SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer 1

Prior to the Inland Revenue (Amendment) (No.3) Ordinance 2015 ("the Amendment") enacted in November 2015, the appellant was required to make a written application requesting the Board of Review to state a case on a question of law for the opinion of the Court of First Instance under s.69(1) of the Inland Revenue Ordinance ("IRO"), and deliver it to the Clerk to the Board of Review within the stipulated timeframe and under guidance specified in s.69 of the IRO. After the Amendment which became effective from April 2016, the above case state procedure was abolished and the appellant may apply directly to the Court of First Instance for leave to appeal against the Board of Review decision on a ground involving only a question of law (Departmental Interpretation and Practice Notes ("DIPN") No. 6 (Revised), paras. 59 to 61, and 63)

Pursuant to the Amendment, PCL's appeal to the Court of First Instance should proceed in a more cost efficient and less time-consuming manner.

Answer 2(a)(i) & (ii)

	Taxable HK$	Non-taxable HK$	Deductible HK$	Non-deductible HK$
Interest income on overdue trade debts	195,730			
Interest income from Bank A	87,500			
Interest income from Bank B		120,300		
Interest income from overseas subsidiaries	3,500,000			
Dividend income		886,200		
Revaluation gain from listed shares (Share X)		3,733,000		
Revaluation loss from listed shares (Share Y)			198,600	
Exchange gain		295,000		
Exchange loss			195,600	
Compensation income		880,000		
Interest expenses to an overseas subsidiary				380,950
Interest expenses to Bank C			184,560	
Interest expenses to Bank D				150,780
Staff loan written off				950,000
Trade debts provision				1,758,320
	3,783,230	**5,914,500**	**578,760**	**3,240,050**

Answer 2(b)

Interest income from Bank B is offshore in nature under the provision of credit test, and therefore should be non-taxable under s.14(1) of the IRO. Dividend income is howsoever non-taxable either under s.26(a) of the IRO if it is derived from a corporation chargeable to profits tax, or under s.14(1) of the IRO as offshore in nature if it is derived from a corporation which carried on business outside Hong Kong. Notional gain on revaluation of listed shares held for trading purposes is not taxable under s.14(1) of the IRO pursuant to the *Nice Cheer* case *[FACV 23/2012]*. Exchange gain on bank accounts balance is capital in nature and therefore non-taxable in accordance with the *Li & Fung Limited* case *[1980] HKT 1193*. Compensation from the former director for the breaching of a non-competing clause in the employment contract is capital in nature and not derived from the normal course of PCL's business, and therefore should be non-taxable under s.14(1) of the IRO.

Loan interest expenses paid to an overseas subsidiary is non-deductible as the amount did not satisfy any of the conditions stipulated under s.16(2) of the IRO. Loan interest expenses to Bank D is non-deductible as the amount was not incurred in the production of chargeable profits and therefore did not satisfy s.16(1) of the IRO. Staff loan written off is non-deductible as well as the amount was not incurred in the production of chargeable profits and therefore did not satisfy s.16(1) of the IRO. Bad debts of HK$1,758,320 is a general provision and not essentially incurred in the production of chargeable profits, and therefore is non-deductible under s.16(1) and s.16(1)(d) of the IRO.

Answer 3

Pursuant to s.14D(1) of the IRO, the assessable profits of a corporation regarded as a qualifying corporate treasury centre ("QCTC") for the year of assessment are chargeable to the concessionary half rate of profits tax, i.e. 8.25%, to the extent to which the respective profits are derived from a qualifying (i) intra-group financing business, (ii) corporate treasury service, or (iii) corporate treasury transaction. The corporation must make an irrevocable application to apply for the concessionary tax rate under s.14D(5)(b) and s.14D(6) of the IRO.

As the envisaged entity to be established by the management of PCL will provide intra-group financing and treasury services to its overseas subsidiaries, the corporation could be considered as a QCTC under s.14D(2)(a) and s.14D(3) of the IRO on the basis that it has carried out in Hong Kong one or more corporate treasury activities, and has not carried out in Hong Kong any activity other than a corporate treasury activity.

Under s.14C(1) of the IRO, intra-group financing business, in relation to a corporation, means the business of the borrowing of money from and lending of money to its associated corporations. Under s.14C(3) and s.1(1) of Schedule 17B of the IRO, corporate treasury service means the provision of managing the cash and liquidity position, processing payments to the vendors or suppliers, etc. to a non-Hong Kong associated corporation. Under s.14C(4) and s.2(1) of Schedule 17B of the IRO, corporate treasury transaction means the specific transactions entered into by the corporation on its own accounts and related to the business of a non-Hong Kong associated corporation, e.g. providing guarantees, investing funds, contracts for hedging, and a factoring or forfaiting transaction.

In addition to the above regulatory requirements, s.14D(5)(a) of the IRO also stipulates that the central management and control of the QCTC should be exercised in Hong Kong, and that the activities that produce the assessable profits chargeable to the concessionary half rate of profits tax are carried out or arranged to be carried out in Hong Kong by the QCTC.

In order to facilitate the interest expense deduction claim on the intra-group financing business, s.16(2)(g) of the IRO is introduced simultaneously to provide interest expense deduction in respect of interest payable by the QCTC on money borrowed from its non-Hong Kong associated corporation if the following conditions are satisfied:

(i) the deduction claimed is in respect of interest payable on money borrowed from a non-Hong Kong associated corporation in the ordinary course of an intra-group financing business;

(ii) the interest income received by the non-Hong Kong associated corporation must be subject to a similar tax in a tax jurisdiction outside Hong Kong at a rate not lower than the concessionary tax rate applicable to the QCTC; and

(iii) the non-Hong Kong associated corporation is the beneficial owner of the respective interest income.

In addition to the abovesaid regulatory requirements, the management of PCL should also pay attention to the DIPN No. 52 – Taxation of Corporate Treasury Activity with respect to the view and practice of the Inland Revenue Department ("IRD") on the tax treatments in relation to the interest income and expenses for intra-group financing business as well as the profits tax concession granted to QCTCs. Particularly, the acceptable requirements on carrying on intra-group financing business (DIPN No. 52, para. 10), the possibility of transfer pricing adjustment with reference to the arm's length principle when fixing the interest rate for intra-group financing transactions (DIPN No. 52, para. 24), and the essential ingredients of central management and control requirement (DIPN No. 52, paras. 50 to 54) should be observed.

Answer 4(a)

Mr Zhang is a Mainland Chinese national and tax resident. He is subject to Individual Income Tax in the Mainland on a worldwide basis regardless of his place of employment and residency of his employer pursuant to Article 1 of Individual Income Tax Law. His total Individual Income Tax liabilities for the four months period are as follows:

Monthly Individual Income Tax taxable employment income = RMB(8,800 + 5,000)
= RMB13,800

Total Individual Income Tax = RMB[(13,800 - $3,500*(monthly standard deduction)*) x 25%*(applicable tax rate)* - 1,005*(quick calculation deduction)*] x 4
= RMB6,280

Answer 4(b)

Pursuant to Article 14 of China-Hong Kong Double Taxation Treaty, the income derived by Mr Zhang should not be chargeable to Hong Kong salaries tax on the following basis:

- Mr Zhang would stay in Hong Kong for less than 183 days in any 12-month period commencing or ending in the taxable period concerned;

- the remuneration to Mr Zhang is exclusively paid by PCN or other entities in the Mainland; and

- the remuneration paid to Mr Zhang is not borne by PCL or any other entities in Hong Kong.

Answer 5

During the provision of the tax consultancy services to PCL, Aplus & Co. should strictly observe professional ethics by putting forward the best position in favour of PCL, provided that the services can be rendered with professional competence, and do not in any way impair the standards of integrity and objectivity. In addition, Aplus & Co. should not hold out to PCL that its tax advice is beyond challenge, whilst Aplus & Co. should ensure that PCL is aware of the limitation attaching to its advice and services. The respective tax advice should also be recorded either in the form of a letter to PCL or in a memorandum for the files. Aplus & Co. should not associate itself with any communication or information which it has reason to believe that a false or misleading statement has been included therein.

* * * END OF SECTION A * * *

SECTION B – ESSAY / SHORT QUESTIONS (Total: 50 marks)

Answer 6(a)

Whether the payments are assessable income

S.9(1)(a) of the IRO provides that income from any office or employment includes any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance.

In the Privy Council case *David Hardy Glynn v CIR [1990] 1 HKLR 604*, it was held that a perquisite not only meant the payment of money, it also included money which could be obtained from property which was capable of being converted into money and money which was paid in discharge of a debt of the employee.

In the Court of Final Appeal case *Fuchs v CIR [2011] 14 HKCFAR 74*, it was held that as the relevant sums were contractual payments made pursuant to the terms of the contract of employment, they were income from employment and should be chargeable to salaries tax. It was also held that income chargeable under s.8(1) of the IRO was not confined to income earned in the course of employment but embraced payments made "in return for acting as an employee" or "as a reward for past services or as an inducement to enter into employment and provide future services".

In this case, as it was Ms Chan who undertook the PCLL course, she was personally liable to pay the course fee. Accordingly, the direct payment of the course fee by L&L to HKU represented a discharge of the debt of Ms Chan and amounted to a perquisite which was specifically included as an income from employment under s.9(1)(a) of the IRO. As regards the maintenance grant, it is clearly a cash allowance paid to Ms Chan to support her living before the employment commenced. As such, it is also an income from employment as defined under s.9(1)(a) of the IRO.

Moreover, the two sums were paid to Ms Chan or on her behalf pursuant to the terms of the offer letter and by accepting the employment offer of L&L, Ms Chan agreed to be employed as a trainee solicitor upon passing the PCLL examinations. Hence, both sums were contractual payments and were paid as an inducement for Ms Chan to enter into employment with L&L. On the authority of the *Fuchs* case, both sums should be regarded as income chargeable to salaries tax.

In which year of assessment the sums should be assessed

S.8(1)(a) of the IRO is the charging section of salaries tax, which would bring into charge income arising in or derived from Hong Kong from any office or employment of profit. Regarding the timing of assessment, s.11B of the IRO provides that the assessable income of a person in any year of assessment shall be the aggregate amount of income accruing to him from all sources in that year of assessment and for the purpose of this section, s.11D(b) defines that income accrues to a person when he becomes entitled to claim payment thereof.

An income would only be brought into charge if it is an income from employment. In this case, the sums were paid by L&L during the period from September 2016 to June 2017 while Ms Chan only confirmed to take up the employment with L&L on 5 September 2017. When L&L paid the sums, they were not yet an income from employment. The sums only became an income from employment on 5 September 2017 when Ms Chan took up the employment. Accordingly, the sums accrued to Ms Chan as income from employment on 5 September 2017 and should be regarded as her assessable income for the year of assessment 2017/18.

Answer 6(b)

S.12(1)(a) of the IRO allows deduction of all outgoings and expenses, other than expenses of a domestic or private nature and capital expenditure, wholly, exclusively and necessarily incurred in the production of the assessable income. The requirements under s.12(1)(a) are notoriously stringent. It has been well established that only expenses which are incurred in the performance of the duties of the employment can be regarded as being "incurred in the production of the assessable income". See *CIR v Humphrey [1970] HKLR 447*. As the PCLL course fee was Ms Chan's private expenses and not incurred in the performance of her duties, it does not satisfy the requirements of s.12(1)(a) and cannot be allowed for deduction in any year of assessment.

S.12(1)(e) of the IRO allows deduction of the amount of the expenses of self-education ("SEE") paid in the year of assessment not exceeding the prescribed amount. As the PCLL course fee of HK$100,000 was paid on 15 February 2017, Ms Chan is entitled to claim deduction of the whole of the SEE in the year of assessment 2016/17 and no deduction is allowable for the year of assessment 2017/18. The maximum amount allowable for deduction in the year of assessment 2016/17 is restricted to HK$80,000, which is the prescribed limit for the year. However, Ms Chan may not be able to benefit from the deduction as she probably did not have assessable income for the year of assessment 2016/17 during which she was studying on a full-time PCLL course.

Answer 7(a)

An expense must satisfy s.16(1) and not be excluded by s.17 of the IRO before it can be allowed for deduction. Any expenditure of a capital nature is not allowed for deduction under s.17(1)(c) of the IRO. There are, however, specific provisions under the IRO which allow tax relief in respect of certain kinds of capital expenditure.

In most circumstances, the purchase cost of a trade mark is of a capital nature as it is made with a view of bringing into existence an asset or advantage for the enduring benefit of a trade or business. Accordingly, it should be denied for deduction under s.17(1)(c) of the IRO. However, s.16EA specifically allows deduction of capital expenditure incurred on purchase of specific intellectual property rights, which includes a trade mark registered under s.47 of the Trade Marks Ordinance (Cap. 559) or under the law of any place outside Hong Kong.

Therefore, if a trade mark is a registered one, the purchase cost of which can be allowed for deduction pursuant to s.16EA of the IRO while that of an unregistered trade mark is not deductible under s.17(1)(c) of the IRO. Deduction under s.16EA is to be allowed in five years of assessment commencing in the year of assessment during the basis period for which the capital expenditure was incurred.

However, s.16EC of the IRO restricts that there are certain circumstances under which deduction under s.16EA is not allowable. For example, s.16EC(2) specifies that no deduction is allowable in respect of any relevant right purchased by a person wholly or partly from an associate. Besides, s.16EC(4)(b) of the IRO specifically denies the deduction of an intellectual property right if at the time when the relevant right is owned by the taxpayer, a person holds rights as a licensee under a license of the relevant right, and the relevant right is, while the license is in force, used wholly or principally outside Hong Kong by a person other than the taxpayer.

Answer 7(b)

Trade Mark A

Trade Mark A is a registered trade mark. Accordingly, its purchase cost can be allowed for deduction under s.16EA of the IRO. Despite the fact that Company M, being a company other than Company HK, was using Trade Mark A in Vietnam to manufacture the toys, Trade Mark A was not a registered trade mark in Vietnam and Company M was actually using an unregistered trade mark in Vietnam. Therefore, s.16EC(4)(b) is not applicable.

However, as Company HK was only subject to profits tax in respect of 60% (600,000 / 1,000,000 x 100%) of its profits, the same portion of the purchase cost of Trade Mark A, i.e. HK$300,000 (60% of HK$500,000) can be allowed for deduction. Accordingly, the amount deductible for the year of assessment 2016/17 is HK$60,000 (HK$300,000 x 1/5).

Trade Mark B

By virtue of s.16EC(2) of the IRO, no deduction is allowable for the purchase cost of Trade Mark B as it was purchased from an associate, irrespective of whether the price is at arms-length.

Regarding the registration cost of Trade Mark B in the Philippines, it can be allowed for deduction under s.16(1)(g) of the IRO as long as Trade Mark B was used by Company HK for producing chargeable profits in Hong Kong.

Answer 8(a)

Property A

Mr Chan and Ms Wong are liable to pay Ad Valorem Stamp Duty ("AVD") in respect of the purchase of Property A. As Property A was a residential property acquired by Mr Chan, who is a Hong Kong permanent resident ("HKPR"), jointly with Ms Wong who, though not a HKPR, is a close relative of Mr Chan, and each of them did not own any other residential property in Hong Kong at the time of acquisition, the purchase transaction would be subject to AVD at Scale 2 rates. The amount of AVD payable is HK$1,062,500 (HK$25,000,000 x 4.25%).

Acquisition of residential property by a HKPR jointly with his close relative, including a spouse, is not chargeable with Buyer's Stamp Duty ("BSD"). Therefore, Mr Chan and Ms Wong are not required to pay BSD for the transaction.

Property B

Ms Wong, a non-HKPR, is liable to pay AVD for the purchase of Property B at Scale 1 rates. The amount of AVD payable is HK$750,000 (HK$10,000,000 x 7.5%).

For stamp duty purposes, the classification of premises in terms of "residential property" or "non-residential property" is by reference to the permitted use rather than the actual use of the property, or the label or description given to the property. Unless there is documentary evidence such as occupation permit showing that the property cannot be used for residential purposes, the instrument signed by a non-HKPR as buyer for the acquisition of the property will be chargeable with BSD. Accordingly, Ms Wong is liable to pay BSD regarding the acquisition of Property B. The amount of BSD payable is HK$1,500,000 (HK$10,000,000 x 15%).

Answer 8(b)

Property A

	HK$
Rent (HK$50,000 x 12) [s.5B(2)]	600,000
Less: Rates (HK$7,500 x 4) [s.5(1A)(b)(i)]	(30,000)
	570,000
Less: 20% statutory outgoings [s.5(1A)(b)(ii)]	(114,000)
Net assessable value	456,000
Property tax payable thereon at 15%	68,400

Property B

Rent (HK$360,000 / 12 x 7) [ss.5B(2) and 5B(4)]	210,000
Less: Rates (HK$4,500 / 3 x 7) [s.5(1A)(b)(i)]	(10,500)
	199,500
Less: 20% statutory outgoings [s.5(1A)(b)(ii)]	(39,900)
Net assessable value	159,600
Property tax payable thereon at 15%	23,940

Answer 8(c)

Under s.5(1) of the IRO, property tax shall be charged on every person being an owner of any land or buildings in respect of the rental income derived from letting of the land or buildings. As both Mr Chan and Ms Wong are owners of Property A, they should be jointly and severally liable to property tax in respect of the rental income derived from the letting of Property A. On the other hand, Ms Wong should be solely liable to property tax in respect of the rental income derived from the letting of Property B, despite the fact that all the rental income was received by Mr Chan.

Accordingly, the amount of property tax payable by Mr Chan is HK$34,200 (HK$68,400 / 2) and the amount of property tax payable by Ms Wong is HK$58,140 (HK$34,200 + HK$23,940).

Answer 9

(a) The published rulings are non-binding on the IRD and provide no protection to any persons other than the applicants.

(b) Reference can only be made to a ruling if the facts are identical to the proposed transactions. In case of doubt as to the similarity of the proposed transactions, the taxpayer should request for a ruling. Caution should also be exercised to ensure that the relevant provisions of the IRO or the relevant case law interpretation and practice of those provisions have not changed. Similarly, a ruling may no longer be appropriate if an administrative practice outlined therein turns out to be used as a tax avoidance device.

* * * END OF EXAMINATION PAPER * * *