SECTION A – CASE QUESTIONS

Answer 1

Fantastic HK is not entitled to the deduction for prescribed fixed assets under s.16G(1) of the Inland Revenue Ordinance ("the IRO") in respect of the Moulds as the Moulds are excluded fixed assets under s.16G(6). S.16G(6) of the IRO provides that an excluded fixed asset means a fixed asset in which any person holds rights as a lessee under a lease. On the authority of ***Braitrim (Far East) Limited v Commissioner of Inland Revenue*** [2013] 4 HKLRD 329, the word "lease" in s.16G(6) bears the meaning as defined in s.2(1) of the IRO. In s.2(1), it provides that "lease", in relation to plant and machinery, includes any arrangement under which a right to use the plant and machinery is granted by the owner to another person.

In the present case, though the Moulds are plant or machinery specified in item 26 of the First Part of the Table annexed to rule 2 of the Inland Revenue Rules ("the IRR") and they are used directly for the manufacturing process, they are excluded fixed assets as their right to use has been granted by Fantastic HK to Fantastic Manufacturing. Such being the case, the cost of the Moulds is not specified capital expenditure allowable for deduction under s.16G(1) of the IRO.

In the present case, the Moulds are used by Fantastic Manufacturing outside Hong Kong under a lease. So, Fantastic HK is not entitled to a depreciation allowance in respect of the Moulds under s.39E(1)(b)(i) of the IRO either. S.39E(1)(b)(i) provides that a depreciation allowance shall be denied if at the time when the machinery or plant is owned by a taxpayer, a person holds rights as lessee under a lease and that while the lease is in force, the machinery or plant is used wholly or principally outside Hong Kong by a person other than the taxpayer. The Court of Appeal has reaffirmed in ***Braitrim*** that the extended definition of "lease" in s.2 is applicable to s.39E.

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Answer 2

S.20(2) of the IRO provides that where a non-resident person carries on business with a closely connected resident person in a way such that it produces to the resident person either no profits or less than the ordinary profits which might be expected to arise in or derive from Hong Kong, the business done by the non-resident person in pursuance of its connection with the resident person shall be deemed to be carried on in Hong Kong and such non-resident person shall be chargeable to tax in respect of those profits in the name of the resident person as if the resident person was the non-resident's agent.

Both Fantastic Procurement and Fantastic HK are wholly owned subsidiaries of Fantastic Holdings. They are closely connected persons by virtue of s.20(1)(a) of the IRO. On the other hand, Fantastic Procurement is said to have no place of business or permanent establishment in any part of the world, including Hong Kong. As such, it is a non-resident person in Hong Kong. Further, the interposition of Fantastic Procurement between the Suppliers and Fantastic HK has certainly reduced the profits of Fantastic HK as part of its profits has been shifted to Fantastic Procurement to the extent of the Mark Up. That being so, the profits so shifted, i.e., the Mark Up, are chargeable to profits tax in the name of Fantastic HK as the agent of Fantastic Procurement by virtue of s.20(2) of the IRO.

Alternatively, the Assessor may disallow the deduction of the Mark Up under ss.16(1) and 17(1)(b) of the IRO. S.16(1) provides that there shall be deducted all outgoings and expenses to the extent to which they are incurred in the production of assessable profits. S.17(1)(b) provides that expenses not incurred in the production of assessable profits are not allowable for deduction. It was held in ***So Kai Tong Stanley trading as Stanley So & Co v CIR*** [2004] 2 HKLRD 416 that s.16(1) entitles the Commissioner of Inland Revenue ("the Commissioner") to ascertain the extent to which the outgoings or expenses are incurred in the production of assessable profits, which are considered to be most reasonable and appropriate in the circumstances of the case.

In the present case, although Fantastic HK did purchase certain raw materials, the purchase cost incurred by Fantastic HK was excessive to the extent of the Mark Up as Fantastic Procurement had done nothing at all to procure the purchases. The Mark Up was not incurred in the production of its assessable profits. Hence, the Assessor may disallow the deduction of the Mark Up claimed by Fantastic HK and consequently increase the assessable profits of Fantastic HK by virtue of ss.16(1) and 17(1)(b) of the IRO.

Alternatively, the purchase of raw materials by Fantastic HK from the associated enterprise Fantastic Procurement may be regarded under s.61A of the IRO, as not having been conducted under the arm's length principle but to avoid liability for tax and the assistant commissioner may then assess the liability to tax of Fantastic HK.

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Answer 3

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, whether derived from the employers or others. S.11B of the IRO provides that the assessable income of a person in any year of assessment shall be the aggregate of income accruing to him from all sources in that year of assessment. S.11D(b) of the IRO further provides that income accrues to a person when he becomes entitled to claim payment thereof.

On the authority of ***Hochstrassers v Mayers*** (1959) 38 TC 673, to be liable to salaries tax, the relevant payment must arise from employment, be attributable to the taxpayer's services because of his employment and be in return for the taxpayer's services past, present or future. Besides, following the decision in ***Shilton v Wilmshurst (Inspector of Taxes)*** (1991) STC 88, an emolument from employment means an emolument from being or becoming an employee.

In the present case, the Sum was paid to Mr McDonald as an emolument for becoming an employee of Fantastic HK. It was an inducement for Mr McDonald to take up the employment. Accordingly, the Sum is chargeable to salaries tax by virtue of s.9(1)(a) of the IRO. Though Mr McDonald has a contingent liability to repay the Sum to Fantastic HK if he resigns on or before 30 November 2016, it is crystal clear that he was entitled to the Sum when he took up the employment on 1 December 2014. Fantastic HK did pay Mr McDonald the Sum according to the employment agreement. The Sum was accrued to Mr McDonald in the year of assessment 2014/15 when he took up the employment with Fantastic HK.

Answer 4

Under s.51(2) of the IRO, every person chargeable to tax for any year of assessment shall inform the Commissioner in writing that he is so chargeable not later than 4 months after the end of the basis period for that year of assessment unless he has already been required to furnish a tax return.

In the present case, Mr McDonald failed to comply with s.51(2) of the IRO in reporting his chargeability to salaries tax for the year of assessment 2014/15.

As such, the penalty provisions under ss.80(2)(e) and 82A(1)(e) of the IRO are applicable to him.

S.80(2)(e) of the IRO provides that any person who without reasonable excuse fails to comply with s.51(2) of the IRO commits an offence and is liable on conviction to a fine at level 3 and a further fine of treble the amount of tax which has been undercharged in consequence of that failure. S.80(5) of the IRO further provides that the Commissioner may compound any offence under s.80.

As to s.82A(1)(e) of the IRO, it provides that any person who without reasonable excuse fails to comply with s.51(2) of the IRO shall be liable to be assessed under s.82A additional tax of an amount not exceeding treble the amount of tax which has been undercharged in consequence of that failure.

Answer 5(a)

Vesting of shares was involved in Mr Richmond's case. As such, the back end approach is to be adopted in the computation of the relevant assessable income. Irrespective of whether Mr Richmond's employment with Fantastic HK is a Hong Kong employment or a non-Hong Kong employment, the assessable income in relation to Shares A is chargeable to salaries tax in the year of assessment 2014/15 because Shares A were vested in him on 30 May 2014. The relevant shares award is not to be assessed in the year of assessment in which the Plan was launched (i.e., 2010/11) or the year of assessment in which Shares A were granted to Mr Richmond (i.e., 2011/12). This is because Mr Richmond was not entitled to Shares A in those two years of assessment. By the same token, as Shares A had not been vested in Mr Richmond in the years of assessment 2012/13 and 2013/14, the relevant shares award is not to be assessed in those years of assessment either.

If Mr Richmond's employment with Fantastic HK is a Hong Kong employment, the relevant assessable income in respect of Shares A is as follows:

(5,000 shares x HK$110 [note 1]) + [5,000 shares x (HK$1.5 + HK$1.1 + HK$1.2)] [note 2]
= HK$569,000

If Mr Richmond's employment with Fantastic HK is a non-Hong Kong employment, the relevant assessable income in respect of Shares A is as follows:

HK$569,000(as above) x 296 / 365 [note3] = HK$461,435

Answer 5(b)

As Ms Taylor was granted Shares B in the year of assessment 2011/12, the assessable income in relation thereto will be assessed in that year of assessment. Though restriction to sell was imposed on Shares B, it did not undermine Ms Taylor's rights to those shares. Indeed, she was registered as a shareholder of Fantastic Holdings on 1 June 2011. The upfront approach is to be adopted in the present case. Having said that, the Inland Revenue Department ("the IRD") will generally allow a 5% discount for each year of sale restriction (Para. 61, in DIPN No. 38 (Revised) issued in March 2008). Such being the case, the relevant assessable income in respect of Shares B is as follows:

3,000 shares x HK$120 [note 4] x (1 - 5% x 2 [note 5]) = HK$324,000

Note 1: Being the market value of Shares A on the vesting date.
Note 2: Being the additional award equivalent to the value of dividends as declared by Fantastic Holdings during the vesting period.
Note 3: The value of the shares awarded is to be assessed on a time apportionment basis in the year of vesting, i.e., year of assessment 2014/15.
Note 4: Being the market value of Shares B on the date of grant.
Note 5: Being the 2-year restriction period.

Answer 6(a)

S.19(16) of Stamp Duty Ordinance ("the SDO") provides that sale or purchase includes any disposal or acquisition other than an allotment. As Mr Richmond was awarded Shares A by allotment, no stamp duty is payable in this regard.

Answer 6(b)(i)

On 31 March 2016, the market value of the ordinary shares in Fantastic Holdings was HK$90 per share. The consideration of HK$40,000 for the transfer of 4,000 ordinary shares from Mr Richmond to the Trust was obviously below the market value. The transfer will be deemed to be a conveyance or transfer operating as a voluntary disposition inter vivos and is chargeable to stamp duty on the basis of the market value of the shares (s.27(4) of the SDO). The stamp duty payable pursuant to Head 2(3) is as follows:

4,000 shares x HK$90 x 0.2% + HK$5 = HK$725

Answer 6(b)(ii)

If Mr Richmond is the sole beneficiary of the Trust, it is a voluntary disposition without a change of beneficial ownership. As such, no stamp duty is payable under s.27(5) of the SDO. However, Mr Richmond may adjudicate the relevant transfer documents (ss.13(1) and 13(3)(b) of the SDO) with an adjudication fee of HK$50.

* * * END OF SECTION A * * *

SECTION B – ESSAY / SHORT QUESTIONS

Answer 7(a)

Prior to the appointment as tax representative, Messrs. Kenneth Chu & Chu should ensure the objectivity of its firm to Global by confirming that conflict of interest does not exist with respect to the appointment. In this regard, Global should not impose any influence on Messrs. Kenneth Chu & Chu alerting its tax practice on the engagement. In addition, Messrs. Kenneth Chu & Chu should gear up with competent professional knowledge to accomplish the engagement.

In addition to the above and particularly upon the acceptance of the engagement, Messrs. Kenneth Chu & Chu should issue a comprehensive engagement letter to Global specifying clearly the scope of tax services to be provided, and requesting Global to sign off the engagement letter before commencing the works.

Answer 7(b)

The CBA of the Property Global is entitled to (For the year of assessment 2014/15):

		HK$
Deemed cost of construction (1/3 of HK$8,400,000)		2,800,000
Less:	Notional rebuilding allowance	
	(1984/85 to 1989/90, 6 years @ 0.75%)	(126,000)
	(1990/91 to 1997/98, 8 years @ 2%)	(448,000)
		2,226,000
Less:	Notional CBA	
	(1998/99 to 2013/14, 16 years x HK$2,226,000 x 4%)	(1,424,640)
Residue of expenditure before sale		801,360
Less:	Sales proceeds (1/3 of HK$96,000,000)	32,000,000
Excess		31,198,640
Residue of expenditure before sale		801,360
Add:	Balancing charge	
	(Restricted to CBA previously claimed)	1,424,640
Residue of expenditure after sale **(A)**		2,226,000
Year of first use (Deemed under s.33A(4)(b))		1998/99
25th year from the year of first use		2023/24
Number of years from 2014/15 to 2023/24 **(B)**		10
CBA thereon (**(A)** x 1/**(B)**)		222,600
Original CBA claimed by Global		
	(@ 4% x 1/3 x HK$96,000,000)	1,280,000
CBA over-claimed by Global		(1,057,400)

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Answer 7(c)

S.33A of the IRO does not specify any stipulated or prescribed percentage of the first assignment price as the capital expenditure for computing the respective CBA of commercial buildings and structures. In this regard, Global may submit to the IRD to take a portion higher than 1/3 of the first assignment price as the cost of construction of the Property in computing CBA with reasonable grounds (e.g. higher cost of construction ratio compared to land cost in early 1980's, etc).

Answer 8

Under the prevailing China turnover tax regime, golf park operation activities conducted by Modern were within the scope of entertainment industry (provision of sites and services for recreational activities), and the respective income should be subject to value-added tax effective from 1 May 2016. The maximum rate of value-added tax applicable to Modern should be 6% since it is not a small-scale taxpayer. Accordingly the maximum amount of value-added tax payable by Modern would be RMB1,080,000 (RMB18 million x 6%).

The income derived from transportation activities conducted by New Modern in July and August 2016 should be subject to value-added tax under the prevailing China turnover tax regime. The relevant value-added tax rate applicable to the provision of transportation services is 11%, and therefore the value-added tax liabilities with respect to the income would be RMB82,500 (RMB750,000 x 11%).

Answer 9(a)

(i) From the perspective of Cambridge

S.16(1) of the IRO provides for a deduction of all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by a person in the production of assessable profits in which he is chargeable to profits tax for any period, subject to the deduction restrictions as stipulated under s.17(1) of the IRO. In this regard, it is possible in the contexts of the IRO that an expense may be deducted in the basis period in which it is incurred, and the related income may be charged to tax in prior or subsequent years of assessment. Quantum of income generated therefrom should have no relevancy to the amount of deductible expenses incurred. However, there must have been sufficient distinct and direct relationship between the expenditure incurred and actual earning of the income in specific years.

With respect to Cambridge, the expenses incurred during the years of assessment 2004/05 to 2014/15 could be claimed as deductible only if the amounts were essentially incurred in a business in which income assessable to profits tax has been generated in the year of assessment 2015/16. From this perspective, Cambridge must prove to the satisfaction of the IRD that there was a distinct and direct relationship between the expenditure incurred and actual earning of the income, and that the expenses incurred were not excessive in the context of s.16(1) of the IRO, i.e. there was a direct causation between the expenses incurred in the years of assessment 2004/05 to 2014/15 and the taxable income derived in the year of assessment 2015/16 longitudinally, and that the respective services provided in the years of assessment 2004/05 to 2014/15 were accordingly not "free of charge" essentially.

(ii) From the perspective of the IRD

However, the IRD may take the view that the provision of the management and administrative services to the subsidiaries at no charge during the years of assessment 2004/05 to 2014/15 was not an arm's length transaction. The entering into the transaction was therefore considered artificial and not commercially realistic. The relationship between the expenses incurred in prior years and the generation of income in the year of assessment 2015/16 was too remote so that the IRD, with reference to s.17(1) of the IRO, may disallow the deduction of the expenses under s.16(1) of the IRO for the reason that they were not incurred in the production of Cambridge's assessable profits. It may also invoke the general anti-avoidance provisions, i.e. under ss.61 and 61A of the IRO, to deny the deduction claim so as to counteract the tax benefit by the postponement of the liability to pay tax.

Answer 9(b)

A statement of loss or loss notice ("the Notice") issued by the IRD is an administrative document and not an assessment within the meaning of the IRO. As the Notice has no statutory force, it cannot become final and conclusive under s.70 of the IRO (***Common Empire Ltd v CIR*** [2007] 1 HKLRD 679). Taxpayers in this connection can lodge a disagreement with the Notice regarding the quantum of tax loss at any time, until any loss claimed affects an assessment to tax (Para. 26, DIPN No. 8 (Revised) issued in September 2009), under which a right of objection under s.64 of the IRO arises.

As there is no statutory time limit in lodging the disagreement with the Notices regarding the tax loss for the years of assessment 2004/05 to 2014/15, Cambridge may pursue the disagreement to revise its profits tax position for the years concerned with relevant justifications any time before the issue of the 2015/16 notice of assessment. Alternatively, Cambridge may lodge a written objection against the 2015/16 profits tax assessment claiming the set-off of the tax loss brought forward from prior years against the assessable profits within the one-month period after the date of the notice of assessment.

Answer 10

S.14(1) of the IRO specifically excludes profits arising from the sale of capital assets from the charge to profits tax. However, the term "capital assets" has not been defined in the IRO. Based on the general commercial rules and established principles, a distinction between fixed capital (attributable to capital in nature receipts) and circulating capital (attributable to revenue in nature receipts) is essential for the differentiation. In this regard, capital receipts are those relating to the structure of the business, whilst revenue or trading receipts are from the disposal of stocks or services in the course or incidental to the business.

Based on the information provided, it appears that the sales consideration (i) with respect to the HK$3 million represents the amount in connection with the disposal of Infinity's capital assets (i.e. the entire customers base and car beauty outlets), and Infinity had ceased its business thereafter. It may therefore be argued that the sales consideration (i) of HK$3 million is capital in nature and should not be subject to profits tax. For the sales consideration (ii) attributable to the waiver of the unutilised customers' deposit of HK$2 million payable by Infinity to Finite, the amount represents realisation of income incidentally derived from customers in the normal course of Infinity's business. The income would likely be regarded as revenue in nature and is chargeable to profits tax under s.14(1) of the IRO.

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Answer 11(a)

The obligations of a non-Hong Kong resident (e.g. Mr Xiao) holding immovable properties in Hong Kong generating rental income are substantially the same as those of a Hong Kong resident, and specifically as follows:

- He should complete the tax returns and file to the IRD within the stipulated time (S.51(1) of the IRO) and pay the respective tax liability.
- He should notify the IRD in writing the chargeability of property tax, if a return has not been received, within four months after the end of that year of assessment (S.51(2) of the IRO).
- He should notify the IRD if the respective property has been sold or transferred within one month after the sale or transfer (S.51(6) of the IRO).
- He should notify the IRD within one month, if his corresponding address has been changed (S.51(8) of the IRO).
- He should keep sufficient rental records of not less than seven years in order to enable his property tax liability to be readily ascertained (S.51D of the IRO).

Answer 11(b)

As the owner of an immovable property in Hong Kong, the Hong Kong limited company is liable to property tax under Part 2 of the IRO in respect of the rental income derived thereon. Yet the definition of "business" under s.2 of the IRO includes, inter alia, letting by any corporation to any person of any premises. Hence the company is prima facie carrying on a business in Hong Kong and is chargeable to profits tax under Part 4 of the IRO in respect of the relevant rental income.

Notwithstanding that the subject rental income may be chargeable to both property tax and profits tax simultaneously, s.25 of the IRO can be applied to allow the property tax paid therefrom, if any, to be utilised for setting off the profits tax liability of the Hong Kong limited company for the same year. In addition, the company may also apply for exemption to property tax under s.5(2)(a) of the IRO if the rental income is reported as assessable to profits tax.

* * * END OF EXAMINATION PAPER * * *