foreign trade entities)**

The entities suitable for this policy are those that have approval for import and export:

- Import and export enterprises who purchased taxable consumer goods and exported the goods directly
- Foreign trade enterprise who export taxable consumer goods entrusted by other foreign trade enterprise.

(b) **Tax exemption, no tax refund (manufacturing entities)**

The entities suitable for this policy are those who have approval for import and export:

- Manufacturing enterprises with the power to export its own taxable consumer goods by themselves; or
- Manufacturing enterprises entrusting foreign trade enterprise to export taxable consumer goods

For this kind of export, the exporters shall be exempted from consumption tax according to the actual amount exported, but no tax is refunded. '**Tax exemption**' refers to production enterprise exempted from consumption tax of exportation chain according to the actual amount exported. '**No tax refund**' refers to the fact that the exported taxable consumer goods have no consumption tax burden included in the FOB because of having exempted from consumption tax while exporting, and there's no need to refund the consumption tax.

(c) **No tax exemption, no tax refund**

The items suitable for this policy are: other enterprises apart from manufacturer and foreign trade enterprise especially refer to general commercial enterprises, are not permitted to refund (exempt) tax when they entrust foreign trade enterprise to export taxable consumer goods.

19.2.2 Tax refund rate

The rate of refundable consumption tax paid for export goods and the per unit tax amount shall be computed according to the *Table of Consumption Tax Categories and Tax Rates (Tax Amount)* attached to the PRCT. For enterprises dealing in taxable consumer goods for export with varying tax rates, the goods shall be accounted and declared separately. If the tax rates cannot be differentiated clearly, the lowest tax rate shall apply.

19.2.3 Tax refund on exports

Computing basis of tax refund:

- The refundable consumption tax amount for goods exported shall be computed on the purchase prices from factories upon which consumption tax is levied if the consumption tax is levied according to the *ad valorem* rate.

Tax refund = Factory sales value of export goods × tax rate

The purchase prices including VAT shall be converted into the prices excluding VAT to be the computed basis of tax refund. The conversion formula is:

Sales value of taxable consumer goods = A ÷ (1 + B)

where:

A = Sales amount including VAT
B = VAT rate or collection rate

- The refundable consumption tax amount for goods exported shall be computed on the amount purchased and the amount declared to be exported if the consumption tax is levied according to the specific rate. The formulation for computation is:

  Tax refund = Factory sales quantity of export goods (export quantity) × Fixed tax amount of per unit

20 Payment of Consumption Tax

20.1 Timing of tax liability

The timing of consumption tax liability arising is determined respectively according to account settlement and occurrence time of the transactions.

(a) For selling taxable consumer goods, the tax periods shall be decided by the following conditions:

Sales of goods on credit or payment by instalment – on the agreed date of collection according to the written contract.

- Sales of goods with payment received in advance – on the date when the goods are delivered;
- Sales of goods with settlement through collection with the debtor's acceptance and entrusts the bank for the collection – on the date when the goods are delivered and the collection procedures are completed;
- Sales of goods with other settlement methods – on the date either the sales consideration is received or the documentary evidence to collect the sales consideration is received.

(b) Taxable consumer goods for self-use – the date on which the goods are delivered to use.

(c) Taxable consumer goods processed on consignment – on the date of the delivery of goods by the taxpayer.

(d) Taxable consumer goods of importation – on the date of declaration of customs entry.

20.2 Tax periods

According to PRCT, the time period for paying consumption tax shall be 1 day, 3 days, 5 days, 10 days, 15 days, one month, or one quarter. Tax that cannot be assessed in regular periods may be assessed on a transaction-by-transaction basis.

21 Individual Income Tax

Topic highlights

Chinese nationals and foreign individuals who reside in China or have derived PRC-sourced income are subject to Individual Income Tax (IIT) on their employment income, business income or other personal income. There are 11 categories of taxable income.

The original *Individual Income Tax Law (IITL)* of the People's Republic of China came into effect on 1 January 1994 and the *Individual Income Tax Implementation Regulations (IITIR)* was issued on 28 January 1994.

The amended IITL came into effect on 1 September 2011. The amended IITIR was issued on 19 July 2011.

21.1 Tax resident

A PRC tax resident would be subject to IIT on his/her worldwide income whilst a non-PRC tax resident would be subject to IIT on his/her PRC-sourced income *(IITL, Article 1)*.

A PRC tax resident is an individual who is usually or habitually resides in China due to household registration, family or economic relationship *(IITIR, Article 2)*.

21.2 Source of income

Whether an individual would be subject to IIT would depend on the following factors:

- Whether he/she is regarded as a PRC tax resident or a non-PRC tax resident
- The length of the individual's stay in the PRC
- Whether he/she holds the position of senior management in a Chinese domestic enterprise
- The locality of services rendered
- Whether tax treaty exemption is applicable

21.3 Categories of taxable income

The following eleven categories of income are subject to IIT (*IITL, Article 2)*:

- Wage and salary
- Production and business operation derived by individual entrepreneurs operating small businesses
- Income derived by an individual from contracting, subcontracting, leasing or subleasing the operations of an enterprise
- Income derived by an individual who acts as an independent contractor
- Remuneration from manuscripts
- Royalties
- Interest, dividends (Note) or bonuses received by an individual from loan credits and equity shares
- Rental income from property leasing
- Income from sales of properties
- Contingency income such as winnings, awards or other 'windfall' income
- Other taxable income specified by the Ministry of Finance

Directors' fees are subject to IIT under the category of 'Income derived by an individual who acts as an independent contractor'.

Income derived from a partnership or a sole proprietorship is taxed under the category of Production and business operation derived by individual entrepreneurs operating small businesses.

Note: The Ministry of Finance and the SAT issued *Caishui [2012] No. 85* which provides a 50% IIT reduction on dividend income earned from listed shares held by individual investors for more

than one month but not more than one year, and a 75% IIT reduction on dividend income earned from listed shares held by individual investors for more than one year. *Caishui [2012] No. 85* became effective from 1 January 2013.

21.4 Employment income

Out of the eleven categories of taxable income, this section will focus on employment income.

21.4.1 Tax relief for temporary visitors

A temporary visitor is an individual who has resided in the Mainland, continuously or cumulatively, for a total of 90 days or less during a calendar year or 183 days or less in the prescribed time period if a tax treaty applies. A temporary visitor is exempt from paying IIIT on their employment income unless such income is borne or deemed borne by any Chinese domestic enterprises.

For the purpose of counting the number of days that an individual is present in the Mainland during a calendar year, the day of entry into the Mainland and the day of departure from the Mainland are each counted as one day presence in the Mainland *(Guoshuifa (4) 97, Article 1)*.

A chief representative or registered representative who holds a position in a representative office in China would not be eligible for the above-mentioned 90-day or 183-day exemption as their remuneration is deemed borne by the representative office.

Special Treatment for Hong Kong resident employees

Starting from 1 June 2012, Hong Kong (and Macau) resident employees can enjoy a favourable treatment for an elimination of double taxation pursuant to a *Public Notice [2012] No. 16* issued by the PRC SAT. The SAT now accepts the time apportionment of the salary and bonus income on the 'physical day presence' which basis is in line with the apportionment basis adopted by the Hong Kong IRD.

According to Public Notice [2012] No. 16, if any Hong Kong resident employee stays in the Mainland *for not more than 183 days in any 12-month period* under the Hong Kong- Mainland double taxation arrangement, his/her PRC IIT liability will be calculated as follows:

$$\text{IIT Payable} = \text{IIT on full income} \times \frac{\text{No. of days physically present in PRC in a particular month}}{\text{No. of days in that calendar month}} \times \frac{\text{Portion of income borne by PRC}}{\text{Full income}}$$

The above special tax treatment is only applicable to Hong Kong tax residents who are employed by a Hong Kong company or who are concurrently employed by both a Hong Kong company and a Mainland company. In other words, if the Hong Kong tax resident employee is employed by a domestic Chinese enterprise, this special treatment would not be applicable.

The Guangzhou Local Tax Bureau issued *Sui Di Shui Ban Fa [2012] No. 27* on 14 August 2012 confirming that starting from 1 June 2012, a Hong Kong or Macau resident who spends all their working days in China but only spends weekends and holidays outside China can enjoy time apportionment based on actual days spent in China.

Besides the above, qualified Hong Kong residents working in Qianhai District of Shenzhen and Hengqin District of Zhuhai would be qualified for preferential IIT treatments.

21.4.2 Non-PRC tax residents who live in the Mainland for more than 90 days or 183 days but less than one full year

Individuals who have resided in the Mainland for 365 days in any 12-month period are deemed to have lived in the Mainland for '**one full year**'. A 'temporary absence' from the Mainland of 30 days or less for a single trip *or* 90 days or less for multiple trips are not counted as non-PRC days *(IITIR, Article 3).*

A non-PRC tax resident who resides in the Mainland for more than 90 days in any 12-month period or 183 days in the prescribed period under the respective tax treaty but less than one full year, would be subject to IIT on employment income derived during their 'actual working days in The Mainland'.

If the taxpayer is employed by a Chinese enterprise, his/her actual working days in the Mainland include public holidays, personal vacation days spent inside or outside the Mainland and training days.

If the taxpayer does not hold any position in a Chinese enterprise or is *not* employed by any Chinese enterprise, his/her actual working days in the Mainland include work days in the Mainland and those public holiday in the period he/she works in the Mainland.

21.4.3 Non-PRC tax residents who live in the Mainland for more than one full year but less than five years

They would be subject to IIT on their PRC-sourced income plus any non-PRC sourced income which is paid to them by a Chinese domestic enterprise.

21.4.4 Individuals who live in the Mainland for five consecutive full years

Once a non-PRC tax resident resides in the Mainland for five consecutive full years, he/she would be subject to IIT on worldwide income in any subsequent year (the sixth year onwards) if he/she lives in the Mainland for one full year.

However, if such an individual does not live in the Mainland for the full year in any subsequent year, he/she would be subject to Individual Income Tax only on his/her PRC-sourced income for that year.

If such an individual lives in the Mainland for less than 90 days in the subsequent year, the five-year period will be re-calculated from the year in which he/she resides for one full year *(Caishuizi (1995) 98).*

21.5 Individual Income Tax Computation

Starting from 1 September 2011, the applicable IIT rate for employment income ranges from 3% to 45% (7 progressive tax brackets), depending on the income level. Please refer to the Appendix in Chapter 1 for details.

The prevailing standard monthly deduction for a PRC tax resident and a non-PRC tax resident is RMB3,500 and RMB4,800 respectively.

The formula for calculating IIT payable on wages and salaries using the quick calculation deduction is as follows:

[Monthly income – standard allowable deduction] × applicable tax rates under the applicable progressive tax brackets

21.6 Senior Management

'Senior management personnel' in a Chinese enterprise is defined in *Guoshuihanfa (1995) 125, Article 3* to include:

- General manager
- Deputy general manager
- Persons assuming functional chief positions
- Chief supervisors
- Other persons assuming similar company management level positions

Guoshuihan (2007) 946 clarifies the IIT calculation methods for senior management personnel.

For those who **do not** spend more than 90 days in a calendar year or 183 days under the respective tax treaty would be subject to IIT as follows:

Formula to learn

$$\text{Total IIT on salaries from inside and outside for a month the Mainland} \times \frac{\text{Salary derived or paid from PRC during the month}}{\text{Total salary received during the month}}$$

For those who spend more than 90 days or 183 days (if treaty applies) but less than five years would be subject to IIT as follows:

$$\text{Total IIT on salaries from inside and outside for a month the Mainland} \times (1 - \text{time apportionment factor})$$

Time apportionment factor

$$\frac{\text{Salary received outside the Mainland during a month}}{\text{Total salary received for a month}} \times \frac{\text{Days worked outside the Mainland during a month}}{\text{Total days in a month}}$$

For those who spend five full consecutive years, they would be subject to IIT on their worldwide income

21.7 Tax Administration

Individuals who are liable to IIT should be required to register with the local tax bureau. The tax registration requirements may vary depending on the requirements of the local tax bureau.

Generally speaking, the employer (the payer of employment income) should act as the withholding agent to withhold IIT from wages and salaries payable to employees *on a monthly basis*.

An individual taxpayer with annual taxable income (from all eleven categories) of more than RMB120,000 per annum would be required to self-report his/her taxable income to the local tax bureau in-charge within three months after the year end *(IITIR, Article 36).*

IIT on wages and salaries is calculated and levied on a monthly basis. Withholding agents should submit IIT withholding returns and make the related tax payments to the local tax bureau in-charge within 15 days after the end of the month.

Self-test question 6

Peter is an expatriate working for a foreign investment enterprise in Shenzhen, the Mainland. His monthly salary is RMB20,000. Peter is stationed in Shenzhen.

Required

Calculate his PRC Individual Income Tax liability

(The answer is at the end of the chapter)

22 Corporate Income Tax

Topic highlights

Starting from 1 January 2008, all enterprises including foreign investment enterprises, foreign enterprises and Chinese domestic enterprises) which derive income within the territory of the PRC shall be liable to Corporate Income Tax (CIT).

The prevailing CIT Law (CITL) was promulgated on 16 March 2007 which unifies the income tax treatments of domestic and foreign investment enterprises. The CITL became effective on 1 January 2008. The CIT Implementation Rules (CITIR) were issued on 11 December 2007.

22.1 Tax resident

A PRC tax resident would be subject to CIT on its worldwide income whilst a non-PRC tax resident would be subject to CIT on the PRC-sourced income.

A PRC tax resident includes an enterprise which is established in the Mainland pursuant to Chinese laws OR an enterprise which is established under the laws of a foreign country but has **'effective management'** in the Mainland. *(CITIR, Article 2)*

The CITIR defines the 'place of effective management' as the place where the exercising of the overall management and control of the production and business operations, personnel, accounting, properties etc. of a foreign company is, **in substance**, located.

A non-PRC tax resident refers to an enterprise established under the laws of a foreign country ***and*** has its place of effective management outside the Mainland. A non-PRC tax resident also includes a foreign company which does not have an 'establishment' in the Mainland. *(CITIR, Article 2)*.

'Establishments' are defined under *CITIR, Article 5* to include:

- a place of management or operation;
- a farm, factory or place of extraction of natural resources;
- a place where services are rendered;
- a place of construction, installation, assembly, repair and exploration; and
- other establishments engaged in manufacturing and business operating activities.

22.2 Corporate Income Tax Computation

22.2.1 PRC tax residents

CIT is levied at a rate of 25% on the taxpayer's net taxable income on an annual basis. The taxpayer's net taxable income in a tax year (1 January to 31 December of every year) after deducting the non-taxable items, tax-exempt items, other allowable items and the agreed tax losses carried forward *(CITL, Article 5).*

The State-encouraged High-and-New Technology Enterprises are subject to a reduced CIT rate of 15% *(CITL, Article 28).*

Small-scale enterprises are subject to a reduced CIT rate of 20% *(CITL, Article 28).* Small-scale enterprises include:

(a) industrial enterprises whose annual taxable income does not exceed RMB300,000, the number of employees does not exceed 100 and the total assets do not exceed RMB30 million,

(b) non-industrial enterprises whose annual taxable income does not exceed RMB300,000, the number of employees does not exceed 80 and the total assets do not exceed RMB10 million *(CITIR, Article 92).*

In calculating the CIT, some items have deduction thresholds. For example, the deduction threshold of employee's welfare expenses, employee's education expenses and labour union fees are 14%, 2.5% and 2% respectively of wages and salaries paid in a tax year. Also, entertainment expenses incurred in relation to the production and business operation are deductible to the extent of 60% of the expenses incurred, but with a cap of 0.5% of total revenue of a tax year. An enterprise may claim qualified donations of up to 12% of its annual profit as deductible expenses *(CITL, Article 9).*

Advertising and promotional expenses will be deductible up to 15% of annual sales revenue for corporate income tax purposes. This cap can be increased to 30% of annual sales revenue for manufacturing companies of cosmetics, pharmaceutical products and non-alcoholic beverages as well as trading companies of cosmetics up until 31 December 2015 *(Caishui [2012] No. 48).*

Depreciation can be computed using the straight line method. According to *CITIR, Article 59*, no more fixed residual percentage is required. The minimum depreciation period ranges from 3 years for electronic equipment to 20 years for building.

Tax losses incurred by enterprises in a tax year can be carried forward to set off against taxable profits of the next five years *(CITL, Article 8)*. Tax losses cannot be carried backward.

22.2.2 Non-PRC tax residents with establishments in the Mainland

Non-resident enterprises with establishments in the Mainland would pay CIT on PRC-sourced income and income which is 'effectively connected' with its establishments in the Mainland *(CITL, Article 3).*

The 'effectively connected income' refers to income earned by the establishments of the non-resident enterprises in the PRC.

According to *Guoshuifa (2010) 19*, non-resident enterprises which has establishments in the Mainland should set up accounting books in accordance with the Tax Collection and Administration Law and maintain adequate accounting records so as to calculate the taxable income. If a non-resident enterprise is unable to accurately calculate its taxable income because of incomplete accounting records or a lack of information, the PRC tax authorities are empowered to assess the taxable income based on one of the following methods *(Guoshuifa (2010) 19, Article 4)*:

Deemed profit based on revenue	$\text{Taxable income} = \text{Gross revenue} \times \text{deemed profit rate}$
Deemed profit based on costs and expenses	$\text{Taxable income} = \left[\frac{\text{Total costs and expenses}}{(1 - \text{deemed profit rate})}\right] \times \text{deemed profit rate}$
Deemed profit based on expenses	$\text{Taxable income} = \left[\frac{\text{Total expenses}}{(1 - \text{deemed profit rate} - \text{Business tax rate})}\right] \times \text{deemed profit rate}$

According to *Guoshuifa (2010) 19, Article 5*, the deemed profit rate of a non-resident enterprise is determined by the local tax bureau in-charge base. The general guidelines are as follows:

Provision of construction, design and related consulting services	15% to 30%
Provision of management services	30% to 50%; and
Provision of other services	not less than 15%

22.2.3 Non-PRC tax residents without any establishment in the Mainland

A non-PRC tax resident which does not have any establishment in the Mainland may derive income sourced from the Mainland such as dividends, interest, royalties, rental income and gains from the transfer of assets. Such non-PRC tax resident would be subject to CIT on a withholding tax basis of the **gross** income.

The applicable withholding tax rate is 10% *(CITIR, Article 91).* The applicable withholding tax rate may be reduced under the respective tax treaties signed with the Chinese government.

According to CITL and CITIR, business tax paid on interest or royalty income is not deductible in calculating the withholding tax liabilities. *(CITL, Article 19; CITIR, Article 103).*

22.3 Tax Administration

22.3.1 PRC tax residents and non-tax residents with establishments in the Mainland

These enterprises should file quarterly provisional CIT returns to the local tax bureau in-charge within 15 days after the end of each quarter and make the corresponding tax payments *(CITL, Article 54)*.

The provisional tax payments can be calculated based on actual profits of a quarter or quarterly taxable income of last tax year.

Regardless of whether an enterprise incurs profits or losses in a tax year, such an enterprise is required to file provisional CIT returns *(CITIR, Article 129).*

The enterprises should also submit annual CIT returns and settle the final tax payments within four months after the end of each tax year (1 January to 31 December).

Audited financial statements should be submitted together with the annual CIT returns.

Provisional quarterly CIT paid can be used to set off the annual CIT liability. Any overpayment will be refunded.

Regardless of whether an enterprise incurs profits or losses in a tax year, such enterprise is required to file its annual CIT return, audited financial statements to the PRC tax bureau *(CITIR, Article 129).*

New CIT filing requirements for enterprises with branches

The Ministry of Finance, the SAT and the People's Bank of China have made some changes to the filing obligations and settlement of CIT liability by enterprises whose head offices and branches are located in different provinces in China (Caiyu [2012] No. 40).

Circular 40 became effective from 1 January 2013. It made changes to the final annual settlement and the selection of historical data to allocate provisional CIT amongst branches.

The head office is responsible for calculating the annual CIT liability. After the deduction of respective provisional CIT paid, the head office and the branches must pay their own underpaid CIT in the respective locations.

22.3.2 Non-PRC tax residents without any establishment in the Mainland

The payer shall be the withholding agent *(CITL, Article 37)*. The withholding agent is required to withhold the tax liability from each payment made to the non-resident recipient upon the time of actual payment or when the payable amount is due or payable *(CITL, Article 37).*

An amount is due or payable when such payable item is booked by the payer as a cost or expense on an accrual basis *(CITIR, Article 105).* When the payer (a PRC enterprise) has already recorded the payments as costs or expenses and claimed deductions for those expenses in their CIT returns, the payer should withhold CIT on such payment to the non-resident recipients.

A tax withholding agent is required to perform the tax withholding registration to the local tax bureau in-charge within 30 days from the commencement of withholding obligations *(Regulations on Implementation of Administration of Tax Collection, Article 13).*

The withholding agent is obliged to withhold tax from dividends, interest, royalties, rental etc. within five days of each payment.

The SAT issued *Public Notice [2013] No. 9* which became effective on 19 February 2013. According to *Public Notice [2013] No. 9,* passive income derived by non-resident enterprises which have no establishment in China from the provision of services stipulated in VAT reform pilot programme (see section 14 above) should be subject to withholding tax on the amount of gross income **net** of VAT.

22.4 Transfer Pricing

The PRC SAT issued the *Implementation Regulations for Special Tax Adjustments (Trial) (Guoshuifa (2009) 2)* in January 2009 which set out the transfer pricing regime in the Mainland. *Guoshuifa (2009) 2* is retroactive for transactions conducted since 1 January 2008.

The Mainland follows the OECD transfer pricing guidelines. Related parties should conduct their transactions on an arm's length basis. In other words, the pricing charged on transactions conducted between related parties should be comparable to that charged between independent enterprises under identical or similar market conditions.

The OECD transfer pricing guidelines have long set the standards for transfer pricing including China. However, now the United Nations, with its 193 members, released the Practical Manual on Transfer Pricing ("UN Manual") in October 2012 with special chapters for developing countries including China.

The SAT states that China wants its "fair share" of global taxes in line with its contribution to global profits. For example, the SAT is taking the view that location savings need to be reflected in the cost-plus markup for R&D. Cost-plus should not be used in cases where the entity has high and new technology status etc.

Self-test question 7

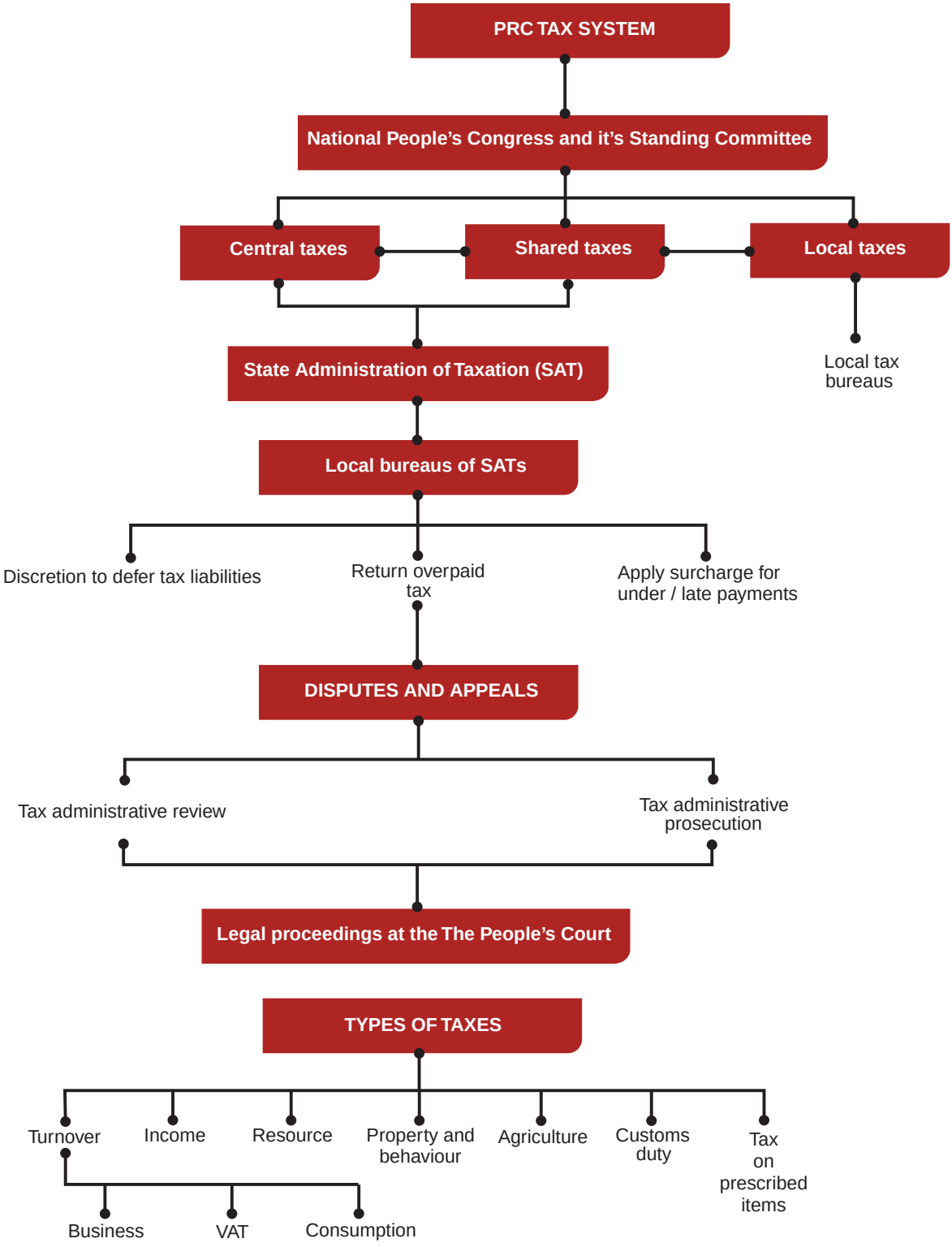
Company A is a Hong Kong incorporated company which has set up a wholly foreign-owned subsidiary in Shanghai, the Mainland. In Year 2012, the Shanghai subsidiary paid a dividend amounted to RMB100,000 to its Hong Kong parent company.

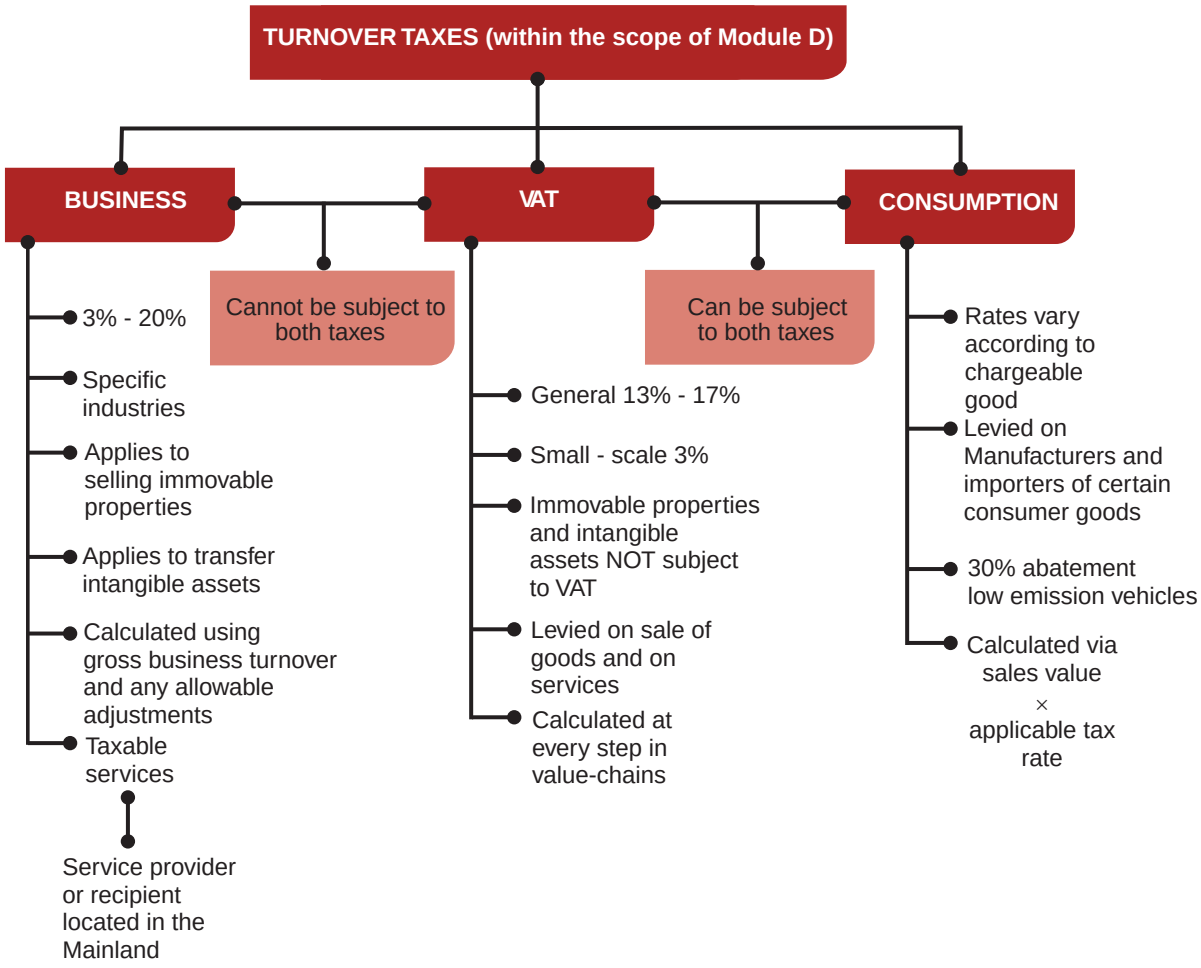
Required

Calculate the PRC Corporate Income Tax exposure of Company A

(The answer is at the end of the chapter)

Topic recap


PRC TAX SYSTEM
National People's Congress and it's Standing Committee
Central taxes
Shared taxes
Local taxes
Local tax bureaus
State Administration of Taxation (SAT)
Local bureaus of SATs
Discretion to defer tax liabilities
Return overpaid tax
Apply surcharge for under / late payments
DISPUTES AND APPEALS
Tax administrative review
Tax administrative prosecution
Legal proceedings at the The People's Court
TYPES OF TAXES
Turnover
Income
Resource
Property and behaviour
Agriculture
Customs duty
Tax on prescribed items
Business
VAT
Consumption


TURNOVER TAXES (within the scope of Module D)
BUSINESS
VAT
CONSUMPTION
3% - 20%
Specific industries
Applies to selling immovable properties
Applies to transfer intangible assets
Calculated using gross business turnover and any allowable adjustments
Taxable services
Service provider or recipient located in the Mainland
Cannot be subject to both taxes
Can be subject to both taxes
General 13% - 17%
Small - scale 3%
Immovable properties and intangible assets NOT subject to VAT
Levied on sale of goods and on services
Calculated at every step in value-chains
Rates vary according to chargeable good
Levied on Manufacturers and importers of certain consumer goods
30% abatement low emission vehicles
Calculated via sales value × applicable tax rate

Answers to self-test questions

Answer 1

The turnover of entertainment includes the sales value of commodities such as tobacco and alcohol provided for recreational activities, the activity belongs to mixed sales activity.

Business tax payable = (50,000 + 100,000 + 10,000 + 150,000) × 10% = RMB 31,000

Answer 2

Transport fares, hotel expenses and admission fees paid by Travel Company for tourists should be deducted from total revenue, only the actual turnover is subject to business tax.

Business tax payable = (3,000 – 1,500 – 750 – 100) × 50 × 5% = RMB 1,625

Answer 3

Distributing purchased goods to shareholders is deemed as sales. Awarding a purchased car to a salesman is using purchased goods for employee welfare, so the input tax cannot be deductible. Then the sales value of the activity is: RMB 130,000 × 4 = RMB 520,000

Answer 4

The business activity involved a mixed sale. The mixed sale is principally engaged in VAT taxable activities. The selling of goods and transporting them generated the mixed sale. The tax authority is likely to treat both sales value of goods and business turnover of transportation as subject to VAT.

VAT payable = RMB [200,000 + 30,000/(1 + 17%)] × 17% – RMB 1,000 = RMB 37,359

Answer 5

The applicable consumption tax rate of cut tobacco is 30%.

Deductible purchase price of cut tobacco purchased from other sources in the current period

= RMB [200,000 + 500,000 – 100,000] = RMB 600,000

Deductible tax paid on cut tobacco purchased from other sources in the current period

= RMB600,000 × 30% = RMB 180,000

Answer 6

Taxable income = RMB(20,000 – 4,800) = RMB15,200

Progressive tax rates on taxable income from wages and salary

Monthly taxable amount (RMB)	Tax rate
1,500 or less	3%
Income in excess of 1,500 to 4,500	10%
Income in excess of 4,500 to 9,000	20%
Income in excess of 9,000 to 35,000	25%
Income in excess of 35,000 to 55,000	30%
Income in excess of 55,000 to 80,000	35%
Income in excess of 80,000	45%

Monthly Individual Income Tax liability

= RMB(1,500 × 3% + 3,000 × 10% + 4,500 × 20% + 6,200 × 25%)

= RMB(45 + 300 + 900 + 1,550)

= RMB2,795

Answer 7

Company A would be subject to PRC withholding tax on dividends.

The prevailing PRC withholding tax rate on dividends is 10%. However, such withholding tax rate on dividends can be reduced to 5% under the Hong Kong-Mainland Double Taxation Arrangement.

PRC withholding tax exposure of Company A on dividends received from Shanghai subsidiary

= RMB100,000 × 5% = RMB5,000

The Shanghai subsidiary is obligated to withhold and pay tax to the PRC tax authority on behalf of Company A.

Exam practice

Business tax

6 minutes

Briefly explain the scope of business tax.

(3 marks)

Prince Limited

Comment on the PRC turnover tax perspectives and, where appropriate, provide your recommendations. Support your answers with relevant provisions of the PRC rules and regulations:

Prince Limited is a consultancy company incorporated and centrally managed in Hong Kong. Recently, it has been engaged by a PRC client to provide business consultancy services directly in the client's office in Guangzhou, Guangdong Province of the PRC. The services were completed within two weeks, and Prince Limited received RMB100,000 and RMB1,800 as income and travelling expenses reimbursement respectively. The accounting manager of Prince Limited has no idea whether the above-said amounts would have any PRC turnover tax exposure in view of the short duration of time providing the services in the PRC, and the relatively small amount of income involved.

(6 Marks)

HKICPA December 2012

Further reading

Suggested References

When studying this topic we suggest the following references:

Primary References

中國注冊會計師考試 - 稅法

中國稅制概覽（2012 年海外版）北京：經濟科學出版社；香港貿易發展局

Advanced Taxation in Hong Kong Pearson (Chapter 23).

China Master Tax Guide 2012/13 (10th edition), CCH Hong Kong Ltd

Hong Kong Taxation and Tax Planning, Pilot Publishing Co Ltd (Chapter 44)

PRC Laws and regulations (**www.chinatax.gov.cn**)

Answers to exam practice questions

Chapter 1 The tax system in Hong Kong

Basic Law

Some articles of the Basic Law that are relevant to Hong Kong taxation are as follows:

Administrative arrangements for the government of the HKSAR, under the principle of 'one country, two systems', are set out in the Basic Law:

Article 5: 'The socialist system and policies shall not be practised in the Hong Kong Special Administrative Region, and the previous capitalist system and way of life shall remain unchanged for 50 years.'

Article 8: 'The laws previously in force in Hong Kong, that is, the common law, rules of equity, ordinances, subordinate legislation and customary law shall be maintained, except for any that contravene this Law, and subject to any amendment by the legislature of the Hong Kong Special Administrative Region.'

Article 73: 'The Legislative Council of the Hong Kong Special Administrative Region shall exercise the following powers and functions:

(3) To approve taxation ...'

Article 106: 'The Hong Kong Special Administrative Region shall have independent finances. The Hong Kong Special Administrative Region shall use its financial revenues exclusively for its own purposes, and they shall not be handed over to the Central People's Government. The Central People's Government shall not levy taxes in the Hong Kong Special Administrative Region.'

Article 107: 'The Hong Kong Special Administrative Region shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product.'

Article 108: 'The Hong Kong Special Administrative Region shall practise an independent taxation system. The Hong Kong Special Administrative Region shall, taking the low tax policy previously pursued in Hong Kong as a reference, enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation.'

Article 151: 'The Hong Kong Special Administrative Region may on its own, using the name 'Hong Kong, China', maintain and develop relations and conclude and implement agreements with foreign states and regions and relevant international organisations in the appropriate fields, including the economic, trade, financial and monetary, shipping, communications, tourism, cultural and sports fields.'

Article 153: 'The application to the Hong Kong Special Administrative Region of international agreements to which the People's Republic of China is or becomes a party shall be decided by the Central People's Government in accordance with the circumstances and needs of the Region, and after seeking the views of the government of the Region. International agreements to which the People's Republic of China is not a party but which are implemented in Hong Kong may continue to be implemented in the Hong Kong Special Administrative Region. The Central People's Government shall, as necessary, authorise or assist the government of the Region to make appropriate arrangements for the application to the Region of other relevant international agreements.'

(Refer to DIPN 29 for fuller explanation on these articles.)

Chapter 2 Administration procedures under the Inland Revenue Ordinance

Mr. Brown

(a) An assessor may raise an additional assessment under s.60 within one year of assessment or within six years after the expiration of the year of assessment if the taxpayer has not been assessed or has been assessed at less than the proper amount. If the non-assessment or under-assessment is due to fraud or wilful evasion, the time limit is ten years after the expiration of the year of assessment.

On the other hand, additional tax is a penalty raised under s. 82A of the IRO, either by the Commissioner or his Deputy personally, on a person who has committed any of the following offences without a reasonable excuse:

- made an incorrect return by omitting or understating anything; or
- made an incorrect statement in connection with a claim for any deduction or allowance; or
- given incorrect information in relation to any matter or thing affecting his own liability to tax or the liability of any other person or of a partnership; or
- failed to comply with the requirements of a notice given to him under s.51(1) or s.51(2A) (ie fails to submit a tax return within the specified time limit); or
- failed to inform the Commissioner of his chargeability to tax (s.51(2)).

Additional tax is payable in addition to any tax payable under an assessment or an additional assessment. The maximum amount of additional tax is three times the tax that was undercharged or would have been undercharged from the offence of the taxpayer. For the Commissioner or his Deputy to raise an additional tax assessment on a taxpayer, there must be no prosecution, either under s.80(2) or s.82(1), initiated against the taxpayer.

(b) Tax avoidance involves the reduction or deferral of tax liability by the use of lawful means. The ambit within which tax avoidance can be applied is limited by:

(1) anti-avoidance provisions (e.g. s.61A); and

(2) the fiscal nullity principle under common law (if there are no general anti-avoidance provisions under the statute).

The transactions or arrangements to avoid tax are entered into before the tax liabilities arise. If enquiries are made by the IRD, there must be no misrepresentation or concealment.

Tax evasion, on the other hand, involves the reduction of tax liabilities by illegal means such as deceit, subterfuge, concealment, attempts to colour or obscure events, or making things seem other than they are. The arrangements for tax evasion are entered into after the tax liabilities arise. Tax evasion is a criminal offence subject to severe punishment including prison sentence.

(c) If the IRD takes legal action against Mr Brown under s.82(1), the burden of proof is on the prosecution. The IRD will need to prove beyond reasonable doubt that Mr Brown has committed certain wrongful acts such as the submission of false statements or returns, falsification of books of accounts or records, etc with a wilful intent to evade tax or assist other persons to evade tax.

If Mr Brown is convicted under s.82(1), he may be subject to penalty as follows:

On summary conviction

A fine at level 3 (i.e. $10,000) plus three times the tax undercharged or that would have been undercharged (in his case: $48,000 × 3 = $144,000) and to imprisonment for six months.

On indictment

A fine at level 5 (ie $50,000) plus three times the tax undercharged or that would have been undercharged (in his case: $48,000 × 3 = $144,000) and to imprisonment for three years.

The Commissioner may compound any offence under s.82 and may before judgment stay or compound any proceedings thereunder.

Varian Inc.

(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.

(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.

(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)).

(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 above said 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.

Barry Fisher

(Draft)

The Commissioner of Inland Revenue
G. P. O. Box 132
Hong Kong
(Our Reference)

Dear Sir,

Mr. Barry Fisher
(IRD File No.)

Objection: Year of Assessment 2010/11

On behalf of our above-named client, we hereby object to the 2010/11 salaries tax assessment under Charge No: X-XXXXXXX-XX-X dated 14 September 2011 in accordance with s.64(1) of the IRO.

Our grounds of objection are as follows:

(a) The assessment is excessive.

(b) Our client's employment had a source outside Hong Kong and his income from employment should be assessed to salaries tax on a time apportionment basis.

(c) He should be entitled to married person's allowance and child allowance.

As the assessment was raised in the absence of our client's tax return, to validate the objection, we enclose herewith his duly completed tax return for the year of assessment 2010/11 for your attention.

We should be grateful if you would agree to our objection and revise the assessment accordingly.

Yours faithfully,

For and on behalf of C Ltd.

XXX
Manager – Tax Services

c.c. Mr. Barry Fisher

Mr. Wong

Under s.63E(2)(b) or (c) of the IRO, Mr. Wong is eligible to apply for the holdover of 2011/12 provisional tax as he has retired since 1 April 2011, and the net chargeable income during the year of assessment assessed to provisional salaries tax is likely to be less than 90% of the net chargeable income for the year preceding the year of assessment or he has ceased to derive income chargeable to salaries tax. However, under s.63E(1)(a), the deadline for Mr. Wong to lodge the holdover of the tax due on 3 January 2012 has lapsed as the holdover application had to be lodged 28 days before the payment due date of 3 January 2012.

The Commissioner of Inland Revenue has no discretionary power to extend the time limit for a holdover application. Therefore, Mr. Wong can no longer make a valid application for holding over the provisional salaries tax due on 3 January 2012 after the application deadline.

However, on the basis that Mr. Wong settled the tax liability due on 3 January 2012, he can apply to hold over the second tax payment due on 2 April 2012 by lodging the application 28 days before the due date i.e. to be lodged on or before 5 March 2012.

If Mr. Wong does not settle the tax liability due on 3 January 2012, the full amount of tax (both in the first and second instalments) becomes due and payable immediately.

Chapter 3 Hong Kong profits tax

New Happy Inn

(a) (i) The ovens and grillers are capital assets and the expenditure incurred on acquisition is capital in nature and not deductible under s.17(1)(c).

However, they could be regarded as 'machinery and plant' used in the restaurant business. Hence, such ovens and grillers should qualify for depreciation allowances (initial allowance 60%, annual allowance 20%).

The installation cost is not of a recurring nature and is thus a capital expenditure not allowable under s.17(1)(c). Nevertheless, such a cost can be regarded as part of the capital expenditure incurred for the ovens and grillers which qualify for depreciation allowances. However, annual repair costs are revenue in nature and deductible.

The costs of hiring the consultant to ensure the proper maintenance of the ovens and thus enabling the restaurant business to carry on smoothly and to earn profits should be deductible under s.16(1). However, the portion of consultancy fees attributable to the installation of the equipment may be argued as being part of the installation cost incurred prior to business commencement and thus not deductible under s.17(1)(c).

It is not clear from the facts as to the amount of the costs of expert advice for (1) installation and (2) for regular inspection and repairs. If the terms are clearly set out in the contract between New Happy Inn and the consultant, the former should not be deductible but the latter is deductible. Nevertheless, the former can be regarded as part of the capital expenditure incurred for the ovens and grillers which qualify for depreciation allowances. Otherwise, Joseph may need to agree with the IRD as to the method for apportioning the costs incurred. Time cost basis may be one acceptable basis to be considered.

(ii) Joseph should review all pre-commencement costs such as electricity, lighting, rental, salaries etc. He should distinguish capital expenditure items (such as cost of renovation, chairs, tables and furniture etc) and revenue items. The former would not be deductible under s.17(1)(c). However, pre-commencement capital expenditure on machinery and plant is treated as if it had been incurred on the day of commencement and qualifies for depreciation allowance (s.40(2)). Strictly speaking, revenue expenditures are also not deductible as no revenue was generated during the pre-commencement period. Nevertheless, they may be considered as necessarily incurred to enable New Happy Inn to derive income upon opening. The deductibility of these expenses would be subject to agreement between New Happy Inn and the IRD. In general, it is the IRD's practice to allow pre-commencement expenses which are revenue in nature in the first basis period.

(b) The advertising costs incurred prior to commencement of business would not be deductible as no assessable profits were generated. However, it may be argued that they were incurred to attract customers to the restaurant once it is opened and help the restaurant to generate taxable income and hence deductible under s.16(1). This would be subject to agreement with the IRD.

Advertising costs incurred after commencement of business would be deductible under s.16(1) if the amounts were incurred in the production of chargeable profits.

(c) Travelling expenses and marketing costs for exploring business opportunities offshore would not be deductible. They are clearly not incurred in the production of assessable profits (s.16(1)) as any income generated will be offshore in nature and not chargeable under s.14.

(d) **License to us the new trade name 'New Happy Inn'**

New Happy Inn is chargeable to profits tax under s.14 if:

(i) it carries on a trade, profession or business in Hong Kong;

(ii) the profits to be charged are from such trade, profession or business; and

(iii) the profits are sourced in Hong Kong.

As New Happy Inn carries on business in Hong Kong and the income to be charged is from such business, New Happy Inn will be chargeable to profits tax under s.14 if the income is sourced in Hong Kong.

To determine the source of profits, the broad guiding principle is *"what the taxpayer has done to earn the profit in question and where he has done it."* (see *Hang Seng Bank* and *HK-TVBI).* According to DIPN 21 (para 45(g)), the source of royalty income (other than those deemed chargeable under ss.15(1)(a), (b) and (ba)) should be determined by the place of acquisition and granting of the license or right to use. Furthermore, pursuant to DIPN 49 (para 73), where the IPR is created or developed by the licensor carrying on a business in Hong Kong, the royalty income will generally be regarded as Hong Kong sourced as it is generated by the taxpayer using his wits and labour to create or develop the IPR in Hong Kong.

As the trade name was established and developed in Hong Kong through the opening and operation of the New Happy Inn restaurant in Hong Kong, and the licensing agreement granting the right to use the trade name is likely to be negotiated and concluded in Hong Kong, the royalty income should be sourced in Hong Kong and chargeable to profits tax under s.14.

Withholding taxes incurred offshore should be deductible as expenses incurred in the production of assessable profits.

License to use the new recipe

Similarly, as the new recipe was invented in Hong Kong and registered in Hong Kong and the licensing agreement granting the right to use the recipe is likely to be negotiated and concluded in Hong Kong, the royalty income from the license to use the new recipe should be sourced in Hong Kong and chargeable to profits tax under s.14. In addition, withholding taxes incurred overseas should also be deductible.

License to use the old recipe

J Co is the legal owner of the old recipe. As J Co does not carry on a business in Hong Kong, it should not be subject to profits tax as the first of the three conditions under s.14 has not been met.

However, the royalty income received by J Co may be deemed to be chargeable to profits tax under s.15(1)(b) if the use or right to use the old recipe is in Hong Kong. As the old recipe was developed in Brazil and the overseas investors intend to use the old recipe in their own jurisdiction (outside Hong Kong), s.15(1)(b) would not apply and the royalty income from the license to use the old recipe should not be chargeable to Hong Kong profits tax.

(e) Pursuant to s.15(1)(b), any sum, not otherwise chargeable to profits tax, received by or accrued to a person for the use of or right to use in Hong Kong a patent, design, trademark, copyright material, secret process or formula or other property of a similar nature, or for imparting or undertaking to impart knowledge directly or indirectly connected with the use in Hong Kong of the aforesaid intellectual properties shall be deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong.

By virtue of ss.15(1)(b) and 21A, J Co will therefore be subject to profits tax at 16.5% on 30% of the royalty income earned during the year under review. The local investors who are carrying on the manufacturing operations in Hong Kong are required to withhold tax and file returns (BIR 54) for J Co.

(f) One may argue that such payment is deductible for the following reasons:

(i) It is incurred in the ordinary course of business.

(ii) If not settled out of court, the case may bring about bad publicity and affect the income earning operation of New Happy Inn, thus the said sum should be deductible.

It may also be challenged as a once and for all payment which brings about an enduring benefit to New Happy Inn and thus is capital in nature and not deductible. New Happy Inn may need to negotiate with the IRD for this tax deduction claim.

(g) **Interest payments to uncle**

As Joseph's uncle is not subject to tax in Hong Kong, the condition in s.16(2)(c) is not satisfied. Therefore the interest payments will not be deductible.

Interest payments to local financial institutions

Interest on a loan used to finance business operations and is revenue in nature should be deductible as conditions in ss.16(1)(a) and 16(2)(d) are satisfied.

However, if the loan is used to finance the expansion overseas, the interest is not deductible irrespective of whether the expenditure is of a capital nature or not as the income derived will not be chargeable to profits tax.

HKCO Ltd

(a) (1) **Tax implications arising from the board's resolutions to decrease head count by 10% and possible closure of the Product A business unit**

The redundancy payments expended to enable the company to continue its business in Hong Kong should be deductible under s.16(1). Redundancy payments arising from the closure of the business unit would also be deductible: see *CIR v Cosmotron Manufacturing Co Ltd* [(1997) 4 HKTC 562].

However, other payments arising from the closing down of a business unit may be capital in nature if it is in relation to the permanent closure of a business operating structure. In this regard, it would not be deductible (s.17(1)(c)).

(2) **To stop hiring**

There are no tax implications.

(3) **To accept an emergency loan from a fellow UK subsidiary**

The interest payable to the UK lender would not be deductible as it fails to comply with the requirements of s.16(2)(c) since the recipient of interest is not carrying on business in Hong Kong and thus the interest it derives from Hong Kong would not be taxable.

(4) **To obtain a financial subsidy**

It is noted that HKCO will ask another fellow subsidiary in Belgium to provide a financial subsidy since HKCO has been helping them to market their products in Hong Kong/the Mainland of China. If they do not subsidise the marketing cost, HKCO would not be able to maintain the marketing team. The financial subsidy (for financing operating expenses) should be taxable under s.15(1)(c).

(5) **To relocate to another commercial complex with cheaper rent**

Voluntary removal costs are capital in nature and not deductible whereas involuntary removal costs may be deductible, depending on the evidence (e.g. lease agreement and factual circumstances) of the case.

(6) **To accept a government subsidy to finance the upgrading of computer equipment**

The subsidy for upgrading computer equipment is capital in nature and not taxable. On the other hand, as no capital expenditure was incurred by HKCO, no depreciation allowances would be granted to it.

(b) **Tax implications of the disposal of the properties**

Whether the profits from the sale of properties are taxable would depend on whether the property transactions are capital or revenue in nature.

The IRO does not define what constitutes 'profits arising from the sale of capital assets'. In practice, reference is often made to the so-called "badges of trade" to distinguish capital assets from trading stock, which include:

(i) Subject matter of the transaction;

(ii) Profit motive / intention to trade for profits;

(iii) Length of ownership;

(iv) Frequency of similar transactions;

(v) Supplementary work done in enhancing the marketability; and

(vi) Circumstances leading to the realisation.

To determine if the profits from the sale of the Repulse Bay properties would be taxable, one would need to ascertain the following:

(i) HKCO's intention of investing in the relevant properties and whether there is supporting evidence to substantiate the above.

(ii) The length of ownership (no information here).

(iii) The fact that the properties have been occupied by directors might suggest that they are for long term investment purposes.

(iv) Whether HKCO has a history in property trading and the nature of HKCO's business in Hong Kong.

(v) Whether HKCO has adequate long term funds to finance the properties as a long term investment.

(vi) Whether the disposal was for trading for profits, or merely due to the adverse economic condition which the company encountered recently and/or other valid commercial reasons to support the disposal was to effect a sale of capital investment.

If the relevant properties were held for long term investment purposes, then the profits on disposal would not be taxable.

On disposal of the residential properties in Repulse Bay, each relevant AFS is a stampable document under Head 1(1A) of the SDO. Where a conveyance on sale of residential property is executed in conformity with a chargeable AFS which is duly stamped, the conveyance is chargeable with stamp duty of $100 only (s.29D(2)(a)).

(c) Cost of tax appeals is not normal business expense incurred in the production of assessable profits and so it would not be deductible.

(d) To ascertain the deductibility of the exchange losses we would need to examine:

(i) If the exchange losses arose from normal course of business and/or business transactions, such losses would be deductible.

(ii) If the exchange losses arose from conversion of bank accounts, it would be capital in nature and hence non-deductible.

(iii) If the exchange losses arose from offshore transactions/business, it would not be deductible.

(e) The sum was expended on staff welfare. Arguably such was incurred for promoting staff morale and enhancing the productivity and profitability of HKCO, and it should meet the requirements of s.16(1) of the IRO.

However, such claims may be denied if:

(i) the party is 'private' in nature;

(ii) the costs incurred are excessive; and/or

(iii) evidence available suggests that the sum was not incurred in the production of assessable profits.

A Ltd

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

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 raw materials and 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 DIPN 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.

(ii) Section 39E(1)(b)(i) denies the granting of depreciation allowance if the machinery or plant concerned was under a lease and they were wholly or principally used outside Hong Kong by a person other than the taxpayer. Section 2 defines the term '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*, the BOR 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 for A Ltd.

(iii) 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 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.

(b) 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), 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) provides that A Ltd, which 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).

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), 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.

Dr. A

(a) (i) The broad guiding principle for determining the source of profits, as laid down by Lord Bridge in *CIR v Hang Seng Bank Ltd* [(1991) 1 AC 306] and expanded by Lord Jauncey in *CIR 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 the present case, Dr. A earned the Consultation Fees by providing medical treatment to a patient in the Mainland. Applying the above broad guiding principle, the Consultation Fees did not arise in or were not derived from Hong Kong.

The fact that Dr. A prepared the medical report for the patient in Hong Kong was merely an antecedent or incidental matter which did not determine the source of the Consultancy Fees: see *Kwong Mile Services Limited v CIR* [(2004) 3 HKLRD 168]. Indeed, there is no evidence suggesting that part of the Consultation Fees arose from the preparation of the medical report and had a locality separate from the part attributable to the provision of medical treatment.

(ii) The Compensation Payment should be revenue in nature because of the following:

(1) Dr. A entered into the service contract with Company B in the ordinary course of his medical practice. Being a sum to compensate for the termination of such a contract, the Compensation Payment should be regarded as a normal trading receipt.

(2) The service contract with Company B only contributed to 10% of Dr. A’s annual income. It is unlikely that the termination of the service contract would affect the entire framework of Dr. A’s business.

(3) The Compensation Payment was computed with reference to the consultation fees that Dr. A would have earned from the contract. It was more akin to compensation for the loss of profits rather than the loss of capital assets.

(b) (i) The medical expenses are not deductible because of the following:

(1) They were incurred by Dr. A for the benefit of his health. Plainly, they are of a private nature and are prohibited from deduction under s.17(1)(a).

(2) Although the expenses could also enable Dr. A to continue to carry on his business, there is no sensible way of apportioning them between private and business purposes.

Relevant authority: *Fahy v CIR* [(1992) 3 HKTC 695]

(ii) The additional tax is not deductible because of the following:

(1) Additional tax is a kind of fine or penalty. It was imposed due to a wrongdoing on the part of Dr. A, i.e. late submission of his tax return. It was not incurred for the purpose of earning profits from his medical practice and was thus not allowable for deduction by virtue of s.17(1)(b).

(2) Moreover, the purpose of a fine or penalty is to punish the wrongdoer, and the legislative policy would be diluted if the wrongdoer is allowed to share the burden with the rest of the community.

Relevant authority: *CIR v Chu Fung Chee* (6 HKTC 743)

(iii) The expenditure on renovation of the **existing clinic** is deductible under s.16F because of the following:

(1) The relevant unit of building has not been used as a domestic building or structure; and

(2) The expenditure was incurred in the production of chargeable profit.

The renovation expenditure is allowed for deduction by five equal instalments, the first of which is allowed in the basis period during which the expenditure was incurred and the remaining four instalments in the basis periods of the next four succeeding years of assessment. Therefore, the deduction of expenditure on renovation of the existing clinic for the year of assessment 2012/13 should be computed as $300,000 x 1/5 = $60,000.

By virtue of s.16F(3), Dr. A is not entitled to CBA in respect of the expenditure which has been allowed under s.16F.

As for the expenditure for the initial decoration of the **new branch clinic**, it was incurred to enable the unit of building to be first used by Dr. A for the production of profits, so does not qualify for deduction under s.16F. However, CBA can be granted in respect of such initial decoration expenditure under s.33A for the year of assessment 2012/13 as follows:

Annual Allowance: $500,000 × 4% = $20,000

Manchester Knitting Ltd

(a) **Calculation of depreciation allowance for 2012/13**

		30% HP	**Total**
		HK$	HK$
Addition		300,000	
Less: Initial Allowance	(Note)	(109,800)	109,800
		190,200	
Less: Annual Allowance		(57,060)	57,060
Tax written down value carried forward		133,140	166,860

Note: Total principal repayment made for the year
= $120,000 (down payment) + ($300,000 – $120,000) ÷ 20 × 7 = $183,000
Initial Allowance = $183,000 × 60% = $109,800

(b)

Manchester Knitting Limited
Profits tax computation for the year of assessment 2012/13
Basis period: year ended 31 March 2013

	$	$
Profit before taxation		3,869,000
Add: Sales proceeds (as balancing charge)	30,000	
Depreciation	84,000	
Interest expenses	15,200	
Exchange loss	10,000	139,200
		4,008,200
Less: Gain on disposal of fixed assets	14,000	
Exempt bank interest income	5,500	
Depreciation allowances	166,860	(186,360)
Assessable profits		3,821,840
Tax thereon @16.5%		630,603

(c) (i) Local bank interest income is exempt from the payment of profits tax under the Exemption from Profits Tax (Interest Income) Order 1998 ('1998 Order'). However, the bank interest income of $8,800 derived from the deposit utilised as security pledged to a loan incurring deductible interest expenses (where conditions under s.16(2)(d) are satisfied and ss.16(2A) and 16(2B) do not apply) would not be eligible for the exemption. Accordingly, the respective interest income is taxable. On the other hand, the bank interest income of $5,500 is exempt from the payment of profits tax under the 1998 Order regardless of the currency denomination.

Interest income from overseas overdue trade debts is taxable as it is derived from the normal course of business and is on-shore in nature.

(ii) The interest expenses of $16,800 incurred on a bank loan and hire purchase of the motor vehicle with a local bank are deductible under ss.16(1)(a) and 16(2)(d) (for the bank loan), and s.16(2)(e) (for the hire purchase of the motor vehicle), and subject to the restrictions of ss.16(2A) and 16(2B). Given that the respective bank loan was pledged by a local bank deposit deriving interest income, the 1998 Order would not be applicable and in this connection, these interest expenses would be treated as deductible whilst the interest income is taxable.

Interest to overseas unrelated suppliers on overdue trade debts is deductible under ss.16(1)(a) and 16(2)(e).

As the interest derived by the individual director is not subject to tax under the IRO, the respective interest expenses incurred by MKL are non-deductible as the conditions under s.16(2)(c) or any other provisions of s.16(2) are not satisfied.

World Corp

(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. 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 sale contracts are effected in Hong Kong, then the profits derived from its trading operations 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.

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

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

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

(b) If supporting evidence clearly demonstrates that the branch maintains a separate trading operation offshore responsible for effecting purchase and sale 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 28.

Chapter 4 Non-resident persons

Aaron Inc.

The trading profits derived from transactions in listed securities carried out in Hong Kong are generally subject to profits tax in Hong Kong: s.14. However, a 'non-resident person' who only carries on a trade, profession or business in Hong Kong involving 'specified transactions' through or arranged by 'specified persons' is exempt from profits tax in respect of profits derived from the 'specified transactions' under s.20AC.

'Specified transactions' include transactions in listed securities (but exclude shares/debentures of private company etc.): Schedule 16 of IRO.

The exemption also covers profits from transactions incidental to the carrying out of the specified transactions provided that the trading receipts from the incidental transactions do not exceed 5% of the total trading receipts from both the specified transactions and the incidental transactions under s.20AC.

Under s.20AC(6), a 'specified person' is defined as a corporation licensed, or an authorised FI registered, under the SFO for carrying on a business in any regulated activity within the meaning of the SFO. Aaron, AA and AI are all within the meaning of specified persons under s.20AC.

Under s.20AB(3), a 'non-resident person' is a person who is not a 'resident person'. For a corporation, a 'resident person' means a corporation with central management and control in Hong Kong.

The place where central management and control of a company is exercised is wholly a question of fact. In general, if the central management and control of a company is exercised by the directors in board meetings, the relevant locality is where those meetings are held (DIPN 43, paragraph 15). The residence of individual directors will not generally be a relevant factor to consider. The mere fact that the majority of the directors of the management board of the company are resident in Hong Kong does not of itself mean that the company is centrally managed and controlled in Hong Kong, and hence would not adversely affect application of the exemption. However, this does not mean that an individual director's residence can be completely ignored in all cases. In reality, the residence of individual directors could be a relevant factor. For instance, where all or majority of the individual directors are Hong Kong residents and there are no genuine commercial reasons for holding board meetings overseas, the IRD may contend that such board meetings are only a formality and that the 'central management and control' of the company is actually exercised by the directors in Hong Kong through other means. Appendix B in DIPN 43 sets out the IRD's views on the residency status of various forms of investment vehicles commonly adopted in holding and managing investment portfolios.

If AA is a non-resident person, exemption under s.20AC will apply to AA's trading profits derived from transactions in listed securities carried out in Hong Kong, including income from other incidental transactions. Other incomes of AA, being profits from transactions incidental to the trading of listed securities in Hong Kong, accounts only for 2% of the total receipts. Therefore they would also be exempt income.

As Aaron's board meets in Hong Kong, Aaron is a resident person in Hong Kong under s.20AB. Exemption under s.20AC does not apply to Aaron even if (as Mr Weber proposed) it derives trading

profit from specified transactions (including profit from listed securities on the Hong Kong Stock Exchange).

Under s.20AE(1), (2) and (3), a Hong Kong resident person who: (i) alone or jointly with his associates, holds direct and/or indirect beneficial interest of 30% or more in a tax-exempt offshore fund, or (ii) holds any percentage in a tax-exempt offshore fund if the tax-exempt offshore fund is his associate, will be deemed to have derived assessable profits in respect of the trading profits earned by the offshore fund from specified transactions and incidental transactions carried out by the offshore fund in Hong Kong.

There would be deemed assessable profits in respect of trading profits of AA from the specified transactions and incidental transactions for Aaron (a Hong Kong resident corporation) as Aaron (jointly with AI) holds beneficial interest (of any percentage) in a tax exempt offshore fund (AA) which is its associated company (under s.20AE(9)). The deeming provisions in s.20AE would apply irrespective of whether Aaron has received or will receive any income or property from AA for the relevant year of assessment.

As the board of AI meets in New York, AI is non-resident under s.20AB. There is no deemed assessable profit under s.20AE for AI even if AA is an exempt non-resident fund under s.20AC. There is also no deemed assessable profit for AI even if Aaron is deriving trading profit from transactions in listed securities in Hong Kong as Aaron is a Hong Kong resident and hence not exempt.

Any loss from the specified transactions of AA is not available for set off against any assessable profits for any subsequent year of assessment (s.20AD).

Newco

(a) Under s.20AC, profits derived by Newco are exempt from profits tax if it is structured and participates in Hong Kong securities market in the following manner:

(1) Newco is a non-resident person; and

(2) Newco does not carry on any trade, profession or business in Hong Kong involving transactions other than:

(i) the specified transactions carried out through or arranged by a specified person; and

(ii) transactions incidental to the carrying out of the specified transactions and the trading receipts from the incidental transactions do not exceed 5% of the total trading receipts from both the specified transactions and the incidental transactions.

In determining the residency status, a corporation is considered to be a resident person if the central management and control of the corporation is exercised in Hong Kong: s.20AB(2)(b). The location of central management and control is wholly a question of fact. In general, if the central management and control of a company is exercised by the directors in board meetings, the relevant locality of central management and control is where those directors' board meetings are held (para 15 of DIPN 43 (Revised Feb 2010)).

Specified transactions are specified in Schedule 16 of the IRO as transactions in (i) securities, (ii) future contracts, (iii) foreign exchange contracts; (iv) consisting in the making of deposit other than by way of a money lending business, (v) foreign currencies and (vi) exchange-trade commodities.

Specified person normally is a corporation licensed, or an authorised FI registered, under the SFO for carrying on a business in any regulated activity within the meaning of the SFO (para 39 of DIPN 43 (Revised Feb 2010)).

Incidental transactions refer to various modes of operation of different offshore funds, including custody of securities, and receipt of interest or dividend on securities acquired through the specified transactions (para 37 of DIPN 43 (Revised Feb 2010)).

(b) A resident person will be deemed to have derived assessable profits in respect of profits derived by the offshore fund from both specified and incidental transactions if the resident person (i) alone or jointly with other associates holds direct and/or indirect beneficial interest of 30% or more in a tax-exempt offshore fund; or (ii) holds any percentage if the offshore fund is the resident person's associate: s.20AE.

(c) The IRO does not have any provisions on the statutory requirements for offshore fund profits tax exemption application or registration. However, a resident person with deemed assessable profits derived under s.20AE bears the legal obligation of complying with other provisions of the IRO on reporting chargeability, lodgement of returns, providing information, payment of tax etc. (para 67 of DIPN 43 (Revised Feb 2010)).

Chapter 5 Hong Kong salaries tax

George

(a) (i) George's employment with A Limited has a source outside Hong Kong because:

(1) George concluded the employment contract in the US.
(2) A Limited is resident in the US.
(3) Part of the remuneration for George was paid in the US.

(ii) S.12(1)(a) provides for deduction of all outgoings and expenses, other than those of a domestic or private nature and capital expenditure, provided that they are wholly, exclusively and necessarily incurred in the production of assessable income.

The professional indemnity fee paid to the US Law Society is not deductible as it was not incurred by George in the performance of his duties, but merely for the purpose of keeping him qualified to perform the duties: see *CIR v Robert Burns* 1 HKTC 1181 and *D91/03*, 18 IRBRD 870.

Strictly speaking, for the same reason above, the subscription paid to the US Law Society is also not deductible: see *Simpson v Tate* [1925] KB 214, *Lomax v Newton* (1923) 34 TC 558. However, as a concession, the IRD would allow deduction of the subscription as the legal qualification seems to be a prerequisite of George's employment and the retention of such qualification and keeping abreast of current developments in the profession are of regular use and benefit in his performance of the duties: see Departmental Interpretation and Practice Notes No. 9 (Revised) and *B/R 19/73*, 1 IRBRD 121.

(b) Under s.5(1A) of the IRO, only the rates paid by George and the 20% allowance for repairs and outgoings are deductible for the computation of net assessable value. The management fees and mortgage interest are not deductible items under property tax.

However, the mortgage interest can be allowable for deduction under PA by virtue of the proviso to s.42(1) of the IRO.

(c) Although George is an American, during the year of assessment 2009/10, he came to Hong Kong and resided here for the settled purpose of his employment. As such, George can be regarded as having ordinarily resided in Hong Kong during the year. He is a "permanent resident" in terms of s.41(4) of the IRO and is eligible to elect for PA for the year.

In any event, George did stay in Hong Kong for 200 days during the year of assessment 2009/10. By this fact he can satisfy the requirements as a "temporary resident" under s.41(4) and thus is eligible for PA election.

		HK$
(d)	Net assessable income from employment (Note 1)	826,700
	Net assessable value of the Property (Note 2)	32,000
		858,700
	Less: Interest deduction (Note 3)	32,000
	Total income	826,700
	Less: Married person's allowance	216,000
	Net Chargeable Income	610,700

Note:

(1) Since George's employment with A Limited has a source outside Hong Kong, his income should be assessed to salaries tax on time apportionment basis as follows:

	HK$
Income from A Limited (HK$1,200,000 × 200/300*)	800,000
Add: Value of residence [(HK$800,000 – HK$3,000) × 10% – HK$50,000]	29,700
	829,700
Less: Subscription to the US Law Society	3,000
Net assessable income	826,700

* No. of days between 5 June 2009 and 31 March 2010: 300

(2) The net assessable value of the Property is computed as follows:

	HK$
Rental income	45,000
Less: Rates	5,000
	40,000
Less: Allowance for repairs and outgoings (HK$40,000 × 20%)	8,000
Net assessable value	32,000

(3) In accordance with the proviso to s.42(1) of the IRO, the allowable amount of interest deduction is restricted to the net assessable value of the Property, i.e. HK$32,000.

Carol Smith

(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 instalment 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.

(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).

(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.

John Chan

(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.

(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.

Barry Fisher

(a) Barry's employment for the year of assessment 2010/11 should have a source outside Hong Kong because:

(i) Barry was employed by A Inc. which was a company incorporated and operated in the US. Such an employer-employee relationship remained unchanged even after his assignment to Hong Kong from 1 April 2010 onwards.

(ii) Barry negotiated and concluded his terms of employment with A Inc. in the US. As both Barry and A Inc. were residents in the US, it is likely that the terms of employment would be enforceable in the US.

(iii) Barry's salary was payable into his bank account in the US.

(b) In Fuchs, Walter Alfred Heinz v CIR, FACV 22/2009, unreported, 1 February 2011, the Court of Final Appeal held that income chargeable to salaries tax under s.8(1) of the IRO is not confined to income earned in the course of employment, but includes, among others, payments as an inducement to enter into employment.

Here, Sum A was the substantial compensation which Barry could enforce pursuant to his employment contract if his employment was terminated prematurely. It is clearly an inducement for him to enter into the employment. Thus, it is chargeable to salaries tax.

(c) The gain realised by Barry from exercising his share option is an income chargeable to salaries tax under s.9(1)(d) of the IRO.

In accordance with s.9(4) of the IRO, the tax liability crystallised when Barry exercised the option (i.e. 31 March 2011).

As Barry's employment with A Inc. was a non-Hong Kong employment and his share option was conditionally granted subject to his services both before and after his assignment to Hong Kong,

Barry's share option gain should be assessed to salaries tax on a time apportionment basis as follows:

Notional share option gain = (US$0.6 – US$0.1) $\times$ 7.8 $\times$ 100,000 shares = HK$390,000

Number of days during the vesting period (i.e. one year from 1 September 2009 to 31 August 2010) = 365 days

Number of days in Hong Kong during the vesting period (i.e. 1 April 2010 to 31 August 2010) = 20 days $\times$ 5 months = 100 days

Therefore, the amount of Barry's share option gain that should be assessed to salaries tax should be HK$390,000 $\times$ 100 days /365 days = HK$106,849.

(d)

(Draft)

The Commissioner of Inland Revenue
G. P. O. Box 132
Hong Kong
(Our Reference)

Dear Sir,

Mr. Barry Fisher
(IRD File No.)

Objection: Year of Assessment 2010/11

On behalf of our above-named client, we hereby object to the 2010/11 salaries tax assessment under Charge No: X-XXXXXXX-XX-X dated 14 September 2011 in accordance with s.64(1) of the IRO.

Our grounds of objection are as follows:

(a) The assessment is excessive.

(b) Our client's employment had a source outside Hong Kong and his income from employment should be assessed to salaries tax on a time apportionment basis.

(c) He should be entitled to married person's allowance and child allowance.

As the assessment was raised in the absence of our client's tax return, to validate the objection, we enclose herewith his duly completed tax return for the year of assessment 2010/11 for your attention.

We should be grateful if you would agree to our objection and revise the assessment accordingly.

Yours faithfully,

For and on behalf of C Ltd.

XXX
Manager – Tax Services

c.c. Mr. Barry Fisher

Chapter 6 Hong Kong property tax

Mr. Wong

(a) **Interest Expenses for Shop A**

Mr. Simon Wong is chargeable to property tax on his income from Shop A. A statutory deduction of 20% is allowable. However, actual interest expenses of $150,000 incurred for Shop A are not allowable under property tax. Mr. Simon Wong may only be able to obtain a relief by electing for personal assessment under which the interest expenses of $150,000 (not exceeding the net assessable value of the property) will be allowable. Whether the recipient of the interest (Mr. Patrick Wong) is taxable or not is irrelevant.

Interest Expenses for Shop B

On the presumption that Mr. Patrick Wong has retired and is not carrying on any business in Hong Kong, the interest income received by him is not chargeable to any tax in Hong Kong. In this connection, the interest paid ($150,000) by Mr. Simon Wong for Shop B is not tax deductible as none of the conditions under s.16(2) is fulfilled.

(b) Assuming no personal assessment is elected, the total tax payable by Mr. Simon Wong is computed as follows:

Property tax payable for 2009/10

	$
Rental income	500,000
Less: Rates	20,000
	480,000
Less: Statutory outgoings (20%)	96,000
Net assessable value	384,000
Tax thereon ($384,000 × 15%)	57,600

Profits tax payable for 2009/10:

Net profit per account (assume all expenses were revenue in nature and incurred in the production of chargeable rental income)	280,000
Add: Interest paid to Patrick Wong	150,000
Assessable profit	430,000
Tax thereon ($430,000 × 15%)	64,500
Total tax payable = $57,600 + $64,500 =	**122,100**

(c) As the two shops are properties located in Hong Kong, the transfers (conveyance on sale) to the limited company are subject to stamp duty (maximum 4.25% on the higher of the market value and consideration of the relevant property). If the two shops are capital assets of the limited company, the stamp duty and legal fees incurred by the limited company in the acquisition of the shops are capital in nature and not tax deductible under profits tax.

The income from the two shops will be chargeable to profits tax at the corporate profits tax rate of 16.5%. There will not be any notional deductions. However, all the interest paid to Patrick Wong ($300,000) is not tax deductible as none of the conditions under s.16(2) is fulfilled.

The rental income of the two shops will also be chargeable to property tax. However, the limited company can claim s.5(2)(a) exemption. If the property tax has been paid, the limited company can set-off the property tax paid against the profits tax payable by the limited company under s.25.

If Mr. Simon Wong and Patrick Wong receive any dividends from the limited company, no tax is payable on the dividends.

If they enter into employment contracts with the limited company, they will be entitled to personal allowances under salaries tax. They may also be able to enjoy tax efficient fringe benefits from the limited company.

For the limited company, the remuneration of Simon Wong and Patrick Wong will be allowable under profits tax, provided the amount is reasonable.

Ms. Poon

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
	144,000
Less: Rates ($3,000 x 3)	(9,000)
	135,000
Less: 20% Statutory deduction	(27,000)
Net assessable value	108,000
Property tax @15%	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
	142,000
Premium ($36,000 x 12/36)	12,000
	154,000
Less: irrecoverable bad debts ([($7,000 x 3)+($18,000 x 4)]- $35,000)	(58,000)
(1 Jan – 31 Mar) (1 Apr – 31 Jul) (Deposit)	96,000
Less: Rates ($3,000 x 4)	12,000
	84,000
Less: 20% Statutory deduction	(16,800)
Net assessable value	$67,200
Property tax @15%	$10,080

Chapter 7 Personal assessment

Emma Wong

(a) Emma is carrying on a business on her own account in Hong Kong. She is not under any contract of services. Therefore, she is chargeable to profits tax under s.14 of the IRO and is thus liable to pay Hong Kong profits tax. She is not liable to pay salaries tax.

(b) Computation of assessable profits for the year of assessment 2008/09:

	$
Tuition fees	1,000,000
Less deductible expenses:	
Rent for studio	(600,000)
Utilities for studio	(10,000)
Office expenses – studio	(200,000)
Assessable profits	190,000

(c) Rent for the apartment, utilities (apartment), travelling (personal), hiring of domestic helper and other personal expenses are private in nature and are not incurred in the production of chargeable profits. Thus they are not deductible under s.16 and s.17(1)(a).

(d) On the facts available, it should be advantageous for Emma to elect for personal assessment. If no election is made, her profits will be taxed at profits tax standard rate.

Whereas by electing personal assessment, she can have the benefit of personal allowance and subject to progressive tax rates which should be below the standard rate.

(e) Since the services were rendered in London, such gratuities are not arising in and/or derived from Hong Kong even if they are attributable to her business carried on in Hong Kong. Therefore, such offshore income would not be taxable under s.14 of the IRO.

This is also in line with the guidelines in DIPN 21.

The related expenses such as travel, hotel accommodation and miscellaneous expenses would not be deductible as they were not incurred in the production of chargeable profits. If Emma recorded her performance in her studio in Hong Kong and the recording was broadcasted in London, the gratuities received by her should be taxable. Following the principle in the *Hang Seng Bank* case, we look at "what the taxpayer has done to earn the profits". In her case, the income earning operation is her performance/recordings in the studio in Hong Kong. Therefore the profit derived from there would be assessable.

Ms. Poon

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).

Chapter 8 Hong Kong stamp duty

Mr. Pang

(a) The sale of Property A from Spring Ltd to Summer Ltd is a voluntary disposition *inter vivos*. The conveyance will be chargeable to stamp duty at *ad valorem* duty under Head 1(1) on the market value of Property A. Although Mr. Pang owns 100% of Spring Ltd and Summer Ltd, the two companies are not associated companies (Mr. Pang is an individual, not a corporation) and s.45 relief under the SDO is not applicable to the transaction.

The letting of Property C by Autumn Ltd to Summer Ltd will be chargeable to stamp duty under Head 1(2) and there is no relief for lease arrangements between associated companies. Since the consideration of the lease arrangement only comprises a premium of $10 million with no rent, the premium is dutiable at 3.75%, which is the same as a conveyance on sale.

(b) The premium from letting Property C is subject to profits tax and property tax.

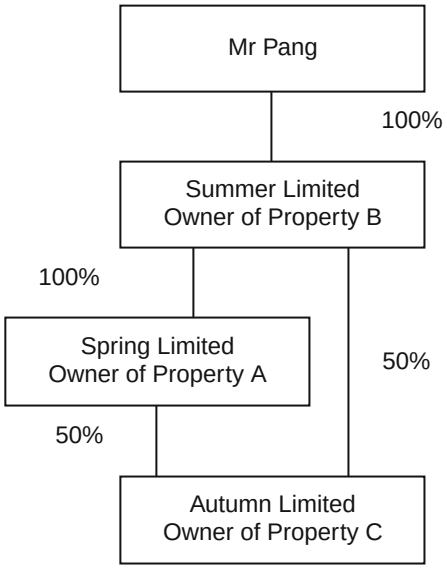
Pursuant to DIPN 4, the IRD indicates that corporations letting a property are carrying on a business and that the premium received from letting is of a revenue nature chargeable under profits tax. Generally accepted accounting principles (Hong Kong Accounting Standard 17) requires that premium receipts be spread over the term of the lease for the purpose of recognising them as income. The lease premium will be recognised in income on a straight line basis over the lease term of 20 years, 1/20 of the premium may be chargeable to profits tax for each year.

Autumn Ltd may apply for an exemption from property tax if it is carrying on business in Hong Kong and its income from Property C is chargeable to profits tax. If it does not apply for an exemption from property tax, the premium of $10 million will be chargeable to property tax (see *Harley Development Inc & Anor* [(1996) 1 HKRC 90-079]. Although the premium is paid for using Property C for 20 years, the IRD will only allow the owner of a property to spread the premium over a period of 36 months (shorter than 20 years) under s.5B(4).

If the IRD assesses the premium to profits tax and property tax, Autumn Ltd should request a set-off of the property tax paid from the profits tax payable pursuant to s.25 for the years of assessment concerned.

(c) A restructuring plan is suggested as follows:

Mr. Pang transfers the shares in Spring Ltd to Summer Ltd. Since Spring Ltd is not incorporated in Hong Kong, the transfer of its shares is not subject to stamp duty in Hong Kong. The group structure after the transfer is as follows:

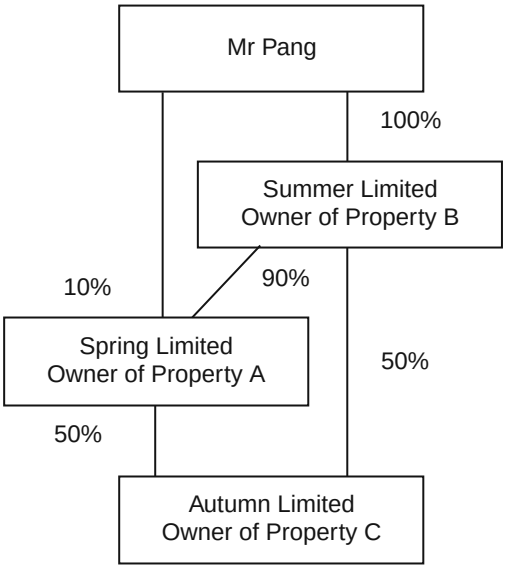


After the transfer of the shares in Spring Ltd from Mr. Pang to Summer Ltd, Summer Ltd holds 100% of Spring Ltd and effectively holds 100% of Autumn Ltd. The three companies are associated companies and s.45 relief under the SDO (adjudication is required) will apply to the property transactions between the companies. Property A and Property C can then be transferred to Summer Ltd to make it the sole owner of the three properties. After the property transactions, the companies need to remain associated for at least two years.

It is possible that the IRD may form a view that the transfer of the shares in Spring Ltd from Mr. Pang to Summer Ltd is a step inserted in a pre-ordained series of transactions to avoid stamp duty and invoke the *Ramsay* principle to disregard the transaction. There are no general anti-avoidance provisions in the SDO. The *Ramsay* principle may apply in aggressive avoidance cases (e.g. the *Ramsay* Principle was applied by the CFA in *CSR v Arrowtown Assets Limited* [(2003) HKRC 90-129].

There are other restructuring plans. For example, an alternative restructuring plan is as follows:

Spring Ltd allotted eighteen shares to Summer Ltd at par. Summer Ltd will then hold 90% of Spring Ltd and 95% (50% + 0.9 $\times$ 50%) of Autumn Ltd after the share allotment. The companies will then qualify for the relief under s.45 of the SDO.



Mr. Au

(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 (SOIPN 1, para 47 and 41).

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

(b) Relief for stamp duty under s.45 of the SDO is applicable to the transfer of the $6m listed shares from D Ltd to B Ltd and therefore there is no stamp duty payable regarding the proposed transfer. This is based on the following grounds:

(i) A Ltd effectively holds 90.25% (95% of C Ltd x 95% of D Ltd) of the shares in D Ltd.

(ii) B Ltd and D Ltd are associated bodies corporate as a third body corporate, A Ltd, is the beneficial owner of not less than 90% of the issued share capital of each of B Ltd and D Ltd;

(iii) the place of incorporation of the bodies corporate is irrelevant to the s.45 relief; and

(iv) Mr. Fischer's 80% beneficial ownership of A Ltd is also irrelevant to the s.45 relief.

However, under ss.45(c) and 45(5A), if the transferor (D Ltd) and the transferee (B Ltd) cease to be associated within two years after the date of the transfer by reason of a change in share holding of the transferee, the s.45 relief will be revoked.

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

For a 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%).

Under the contingency principle, if the maximum or minimum amount of rent payable is stated in the lease agreement, stamp duty will be assessed on the maximum amount, i.e. the $1.2 million in the lease agreement.

The stamp duty on the lease contract is therefore $51,750 [($100,000 + $1,200,000) $\times$ 12 $\times$ 0.25% + $300,000 $\times$ 4.25%].

(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 (SOIPN 3, para 21(g)).

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

XYZ Ltd

(a) *Profits tax implications*

ABC Inc is not carrying on any business in Hong Kong. The shares in XYZ Ltd held by ABC Inc are for long-term investment. In this regard, any profit on disposal of the shares in XYZ Ltd should be excluded from profits tax pursuant to s.14.

Stamp duty implications

Stamp duty is chargeable on the instrument transferring the ownership of Hong Kong stock, which means the stock the transfer of which is required to be registered in Hong Kong. The dutiable amount is the higher of the consideration and the value of the stock being

transferred. The current rate of stamp duty on share transfer is 0.2% (0.1% on the bought note and 0.1% on the sold note).

With regard to transfers between associated companies (including a parent company), exemption from stamp duty under s.45 could be applied for when:

(i) one body corporate is the beneficial owner of not less than 90% of the issued share capital of the other; or

(ii) a third body corporate is the beneficial owner of not less than 90% of the issued share capital of each of the bodies corporate.

Issued share capital refers to both ordinary and preference shares at par value; and s.45 relief is available where ownership can be traced trough shareholdings in another body corporate. However, application for the relief must be supported by a statutory declaration made by a responsible officer of the holding company, or its solicitor; and adjudication (a formal assessment procedure) is compulsory.

It should be noted that, in order to qualify for the s.45 exemption, the transferor and transferee are to remain associated for at least two years after the transfer. If they cease to be associated within the two-year period, the stamp duty exemption will be revoked and duty is payable within 30 days of the change.

Moreover, the following anti-avoidance provisions prevent the abuse of the s.45 relief,and exemption shall not apply to instruments executed in connection with an arrangement under which:

(i) any part of the consideration for the transfer of immovable property or Hong Kong stock was provided or received, directly or indirectly, by a person other than an associated body corporate of the transferor or transferee: s.45(4)(a).

(ii) beneficial interest in the immovable property or Hong Kong stock was previously conveyed, transferred, sold or purchased, directly or indirectly, by a third person: s.45(4)(b);

(iii) the transferor and transferee were to cease to be associated due to a change in shareholding in the transferee within two years of the transfer: s.45(4)(c).

If money has been obtained from a bank for the purpose of acquiring the property from an associated body corporate, s.45 relief might be denied pursuant to s.45(4)(a) as the bank is an unrelated non-associated person. However, the Collector has issued a ruling stating that as long as he is satisfied that the loan was made by a bank or a deposit-taking company in the ordinary course of business, and that neither the bank nor the deposit-taking company had any interest in the property other than as security, the provision of the purchase money by that bank or deposit-taking company would not cause a denial of the s.45 relief.

(b) The advice would be the same from the Hong Kong tax perspective as only the shares in XYZ Ltd would be transferred from ABC Inc to NEWCO and there would be no transfer of the shares in SZCO.

(c) Assuming the shares in SZCO are held by XYZ Ltd and are for long term investment, any gain/loss on disposal of the shares in SZCO to NEWCO would be of a capital nature and not taxable/deductible under profits tax.

The shares in SZCO are not ‘Hong Kong stock’. In this regard, no stamp duty is payable in Hong Kong on the documents of transfer and application for exemption from stamp duty is not required.

(d) The loss of $10 million can be carried forward, without any time limit, to offset the future profits of XYZ Ltd provided that:

(i) there is no change in the shareholding of XYZ Ltd; or

(ii) if there were a change, the sole or dominant purpose of the change is not to enable any person to obtain a tax benefit (see s.61B of the IRO).

As there will be a change of ownership of XYZ Ltd (i.e. from ABC Inc to NEWCO), it is important to ensure that there are sufficient commercial reasons for the change (i.e. for group restructuring) and that the change is not to enable any person to obtain a tax benefit.

Douglas

(a) The chargeability of the profits in question depends on whether the flat is a trading stock or a capital asset. In deciding, it is necessary to ascertain Douglas' intention towards the flat at the time of acquisition. A stated intention is of limited probative value as the intention can only be ascertained by reference to the objective facts and circumstances. Furthermore, the intention must be, on the evidence, genuinely held, realistic and realisable

There is no information given about the stated intention of Douglas at the time of the acquisition. For the reasons given below, however, Douglas will have a reasonable case to argue that the flat was acquired as a capital asset and the profits from its sale should not be chargeable to profits tax:

(i) There is no evidence that Douglas frequently engaged in property dealing. As stated in the question, the flat is the first one purchased by him.

(ii) The flat is not luxurious (purchase price of $4 million). Given his then income level ($100,000 per month) and the significant dividend received ($2 million), Douglas was financially capable of holding the flat on a long-term basis.

(iii) The sale of the flat was triggered by the liquidity problem of E Ltd, and part of the sale proceeds were advanced to the company for operation purposes.

(b) In accordance with ss.19(1)(a) and (d) of the SDO, Douglas and Frank who effected the sale and purchase of the shares in E Ltd should each make and execute a contract note for stamping under Head 2(1) in the First Schedule of the SDO, and cause an endorsement to be made on the relevant instrument of transfer under Head 2(4) in the First Schedule of the SDO.

Except for the agreed consideration of $11 million, Frank also undertook to make a loan to E Ltd to enable it to repay the shareholder's loan of $2 million to Douglas. In accordance with SOIPN 3, such a guaranteed injection of funds into E Ltd is a 'payment of money' for the purposes of s.24(1) of the SDO, and s.24(1) applies to deem the amount of the injected funds to be part of the consideration for the transfer.

In light of the foregoing, the stamp duty that Douglas and Frank were liable to pay in respect of the share transaction should be computed as follows:

Two contract notes: ($11 million + $2 million) x 0.1% x 2 = $26,000

Instrument of transfer: $5

Dr. A

(a) Under this nomination agreement, the nominee (i.e. Mrs. A) is the wife of the nominator (i.e. Dr. A). By virtue of s.29CA(10) of the SDO, the nomination agreement is exempted from SSD.

(b) Dr. A entered into an agreement to purchase Flat D on 1 March 2012. By entering into the nomination agreement on 1 October 2012, Dr. A is regarded as having sold the flat to Company E on that date.

The period between 1 March 2012 and 1 October 2012 is 7 months and 1 day. Since the holding period is more than 6 months but less than 12 months, the nomination agreement will be chargeable with SSD at 10% of the consideration stated therein (if any) or the market value of Flat D on 1 October 2012, whichever is the higher, under Head 1(1B)(b) in the First Schedule to the SDO.

Chapter 9 Introduction to tax planning

Ocean Ltd

(a) The IRD will certainly raise an enquiry on the agreement between Ocean Ltd and Island Ltd. It is likely that they will request information such as documentary evidence of the property management and rental collection services provided by Ocean Ltd, reasons that Ocean Ltd was appointed for property management and rental collection purposes, a copy of the service fee agreement, basis of the service fee, directors' minutes approving the agreement or payment of service fee and documentary evidence of the payment of the service fee.

(b) If there is no supporting evidence that property management and rental collection services were provided by Ocean Ltd for the service fee, an assessor may invoke s.61 to disregard the transaction as 'artificial' or 'fictitious'. If s.61 is invoked by the IRD, there will not be any deduction allowable to Island Ltd and Ocean Ltd will also not be assessed on the service fee income.

If there is evidence that Ocean Ltd did provide property management and rental collection services to Island Ltd in return for the payment of the service fee, the IRD will not be able to invoke s.61. Ocean L Ltd will be subject to tax on its service fee income. However, Island Ltd may not be allowed to deduct the full amount of the service fee unless it is able to demonstrate that the relevant sum is incurred in the production of assessable profits.

In *D96/89*, the amount of deductible fees paid to a related company for property management was determined by reference to the amount charged by Hong Kong rental agencies for management of property and rent collection.

If there is no evidence that Ocean Ltd has provided property management and rental collection services to Island Ltd then the sum will not be allowable under s.16(1). If Island Ltd has its own property management/rental collection staff but merely engages Ocean Ltd as a service provider merely for the purpose of 'transferring' a fee from a profitable company to a less profitable company, the IRD may take the view that the transaction between Ocean Ltd and Island Ltd was for the sole or dominant purpose of obtaining a tax benefit. If such a view is formed by the IRD, the Assistant Commissioner may invoke s.61A. He may either disregard the transaction or counteract the tax benefit being sought by the parties. The Assistant Commissioner will have the discretion to raise assessments as he thinks fit.

As there is no change in the shareholdings of Ocean Ltd, s.61B is not applicable under the circumstances.

(c) After acquiring the property with an existing tenancy, the trading loss of Ocean Ltd can be set off against the rental income from the property.

Since the property transaction between the two companies is in fact carried out and the price of the property is at market price, s.61 should not be applicable as the transaction is neither 'artificial' nor 'fictitious'.

Section 61A may be applicable if the IRD is of the view that the sole or dominant purpose of the transaction is to obtain a tax benefit. The fact that the transaction is motivated by tax mitigation intention is not sufficient (see *Craven v White* (1988) STC 476).

Island Ltd and Ocean Ltd may be able to defend themselves on the basis that the transaction is made for the purpose of group restructuring rather than obtaining a tax benefit. In restructuring the group, Ocean Ltd will take up all business operations (trading and letting) while Island Ltd will become an investment holding company with no operational activities. It is likely that the market value of the property is higher than its book value in Island Ltd. With the group restructuring, the financial position of the group as a whole will improve as the property is now stated at its fair market value in the books of Ocean L Ltd. The transaction will therefore have a commercial substance other than the tax benefit.

Furthermore, since the property had been held by Island Ltd for rental purposes, it is likely that the profit on disposal of the property is capital in nature and not chargeable to tax.

Provided Ocean Ltd also keeps the property for long term investment purposes, the profits derived from the future disposal of the property by Ocean Ltd to a third party may also be exempt from profits tax.

As Ocean Ltd is the wholly owned subsidiary of Island Ltd, the two companies will be entitled to s.45 relief under the SDO and no stamp duty will be payable on the property transaction. However, they will still need to incur other legal and professional charges on the property transfer.

Mr. X

(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). He would also be entitled to home loan interest deduction under s.26E(1).

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).

On the other hand, the Sum would be assessed to property tax by virtue of s.5(1) after deduction of the rates paid by Mr. X (s.5(1A)) and 20% allowance for outgoings and repairs (s.5(1B)). Further, if Mr. X elected to be assessed under personal assessment, he would also be entitled to a deduction of the mortgage interest paid in respect o the Property under the proviso to s.42(1). 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.

(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 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 its base salary, and it should be fully chargeable to salaries tax by virtue of s.9(1)(a).

Even if it were accepted that Mr. X ad 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 artificial within the ambit of s.61, having regard to the following:

(i) 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 a need nor commercial sense for him to let the Property to A Ltd and then get it back as free quarters.

(ii) 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 (a) above), it should be disregarded pursuant to s.61. It follows that the Sum was not rental payment of Mr. X but part of his base salary and it should be fully chargeable to salaries tax under s.9(1)(a).

Dr. A

(a) By carrying on his medical practice through Company E, Dr. A may reduce his tax liabilities as follows:

(i) As Company E becomes the person carrying on the medical practice, Dr. A will no longer be liable to profits tax in respect of the profits of the clinics. Instead, he, being the director of Company E, will provide medical services at the clinics in return for his director's remuneration. His remuneration package can be arranged to include a lot of fully or partially non-taxable fringe benefits (e.g. provision of quarters, domestic helper employed by Company E, etc.), whereas Company E will be able to claim deduction of those benefits as business expenses. By such an arrangement, although the profits tax rate for a corporation (16.5%) is higher than the standard tax rate for individual (15%), the overall tax liabilities of both Dr. A and Company E can be reduced.

(ii) The substantial loss sustained by Company E from share dealing has not yet been utilised due to its dormancy since 1997. In the circumstances, by injecting the medical practice into Company E, the aforesaid loss can be utilised to set off against the profits of the clinics.

(b) In advising Dr. A on his tax planning idea, the accountant should be aware of the following:

(i) Tax is a major source of the government's income. To preserve the welfare of the community, the accountant should act honestly in advising Dr. A on his tax planning idea.

(ii) The accountant is entitled to put forward tax advice as to the best position for Dr. A, provided that he does so within his professional competence and it does not in any way impair his standard of integrity and objectivity, and is in his opinion consistent with the law.

(iii) The accountant should not hold out to Dr. A the assurance that the tax advice he offers is beyond challenge. Instead, the accountant should ensure that Dr. A is aware of the limitations attaching to the advice (such as the possibility that the Commissioner may invoke ss.61 and 61A to deny any tax benefit obtained from the tax plan), so that he does not misinterpret an expression of opinion as an assertion of fact. Moreover, the accountant should remind Dr. A of his exposure to penalty provided under the IRO if the tax plan fails eventually.

(iv) If the accountant also assists Dr. A in preparing his tax return in accordance with the tax advice, he should advise Dr. A that the responsibility for the content of the return rests primarily with Dr. A.

(v) The accountant should not disclose any information acquired in the course of advising Dr. A to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose.

Chapter 10 Tax investigation and field audit

Mr. Chan

(a) Pursuant to s.60, the IRD may raise an assessment or an additional assessment within six years after the year of assessment, or within ten years after the year of assessment if the non-assessment or understatement is due to fraud or wilful evasion.

If Mr. Chan has passed away, then the IRD will need to raise all the assessments on the executor of Mr. Chan's estate within three years from the end of the year of assessment in which Mr. Chan died (s.54(c)).

(b) The field audit team may adopt a net worth approach (Assets Betterment Statement) in ascertaining the profits of Mr. Chan's business in the absence of business records.

The information required in a net worth approach (Assets Betterment Statement) includes:

Increase in net assets (HK and overseas) during the period. This is to be computed based on cost rather than valuation.

Items to be added:

- Disallowable items in the accounts;
- Tax paid (nil in Mr. Chan's case);
- Capital loss on sale of assets;
- Funds remitted to overseas;
- Gifts made;
- Household expenditures;
- Other private expenditures; and
- Unidentified withdrawals.

Items to be deducted:

- Gains on sale of assets;
- Gifts received;
- Funds remitted from overseas; and
- Income other than from business (eg interest from bank deposits).

The betterment profits so computed will then be compared with the returned profits of $1.5 million to arrive at the understated profits during the past ten years (assume the investigation covers ten years).

(c) Mr. Chan may be prosecuted by the IRD under s.80(1A) for failure to keep proper business records for a period of not less than seven years. The maximum penalty under s.80(1A) is a fine at level 6 (i.e. $100,000).

Mr. Chan may be prosecuted by the IRD under s.80(2)(a) on the grounds that he has, without reasonable excuse, made incorrect returns by omitting or understating anything in the returns. The maximum penalty under s.80(2) will be a fine at level 3 (i.e. $10,000) plus a further fine of 300% of tax undercharged or that would have been undercharged.

If there is evidence of tax evasion, Mr. Chan may be prosecuted by the IRD under s.82(1) on the grounds that he has, with a wilful intent to evade tax, made a false statement or entry in his returns; omitted from the returns any sums that should be included; signed any statement or returns furnished without reasonable grounds for believing the same to be true. The maximum penalty under s.82(1) is as follows:

On summary conviction

A fine at level 3 plus a further fine of 300% of tax undercharged or that would have been undercharged plus imprisonment for six months.

On indictment

A fine at level 5 (i.e. $50,000) plus a further fine of 300% of tax undercharged or that would have been undercharged plus imprisonment for three years.

If Mr. Chan has passed away, the IRD will unlikely prosecute the executor of his estate for criminal offences committed by the deceased.

If no prosecution has been initiated by the IRD, the Commissioner or a Deputy Commissioner may raise additional tax assessments under s.82A on Mr. Chan or the executor of his estate if Mr. Chan has passed away. The maximum amount of the additional tax is 300% of tax undercharged or that would have been undercharged.

Alternatively, the Commissioner can compound any s.80 and s.82 offences.

Herbert

(a) Herbert entered into a service contract with the insurance company and thus received the initial signing fee in the course of carrying on his insurance agency business. Clearly, the fee was remuneration provided by the insurance company for Herbert's services or in compensation for his loss of earnings from the previous insurance company. It was a trading receipt which arose from Herbert's agency business and should be taxable.

Herbert received the initial signing fee on 1 July 2012 (i.e. in the year of assessment 2012/13). On that day, Herbert held the fee beneficially and was entitled to use it for whatever purpose he liked. Although Herbert had a contingent liability to repay the fee if his service contract was terminated within the next five years, such liability did not crystallise in the year of assessment 2012/13. On the authority of *Lo Tim Fat v CIR* (6 HKTC 725), the initial signing fee accrued to Herbert in the year of assessment 2012/13 and the whole of it should be assessed to profits tax for that year.

(b) (i) J & Co should advise Herbert of the irregularities (i.e. the omission of the initial signing fee in the accounts and the missing invoices and receipts in relation to certain expense claims) and recommend him to make full disclosure to the IRD. The firm is, however, not obligated to inform the IRD, nor may it do so without Herbert's consent.

If Herbert refuses to disclose and rectify the irregularities, J & Co should inform Herbert that it can no longer act for him in matters of taxation.

(ii) J & Co should decline Herbert's request immediately and inform him of the seriousness of his intended act (i.e. willful submission of incorrect information in relation to expense claims) and the possible consequences (including criminal prosecution and the possibility of imprisonment upon conviction). The firm should also cease to act for Herbert and dissociate itself from the fictitious invoices and receipts provided by Herbert.

D & Co

Having noticed the failure of A Ltd to return the profits on sale of the shares 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 A Ltd to make disclosure to the IRD. D & Co 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 to represent A Ltd in connection with the relevant tax return and/or other related information submitted to the authorities. D & Co 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 relationship 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 for A Ltd and should give no further information to the authorities without the consent of A Ltd, unless required to do so by law.

Chapter 11 Tax compliance and tax advisory services

Mr. Lee

Mr. Lee may consider applying for an Advance Ruling regarding the Company's offshore operation.

S.88A of the Inland Revenue Ordinance provides the statutory mechanism for the granting by the IRD of advance rulings. Every ruling application must include the following:

- Identification of the applicant and hence, the party to which the ruling relates;

- Disclose all the relevant facts and documents in connection with the arrangement to which the application relates;
- State the provision of the IRO upon which a ruling is sought;
- State the proposition of law which is relevant to the issues raised in the ruling;
- Provide any other information which the IRD may specify in writing for the purposes of the ruling application; and
- Be accompanied by a draft ruling. In other words, the taxpayer is required to provide a first draft of the ruling sought.

Mr. Lee should refer to DIPN 31 which sets out the information and documentation generally required by the IRD before considering a ruling application.

The application must be accompanied by the prescribed fee, which is set at $30,000 for offshore profits claim. The IRD may charge additional fees on a time cost basis if the time required in reviewing the application exceeds the hours set by the Department.

Once a ruling is obtained, the company must disclose in the return:

- the existence of the ruling,
- whether the ruling has been relied upon when the return is prepared; and

whether there have been material changes to the arrangement identified in the ruling.

D Limited

[Draft]

Mr. X
D Limited
[Address]

[Our Reference]

Dear Mr. X,

We refer to your recent engagement with this firm to review the 2008/09 final tax assessment and the 2009/10 demand for provisional tax of D Limited. In particular, you would like to explore the taxability of the Compensation and the deductibility of the Severance Payment. We summarise our comments and advice as follows.

(1) **The Compensation**

We consider that the Compensation should be chargeable to profits tax because of the following:

(a) D Limited is a garment manufacturer and the contract with the Brand was just one of the manufacturing contracts which D Limited entered into with its customers. Being a sum to compensate for the termination of such a contract, the Compensation should be regarded as a business receipt in the ordinary course of trading: see *Short Bros. Ltd. v CIR* [1927] 12 TC 955 and *Kelsall Parsons & Co. v CIR* [1938] 21 TC 608.

(b) The contract with the Brand only contributed to 15% of D Limited's turnover. Its termination did not affect the entire framework of the business: see *Fleming v Bellow Machine Co. Ltd.* [1965] 42 TC 308.

(c) The Compensation was computed with reference to the profits which D Limited would have earned from the contract. It was more akin to compensation for the loss of profits rather than the loss of capital assets.

(2) **The Severance Payment**

On the authority of *Cosmotron Manufacturing Co. Ltd. v CIR* 4 HKTC 562, we consider the Severance Payment is deductible for the following reasons:

(a) The liability for the payment, though crystallised upon the closing of the production line, was not incurred to close the production line.

(b) The obligation to make such payment, though contingent, was incurred as a necessary condition of retaining the services of the employees concerned.

(3) **Suggested actions**

In light of the above circumstances, we suggest that D Limited may take the following actions:

(a) D Limited should object to the 2008/09 profits tax assessment pursuant to s.64(1) of the IRO. The notice of objection shall:

(i) be in writing;

(ii) state precisely the ground of objection, that is, the Severance Payment should be deducted from the company's assessable profits; and

(iii) be received by the Commissioner within one month after the date of the notice of assessment.

(b) Even if D Limited fails to observe the above time limit for objection, under s.70A of the IRO, the company may still apply for a correction of the assessment on the grounds that it is excessive due to an error or omission in a statement. Here, the statement concerned is the company's accounts and the error or omission should be the failure to recognise the Severance Payment as an expense. In any event, the application shall be made within 6 years after the end of the relevant year of assessment, or 6 months after the date on which the relevant notice of assessment was served, whichever is the later.

(c) Bearing in mind the contract with the Brand accounted for 15% of D Limited's turnover, the latter might probably suffer from a drop in assessable profits of more than 10% for the year of assessment 2009/10. Moreover, the Compensation, being a one-off payment, does not recur in the year of assessment 2009/10. In these circumstances, D Limited can apply to the Commissioner to have the payment of part of the 2009/10 provisional tax held over pursuant to s.63J(2)(a) of the IRO. The deadline for making such application, as stipulated under s.63J(1), shall be 28 days before the due date for payment of the provisional tax, or 14 days after the date of the relevant notice of assessment, whichever is the later.

We trust the above will be of assistance to you. Should you have any questions, please feel free to contact me at [telephone number] or Mr./Ms. Y, Tax Manager of this office, at [telephone number].

Yours sincerely,

Partner

E & Co.

Varian Inc.

(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.

(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.

(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)).

(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.

Herbert

(i) J & Co. should advise Herbert of the irregularities (i.e. the omission of the initial signing fee in the accounts and the missing invoices and receipts in relation to certain expense claims) and recommend him to make full disclosure to the IRD. The firm is, however, not obligated to inform the IRD, nor may it do so without Herbert's consent.

If Herbert refuses to disclose and rectify the irregularities, J & Co. should inform Herbert that it can no longer act for him in matters of taxation.

(ii) J & Co. should decline Herbert's request immediately and inform him of the seriousness of his intended act (i.e. willful submission of incorrect information in relation to expense claims) and the possible consequences (including criminal prosecution and the possibility of imprisonment upon conviction). The firm should also cease to act for Herbert and dissociate itself from the fictitious invoices and receipts provided by Herbert.

Chapter 12 Double taxation arrangement and agreements

Blue Hero Consultancy Ltd

(a) **BHC's Income Tax position**

The new Corporate Income Tax Law (CITL) was enacted at the Tenth National People's Congress on 16 March 2007 and unifies the income tax treatments of domestic and foreign enterprises. The CITL became effective on 1 January 2008. From that date onwards, all enterprises (including foreign investment enterprises, foreign enterprises, and domestic enterprises) and income generating organisations within the territory of China shall be liable to income tax under the CITL. Enterprises subject to enterprise income tax (CIT) are categorised into resident and non-resident enterprises.

Tax resident enterprises (TRE) are subject to CIT on worldwide income and non-TREs are subject to CIT on China-source income only.

A TRE is an enterprise established in China, or an enterprise that is established under the laws of a foreign country (or other tax region) but whose place of effective management is located in China *(CITL, Article 2).*

A non-TRE is an enterprise established under the laws of foreign country (or other tax region) and whose place of effective management is located outside China. A non-TRE which has an establishment in China is subject to income tax to the extent the income is effectively connected with its establishment in China (CITL, Article 2). The word 'establishment' will be replaced by a permanent establishment (PE) for company which is a resident of a country or tax region having entered into a tax treaty/arrangement with China. A non-TRE, which do not have an establishment (or PE) in China, but which derived income from China, may be subject to income tax on that income. Dividends, interest, rental, royalty and other income derived from sources within China by such non-TRE without an establishment (PE) in China are subject to CIT on a withholding basis *(CITL, Article 19).*

Before 1 January 2008, the income tax charging scope for a foreign enterprise is more or less the same. That is, a foreign enterprise, which maintains an establishment (PE) in China, will be subject to foreign enterprise income tax (FEIT), to the extent the income derived is attributable to that establishment (PE). A foreign enterprise, without any establishment (PE) in China, will be subject to FEIT in respect of its income derived from China. Dividends, interest, rental, royalty and other income derived from sources within China by such foreign enterprise without any establishment (PE) in China are subject to FEIT on a withholding basis.

According to the Mainland-Hong Kong CDTA, The term 'permanent establishment' is defined to include:

(i) a place of management;

(ii) a branch;

(iii) an office;

(iv) a factory;

(v) a workshop;

(vi) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources; and

(vii) an agency with general authority to conclude contract.

For consultancy services, if the services have been furnished in one side for the same project or a connected project for a period or periods exceeding in the aggregate six months in any 12-month period commencing or ending in a taxable year, the provision of services will be treated as a 'permanent establishment' in that side. *(Note: According to the 2nd Protocol to the DTA signed on 30 January 2008, the six months have been changed to 183 days; this rule will be applicable to those contracts with services commenced on or after 11 June 2008.)*

Before the Second Protocol comes into effect, in counting whether the service-rendering period amounts to six months, the China Tax Authority takes the position that the entire period starting from the first month when the first employee arrives the Mainland till the last month when the last employee leaves the Mainland should be counted. In other words, even if the employees are present in the Mainland for one day in a particular month, that would still be regarded as 'a month'.

However, it is subject to the exclusion of a period or periods of absence from the Mainland for this purpose, eg any period of 30 consecutive days without any services rendered by any employee working in the Mainland for the project can be excluded as ‘a month’.

Based on the above rule, for BHC, the aggregate service-rendering period in the Mainland is seven months, BHC should be treated as having a permanent establishment in the Mainland in this regard. It will be subject to FEIT for the year 2007 and CIT for the year 2008 in the Mainland.

Individual Income Tax position of BHC's employees

In order to be exempted from the Individual Income Tax in the Mainland, the following condition must be satisfied:

(i) the taxpayer stays in the Mainland for a period or periods not exceeding in the aggregate 183 days in any 12-month period commencing or ending in the taxable period concerned;

(ii) the remuneration is paid by or on behalf of an employer who is not a resident of the Mainland; and

(iii) the remuneration is not borne by a permanent establishment which the employer has in the Mainland.

As to the Individual Income Tax position of the employees working for the project, they will not be exempt from Individual Income Tax as their remuneration will be borne by a permanent establishment of BHC in the Mainland.

(b) **BHC's Income Tax position**

If the service-rendering period is from 1 September 2008 to 1 March 2009, the 2nd Protocol is applicable (which takes effect from 11 June 2008). Thus, instead of considering the six month out of a 12 month period, 183-day rule applies. In aggregate, BHC has rendered 182 days of services in the Mainland (30 days (September 2008) + 31 days (October 2008) + 30 days (November 2008) + 31 days (December 2008) + 31 days (January 2009) + 28 days (February 2009) + 1 day (March 2009)). Therefore BHC will not be regarded as maintaining a permanent establishment in providing the services. Thus, it will not be subject to CIT in this regard.

Individual Income Tax position of BHC's employees

As to the Individual Income Tax position of the staff working for the project, their remuneration will not be borne by a permanent establishment of BHC in the Mainland. Also,

they will not stay in the Mainland for more than 183 days. It seems that their salary is not paid or borne by a resident in the Mainland. Accordingly, they would be exempted from Individual Income Tax in the Mainland.

(c) BHC can claim tax credits for the Income Tax paid against its Hong Kong Profits Tax paid/payable according to the CDTA. The amount of Income Tax that can be credited against Hong Kong Profits Tax is limited to the amount of Profits Tax that would be charged under the Hong Kong Inland Revenue Ordinance for the relevant income.

BHC can claim Profits Tax deduction in respect of the Business Tax paid under s.16(1) of the Inland Revenue Ordinance as the tax was charged on the gross receipt and hence was incurred in the production of the services fee, which is assessable in Hong Kong.

Note: Arguably, the service income derived from services rendered in China may not be taxable in Hong Kong as it should be regarded as sourced outside Hong Kong. If the income is not taxable in Hong Kong then there should not be any issue of double taxation.

B Limited

(a) S.14 of the IRO provides, *inter alia*, that profits tax will be charged on every person carrying on a trade, business or profession in Hong Kong in respect of its profits arising in or derived from Hong Kong.

C Limited was incorporated in Hong Kong and engaged a secretarial company to perform certain business activities on its behalf in Hong Kong. Therefore, it was carrying on business in Hong Kong and its profits should be chargeable to profits tax if they were sourced in Hong Kong.

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, the broad guiding principle for determining the source of profits was "one looks to see what the taxpayer has done to earn the profit in question and where he has done it".

Having regard to the facts given in the question, there are two possible analyses on the question of source:

Analysis (1): Service income

The profits which C Limited derived were in the nature of service income and it should have a source in Hong Kong because of the following:

(i) There is no evidence that C Limited did anything outside Hong Kong. All the offshore activities were undertaken by B Limited and the Mainland Factory. On the authority of *ING Baring Securities (Hong Kong) Limited v CIR* [2008] 1 HKLRD 412, the source of the profits for C Limited must be ascribed to its own operations, not to those of B Limited and the Mainland Factory. In any event, the available facts seem to suggest that the three companies dealt with each other on their own accounts. There is no evidence that B Limited and the Mainland Factory acted on behalf of C Limited.

(ii) C Limited arranged the production of electronic parts for B Limited, and it was such service which earned C Limited its profits. As C Limited did all the arrangements, such as transshipment, invoicing, customs clearance, etc., in Hong Kong, the source of its profits should be in Hong Kong.

(iii) The purpose of establishing C Limited was to circumvent the then trade barrier between Taiwan and the Mainland. C Limited was remunerated for its interposition in the business relationship between B Limited and the Mainland Factory and for the necessary work in Hong Kong which it performed to make this interposition effective. On the authority of *Kim Eng Securities (Hong Kong) Ltd v CIR* [2007] 2 HKLRD 117, no matter how little C Limited did in Hong Kong, if the profits were derived from what it did in Hong Kong, then the profits should thus be wholly sourced from Hong Kong.

Such a view was echoed by the Board of Review in *D7/08*, (2008-09) 23 IRBRD 102 and the IRD in paragraph 44 of DIPN 21 (Revised).

(iv) The fact that C Limited neither had any staff nor a permanent office in Hong Kong would not by itself render its profits wholly offshore. As it engaged a secretarial company to perform various profit-producing activities on its behalf in Hong Kong, appropriate weight should be accorded thereto in determining the source of profits: see paragraph 17(j) of DIPN 21 (Revised).

Analysis (2): Trading profits

Alternatively, C Limited may be regarded as having derived trading profits outside Hong Kong because of the following:

(i) C Limited purchased semi-finished parts from the Mainland Factory and resold them to B Limited at a mark-up. Plainly, the profits earned by C Limited were trading profits.

(ii) In accordance with DIPN 21 (Revised), the source of trading profits should be the place where the sale and purchase contracts were affected. If either contract was effected in Hong Kong, then the initial presumption is that the profits are chargeable to profits tax.

(iii) B Limited and the Mainland Factory, the only customer and the only supplier of C Limited respectively, were not in Hong Kong. There is no evidence that they had any business presence in Hong Kong. C Limited also did not have any office nor staff in Hong Kong. In the circumstances, it is likely that both the sale contracts (with B Limited) and the purchase contracts (with the Mainland Factory) were effected outside Hong Kong.

(iv) The arm's length principle requires C Limited to charge B Limited a mark-up based on what it would have done in an uncontrolled transaction in comparable circumstances, so that C Limited would be remunerated with a reasonable return on its co-ordinating work in Hong Kong.

(b) The arm's length principle requires C Limited to charge B Limited a mark-up based on what it would have done in an uncontrolled transaction in comparable circumstances, so that C Limited would be remunerated with a reasonable return on its co-ordinating work in Hong Kong.

In applying the above principle, I would first characterise the transactions between C Limited and B Limited. On the basis of such characterisation, I would then select an appropriate transfer pricing methodology; and apply the selected methodology and determine the arm's length mark-up which C Limited should charge B Limited.

Three common transfer pricing methodologies include:

(1) Comparable Uncontrolled Price (CUP) Method;
(2) Resale Price Method; and
(3) Cost Plus Method.

As the products involved in the present case were electronic parts, which might not have any external market, CUP Method and Resale Price Method are difficult to apply. Cost Plus Method is therefore the one which the assessor may adopt in determining the arm's length mark-up earned by C Limited.

Chapter 13 Overview of China tax system

Business Tax

According to the *Provisional Regulations of Business Tax of the People's Republic of China* (*PRBT*), Article 1, all units and individuals providing prescribed taxable services, transferring intangible assets, or selling immovable properties (together called 'taxable services') within the territory of People's Republic of China are subject to business tax.

The prescribed taxable services include transportation service, construction industry, financial and insurance industry, post and telecommunications industry, culture and sports industry, entertainment industry and certain service industries (like hotel, catering, tourism, storing, leasing, advertising etc.) (*Detailed Rules for the Implementation of the Provisional Regulations of the People's Republic of China on Business Tax (PRBTIR), Art 2*).

It should be noted that provision of taxable services, transfer of intangible assets, or sale of immovable properties have to be 'within the territory of People's Republic of China' to be subject to business tax. Under the PRBTIR, the SAT takes the interpretation that taxable labour service is based on the place where the service recipient or service provider is located, not where the service is performed.

However, pursuant to *Caishui* [2009]114, certain services provided wholly outside the territory of the PRC will not be subject to business tax. These include cultural and athletic activities, entertainment, hotel and catering, storage and other services such as laundering and dyeing, mounting, transcription, engraving, photocopying and packing services.

Prince Limited

From the PRC turnover tax perspective, income derived from services received by the PRC client in the PRC are subject to PRC business tax (Article 1 of the Provisional Regulations of the People's Republic of China on Business Tax).

As business consultancy is in the scope of service industry, the applicable rate for business tax is 5%.

The business tax liability is therefore RMB101,800 x 5% = RMB5,090, as taxable income includes turnover and expenses reimbursement.

There is no business tax exemption provision with respect to income threshold and services duration and accordingly Prince Limited is liable to the abovesaid PRC business tax.

Question bank - questions

CASE STUDY 1

Linda Fu is the Finance Director of HKCO Limited ('HKCO'), the Hong Kong subsidiary of ABC Inc which is incorporated in Country X. She joined HKCO upon her graduation from university at the age of 22 and she has just completed 28 years of services with the company.

The normal retirement age in HKCO is 55. Upon retirement, any employee who has served the firm for over 20 years would obtain a special gratuity computed by reference to the monthly salary as at the last day of work.

After going on a holiday in the mainland of China with friends, Linda discovered that she was interested in working for a charitable organisation to engage in building schools for children living in rural areas. As she was single and has no financial obligations, she concluded that the retirement gratuity should be able to sustain her in the mainland of China. After some careful consideration, she decided to retire at the end of the year. Under the terms of her employment contract, she is required to give three months' notice.

The management of HKCO was disappointed to learn of her departure. However, they have in front of them other pressing issues to attend to. ABC Inc was in financial difficulties and will not be able to give HKCO any financial support. The bankers were refusing to extend further credit facilities to HKCO.

HKCO's board of directors held an emergency meeting and resolved the following:

(1) To decrease head count by 10%. Redundancy payments would be around $10 million. The management agreed to examine if they should maintain the Product-A business unit or simply close it down as it has not been profitable for five years running.

(2) To stop hiring.

(3) To accept an emergency loan (interest bearing) from a fellow UK subsidiary (assume that the subsidiary has not carried on business in Hong Kong and it is not a financial institution).

(4) To ask another fellow subsidiary in Belgium to provide financial subsidy since HKCO has been helping them to market their products in Hong Kong/ the mainland of China. If they do not subsidise the marketing cost, HKCO would not be able to maintain the marketing team.

(5) To relocate to another commercial complex with a cheaper rent. HKCO would need to pay compensation to the landlord of $5 million.

(6) To accept a government subsidy to finance the upgrading of computer equipment.

Due to the world economic conditions, HKCO realised substantial exchange losses in foreign currencies. Furthermore, despite the overseas loan and subsidies, HKCO still experienced liquidity strain. HKCO decided to dispose of two properties in Repulse Bay which had been used as directors' quarters. The proceeds from sales should be able to assist HKCO with their liquidity problems.

One week prior to Linda's departure, HKCO concluded a consulting contract with a client in Dubai. The contract revenue is US$20 million. HKCO immediately sent a team of experts to Dubai to conduct preliminary studies. The management was so thrilled to have secured this contract that they spent $100,000 to give Linda a farewell party.

Question 1 — 9 minutes

Explain the tax implications of the sums Linda Fu received upon retirement.

(3 marks)

Suppose Linda received a letter from a charitable organisation informing her of an urgent request for voluntary workers and that her prompt assistance would be much appreciated. Linda decided that she would give three months' payment in lieu of notice to the company and then depart from Hong Kong. Advise Linda of the tax implications, if any.

(2 marks)

Question 2 — 9 minutes

Comment on Linda's source of employment and taxability of income under Hong Kong salaries tax if Linda was employed by ABC Inc instead of HKCO.

Background for Question 2

Linda attended an interview with ABC Inc when she was visiting her grandparents in Singapore. The managing director was so impressed with her that he hired her as a trainee accountant. She signed the contract in Singapore and completed her probation in Hong Kong.

Five years ago, Linda was promoted to Finance Manager and her duties included overseeing the accounting functions of the various subsidiaries in Hong Kong, Singapore and Taiwan. She spends an average of 100 days a year in Hong Kong.

(5 marks)

Question 3 — 33 minutes

List out the tax implications, if any, arising from the board's resolutions.

(18 marks)

Question 4 — 27 minutes

What are the tax implications (including stamp duty) surrounding the disposal of the Repulse Bay properties?

(13 marks)

Suppose the Commissioner of Inland Revenue issued a determination concluding that the profits from the sale of the Repulse Bay properties are taxable and HKCO resolved to engage legal advisers to defend its position through the normal appeals channel, would such legal costs be deductible?

(2 marks)

Question 5 — 5 minutes

Discuss whether the exchange losses are deductible. (List the grounds for deductibility and/or any challenges against deductibility.)

(3 marks)

Question 6 — 7 minutes

Discuss whether the money spent on the farewell party is deductible.

(4 marks)

(Total = 50 marks)

HKICPA September 2009 (amended)

CASE STUDY 2

MCO is an entity established in an overseas jurisdiction. It is one of the largest producers of medical equipment. It employs over 1000 employees in 10 major cities around the world.

MCO has appointed its subsidiary MHK (a company incorporated in HK) to be its agent in Asia.

MHK engages a fellow subsidiary MSCO (a company incorporated in Singapore) to assist with a range of trading activities. MSCO has established an experienced sales and marketing team of over 50 professionals. It has also set up a sophisticated computer system for processing orders.

Orders from customers will be directed to MSCO. Based on these orders, MSCO would place production orders with MCO. Goods would be shipped and delivered from MCO directly to customers after production. There are no manufacturing activities in Hong Kong. All after sales services will be provided by MSCO and MCO offshore.

MHK does not have any employees/staff in Hong Kong. It will engage HK Accounting & Management Services Ltd, an independent third party, to perform certain administrative activities (e.g., keeping books and records, and issuing invoices) in Hong Kong.

Each entity will finance its own operation in line with corporate guidelines laid down for the group.

Human resources policies are also consistent throughout the group.

As the group intends to expand its business activities in Hong Kong in a few years' time, it is closely monitoring the tax developments in Hong Kong. MHK was established with the understanding that Hong Kong is a simple, low tax jurisdiction exempting offshore profits and capital gains from profits tax. Furthermore, Hong Kong is a leading financial centre and has a good legal system as well as proximity to the group's major markets/customers.

Question 1 — 36 minutes

MCO would like you to advise them as to whether MHK will have any tax exposure in Hong Kong. Outline relevant tax provisions, guidelines published by the Inland Revenue Department and/or relevant tax cases in support.

(15 marks)

MCO would like you to advise if MCO has any tax exposure in Hong Kong.

(5 marks)

Question 2 — 18 minutes

If the assessor is of the view that MHK is liable to tax in Hong Kong and assessed MHK for profits tax, advise MHK what actions can be taken to challenge such assessments.

(10 marks)

Question 3 — 36 minutes

(a) Assuming MHK intends to expand its business operation and will recruit a team in Hong Kong to provide procurement services. MHK will receive a commission from Universal Co., a customer, for various procurement services rendered. Explain whether the commission income will be taxable.

(4 marks)

(b) Will the commission in part (a) above be taxable if the services were rendered by its agent in Manila? Would the expenses incurred be deductible? (Assume it has no employee in Hong Kong.)

(4 marks)

(c) Will the commission mentioned in part (a) above be taxable if the relevant services were rendered partly in Hong Kong and partly outside Hong Kong? (Highlight one recent tax case in support.)

(12 marks)

(Total = 50 marks)

HKICPA February 2009 (amended)

CASE STUDY 3

Nick is a famous composer. He transferred all the rights of his musical works to a Hong Kong company namely Nick Production Workshop Limited ('NPWL') for commercial exploitation. Nick is the major shareholder and director of NPWL. During the year ended 31 March 2010, NPWL's profit and loss account shows the following particulars:

	$
Income	
Sale of album	4,008,200
Royalty income (Note 1)	379,266
Rental income (Note 2)	400,000
Compensation received (Note 2)	180,000
	4,967,466
Expenses	
Auditor's remuneration	2,250
Bank charges	150
Legal fee on transfer of the company's shares	4,800
Staff salary	1,923,117
Regular contributions to MPF scheme	
Mandatory	96,156
Voluntary	200,800
Compensation payment (Note 3)	480,000
Account receivable written off (Note 4)	729,012
Penalty for late filing of tax return	205,000
Other operating expenses	228,000
	3,869,285
Profit before taxation	1,098,181

Note 1

The royalty income was derived from XYZ Music Publishing Limited ('XYZ'), a company incorporated in the UK. In February 2009, the Managing Director of XYZ visited Hong Kong and was impressed by the songs written by Nick. By a licensing agreement dated 16 February 2009 ('the Agreement'), NPWL agreed to grant an exclusive licence to XYZ to exploit the rights of certain music works in the territory of Germany, Australia and New Zealand ('the Territory') in return for a fee. The fee payable by XYZ to NPWL under the Agreement would be a percentage of the actual income received by XYZ from performance and broadcast of NPWL's musical works in the Territory.

XYZ settled the royalties under the Agreement by transfer from its bank account in Australia to NPWL's bank account, also maintained in Australia. The sum of $379,266 was the net royalty income after the deduction of applicable overseas withholding tax of $31,119 in Australia and New Zealand.

Note 2

NPWL and Company A had previously entered into a tenancy agreement where NPWL let its property located in Hong Kong to Company A for a term of 3 years starting from 1 October 2008 at a monthly rental of $50,000. By an agreement dated 25 November 2009, NPWL and Company A agreed to terminate the tenancy agreement prematurely on 30 November 2009. Company A paid NPWL a sum of $180,000 as compensation. After taking possession, NPWL let the property to

Company B with effect from 1 March 2010 at a monthly rental of $53,000. As the rental income was settled in cash by Company B directly to Nick, no entries were recorded in NPWL's ledgers.

Note 3

The compensation payment was made to John, the senior manager of NPWL, upon termination of his employment with NPWL. This amount was in consideration for his agreement not to enter the same industry for 3 years from the date of his termination.

Note 4

The account balance represented a loan advanced by NPWL to its related company, Best Limited ('Best'), in year 2007. Best has been carrying on a business in Hong Kong and the loan was borrowed for the purpose of financing its operation. The sum comprised a principal of $560,000 and interest of $169,012. As Best was in financial difficulties, NPWL considered that the chance of recovering the debt was remote. Therefore, NPWL decided to write-off the debt.

Further information

NPWL and Best formed a partnership, N & B Partnership ('Partnership 1'). NPWL sustained a loss of $199,400 from Partnership 1 for the year of assessment 2009/10. Nick is also a partner in the partnership, Nick & Co. ('Partnership 2'). The loss Nick sustained from Partnership 2 for the year of assessment 2009/10 amounted to $127,430. Nick would like to set off the two losses against the assessable profits of NPWL.

Question 1 — 43 minutes

Explain the profits tax position of NPWL in respect of:

(a) The royalty income derived from XYZ (Note 1 above).

(12 marks)

(b) The compensation received from Company A for the premature termination of the tenancy (Note 2 above).

(12 marks)

Question 2 — 31 minutes

Assuming the royalty income and compensation in Question 1 are both chargeable to profits tax for the purpose of this question, prepare NPWL's profits tax computation for the year of assessment 2009/10. Marks will be awarded for all the necessary explanation.

(17 marks)

Question 3 — 16 minutes

The rental income from Company B was not recorded in NPWL's ledgers (Note 2 above). Discuss the possible penalty actions that may be taken by the Inland Revenue Department.

(9 marks)

(Total = 50 marks)

HKICPA May 2008 (amended)

CASE STUDY 4

Alpha Limited ('Alpha') was registered as a private company in Hong Kong in the year 2003. It is a wholly-owned subsidiary of a Korean company ('the Korean Company') which is a trader of electronic goods and the sole customer of Alpha. Alpha derived profits from the sales of Product C it made to the Korean Company. The Korean Company would fax its orders for the purchase of Product C to the Hong Kong office of Alpha. Upon receipt of each order, Alpha would compute the raw materials required for the manufacture of Product C and acquire the raw materials from suppliers both in Hong Kong and Korea. The sale of Product C to the Korean Company and the purchase of raw materials from suppliers were handled by the sales and purchasing department of Alpha in Hong Kong.

To take advantage of lower labour and other costs in the Mainland of China ['the Mainland'], Alpha has set up a wholly owned subsidiary, Beta Limited ('Beta') in the Mainland for the manufacture of Product C. Beta was registered as a wholly foreign owned enterprise in the Mainland in the year 2008. Beta was granted a license to carry on manufacturing and trading in the Mainland. Alpha did not have any business license in the Mainland.

Alpha has entered into a processing agreement ('the Processing Agreement') with Beta under which Beta would carry out the manufacturing work of Product C. The business license of Beta is an import processing license which only allows transfer of raw materials and finished goods between Alpha and Beta to be by way of sales and purchases. It was so arranged that Alpha would sell raw materials to Beta and, after processing, buy finished goods from Beta. The sale and purchase contracts were prepared by the sale and purchasing department of Alpha in Hong Kong. The selling prices of the raw materials and finished goods were determined on an arm's length basis. The sales and purchase transactions were entered into the books of accounts of Alpha and Beta accordingly. Beta derived profits from buying raw materials from Alpha and selling finished goods to Alpha. Beta was subject to tax in the Mainland in respect of the profits made. The Processing Agreement also provided that Alpha would be required to provide design and technical know-how to Beta in return for a fee which was determined on an arm's length basis.

Beta recruited its staff locally and employed about 2,000 employees. Except for the manufacture of Product C for Alpha, Beta also carried out manufacturing work for other customers in the Mainland. To make sure the production schedule is met, Alpha occasionally sent staff to Beta to oversee the production operation.

Alpha employed Mr Kong as its Managing Director. Mr Kong was born in Hong Kong and had been working in Hong Kong for years before joining Alpha. Mr Kong negotiated and signed a contract of employment with Alpha in Hong Kong. The employment commenced on 1 March 2009. According to the contract, Mr Kong was entitled to a monthly salary of $100,000.

For the year of assessment 2009/10, Alpha made a total payment of $240,000 to cover the school fee of Mr Kong’s daughter, aged 20. She was studying full time at a university in Manchester. It was arranged with the university that Alpha would be liable for the school fee. Mr Kong purchased a property in Sai Kung in the year 2008. This property has been used as his place of residence since its purchase. Mr Kong arranged with Alpha that Alpha would rent this property from him at a monthly rent of $50,000 starting from 1 April 2009 for a two-year period. Alpha provided this property rent-free to him. A written tenancy agreement was entered into between Alpha and Mr Kong and was properly stamped. Mr Kong has obtained a bank loan for the purpose of purchasing the property and incurred interest expense of $500,000 for the year ended 31 March 2010.

Under the terms of employment, Mr Kong was required to travel overseas to carry out his duties. During the period 1 April 2009 to 31 March 2010, Mr Kong spent 100 days outside Hong Kong on business trips. In February 2010, Mr Kong attended a business conference in Perth and his wife was invited to accompany him to attend the conference. Alpha paid $30,000 for two air tickets for Mr Kong and his wife.

Mr Kong appointed you as the tax representative of Alpha. He would like to know if Alpha could lodge an offshore claim for all or part of its profits. He admitted that Beta was not acting as Alpha's agent. For the purpose of manufacturing Product C, Beta requested Alpha to provide some electronic plant and machinery. Mr Kong is considering buying the required plant and machinery in Hong Kong and providing them to Beta for free.

Question 1 — 20 minutes

(a) Discuss the general principles regarding the source of profits in respect of the above processing arrangement entered into between Alpha and Beta.

(10 marks)

(b) Advise Mr Kong how Alpha's profits from the sale of Product C would be taxed under Hong Kong profits tax and whether an apportionment of profits would be available to Alpha.

(12 marks)

Question 2 — 9 minutes

Explain to Mr Kong whether any allowance or deduction would be granted to Alpha in respect of the proposed acquisition of manufacturing plant and machinery.

(5 marks)

Question 3 — 18 minutes

Referring to the rental arrangement between Alpha and Mr Kong, explain without computation the tax benefits that Mr Kong may obtain for the year of assessment 2009/10.

(10 marks)

Question 4 — 23 minutes

Compute, with necessary explanations, the salaries tax liability of Mr Kong for the year of assessment 2009/10.

You can assume that:

Mr Kong is married and his wife did not derive any income chargeable to Hong Kong tax; and

The housing arrangement of Alpha and Mr Kong is not challenged by the Inland Revenue Department.

(13 marks)

(Total = 50 marks)

HKICPA September 2007 (amended)

Question bank - answers

CASE STUDY 1 (September 2009)

Answer 1

(a) Any sums Linda received in relation to her employment and/or services rendered in the past would be taxable. Therefore, any salary income and /or retirement gratuity would be subject to Salaries Tax.

The retirement gratuity could be related back three years ending on the date of retirement or entitlement to claim payment thereof whichever is the earlier pursuant to proviso (i) of Section 11D(b) of the IRO.

(b) Payment in lieu of notice would not be deductible as such was not incurred in the production of assessable income (Section 12(1)(a)).

Linda's employer would need to notify CIR in writing of her departure from Hong Kong not later than one month before she actually leaves (Section 52(6)). HKCO would also be required to withhold any payment to her for a period of 1 month from the date of that notice, except with the consent of CIR in writing (Section 52(7)).

Answer 2

Linda would be regarded as having a foreign employment for Hong Kong Salaries Tax purpose having regard to the following factors (DIPN 10):

The employment contract was negotiated, entered into and enforceable in Singapore

Employer – ABC Inc (a foreign corporation)

Where remuneration was paid to Linda (no information)

In this regard, only income derived from services rendered in Hong Kong would be taxable. The assessable income would be ascertained by time apportionment basis.

Answer 3

(1) **To decrease head count by 10% and possible close down of business unit.**

It is estimated that the redundancy payments would be around $10 million. (The management agreed to examine if they should maintain the Product A business unit or simply just close it down as it has not been profitable for five years running.)

In this regard, the redundancy payments expended to enable the company to continue its business in Hong Kong should be deductible under Section 16(1) of the IRO. Redundancy payments arising from the closure of the business unit would also be deductible following the *Cosmotron* case ((1997) 4 HKTC 562).

However, other payments arising from the closing down of a business unit may be capital in nature if it is in relation to the permanent closure of a business operating structure. In this regard, it would not be deductible (Section 17(1)(c)).

(2) **To stop hiring**. (No tax implications)

(3) **To accept an emergency loan from a fellow UK subsidiary**.

The interest payable to the UK lender would not be deductible as it failed to comply with the requirements of Section 16(2) (such as Section 16(2)(c)) of the IRO since the recipient is not carrying on business in Hong Kong and thus the interest it derived from Hong Kong would not be taxable.

(4) **Financial subsidy**

It is noted that HKCO will ask another fellow subsidiary in Belgium to provide financial subsidy since HKCO has been helping them to market their products in Hong Kong/ the Mainland of China. If they do not subsidise the marketing cost, HKCO would not be able to maintain the marketing team.

In this regard, the financial subsidy (for financing operating expenses) should be taxable under Section 15(1)(c).

(5) **Relocation**

To relocate to another commercial complex with cheaper rent. HKCO would need to pay compensation to the landlord of $5 million.

Voluntary removal costs are capital in nature and not deductible whereas involuntary removal costs may be deductible, depending on the evidence (e.g. lease agreement and factual circumstances) of the case.

(6) **To accept a government subsidy to finance the upgrading of computer equipment**.

The subsidy for upgrading computer equipment is capital in nature and not taxable. As no capital expenditure was incurred by HKCO, no depreciation allowances would be granted to it.

Answer 4

(a) Whether the profits from the sale of properties are taxable would depend on whether the property transactions are capital or revenue in nature.

The IRO does not define what constitutes 'profits arising from the sale of capital assets'. In practice, reference is often made to the so-called 'badges of trade' to distinguish capital assets from trading stock.

The so-called 'badges of trade' include:

- Subject matter of the transaction
- Profit motive / intention to trade for profits
- Length of ownership
- Frequency of similar transactions
- Supplementary work done in enhancing marketability
- Circumstances leading to the realisation

To determine if the profits from the sale of the Repulse Bay properties would be taxable, one would need to ascertain the following:

- HKCO's intention of investing in the relevant properties and whether there is supporting evidence to substantiate the above
- The length of ownership (no information here)
- The fact that the properties have been occupied by directors might suggest that they are for long term investment purposes
- Whether HKCO has a history in property trading and the nature of HKCO's business in Hong Kong
- Whether HKCO has adequate long term funds to finance the properties as a long term investment
- Whether the disposal was for trading for profits, or merely due to the adverse economic condition which the company encountered recently and /or other valid commercial reasons to support the disposal was to effect a sale of capital investment.

If the relevant properties were held for long term investment purposes, then the profits on disposal would not be taxable.

On disposal of the residential properties in Repulse Bay, each relevant Sale & Purchase agreement is a stampable document under Head 1(1A) of the Stamp Duty Ordinance. Where a conveyance on sale of residential property is executed in conformity with a chargeable agreement for sale which is stamped, the conveyance is chargeable with stamp duty of $100 only (Section 29D(2)(a)).

(b) Cost of tax appeals is not normal business expense incurred in the production of assessable profits and so it would not be deductible.

Answer 5

To ascertain the deductibility of the exchanges losses would need to examine:

- If the exchange losses arose from normal course of business and/or business transactions, such losses would be deductible.
- If the exchange losses arose from conversion of bank accounts, it would be capital in nature and hence non-deductible.
- If the exchange losses arose from offshore transactions/business, it would not be deductible.

Answer 6

The sum was expended in staff welfare. Arguably such was incurred for promoting staff morale and enhancing the productivity and profitability of HKCO, and it should meet the requirements of Section 16(1) of the IRO.

However, such claims may be denied if:

- the party is 'private' in nature and
- the costs incurred are excessive and/or
- evidence available suggests that such sum was not incurred in the production of assessable profits

CASE STUDY 2 (February 2009)

Answer 1

(a) On the facts before us, it seems that all the relevant income earning trading activities were carried out by MSCO offshore. Therefore MHK should not be liable to tax in Hong Kong.

In reaching this conclusion, the following relevant tax rules and court decision have been taken into consideration:

The tax system in Hong Kong is territorial based. According to Section 14 of the Inland Revenue Ordinance ('IRO'), three conditions must be satisfied in order for a person to be chargeable to profits tax:

(i) the person carries on a trade, profession or business in Hong Kong;

(ii) the person derives profits from that trade, profession or business; and

(iii) the profits arise in or are derived from Hong Kong (i.e., sourced from Hong Kong).

In ascertaining the 'source' of a person's profits, the broad guiding principle in determining the locality of profits is 'one should look to see what the taxpayer has done to earn the profits and where he has done it (i.e., the so-called operations test)'.

According to the Departmental Interpretation & Practice Notes ('DIPN') No. 21 (Revised 2009) issued by the Inland Revenue Department ('IRD'), the IRD has set out guidelines in determining the locality of profits.

(Note that DIPN only serves as a reference on the views of the IRD and does not have any legal binding force. In practice, the IRD usually follows the DIPN in issuing assessments.)

Pursuant to DIPN No. 21, the IRD considers the important factors for determining the 'source' of trading profits to be the place or places where the contract of purchase and contract of sale are 'effected'.

The IRD considers the word 'effected' cannot merely mean legally executed. It would contemplate the actual steps leading to the existence of the contracts including the negotiation and, in substance, conclusion and execution of the contracts.

In DIPN No. 21 (Revised 2009), the IRD also indicates that while the purchase and sale contracts are important factors, the 'totality of facts' must be looked at to determine the locality of the profits.

Examples of questions in connection with the 'totality of facts' are as follows:

- How were the goods procured and stored?
- How were the sales solicited?
- How were the orders processed?
- How were the goods shipped?
- How was the financing arranged?
- How was payment effected?

The IRD further clarifies that the nature and quality of the activities would be more important.

Consco Trading Co. Ltd v. Commissioner of Inland Revenue (the 'Consco case')

The *Consco* case was decided in May 2004. In this case, the taxpayer was incorporated in Hong Kong in 1985 and commenced its trading business in 1994. It does not have any overseas office or any other form of permanent establishment outside Hong Kong. The goods were produced in the Mainland of China for direct shipment to the customers without routing through Hong Kong. The 'totality of facts' in that particular case covered the following:

- Pre-contract negotiations;
- The making of contracts of purchase;
- The making of contracts of sale;
- The post-contract performance such as arrangement for finance, preparation of shipping documents, delivery of goods and effecting and receipts of payments; and
- The making of processing agreements (for production of the products).

The Court took into account all of the above but did not indicate the weight of each of the relevant 'facts' in the *Consco* case. The funding arrangement (i.e., opening letters of credit) was considered as relevant in determining the 'source' of the company's trading profits. It appears that the places where the purchase and sale contracts are 'effected' may or may not outweigh other facts under the 'totality of facts' approach.

Applying the totality of facts approach to analysing the facts of the present case, it is considered that the trading profits at issue are sourced offshore and not taxable.

(b) MHK is MCO's agent in Hong Kong. If MHK has the authority to conclude contracts on behalf of MCO in Hong Kong, then according to IRR Rule 5, MCO would be considered as having a permanent establishment in Hong Kong. MCO would only be liable to Hong Kong profits tax in respect of the profits arising in and derived from Hong Kong attributable to the permanent establishment.

If MHK has no general authority to conclude contracts for and on behalf of MCO, MCO should not have any tax exposure in Hong Kong.

Answer 2

MHK should lodge an objection under Section 64(1) of the IRO one month after the date of issue of the assessment stating the grounds of objection.

MHK should collect supporting evidence, such as:

- Organisation chart
- Operational flow chart – demonstrating all activities conducted offshore
- Sample transaction documents – demonstrating all relevant transactions were effected offshore
- Any supporting evidence of operations conducted abroad

MHK should expect enquiries letters from the assessor as to its mode of operation. MHK should collate such documents and prepare a detailed reply and submission to the IRD to defend their offshore claim.

If the Commissioner issued a determination to uphold the assessor's assessment, MHK would have the right to lodge an appeal to the Board of Review against the Commissioner's determination. The notice of appeal should be lodged within 1 month after the transmission of the determination to the taxpayer with the Clerk to the Board of Review together with the grounds of appeal and a copy of the Commissioner's determination, the reasons therefor, and the statement of facts.

The onus of proof is on the taxpayer in an appeal to the Board of Review.

Answer 3

(a) The source of service fees / commissions is normally determined by reference to the location where services are rendered.

If the relevant services are rendered in Hong Kong, the commission income should be taxable under Section 14 of the IRO.

If the relevant services are rendered overseas, the relevant commission should be sourced offshore and is not taxable.

(b) If the services were rendered abroad to earn the income with supporting evidence to substantiate, then the income should be sourced offshore and is not taxable.

The relevant expenses incurred would not be deductible as they are not incurred in the production of assessable profit.

(c) Applying the principle from the *Hang Seng Bank* case, when ascertaining the source of profit, one must examine 'what the taxpayer has done to earn the profit'.

Furthermore, in the recent *ING Baring* case, the Court held that the activities carried out by related companies overseas on the taxpayer's account were crucial for earning the relevant commission and hence the relevant profit was held to be offshore and not taxable.

In the present case, to determine the source of commission, one needs to examine the nature and extent of the services rendered in Hong Kong and those abroad. If the services rendered abroad are crucial for earning the profit and without the support provided abroad, MHK would not be able to earn the profit, then this would lend support to the claim that the relevant profit is sourced offshore and not taxable.

To substantiate the offshore claim, MHK would need to outline the details of services rendered offshore with supporting evidence.

In some cases, the assessor may consider that part of the profit are sourced offshore and not taxable whereas part of the profit are derived from Hong Kong and taxable. The taxpayer and the assessor may need to agree on an apportionment basis.

CASE STUDY 3 (May 2008)

Answer 1

(a) Under Section 14, profits tax shall be charged on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong.

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'.

It is only the operations of the taxpayer which are the relevant consideration.

NPWL was carrying on business in Hong Kong. There is no evidence that it had any permanent establishment outside Hong Kong.

The issue is whether the royalty income arose in or was derived from Hong Kong.

NPWL acquired the music license rights from Nick in Hong Kong.

NPWL executed a licensing agreement in Hong Kong to grant a licence in respect of the music works.

NPWL derived the royalties from the acquisition and granting of the music rights.

As the acquisition and granting of the music rights were carried out in Hong Kong, the source of the royalties was in Hong Kong.

The place of payment has no bearing in determining the locality of profit in the present case.

Although the broadcast and performance of the musical works took place overseas, they were not relevant considerations. These were the operations of XYZ and not NPWL.

(b) The question to be considered is whether the compensation was a trading receipt or a capital receipt.

Section 14 excludes from profits tax charge any profits capital in nature.

The early termination of the tenancy agreement did not destroy NPWL's profit-making apparatus. The property was let to another tenant soon after NPWL had taken possession of the property. The compensation was not a capital receipt for the loss of a capital asset.

NPWL has been carrying on the business of property letting. The tenancy agreement with Company A was entered into in the ordinary course of its business. The compensation for releasing the parties from their respective responsibilities and liabilities under the tenancy agreement in the ordinary course of business was revenue in nature.

As a general principle in common law, a compensation payment usually takes the character of the item which it replaces.

The compensation was for the failure to receive, or for the loss of, trading receipts, that is, rental income for the unexpired period covered in the tenancy agreement. The compensation was therefore a trading receipt.

Answer 2

Nick Production Workshop Limited
Profits Tax Computation

Year of assessment 2009/10

		$	$
Profit per account			1,098,181
Add:	Legal fee on transfer of the company's shares	4,800	
	Regular contributions to MPF scheme	8,488	
	Compensation payment	480,000	
	Account receivable written off	560,000	
	Penalty for late filing of tax return	205,000	
	Rental income from Company B	53,000	1,311,288
	Assessable profits		2,409,469
Less:	Loss set-off from Partnership 1		(199,400)
	Net assessable profits		2,210,069
Tax payable thereon @16.5%			364,661

The withholding tax is deductible as it was charged on earnings rather than on profits. As the royalty income was taken to the P&L account on a net basis, no adjustment is required.

The legal fee on transfer of the Company's shares was capital in nature and not deductible under Section 17(1)(c).

Regular contributions (mandatory or voluntary or both) to an MPF scheme by an employer are deductible under Section 16(1). The allowable deduction is limited to 15% of the total emoluments of the employee.

$(96,156+200,800) – $1,923,117 x 15% = $8,488

The compensation payment was for prevention of future competition. It is capital in nature and not deductible.

The loss on the loan was not an **expense** under Section 16(1).

NPWL was not carrying on a money lending business. The loss on the loan is not deductible under Section 16(1)(d).

Since the provision of credit was in Hong Kong, interest on the loan should have been previously offered for tax. The writing off of the uncollected interest of $169,012 is deductible.

The penalty incurred for late filing of the tax return is not deductible as it was not incurred in the production of assessable profits.

NPWL is the owner of the property. The rental income derived from letting the property to Company B for March 2010 should be treated as NPWL's assessable profits.

NPWL was entitled to set-off the loss sustained from Partnership 1 against the assessable profits of NPWL under Section 19C(5).

If Nick does not elect personal assessment, the loss incurred by him from Partnership 2 can only carry forward to set off against his share of Partnership 2's assessable profits in subsequent years, under Section 19C(2).

Answer 3

NPWL's failure to record the rental income received from Company B would result in the understatement of assessable profits declared in the tax return. The IRD may consider the following penalty actions:

– prosecution under Section 82(1) for wilful tax evasion;

– prosecution under Section 80(2);

– additional tax assessments raised by the Commissioner or a Deputy Commissioner personally under Section 82A.

The maximum penalty of the offence under Section 82(1):

On summary conviction:

– a level 3 fine;

– an additional fine of up to treble the amount of tax undercharged or which would have been undercharged and

– imprisonment for 6 months.

On indictment,

– a level 5 fine;

– an additional fine of up to treble the amount of tax undercharged or which would have been undercharged; and

– imprisonment for 3 years.

The maximum penalty for the offence under Section 80(2),

– a level 3 fine;

– an additional fine of up to treble amount of tax undercharged or which would have been undercharged.

The maximum amount to be assessed under Section 82A will not exceed treble the amount of tax which has been undercharged / would have been so undercharged.

The Commissioner may compound the offence under Sections 80 and 82 in lieu of prosecution (Sections 80(5) & 82(2)).

The IRD indicates in its penalty policy that offences that do not involve any wilful intent to evade tax are generally dealt with by imposition of additional tax under Section 82A.

The IRD will consider whether NPWL has a 'reasonable excuse' for making an incorrect return.

What amounts to 'reasonable excuse' would depend on the circumstances giving rise to the under-statement.

In D13/85, the Board of Review described the concept of 'reasonable excuse' as follows:

Reasonable excuse is what one would expect a reasonable person to do in all of the circumstances. A reasonable person is not a perfect person, but an average person using the reasonable skill and care in handling his tax affairs which one would expect to see from such an average person.

CASE STUDY 4 (September 2007)

Answer 1

(a) Under Section 14, profits tax is charged on every person carrying on a trade, profession or business in Hong Kong in respect of assessable profits arising in or derived from Hong Kong from such trade, profession or business.

The broad guiding principle is 'one looks to see what the taxpayer has done to earn the profits in question and where he has done it (*Hang Seng Bank case, HK-TVBI case*).'

For this purpose, it is only the taxpayer's operations, not anybody else's, that are relevant [*Wardley Investment Services (Hong Kong) Ltd*].

For a taxpayer engaging in the manufacture of goods, the profit would arise in or derive from the place where the profit making activity is carried on (*Hang Seng Bank case*).

Where a Hong Kong company manufactures goods partly in Hong Kong and partly outside Hong Kong (say in the Mainland), the profits which relates to the manufacture of the goods in the Mainland will not be regarded as arising in Hong Kong.

DIPN 21 (Revised 2009) provides for an apportionment of profits for the processing arrangement entered into by a Hong Kong entity with a Mainland entity. An apportionment of profits is generally given on a 50:50 basis in practice.

Under the typical contract processing arrangement, the Mainland entity provides the factory premises, the land and labour. For this, it charges a processing fee and exports the completed goods to the Hong Kong manufacturing business.

The Hong Kong manufacturing business normally provides the raw materials. It may also provide technical know-how, management, production skills, design, skilled labour, training and supervision for the locally recruited labour and the manufacturing plant and machinery.

In law, the Mainland processing unit is a sub-contractor separate and distinct from the Hong Kong manufacturing business and the question of apportionment strictly does not arise. However, recognising that the Hong Kong manufacturing business is involved in the manufacturing activities in the Mainland, the IRD is prepared to concede that the profits on the sale of goods in question can be apportioned.

If, however, the manufacturing work has been contracted to a sub-contractor (whether a related party or not) and paid for on an arm's length basis, which requires minimal involvement of the Hong Kong business, the question of apportionment will not arise. For the Hong Kong business, this will not be a case of manufacturing profits but rather a case of trading profits.

For import processing arrangement, the Court of Appeal in July 2009 handed down its judgement in favour of the Commissioner that the profits in question were fully taxable (*Datatronic Limited case*). The Court of Appeal held that taxpayer's profits were not manufacturing profits and the arrangement between the parties involved was import processing instead of contract processing. The Court of Appeal's decision highlighted that '…The focus is, therefore, on establishing the geographical location of the taxpayer's profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions.' The taxpayer applied for leave to appeal to the Court of Appeal, but the application was subsequently withdrawn by the taxpayer.

(b) Alpha and Beta are separate and distinct from each other. Beta has a role of its own. The following facts support the arguments:

- Beta was registered as a wholly foreign owned enterprise under the laws of the Mainland. It was a separate legal person and allowed to carry on a business in the Mainland.
- Beta employed its own employees in the Mainland.
- Alpha sells raw materials to Beta and buys the finished products from Beta at arm's length prices.
- The profits derived by Beta from buying and selling from and to Alpha were subject to tax in the Mainland.
- Beta also performed manufacturing work for other customers in the Mainland.
- Alpha provided design and know how to Beta at arm's length prices.

In the circumstances, the manufacturing operations of Beta in the Mainland were the activities of Beta and not Alpha. Beta was not acting as the agent of Alpha. Beta is a manufacturer which manufactures its own products for sale to Alpha and other customers.

On the other hand, Alpha has no substantial involvement in the Mainland manufacturing operations as it only occasionally sent staff to Beta to oversee the production.

Therefore, Alpha was not a manufacturer but a trader deriving profits from buying finished goods from Beta and selling the same to the Korean Company.

The apportionment of profits as provided in DIPN 21 (Revised 2009) is not applicable for the arrangement of 'buying and selling' at arm's length prices.

Applying the Datatronic's decision to the case in question, Alpha's activities in the Mainland were commercially essential to the operations and profitability of its business, but they were merely antecedent or incidental to the profit-generating activities. Alpha had derived its assessable profit from its trading activities instead of manufacturing in the Mainland.

For trading profits, an important factor to consider is the place where the contracts for purchase and sale were effected, but other factors must also be looked at. For example: How were the goods procured and stored? How were the sales solicited? How were the orders processed? How were the goods shipped? How was the financing arranged?

The essential operations of Alpha, including the buying from Beta and other suppliers and selling to the Korean Company were carried out in Hong Kong. The purchase and sales contracts were also effected in Hong Kong. The profits of Alpha should be chargeable to profits tax in full.

Answer 2

Under Section 2, a 'lease' in relation to machinery or plant includes any arrangement under which a right to use the machinery or plant is granted by the owner to another person.

Although no rental is charged, the arrangement is still a lease under Section 2.

As the machinery or plant is under a lease, it is an excluded fixed asset under Section 16G(6) and falls outside the purview of Section 16G. Hence no deduction under 16G would be given.

Alpha should also be denied depreciation allowances in respect of the plant and machinery under Section 39E(1)(b)(i) as the plant and machinery would be used outside Hong Kong.

Answer 3

Mr Kong was employed by Alpha during the year of assessment 2009/10. Any housing allowance received by Mr Kong from Alpha by virtue of his employment would be subject to Hong Kong salaries tax under Section 9(1)(a).

However, by entering into the housing arrangement with Alpha, the monthly rental income of $50,000 would not be chargeable to salaries tax. This is because the sum was received by Mr. Kong in his capacity as landlord of the property.

Mr Kong is only required to pay salaries tax on the rental value, being 10% of his net assessable income.

The rental income would be subject to property tax. However, he would benefit from electing personal assessment if he is either a permanent resident or temporary resident of Hong Kong.

On the facts available, Mr Kong is entitled to personal assessment under Section 41(4).

– Mr Kong was born in Hong Kong and has been working in Hong Kong for years, he should be regarded as a permanent resident of Hong Kong.

– Mr Kong spent more than 180 days in Hong Kong for the year of assessment 2009/10, he is also qualified as a temporary resident of Hong Kong for this year.

The net assessable value of the property would be set off by the interest expenses of $500,000 under personal assessment.

The offset is limited to net assessable value of $480,000 ($50,000 × 12 × 80%).

Answer 4

Salaries tax computation for Mr Kong for the year of assessment 2009/10:

	$	$
Salary (100,000 × 12)		1,200,000
Education allowance		240,000
Ticket expense for Mrs. Kong (30,000 × 1/2)		15,000
		1,455,000
Rental value (1,455,000 × 10%)		145,500
Assessable income		1,600,500
Less: Allowances		
Married Person's allowance	216,000	
Child allowance	50,000	266,000
Net chargeable income		1,334,500
Tax thereon		
First $40,000 @2%		800
Next $40,000 @7%		2,800
Next $40,000 @12%		4,800
Remainder @17%		206,465
Tax payable at progressive rate		214,865
Less: 75% tax deduction for Y/A 2009/10 (subject to the maximum of $6,000)		6,000
Tax payable thereon		208,865

($1,600,500@15% = $240,075)

Notes:

1 Mr Kong was employed by Alpha during the year of assessment 2009/10. Alpha was a company incorporated in Hong Kong. The employment contract was also signed and concluded in Hong Kong. These factors suggest that this was Hong Kong employment. The income derived by Mr Kong from Alpha should be taxable in full.

2 The fact that Mr Kong spent 100 days outside Hong Kong is irrelevant in determining the source of his employment income from Alpha.

3 The monthly school fees paid by Alpha in connection with the education of the child of an employee are taxable under Section 9(2A)(b), even though Alpha would be liable for the payment and Section 9(1)(a)(iv) is not applicable.

4 The trip taken by Mr Kong was for business purposes and the cost incurred by Alpha in connection with his trip is not included as Mr Kong's assessable income.

5 However, Mrs Kong was not an employee of Alpha and had no contractual liability to perform any employment duties. The cost of Mrs Kong's ticket is a private expense of Mr Kong and should be taxable as a perquisite.

Glossary of terms

The term **agent**, in relation to a non-resident, is defined under Section 2(1) to include:

- the agent, attorney, factor, receiver, or manager of the non-resident in Hong Kong; and
- any person in Hong Kong through whom a non-resident receives any profits or income arising in or derived from Hong Kong.

Approved investment advisor means:

(a) a person registered as an investment advisor under Part VI of the Securities Ordinance (Cap. 333); or

(b) a person who would otherwise be required to be registered as an investment advisor under the Securities Ordinance (Cap. 333) but is exempt from registration as an investment advisor under that ordinance, to the extent that the person carries on business as an investment advisor only.

Artificial is not defined. In general, an artificial transaction refers to an unusual transaction that is not 'natural or not ordinary', or a transaction which has been carried out but is commercially unrealistic.

Associated corporation means:

(a) a corporation over which the employer has control;

(b) if the employer is a corporation –

  (i) a corporation which has control over the employer; or

  (ii) a corporation which is under the control of the same person as is the employer.

Broker means:

(a) a person registered as a dealer under Part VI of the Securities Ordinance (Cap. 333); or

(b) a person exempted from registration as a dealer under Part VI of the Securities Ordinance (Cap. 333), to the extent that the person carries on business as a dealer only.

Under s.2, **business** includes agricultural undertaking, poultry and pig rearing and 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.

Commercial occasion or event is defined to include any description of occasion or event:

- for which an entertainer or sportsman (or other person) might, by virtue of his performance of the activity, receive or become entitled to receive anything by way of cash or any other form of property; or
- which is designed to promote commercial sales or activity by advertising, the endorsement of goods or services, sponsorship, or other promotional means of any kind.

Common part, in relation to any land or buildings or land and buildings is further defined as

(a) the whole of the land or buildings or land and buildings, except such parts as have been specified or designated in an instrument registered in the Land Registry as being for the exclusive use, occupation or enjoyment of an owner; and

(b) includes, unless so specified or designated in the instrument mentioned in paragraph (a), those parts of a building specified in Schedule 1 to the Building Management Ordinance (Cap 344)

A **conditional sale agreement** means an agreement for the sale of goods under which the purchase price or part of the purchase price is payable by instalments, and the property in the goods remains in the seller such conditions as to the payment of instalments or otherwise as may be specified in the agreement are fulfilled: s.2.

Consideration includes any consideration payable in respect of the provision of any services or benefits connected with or related to the right of use (e.g. management or service fees payable to the owner).

Control, in relation to a corporation, means the power of a person to secure –

(a) by means of the holding of shares or the possession of voting power in or in relation to that or any other corporation; or

(b) by virtue of any powers conferred by the articles of association or other document regulating that or any other corporation,

that the affairs of the first-mentioned corporation are conducted in accordance with the wishes of that person.

Copyright means

(a) a copyright within the meaning of s.2(1) of the Copyright Ordinance, including an unregistered corresponding design as defined by s.87(5)(b) of that Ordinance; or

(b) any right that

  (i) subsists under the law of a place outside Hong Kong in any work in which a copyright referred to in (a) above may subsist; and

  (ii) corresponds to a copyright referred to in (a) above.

Debt instrument means an instrument specified in Part I of Schedule 6 of the IRO which:

- is lodged with and cleared through the Hong Kong Monetary Authority;
- is issued by a person who has a suitable credit rating;
- has an original maturity of five years or more;
- has a minimum denomination of HK$50,000 (with effect from 1 April 1999) or its equivalent in a foreign currency;
- is issued to the public in Hong Kong; and
- if it is a scripless instrument, it is one that would qualify if it were in a physical form.

Dominant purpose means the purpose which outweighs all other purposes combined (DIPN 15 (revised), para 54).

Dwelling means any building or any part of a building:

- that is designed and constructed for use exclusively or partly for residential purposes; and
- the rateable value of which is separately estimated under Section 10 of the Rating Ordinance.

Education provider means:

(i) a university, university college or technical college;

(ii) a place of education to which the Education Ordinance (Cap. 279) does not apply by virtue of Section 2 of that Ordinance;

(iii) a school registered under Section 13(a) of the Education Ordinance (Cap. 279);

(iv) a school exempted from registration under Section 9(1) of the Education Ordinance (Cap.279);

(v) an institution approved by the Commissioner for the purposes of Section 16C; or

(vi) an institution approved by the Commissioner.

Effected means shares are transferred from one person to another. The transferee may or may not be an existing shareholder, and the transferor may or may not continue to be a shareholder.

End-user means any person (whether alone or with others) holding rights as a licensee under a licence or any relevant right or any associate of the person.

Entertainer or sportsman means a person, other than a corporation, who gives performances in any kind of entertainment or sport, including any physical activity which the public is permitted to see or hear. DIPN 17 states that in terms of the definition it matters not whether the activity is in a live or recorded form or whether the public is required to make payment to see or hear.

Excluded fixed asset means a fixed asset in which any person holds rights as a lessee under a lease.

Expenses of self-education means expenses paid by the taxpayer as –

(i) fees, including tuition and examination fees, in connection with a prescribed course of education undertaken by the taxpayer; or

(ii) fees in respect of an examination set by education provider, or by a trade, professional or business association for its members, and undertaken by the taxpayer to gain or maintain qualifications for use in any employment,

but does not include:

(i) expenses for which a deduction is allowable or has been allowed to the taxpayer in any year of assessment under any other provision of the IRO; or

(ii) expenses to the extent to which they have been reimbursed or are reimbursable to the taxpayer by his employer or any other person unless the reimbursement has been or will be included in the assessable income of the taxpayer.

Fictitious is not defined**.** A fictitious transaction refers to a transaction which is 'not genuine or unreal', or a transaction which the parties to it never intended to make or carry out (i.e. a 'sham').

A transaction which has been effectively carried out cannot be fictitious but can be artificial.

A **hire-purchase agreement** means an agreement for the bailment (hire) of goods under which the bailee (hirer) may buy the goods or under which the property in the goods will or may pass to the bailee: s.2.

Home loan in relation to a person claiming a deduction of home loan interest in any year of assessment, means a loan of money which is:

(a) applied wholly or partly for the acquisition of a dwelling that:

  (i) during any period of time in that year of assessment is held by the person as a sole owner, or as a joint tenant or tenant in common; and

  (ii) during that period of time is used by the person exclusively or partly as his place of residence; and

(b) secured during that period of time by a mortgage or charge over that dwelling or any other property in Hong Kong.

Home loan interest, in relation to a person claiming a deduction in respect of a dwelling, means interest paid by the person as a sole owner, or as a joint tenant or tenant in common of the dwelling for the purposes of a home loan to:

(a) the Government;

(b) a financial institution;

(c) a credit union registered under the Credit Unions Ordinance (Cap. 119);

(d) a money lender licensed under the Money Lenders Ordinance (Cap. 163);

(e) the Hong Kong Housing Society;

(f) an employer of the person; or

(g) any recognised organisation or association.

An **industrial building or structure** is any building or structure, or part thereof, which is used:

- for the purposes of a trade carried on in a mill, factory or similar premises;
- for the purposes of a transport, tunnel, dock, water, gas or electricity undertaking or a public telephone or telegraph service;
- for the purposes of a trade consisting of the manufacture or processing of goods or materials;
- for the purposes of a trade which consists of the storage:
  - of goods or materials which are to be used in the manufacture of other goods and material;
  - of goods or materials which are to be subjected to any process in the course of a trade; or
  - of goods or materials on their arrival into Hong Kong;
- for the purposes of a farming business; or
- for the purposes of research and development in relation to any trade, profession or business.

Know-how means any industrial information or techniques likely to assist in the manufacture or processing of goods or materials.

Under s.2, **lease** in relation to any machinery or plant includes:

(a) any arrangement under which a right to use it is granted by the owner to another person; and

(b) any arrangement under which a right to use it, being a right derived directly or indirectly from a right referred to in (a) above, is granted by a person to another person;

but excludes a hire-purchase agreement or a conditional sale agreement unless the Commissioner considers that the right under the agreement to purchase or obtain the property in the goods would reasonably be expected not to be exercised.

Licence, in relation to a relevant right,

(a) means a licence (however described and whether general or limited) authorizing the licensee to use the relevant right in the manner authorised by the licence; but

(b) does not include an agreement under which the ownership of the relevant right will or may be sold to or pass to the licensee unless, in the opinion of the Commissioner, the right under the agreement to purchase or obtain the ownership of the relevant right would reasonably be expected not to be exercised, and licensee is to be construed accordingly.

Limited partner is defined in Section 22B(1) to mean a person who is a partner in a partnership which is carrying on a trade, profession or business and that person is:

(a) a limited partner in a limited partnership registered under the Limited Partnerships Ordinance (Cap. 37);

(b) a general partner in a partnership in which he is not entitled to or does not take part in the management of the partnership but is entitled to have his liabilities, or his liabilities beyond a certain limit, for debts or obligations incurred by the partnership for the purposes of the trade, profession or business, discharged or reimbursed by some other person; or

(c) under the law of any place outside Hong Kong, not entitled to or does not take part in the management of the partnership and is not liable beyond a certain limit for debts or obligations incurred by the partnership for the purposes of the trade, profession or business.

Long term debt instrument means a debt instrument as defined in Section 14A that –

- is issued on or after 5 March 2003;

- has an original maturity of not less than 7 years or is undated; and
- cannot be redeemed within 7 years from the date of issue.

Medium term debt instrument means

- a debt instrument that –
  - is issued before 5 March 2003;
  - has an original maturity of not less than 5 years or is undated; and
  - cannot be redeemed within 5 years from the date of its issue; or
- a debt instrument that –
  - is issued on or after 5 March 2003;
  - has an original maturity of less than 7 years but not less than 3 years or is undated; and
  - can be redeemed within 7 years from the date of its issue but not within the first 3 years.

An economic activity that involves sales of goods as well as the provision of non-taxable labor services is referred to '**mixed sales**'. In other words, a mixed sales is a single sales transaction which involves both the supplies of goods, taxable services of VAT and the provision of non-taxable services of VAT but taxable under business tax.

In *Great Western Railway Co v Bater* [(1922) 8 TC 231], '**office**' was defined as 'a subsisting, permanent, substantive position, which has an existence independent from the person who fills it and which goes on and is filled in succession by successive holders'.

The definition of '**owner**' as defined in Section 2 of the IRO is:

'Owner', in respect of land or buildings or land and buildings, includes:

a person holding the land or buildings or land and buildings directly from the Government (i.e. the Government lessee);

(a) a beneficial owner;

(b) a tenant for life;

(c) a mortgagor;

(d) a mortgagee in possession;

(e) a person with adverse title to land who is receiving rent from buildings or other structures erected on the land;

(f) a person who is making payments to a co-operative society registered under the Co-operative Societies Ordinance for the purpose of the purchase of the land or buildings or land and buildings;

(g) a person who holds land or buildings or land and buildings subject to a ground rent or other annual charge; and

(h) (in so far as common parts are concerned) a corporation registered under Section 8 of the Building Management Ordinance (Cap. 344) or a person who, on the person's own behalf or on behalf of another person, receives any consideration, in money or money's worth, in respect of the right of use of any common parts solely or with another; and

(i) an executor of the estate of an owner.

Patent rights means the rights to do, or authorise the doing of anything which would otherwise be an infringement of a patent.

Pension refers to an annuity or other recurring periodic payments for consideration of past services. Section 9(3) of the IRO extends the meaning of "pension" to include payments that are voluntary or capable of being discontinued.

Under Section 2 of the IRO, the definition of **person** includes a corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons.

Place of residence in relation to a person who has more than one place of residence, means his principal place of residence.

Premium refers to the consideration payable in respect of a period of the right of use that is not contained within any one year of assessment.

Prescribed course of education means a course undertaken to gain or maintain qualifications for use in any employment and being:

(i) a course of education provided by an education provider;

(ii) a training or development course provided by a trade, professional or business association; or

(iii) a training or development course accredited or recognised by an institution specified in Schedule 13 of the IRO (commencing from 1 April 2004).

Prescribed fixed asset means

(a) such of the machinery or plant specified in items 16, 20, 24, 26, 28, 29, 31, 33 and 35 of the First Part of the Table annexed to IRR 2 as is used specifically and directly for any manufacturing process;

(b) computer hardware, other than that which is an integral part of any machinery or plant;

(c) computer software and computer systems;

but does not include an excluded fixed asset.

Reasonable excuse is what one would expect a reasonable person to do in all of the circumstances. A reasonable person is not a perfect person, but an average person using the reasonable skill and care in handling his tax affairs which one would expect to see from such an average person.

A '**recognised occupational retirement scheme**' is an occupational retirement scheme that:

- is registered under Section 18 of the Occupational Retirement Schemes Ordinance (ORSO);
- is exempt from registration by virtue of Section 7(1) of the ORSO;
- is operated either by a foreign government, or by a non-profit agency or undertaking of a foreign government; or
- is established by or contained in any other Hong Kong ordinance.

Recognised organisation or association means any organisation or association approved as such by the Commissioner.

Pursuant to Section 2 of the IRO, '**recognised retirement scheme**' means:

- a recognised occupational retirement scheme; or
- a mandatory provident fund (MPF) scheme.

Registered design means a design registered under s.25 of the Registered Designs Ordinance or under the law of any place outside Hong Kong.

Registered trade mark means a trade mark registered under s.47 of the Trade Marks Ordinance or under the law of any place outside Hong Kong.

'**Relevant sum**' is defined as the amount of the person's contribution to the partnership as at the end of the relevant year of assessment in which the loss is sustained, except that where the person ceased to be a partner in the partnership during that year of assessment, it is the time when he so ceased.

A **'short term debt instrument'** means a debt instrument that:

- is issued on or after 24 March 2011;
- has an original maturity of less than 3 years or is undated; and;
- can be redeemed within three years from the date of its issue.

'**Sole or dominant purpose**' is not defined in the IRO. 'Sole' is defined in the Oxford Dictionary as 'one and only' and 'dominant' is defined as 'occupying a commanding position'. A sole purpose is therefore the only purpose for entering into a transaction or an arrangement whereas a dominant purpose is an 'overwhelming' purpose (ie not just the main or principal purpose).

Specified capital expenditure means any capital expenditure incurred on the purchase of any specified intellectual property right and includes legal expenses and valuation fees incurred in connection with the purchase.

Specified intellectual property right means copyright, registered design or registered trade mark.

Under Section 20AC, a '**specified person**' is defined as:

(a) In relation to a transaction carried out before 1 April 2003:

  (i) a bank within the meaning of section 2(1) of the Banking Ordinance (Chapter 155);

  (ii) a person registered as a dealer or commodity trading adviser under Part IV of the Commodities Trading Ordinance (Chapter 250) repealed under section 406 of the Securities and Futures Ordinance (SFO);

  (iii) a person registered as a dealer or an investment adviser under Part VI, or as a securities margin financier under Part XA, of the Securities Ordinance (Chapter 333) repealed under section 406 of the SFO; or

  (iv) a person licensed as a leveraged foreign exchange trader under Part IV of the Leveraged Foreign Exchange Trading Ordinance (Chapter 451) repealed under section 406 of the SFO.

(b) In relation to a transaction carried out on or after 1 April 2003, a corporation licensed or an authorised financial institution registered under the SFO, Chapter 571 for carrying on a business in any regulated activity within the meaning of the SFO.

Schedule 16 of the IRO contains the list of '**specified transactions**':

(a) a transaction in securities (excluding shares/debentures of a private company);

(b) a transaction in future contracts;

(c) a transaction in foreign exchange contracts;

(d) a transaction consisting in the making of a deposit other than by way of money-lending business;

(e) a transaction in foreign currencies; and

(f) a transaction in exchange-trade commodities.

'**Tax benefit**' is defined in Section 61A(3) as 'the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof'.

Under Section 2 of the IRO, **trade** includes every trade and manufacture, and every adventure and concern in the nature of trade. This definition is wide as it covers isolated transactions.

'**Transaction**' is defined in Section 61A(3) to include 'a transaction, operation or scheme whether or not such transaction, operation or scheme is enforceable, or intended to be enforceable, by legal proceedings'.

VAT special invoice means the invoice which indicates the selling price and output tax respectively when issued to the purchasers, and the VAT on the invoice is the output tax to the sellers but the input tax to the buyers.

Table of Legislation

Hong Kong Legislation

Inland Revenue Rules

PRC Legislation, Regulations, Rules and Notices

Administrative

Business Tax

Consumption Tax

Corporate Tax

Corporate Income Tax Law (CITL), 749

Corporate Income Tax Implementation Rules (CITIR)

Income Tax

Individual Income Tax Law (IITL), 746

Individual Income Tax Implementation Regulations (IITIR), 746

Value-added Tax

Table of cases

Board of Review decisions

Practice Notes and Circulars

Departmental Interpretation & Practice Notes 15

Estate Duty Office Interpretation & Practices Notes (EDOIPN), 18

Stamp Office Interpretation & Practice Notes (SOIPN), 8, 18

SOIPN 1, 476
SOIPN 2, 484
SOIPN 3, 468
SOIPN 4, 484
SOIPN 5, 480

Index

Note: **Key Terms** and their page references are given in **bold.**

A

D

E

F

G

H

I

J

K

L

M

N

O

P

Q

R

S

T

U

V

W

Z

Notes

Notes

Notes

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