

## **SECTION A – CASE QUESTIONS**

### **Answer 1(a)**

The five transfer pricing methods are discussed in detail in the OECD Transfer Pricing Guidelines and Departmental Interpretation and Practice Notes No. 46 viz. comparable uncontrolled price (“the CUP”) method, cost plus method, resale price method, transactional net margin method (“TNMM”) and profit split method.

In the present case, the CUP method is the most appropriate method. The CUP method is essentially a comparison of price. It compares the price of a controlled transaction to the price of a comparable uncontrolled transaction. In applying the CUP method, there are two possible types of comparable price – internal comparable uncontrolled price and external comparable uncontrolled price. The former refers to the comparison between the price of the controlled transaction and the price charged in a comparable transaction between one of the enterprises to the transaction and an independent party. The latter refers to the comparison between the price of the controlled transaction and the price of a comparable transaction between independent parties.

The Shares at issue are identical to the shares in Saffron being traded on the Hong Kong Stock Exchange both in terms of the product and the market. Although internal comparable uncontrolled price is not available in the present case as the Company had not traded any shares in Saffron apart from the Shares, transaction prices are, however, readily available on the Hong Kong Stock Exchange. They provide the external comparable uncontrolled prices to establish the arm’s length price of the Shares. Hence, there is little, or no, difficulty in finding an external comparable uncontrolled price for the Shares when applying the CUP method.

### **Answer 1(b)**

With regard to the cost plus method, which compares the different mark up on the costs commanded by different suppliers, and the resale price method, which compares the gross margin commanded by different resellers or distributors, the former is mostly used in the case of manufacturers while the latter is used for distributors. Although it is not incorrect to say that a share dealer may have a target mark up or gross margin, to a certain extent, that mark up or gross margin is determined, among others, by the investment strategy and the financial position of that share dealer. Such being the case, the mark up or gross margin commanded by other share dealers is not a good comparable in establishing the arm's length price of the Shares as there may be differences in the position of the Company and that of the other share dealers. Reasonably accurate adjustments have to be made to eliminate the effects of those differences. The cost plus method and the resale price method are therefore less appropriate, or probably not preferred, in the present case.

As to TNMM, it is a comparison of the net profit margin, which may be operating net profit as a percentage of sales, cost or assets. This method is not appropriate in the present case which is an issue concerning the selling of the Shares, not net profit margin.

Turning to the profit split method. This method is concerned with the splitting of the aggregate profits between the associated enterprises based on an economically valid basis. This method is applicable in cases where the functions of the group are intertwined and it is necessary to examine the whole process to ascertain the real economic contribution of each group member. In the present case, the Shares were initially acquired by the Company for trading purposes. ABC (Investments) Limited played no role on the acquisition. Indeed, ABC (Investments) Limited had not been incorporated when the Company acquired the Shares. The function of ABC (Investments) Limited is only to streamline the business of the Company, which is why the Shares were transferred. The present case is not a case where the functions of the group are intertwined. Hence, the profit split method is not appropriate.

## **Answer 2**

As Arrangement B is a qualified investment arrangement, it is to be regarded as a debt arrangement between the Company as borrower and ABC (Financing) Limited as lender. The investment return payable (i.e., the rental expense incurred by the Company in respect of the Property) is to be regarded as interest payable on the money borrowed by the Company from ABC (Financing) Limited under s.22(2)(b) of Schedule 17A (“the Schedule”) of the Inland Revenue Ordinance (“the IRO”). Also, by virtue of s.22(7) of the Schedule, the relevant interest expense is deductible under s.16(2)(f)(iii) of the IRO.

Further, as ABC (Financing) Limited is to be regarded as not having any legal or beneficial interest in the Property over the term of the qualified investment arrangement by virtue of s.22(2)(c) of the Schedule and that the selling of the Property by the Company to ABC (Financing) Limited is to be disregarded under s.22(3)(a) of the Schedule, it follows that the Company remains the owner of the Property. Coupled with the fact that the Company occupies the Property throughout, the Company is entitled to the deduction of the commercial building allowance in respect of the Property.

## **Answer 3**

As the Collector of Stamp Revenue accepts that the Arrangements are an alternative bond scheme, the relevant parties are entitled to stamp duty relief by virtue of s.47E and s.47F(1) of the Stamp Duty Ordinance (“the SDO”). Accordingly, the sale and purchase agreements / assignments on the transfer of the Property from the Company to ABC (Financing) Limited and vice versa, the lease agreement entered into between ABC (Financing) Limited and the Company on the leasing of the Property at a monthly rent of HK\$300,000 for a term of 4 years, the purchase undertaking entered into by the Company and the declaration of trust executed by ABC (Financing) Limited in favour of the Investors are not chargeable to stamp duty.

#### **Answer 4(a)**

S.8(1)(a) of the IRO provides that salaries tax shall be charged for each year of assessment on every person in respect of his income arising in or derived from Hong Kong from any office or employment of profit. S.8(1A)(a) of the IRO extends the basic charge on salaries tax in respect of income arising in or derived from Hong Kong from any employment while s.8(1A)(b) and (c) exclude certain income derived from Hong Kong from any employment. As the extension of the basic salaries tax charge under s.8(1A) and the exclusion under s.8(1A)(b) or (c) only cover income from employment, neither the extension charge nor the exclusion provisions has any application to income derived from an office. S.9 of the IRO provides that income from any office or employment includes fees.

Turning to the relevant case law, a guiding principle has been laid down by the High Court in *CIR v Goepfert* (1987) 2 HKTC 210 in which Macdougall J ruled that the totality of facts have to be considered in determining the source of an employment. Though *Goepfert* was a case dealing with the source of employment, in the Board of Review Decision No. D123/02 18 IRBRD 150, the Board held that the totality of facts test is equally applicable to determine the source of income from an office. As to the issue on the locality of an office, on the authority of *McMillan v Guest* 24 TC 190, the office of a director of a corporation is where the central management and control of the corporation is exercised. And, following the decision in *Swedish Central Railway Company Ltd v Thompson* (1925) 9 TC 342, a company may have more than one residence for the purposes of establishing liability to income tax.

In the present case, the director's fee received by Mr Au for the year of assessment 2013/14 is chargeable to tax under s.8(1)(a) of the IRO as it was an income derived by Mr Au from an office located in Hong Kong. First, the central management and control of the Company was in Hong Kong. The Company conducted substantial business operations in Hong Kong. Mr Chan made decisions on his own in Hong Kong on the running of the Company. Also, he had meetings with Mr But and their employees in Hong Kong. Although Mr Chan and Mr But did discuss the business of the Company through emails and teleconferences, it does not necessarily follow that the place of central management and control is not in Hong Kong as, after all, Mr Chan and the senior management were stationed in Hong Kong. Second, the Company kept house in Hong Kong. Its statutory registers as well as its accounting records were kept in Hong Kong. Hence, the Company was resident in Hong Kong. It therefore follows that Mr Au's office was located in Hong Kong.

Although Mr Au stayed in Hong Kong for less than 60 days in the year of assessment 2013/14 and that he paid tax of the same nature in Country X, that director's fee, however, is not to be excluded under s.8(1A)(b)(ii) nor s.8(1A)(c) of the IRO as those exclusions are restricted to the income derived by the taxpayer in connection with his employment. The director's fee received by Mr Au is therefore fully chargeable to salaries tax in Hong Kong.

### Answer 4(b)

Mr and Mrs Au (“the Couple”) migrated to Country X in early April 2013. They have not ordinarily resided in Hong Kong since then. It follows that both of them were not permanent residents of Hong Kong for the year of assessment 2013/14.

The Couple were not temporary residents for that year of assessment either. They stayed in Hong Kong for 50 days only, which is less than 180 days, for the year of assessment 2013/14. Also, in the relevant two consecutive years of assessment (a) 2012/13 and 2013/14; (b) 2013/14 and 2014/15, they stayed in Hong Kong for (a) 270 days and (b) 70 days, both of which were less than 300 days. Hence, Mr Au was not eligible to have his income assessed under personal assessment for the year of assessment 2013/14 as both he and his wife did not satisfy the conditions set out in s.41(1) of the IRO. Such being the case, Mr Au’s total tax liability will be computed on a schedular basis as follows:

#### Year of assessment 2013/14

##### Salaries tax liability

	HK\$
Assessable income	250,000
Less: Married person’s allowance	<u>(240,000)</u>
Net chargeable income	<u>10,000</u>
Salaries tax payable at progressive rate first HK\$40,000 @2%	<u>200</u>
Salaries tax payable at standard rate HK\$250,000 @15%	<u>37,500</u>
Salaries tax payable at lower of the above	<u>200</u>

##### Profits tax liability

	HK\$
Assessable Profits	<u>30,000</u>
Tax @15%	<u>4,500</u>

## **Answer 5**

The relevant salaries tax assessment was issued on 1 June 2012. Unless there is evidence which proves to the satisfaction of the Commissioner that Mr Au was prevented from lodging a notice of objection within one month of the issue of the assessment, it is unlikely that his late objection will be accepted by the Commissioner by virtue of the proviso to s.64(1) of the IRO.

Unfortunately, Mr Au cannot rely on s.70A of the IRO to request the revision of the relevant salaries tax assessment either. S.70A(1) provides, inter alia, that, if upon application made within 6 years after the end of the year of assessment or within 6 months after the date on which the relevant notice of assessment was served, whichever is the later, it is established to the satisfaction of an Assessor that the tax charged for that year of assessment is excessive by reason of an error or omission in the return, the Assessor shall correct such assessment. In the present case, the year of assessment in dispute is 2006/07. The relevant assessment was issued on 1 June 2012. The later of 6 years after the end of the year of assessment 2006/07 or within 6 months after the issue of that assessment was 31 March 2013. Mr Au came to notice the over-reporting of the bonus in April 2013. It was beyond the six years' time limit by the time Mr Au was aware of the error. Not to mention that it was also six months after the issue of the relevant salaries tax assessment.

To conclude, the relevant salaries tax assessment has become final and conclusive in terms of s.70 of the IRO. Also, s.79 of the IRO provides that if it is proved to the satisfaction of the Commissioner within six years of the end of a year of assessment or within six months after the date on which the relevant notice of assessment was served, whichever is the later, any person who has paid tax in excess of the proper amount shall be entitled to be refunded the amount paid in excess. Proviso to s.79 provides that nothing in that section shall operate to extend the time limit for objection or repayment specified in other sections of the IRO. As such, Mr Au cannot resort to s.79 to request for a refund of the excess amount of the tax which he paid.

\* \* \* END OF SECTION A \* \* \*

## **SECTION B – ESSAY / SHORT QUESTIONS**

### **Answer 6**

Deductible expenditure on replacement of implement, utensil or article under s.16(1)(f) of the IRO: HK\$500,000 (carpet replacement)

Deduction of capital expenditure on renovation of building or structure (other than domestic buildings) under s.16F of the IRO:  $(\text{HK}\$4,000,000 + \text{HK}\$850,000) \div 5 = \text{HK}\$970,000$

Deduction of capital expenditure for Prescribed Fixed Assets under s.16G(1) of the IRO: HK\$130,000 for the computer system (HK\$30,000 trade-in value should be deemed as taxable trading receipt under s.16G(3) of the IRO.)

Deduction of capital expenditure for environmental protection facilities under s.16I(2)&(3) of the IRO:  $\text{HK}\$760,000 + (\text{HK}\$600,000 \div 5) = \text{HK}\$880,000$

Depreciation allowance attributable to Suckling for the year:-

	20% pool HK\$	30% pool HK\$	Total allowances HK\$
T.W.D.V. b/fwd	1,276,000	96,000	
Addition (furniture)	253,000	-	
Less: I.A. @ 60% on addition	<u>(151,800)</u>	<u>-</u>	151,800
	1,377,200	96,000	
Less: A.A.	<u>(275,440)</u>	<u>(28,800)</u>	<u>304,240</u>
T.W.D.V. c/fwd	<u>1,101,760</u>	<u>67,200</u>	<u>456,040</u>

Depreciation allowance for hire purchase asset (motor vehicle):

	HK\$	Total allowances HK\$
Addition	500,000	
Less: I.A.		
$[\text{HK}\$100,000 + \text{HK}\$ (500,000 - 100,000) \times 8] \times 60\%$		
40	<u>(108,000)</u>	108,000
	392,000	
Less: A.A. @ 30%	<u>(117,600)</u>	<u>117,600</u>
	<u>274,400</u>	<u>225,600</u>

Interest expense deduction for monthly installments on motor vehicle under s.16(1)(a) & 16(2)(d) of the IRO:  $(\text{HK\$}11,000 - \text{HK\$}10,000) \times 8 = \text{HK\$}8,000$

Commercial building allowance attributable to Suckling for the year:

	HK\$	
Ranking cost b/fwd	6,354,000	
Less: Disposal during the year	(500,000)	
Add: Addition during year (renovation of directors' quarters)	<u>380,000</u>	
Ranking cost c/fwd	<u>6,234,000</u>	
		Total allowances
	HK\$	HK\$
T.W.D.V. b/fwd	4,652,400	
Les: Balancing allowance (Residue of expenditure)	(300,000)	300,000
Add: Addition during the year as per above	<u>380,000</u>	
	4,732,400	
Less: A.A. @ 4% of ranking cost c/fwd	<u>(249,360)</u>	<u>249,360</u>
	<u>4,483,040</u>	<u>549,360</u>



### **Answer 7(a)**

As Mr Tam is a non-PRC tax resident with employment income from a non-Chinese enterprise, he would be subject to the China Individual Income Tax (“IIT”) on his employment income sourced from the PRC pursuant to Article 1 of Individual Income Tax Law (Revised 2011).

As Taiwan and the PRC have not entered into any tax treaty arrangement, Mr Tam would be subject to IIT if he resides in the PRC for more than 90 days during a calendar year. To count the number of days for the abovesaid purpose, the day of entry into the PRC and the day of departure from the PRC are each counted as a one-day presence in the PRC pursuant to Guoshuifa (2004)97, Article 1. Specifically Mr Tam would be subject to IIT on his employment income derived during his “actual working days” in the PRC pursuant to Guoshuifa (2004)97, Articles 2 & 3.

### **Answer 7(b)**

In the course of providing the tax consultancy services, Kwan & Co. should ensure that they have competent professional knowledge for their tax practice. In addition, Kwan & Co. should put forward the best position in favor of their clients, provided that it does not in any way impair the standard of integrity and objectivity under Section 430 “Ethics in Tax Practice” in the Code of Ethics for Professional Accountants (Revised Jan 2015) issued by the Hong Kong Institute of Certified Public Accountants.

Kwan & Co. should not hold out to Mr Tam the assurance that their tax advice is beyond challenge. In addition, tax advice given to Mr Tam should be recorded either in the form of a letter or memorandum for record purposes.

### **Answer 8(a)**

#### **Possible arguments for subject to salaries tax**

Under s.9(1)(a) of the IRO, income from employment includes wages, salary, etc, derived from the employer or others. In this regard, the income of Mr Koo derived from the employment with Ocean View Limited can be paid by others, especially from Mr Cheung as he is the sole director and shareholder of the company. The payment is possibly part and parcel of the remuneration of Mr Koo attributable to his employment with Ocean View.

There is no concrete evidence substantiating the argument that the money was a gift given because of personal friendship. The assertion of Mr Cheung is self-serving and has no objective justification.

The amount received by Mr Koo is substantially in proportion to his annual salary and the date of receipt is also the eve of Chinese New Year. This pattern is in line with the payment of a performance-based bonus typically found in generic employment arrangements.

### **Answer 8(b)**

#### **Possible arguments for not subject to salaries tax**

There was no implicit or explicit agreement entered into by Mr Koo with Ocean View nor Mr Cheung for any new employment contract or extension of existing employment covering the payment of the subject amount to Mr Koo. Substantially the amount is a spontaneous payment and has no connection to the present or any other employment of Mr Koo.

The amount was substantially higher than Mr Koo's existing annual salary. The quantum was unlikely to be in line with any performance-based bonus paid principally and directly by the employer or others, and therefore should not be regarded as part of his employment income.

The payment to Mr Koo was unexpected and was solely on a discretionary basis made by Mr Cheung personally. This is not likely to be a pattern generically found in any contractual arrangement for employment of income.

### **Answer 8(c)**

Relevant additional information for further evaluation could be obtained from the following perspectives:-

- Details of similar payments, if any, paid to Mr Koo by Mr Cheung in prior years.
- Details of similar payments, if any, paid by Mr Cheung to other employees of Ocean View and / or other close contacts of Mr Cheung.
- Evidence justifying the long-term friendship between Mr Koo and Mr Cheung.
- Financial information and business performance of Ocean View for examination if there is any co-relation between the payment and the profitability of Ocean View during the relevant financial period.
- Detailed comparison of the remuneration package of Mr Koo in current and prior years in order to evaluate if the prevailing package had been revised in line with the incorporation of the subject payment.
- Examine whether Mr Koo has reached the retirement age and if the amount received by him is substantially a retirement gratuity paid by Mr Cheung.

### **Answer 9(a)**

Under s.5(1) of the IRO, rental income derived by Mr Lee from his owned property situated in Hong Kong is subject to property tax. By way of election of personal assessment under Part 7 of the IRO, the interest expenses on money borrowed for producing the rental income can only be deducted to the extent of the nominal rental income received from Ms Wong under s.42(1) of the IRO. Excessive interest expenses, if any, incurred by Mr Lee cannot be allowed for deduction against his other taxable income under s.42(1) of the IRO.

Under s.30(1) of the IRO and on the basis that Mr Lee continues to maintain and resides with his mother, Ms Wong, he can be entitled to claim Dependent Parent and Additional Dependent Parent Allowances continuously notwithstanding that Ms Wong has derived rental income subject to tax.

In the context of Ms Wong, the rental income derived by her under the arrangement would be subject to profits tax under s.14(1) of the IRO instead of property tax on the basis that she carries on a property sub-letting business in Hong Kong.

In order to minimise the respective tax liabilities, Ms Wong may consider applying for personal assessment and claim the Personal Allowance to deduct against the property rental income. However, Ms Wong cannot deduct the interest expenses, if any, incurred on the loan borrowed for the acquisition of the respective property under s.42(1) of the IRO as the loan, if any, is borrowed by her son Mr Lee as the owner of the property instead of by herself.

### **Answer 9(b)**

In view of the possible overall tax benefit derived by Ms Wong from the arrangement proposed by Mr Lee, the IRD may challenge the plan and seek to apply respective anti-avoidance provisions in the IRO to counteract the tax benefit derived thereon. Specifically, the IRD may apply s.61 and / or s.61A of the IRO in the circumstances.

Under s.61 of the IRO, the IRD may disregard any transaction or disposition, and the person concerned shall be assessed accordingly where an assessor of the IRD is of the opinion that:-

- (a) any transaction which reduces or would reduce the amount of tax payable by any person is artificial and fictitious, or that
- (b) any disposition is not in fact given effect.

Alternatively under s.61A(2) of the IRO, the assistant commissioner may raise an assessment on the relevant person (i) as if the transaction or any part thereof had not been entered into or carried out, or (ii) in such manner as he considers appropriate to counteract the tax benefit which would otherwise be obtained, in the circumstances that:-

- (a) there must be a transaction as defined;
- (b) the transaction has or would have had the effect of conferring a tax benefit on a person; and
- (c) having regard to the seven specific matters under s.61A(1)(a) to (g) of the IRO, it would be concluded that the sole or dominant purpose of entering into that transaction was to enable the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit.

As Mr Lee intended to use a nominal value instead of the market price for leasing the property to his mother for further leasing out to generate rental income, and in which the tax liabilities of Ms Wong could be reduced by the election of personal assessment, the IRD may use the abovesaid general anti-avoidance provisions to assess the respective tax liabilities of Mr Lee and Ms Wong on the basis that the transaction (i.e. the use of nominal value in leasing the property to Ms Wong for further leasing out in the property market) is artificial and fictitious, and / or the sole or dominant purpose of entering into that transaction was to obtain tax benefit.

In this regard, Mr Lee should review the proposed transaction and explore the genuine and commercial justification of the arrangement in order to defend their tax positions and the possible challenge from the IRD.

\* \* \* END OF EXAMINATION PAPER \* \* \*