SECTION A – CASE QUESTIONS

Answer 1(a)

The ovens and grillers are capital assets and the expenditure incurred in acquisition is capital in nature and not deductible under s.17(1)(c) of the Inland Revenue Ordinance (IRO).

However, they could be regarded as "plant and machineries" used in the restaurant business. Hence such ovens and grillers should be entitled to 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 are entitled to 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) of the IRO. 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, then the former should not be deductible and the latter deductible. Otherwise, Joseph may need to agree with the Inland Revenue Department (IRD) as to the method for apportioning the costs incurred. Time cost basis may be one acceptable basis to be considered.

Joseph should review all pre-commencement costs such as electricity, lighting, rental, salaries etc. He should distinguish capital expenditure items (such as renovation, chairs, tables and furniture etc) and revenue items. The former would not be deductible under s.17(1)(c). 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.

Answer 1(b)

S.51(2) of the IRO requires taxpayers to notify the Commissioner if they are chargeable to tax, in writing, no more than four months after the end of the basis period of the relevant year of assessment. Therefore, New Happy Inn should comply with this requirement. New Happy Inn is also required to file profits tax returns within the specified time limit under s.51(1) should an assessor issue those to it.

In support of the profits tax return, New Happy Inn should submit the following:

- signed audited financial statements;
- profits tax computation and supporting schedules; and
- other documents or information as specified in the notes to the return.

As an employer, New Happy Inn is required to furnish the remuneration of its restaurant employees under s.52(2) of the IRO (Forms BIR56A and IR56B). For new employees, it should also notify the Commissioner no later than 3 months after the date of commencement of employment (Form IR56E).

Furthermore, Joseph needs to consider if the contract between New Happy Inn and the consultant is a contract for service or contract of service. Income arising from the former may be subject to profits tax under s.14 as the consulting business/services were carried on/rendered in Hong Kong. If it is the latter, then the consultant is under an employment with New Happy Inn and should be subject to salaries tax.

If the consultant is under a contract of service with New Happy Inn, then the consultant is employed by New Happy Inn. New Happy Inn, being the employer should notify IRD of commencement of employment and chargeability under salaries tax (s.52(2)). New Happy Inn has a duty to inform the Commissioner of the consultant's chargeability to salaries tax.

Answer 2(a)

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.

Answer 2(b)

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.

Answer 3(a)

The New Trade name "New Happy Inn"

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

- it carried on a trade, profession or business in Hong Kong;
- the profits to be charged were from such trade, profession or business; and
- the profits were sourced in Hong Kong.

As New Happy Inn carried on business in Hong Kong and the income to be charged was from such business, New Happy Inn would be chargeable to profits tax under s.14 if the income was 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."

(*Hang Seng Bank* case or *HK-TVBI* case)

Furthermore, according to Departmental Interpretation and Practice Notes No.21 (Revised), paragraph 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 licence or right to use.

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 of the IRO.

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

The New Recipe

Similarly, as the 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 should be sourced in Hong Kong and chargeable to profits tax under s.14 of the IRO. In addition, withholding taxes incurred overseas should also be deductible.

The Old Recipe

JCo is the legal owner of the old recipe. As JCo does not carry on a business in Hong Kong, it should not be subject to Hong Kong profits tax as the first of the 3 conditions under s.14 has not been met.

However, the royalty income received by JCo may be deemed to be chargeable to Hong Kong profits tax under s.15(1)(b) if the use or right to use the intellectual property was in Hong Kong.

In this case, as the old recipe was developed in Brazil and the overseas investors intended to use the old recipe in their own jurisdiction (outside Hong Kong), s.15(1)(b) would not apply and the royalty income on the old recipe should not be chargeable to Hong Kong profits tax.

Answer 3(b)

Pursuant to s.15(1)(b) of the IRO, 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 s.15(1)(b) and s.21A of the IRO, JCo will therefore be subject to profits tax 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 JCo.

Answer 4(a)

One may argue that such payments are deductible for the following reasons:

(1) Incurred in the ordinary course of business.

(2) If not settled out of court, may bring about bad publicity and affect the income earning operation, 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.

Answer 4(b)

Interest payments to uncle

As Joseph's uncle is not subject to tax in Hong Kong, the conditions in s.16(2)(c) are 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 not to finance capital expenditures should be deductible as conditions in s.16(1)(a) and s.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.

* * * END OF SECTION A * * *

SECTION B – ESSAY / SHORT QUESTIONS

Answer 5(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.

Answer 5(a)(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.

Answer 5(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.

Answer 5(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.

Answer 5(d)

	HK$
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 x 200/300*)	800,000
Add: Value of residence [(HK$800,000 - HK$3,000) x 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 x 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.

Answer 6(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:

(a) 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.

(b) 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.

(c) 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).

(d) 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).

<u>Analysis (2): Trading profits</u>

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

(a) 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.

(b) 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.

(c) 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.

<u>Answer 6(b)</u>

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 coordinating 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.

Answer 7

[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.

* * * END OF EXAMINATION PAPER * * *