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Module Preparation Seminar – Agenda

- Distinction between capital and revenue receipts under profits tax (Ch 3)
- Depreciation allowances, industrial building allowances and commercial building allowances (Ch 3)
- Profits tax implications on transactions with non-resident persons (Ch 4)
- Anti-avoidance provisions under the IRO (Ch 9)



Distinction between capital and revenue receipts under profits tax (LP Ch 3)

Distinction between capital and revenue receipts under profits tax



Capital receipts and revenue receipts

Whether a receipt is capital or revenue in nature, the general test is to distinguish between **fixed capital and circulating capital**.

Receipts are **capital in nature** if connected with **fixed capital (fixed assets)** of the business but **revenue in nature** if connected with **circulating capital (current assets)** of the business.

Distinction between capital and revenue receipts under profits tax



Revenue or trading receipts include:

- (a) Receipts from disposal of **trading stock or services** in the course of business; and
- (b) Receipts arising incidentally to the business, e.g. forfeiture of deposits from customers who failed to collect goods ordered

Capital receipts include:

Capital receipts are those relating to **the structure of the business**, e.g. proceeds from sale of office premises.

Distinction between capital and revenue receipts under profits tax



Principles established in case law help to illustrate the distinction between capital or revenue receipts:

- Any sum received for **permanent loss or destruction of a fixed asset** is a capital receipt [*Case: Glenboig Union Fireclay Co Ltd*]
- Any sum received for **temporary loss of use of a fixed asset**, or payment for loss of profits is a revenue receipt [*Case: London and Thames Haven Oil Wharves Ltd v Attwool*]
- Any sum received for **repairable damage** to a fixed asset is a capital receipt. [*Case: London and Thames Haven Oil Wharves Ltd v Attwool*]

Distinction between capital and revenue receipts under profits tax



Principles established in case law help to illustrate the distinction between capital or revenue receipts:

- Any sum received for **the loss of trading stock** is a trading receipt while any sum received for the loss of capital asset is a capital receipt
- Any sum received for the **cancellation of a trading contract** is a revenue receipt
- Any sum received for the **cancellation** of one of a number of agency contracts is a revenue receipt
- Any compensation received for the **cancellation of the major or only contract** which led to the cancellation of a **material part or the whole of the company's business** is a capital receipt

Distinction between capital and revenue receipts under profits tax



Compensation

- Compensation received **in lieu of trading receipts** is taxable as trading income
- Compensation for **loss or damage to the profit making structure** of the business
- Compensation received in relation to the sterilisation of business assets, **closure of business or entering into a restrictive covenant** for not performing certain acts

If a lump sum is received without making any distinction between compensation for the loss of capital and compensation for the loss of revenue assets or income, the whole sum may be regarded as a capital receipt .

Distinction between capital and revenue receipts under profits tax



Capital expenditure and revenue expenditure

The analysis made by the judge in **Ammonia Soda Co Ltd v Chamberlain** on fixed and circulating capital is useful in distinguishing the nature of an expenditure. A summary of the analysis is on 'Capital receipts and revenue receipts':

The following is a general comparison of capital expenditures and revenue expenditures:

| Capital expenditures | Revenue expenditures |
|--|---|
| Once and for all | Often recur |
| Usually of large amount | Usually of small amount |
| Provide an enduring benefit to the business | Provide short-term benefits or temporary influence to the business |
| Influence the profit yielding structure of the business | No or limited effect on the profit yielding structure of the business |
| May be fixed within the business in the form of an asset (e.g. machinery or plant) | May circulate within or depart from the business (e.g. trading stock) |
| Shown in the statement of financial position as assets | Charged to the statement of profit or loss as expenses |

Distinction between capital and revenue receipts under profits tax



The following principles established in case law help to **distinguish between capital and revenue expenditure:**

- The cost of **acquiring raw materials** in their natural state, is a capital expenditure.
- The cost of **taking over a business** is a capital expenditure.
- The cost of acquiring or **disposing of an agreement or a lease** which is part of the fixed assets of a trade is a capital expenditure.
- The cost of removing and replacing part of an entire asset is a revenue expenditure.
- Expenses incurred in erecting a new structure 'in its entirety' or the cost of replacing an entire asset so that a new capital asset is created is a capital expenditure

Distinction between capital and revenue receipts under profits tax



The following principles established in case law help to **distinguish between capital and revenue expenditure:**

If instead of repairing an asset, an alternative or **improved part** is constructed, the expenditure is a **capital expenditure** and no allowance is due for the hypothetical repairs which might have been carried out .

The cost of initial repairs **to improve a newly acquired asset** to put it into a usable condition is a capital expenditure.

The cost of initial **repairs to remedy normal wear** and tear of a newly acquired asset which is in working condition is a revenue expenditure.

A lump sum payment to **dispense with a continuing revenue expense** does not create any new intangible asset and is therefore a revenue expenditure.

Distinction between capital and revenue receipts under profits tax



A payment to **get rid of an unsatisfactory director** is a normal revenue expense which is regarded as part of the cost of engaging and dismissing servants.

A payment to retiring directors for agreeing **not to compete** with the company would increase the company's goodwill by buying off potential competitors and is therefore a capital expenditure.

Distinction between capital and revenue receipts under profits tax



Past Paper Practice: HKICPA December 2010 (Amended)

Joyce Ltd ('JL') is a garment manufacturer for many US and European brands. During the year ended 31 December 2014, a US brand terminated its manufacturing contract with JL, which accounted for 15% of JL's turnover. After negotiation, the US brand agreed **to compensate** JL with a sum of \$20 million. The compensation was decided with reference to the profits which JL derived during the remaining period of the contract.

Required:

Analyse the taxability of the compensation received from the US brand for the termination of the manufacturing contract.

Distinction between capital and revenue receipts under profits tax



HKICPA December 2010 (Amended)

Answer:

The compensation should be chargeable to profits tax because of the following:

- (a) JL is a garment manufacturer and the contract with the US brand was just one of the manufacturing contracts which JL 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 business.

Distinction between capital and revenue receipts under profits tax



HKICPA December 2010 (Amended)

Answer:

- (b) The contract with the US brand only contributed to 15% of JL's turnover. Its termination did not affect the entire framework of the business: see *Fleming v Bellow Machine Co Ltd*.
- (c) The compensation was computed with reference to the profits which JL would have earned from the contract. It was more akin to compensation for the loss of profits rather than the loss of capital assets.



Depreciation allowances, industrial building allowances and commercial building allowances (Ch 3)

Depreciation allowances, industrial building allowances and commercial building allowances



Depreciation allowances are available for capital expenditure incurred on (i) industrial buildings or structures; (ii) commercial buildings or structures; and (iii) machinery or plant.

Depreciation allowances for these fixed assets are as follows:

| Allowance | Industrial building | Commercial building | Machinery or plant |
|----------------------|--|--|---|
| Initial allowance | 20% | N/A | 60% |
| Annual allowance | 4% on cost or computed based on the residue of expenditure | 4% on cost or computed based on the residue of expenditure | 10%, 20% or 30% on reducing balance |
| Balancing adjustment | Balancing charge or balancing allowance | Balancing charge or balancing allowance | Balancing charge or balancing allowance |

Depreciation allowances, industrial building allowances and commercial building allowances



Industrial building allowance ('IBA')

'Industrial building or structure' means any building or structure, or part thereof, which is used in a qualifying trade.

Pursuant to s.40(1), 'qualifying trade' means:

- (a) A trade carried on in a mill, factory or similar premises;
- (b) A transport, tunnel, dock, water, gas or electricity undertaking or a public telephonic or telegraphic service;
- (c) A trade consisting of the manufacture of goods or materials or the subjecting of goods or materials to any process;
- (d) A trade consisting of the storage of goods or materials
 - (i) Which are to be used in the manufacture of other goods or materials;
 - (ii) Which are to be subjected in the course of a trade to any process; or
 - (iii) On their arrival into Hong Kong;
- (e) Farming business; or
- (f) For the purposes of R&D related to any trade, profession or business.

Depreciation allowances, industrial building allowances and commercial building allowances



Qualifying capital expenditure includes:

- Interest paid and any commitment fees incurred in connection with a loan made for the purpose of financing an industrial building or structure;
- Expenditure incurred on ordinary work done in preparation for the laying of foundations, or in the laying of drains, sewers and water mains for a building.

Qualifying capital expenditure however excludes:

- Expenditure incurred on the acquisition of land, or rights in or over land
- Expenditure incurred on demolishing the existing building on the land
- Expenditure incurred on preparation and leveling of the land

Depreciation allowances, industrial building allowances and commercial building allowances



Industrial building – initial allowances

As provided under Section 35B(a), an **initial allowance** is only granted to:

- (a) A person who incurs the cost of construction, or
- (b) A purchaser who purchases an unused building or structure and brings it into use.

No initial allowances for commercial buildings.

Annual allowance is 4% on qualifying cost.

Depreciation allowances, industrial building allowances and commercial building allowances



Commercial Building Allowances (CBA)

For commercial building/structure carried forward to 1998/99, **deemed qualifying cost** is original qualifying cost less annual allowances for all prior years up to 1997/98 – s. 33A(4).

Annual allowance for **newly purchased building**:

If the commercial building/structure had been used before 1998/99, then CBA = residue of expenditure after sale x (1/ no. of years from the first year present purchaser is entitled to claim CBA to 25th year after 1998/99 - the deemed 1st year of use).

Depreciation allowances, industrial building allowances and commercial building allowances



Commercial Building Allowances (CBA)

If the commercial building/structure is used since 1998/99 or afterwards, then CBA = residue of expenditure after sale x (1/ no. of years from the first year present purchaser is entitled to claim CBA to 25th year after the year of assessment in which the building or structure was first used) [s. 33A(2)].

Decoration expenses for office are prima facie capital in nature, and hence only commercial building allowance can be granted for this expenditure. The amount of such an allowance is 4% of the cost per year (section 33A).

Disposal of properties – calculate balancing adjustments

Depreciation allowances, industrial building allowances and commercial building allowances



Sales proceeds:

For the purpose of ascertaining the sale price attributable to the building element when computing the balancing adjustment, the sale price of the Building has to be **apportioned between the land and the building elements**. The IRD usually accepts a basis of apportionment which follows that adopted when allocating the price paid by the company to purchase the Building between the land and the construction cost of the building.

Demolish the Building

No balancing allowance shall be made to any person where the building or structure is demolished for a purpose unconnected with or not in the ordinary course of conduct of the trade or business for the purpose of which the building or structure was used in circumstances qualifying for AA.

When the company is going to demolish the Building for the purpose of redeveloping it for sale or letting, this is clearly **unconnected with and not in the ordinary course of conduct of its original business**.

Depreciation allowances, industrial building allowances and commercial building allowances



Capital expenditure is disallowed under s. 17(1)(c)

For **plant and machinery**, capital expenditure which qualifies as **scientific research expenditure under s.16B** is specifically excluded for depreciation allowances because it qualifies for full deduction under s.16B(1)(b). In general, except for **hire purchase asset**, the pooling system is used for computing depreciation allowances.

Initial allowance is **60% on capital expenditure incurred**. If the asset is obtained not by way of purchase, but just transferred to the trader because of succession to a trade, then no initial allowance is allowable [Section 39B(8)]. In addition, if the asset was acquired for private use before, and is now transferred to the relevant pool for business purpose, then no initial allowance is allowable [Section 39B(6)]. Annual allowance is based on the reducing value of the pools of depreciable asset so long as the asset has been owned and used in the production of profits.

Depreciation allowances, industrial building allowances and commercial building allowances



If expenditure is incurred on acquiring a capital asset which is subject to depreciation allowance, but incurred **before the commencement** of the business, s.40(2) provides that the capital expenditure would be treated as if it was incurred on the day on which trading/business commenced.

Tax depreciation allowance would be allowed on the capital expenditure and a **full-year allowance** would be granted.

A **balancing allowance** is granted when a person ceases to carry on a trade and the receipts from disposal of the machinery and plant are less than the reducing value in the pool. The balancing allowance is equal to the difference [Section 39D(2)].

A **balancing charge** arises when either (a) a person ceases to carry on a trade, and the receipts from disposal of the machinery and plant are greater than the reducing value in the pool, or (b) at the end of a basis period of a year of assessment, the disposal proceeds of one or more assets exceed the reducing value of the pool.

Depreciation allowances, industrial building allowances and commercial building allowances



Assets under hire purchase: Annual allowances are granted on a reducing balance basis on the full cash cost (i.e. excluding interest) less any initial and annual allowances granted (section 37(3)). The machinery is **not to be “pooled” together** with other assets qualified for depreciation allowances. It will only be so “pooled” in the year following the year in which ownership of the machinery passes to taxpayer.

s.16G, however, precludes **computer hardware which is integral to any machinery or plant**. It should also be mentioned that capital expenditure incurred under a hire-purchase agreement cannot be deducted as “specified capital expenditure” under section 16G of the IRO, see section 16(G)(6).

Depreciation Allowances / IBA /CBA



Past Paper Practice : Feb 2007 B5 Qu

A Ltd is a company carrying on garment manufacturing business from 1980. It makes up accounts to 31 December each year.

On 1 January 2004, it purchased an old factory building, demolished the building, prepared the site and constructed a new 8-storey building. All floors of the new building are of equal area.

The building was completed on 28 February 2006, on which date A Ltd sold it to B Ltd for a total consideration of \$15 million (excluding the value of the land). A Ltd claimed and the Inland Revenue Department accepted that the profit from the sale of the building was a capital gain.

During the period from 1 January 2004 to 28 February 2006, A Ltd has incurred the following expenditure:

Depreciation Allowances / IBA /CBA



Past Paper Practice : Feb 2007 B5 Qu

| | HK\$ |
|--|-----------|
| Cost of site including old factory building | 8,000,000 |
| Compensation paid to old tenant | 500,000 |
| Architect fees | 200,000 |
| Demolition work | 400,000 |
| Preparation and leveling of land | 150,000 |
| Construction cost | 9,500,000 |
| Interest on a loan of \$10 million, which was used to finance the development cost | 800,000 |

Depreciation Allowances / IBA /CBA



Past Paper Practice : Feb 2007 B5 Qu

B Ltd is also a garment manufacturer and it makes up accounts to 31 March each year. The building was occupied as from 1 May 2006 and used as follows:

| | |
|---|--|
| Ground Floor | Office and show room |
| 1 st Floor | Workers canteen and caretakers' quarters |
| 2 nd to 4 th Floors | Manufacturing operation |
| 5 th to 7 th Floors | Let to and receiving rental income from C Ltd, whose business was to import rattan goods manufactured in the PRC and sell them in Hong Kong. (The rattan goods were stored on the premises pending sale, and were sorted and repacked. Repairs as were necessary to remedy defects were also carried out.) |

Depreciation Allowances / IBA / CBA



Past Paper Practice : Feb 2007 B5 Qu

Required:

(a) For tax purposes, explain the deduction or allowance that A Ltd is entitled to for the expenditure it incurred.

(4 marks)

(b) Compute, with detailed workings, the tax allowances that B Ltd is entitled to for the years of assessment 2005/06 and 2006/07.

(16 marks)

Depreciation Allowances / IBA / CBA



Past Paper Answer: Feb 2007 B5

The expenditures are all in capital nature **S17(1)(c)** and thus they would not be deductible.

A Ltd carries on a qualifying trade for the purpose of the industrial building allowance ["IBA"]. If the building was put into use by A Ltd, A Ltd would be entitled to IBA on the ranking expenditure it incurred.

However, the building was sold before it was used.

Section 35B (a) provides that no allowances may be claimed by A Ltd. If initial allowance is granted to A Ltd on the capital expenditure incurred by it on the construction of the building, additional assessments will be raised by the IRD to withdraw the allowance previously.

Depreciation Allowances / IBA / CBA



Past Paper Answer: Feb 2007 B5:

B Ltd carries on a qualifying trade for the purpose of IBA.

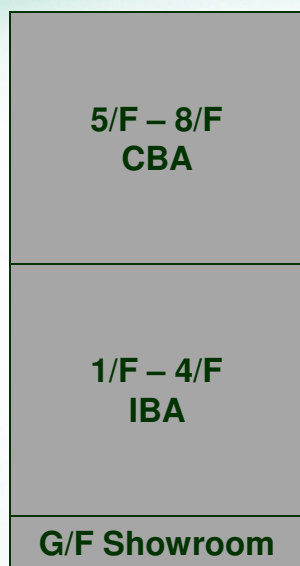
The seller A Ltd is not a property developer. Under Section 35B(b)(ii), B Ltd as purchaser will receive an initial allowance on the lower of the net purchase price or the actual cost of construction.

| Ranking cost incurred by A Ltd | \$ HKD |
|----------------------------------|-----------|
| Architect fees | 200,000 |
| Construction cost | 9,500,000 |
| Interest on loan of \$10 million | 800,000 |
| | <hr/> |

Depreciation Allowances / IBA / CBA



Past Paper Answer: Feb 2007 B5:



CBA

Depreciation Allowances / IBA /CBA



Past Paper Answer: Feb 2007 B5

Since the purchase price of \$15 million exceeds the cost of construction of \$10.5 million, B Ltd is entitled to claim IBA on the construction cost of \$10.5 million.

Use of building:

- G/F was used for a non-qualifying purpose. B Ltd can only claim for a commercial building allowance ["CBA"].
- 1/F to 4/F were used for qualifying purposes. B Ltd can claim for IBA.
- 5/F to 7/F. The nature of the tenant's business is not one of the qualifying trades for the purpose of IBA [Tai On Machinery Works Ltd]. B Ltd can only claim for CBA.

Depreciation Allowances / IBA /CBA



Past Paper Answer: Feb 2007 B5

Qualifying expenditures:

- For the purpose of IBA,
 $\$10,500,000 \times 4/8 = \$5,250,000$
- For the purpose of CBA,
 $\$10,500,000 \times 4/8 = \$5,250,000$

B Ltd is entitled to the initial allowance in the year in which the building was acquired, i.e. year of assessment 2005/06.

The building was only put to use after 31.3.2006. Therefore, for the purposes of calculating IBA and CBA, no annual allowance is due for the year of assessment 2005/06.

Depreciation Allowances / IBA /CBA



Past Paper Practice : Feb 2007 B5 Qu

| <u>Year of assessment 2005/06</u> | IBA Calculation | CBA Calculation |
|---------------------------------------|-----------------|-----------------|
| Cost of construction | 5,250,000 | |
| Less: Initial allowance @20% | 1,050,000 | |
| | <hr/> | |
| | 4,200,000 | |
| <u>Year of assessment 2006/07</u> | | |
| Cost of construction | | 5,250,000 |
| Less: annual allowance @4% | 210,000 | 210,000 |
| | <hr/> | |
| WDV c/f | 3,990,000 | 5,040,000 |

MD Taxation



Profits tax implications on transactions with non-resident persons (Ch 4)

Profits tax implications on transactions with non-resident persons



Provisions concerning non-resident persons

| Section | Scope |
|-----------------------------|--|
| 15(1)(a), (b), (ba) and (d) | Deemed trading receipts |
| 20 | Business with closely connected resident persons |
| 20A | Assessments on Hong Kong agents and non-resident persons and goods on consignment |
| 20AA | Stockbrokers and approved investment advisers not to be treated as agents of non-resident persons |
| 20AB, AC, AD and AE | Exemption for offshore funds |
| 20B | Withholding obligations on resident persons paying or crediting certain payments to non-resident persons |
| 21 | Assessable profits to be computed on a fair percentage of turnover |
| 21A | Assessable profits from deemed trading receipts under ss.15(1)(a), 15(1)(b) or 15(1)(ba) |
| 70AB | Revision of assessment due to exemption for offshore funds |
| 79 (3) | Tax overpaid by non-resident persons to be refunded |

Profits tax implications on transactions with non-resident persons



Pursuant to IRR 5, the profits of the Hong Kong branch of a person whose head office is situated elsewhere than in Hong Kong, will be ascertained as follows:

- (a) Where accounts are kept which disclose the true profits arising in or derived from Hong Kong, those accounts will be adopted and adjusted in accordance with the provisions of the IRO;
- (b) Where accounts do not disclose the true profits arising in or derived from Hong Kong or accounts are not kept;

$$\text{Assessable profit} = \text{Adjusted worldwide profits} \times \frac{\text{Hong Kong turnover}}{\text{Worldwide turnover}}$$

- (c) Where the assessor is of the opinion that it would be impracticable or inequitable to adopt (a) or (b) above, he may estimate the assessable profits of the branch.

If the person disagrees with the assessment raised by the assessor under IRR 3 or 5, he might lodge an objection under s.64(1).

Profits tax implications on transactions with non-resident persons



Deemed trading receipts under s.15(1)

A non-resident person who does not carry on any trade, profession or business in Hong Kong may still be chargeable to profits tax if he or she has the following income:

| Section | Deemed trading receipts |
|-----------|--|
| 15(1)(a) | Sums not otherwise chargeable to profits tax, received by or accrued to a person from the exhibition or use in Hong Kong of cinematograph or television film or tape, sound recording, or any connected advertising material. |
| 15(1)(b) | Sums not otherwise chargeable to profits tax, received by or accrued to a person for the use of or right to use in Hong Kong any patent, design, trade mark, copyright material, secret process or formula or other similar property, or for imparting knowledge connected with the use in Hong Kong of any such properties. |
| 15(1)(ba) | Sums not otherwise chargeable to profits tax, received by or accrued to a person for the use of or right to use outside Hong Kong any intellectual properties listed in s.15(1)(b), or for imparting knowledge connected with the use outside Hong Kong of any such properties, which are deductible in ascertaining the assessable profits of a person under profits tax. |
| 15(1)(d) | Sums received by or accrued to a person by way of hire, rental or similar charges for the use of or right to use movable property in Hong Kong. |

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Profits tax implications on transactions with non-resident persons



Pursuant to s.21A, assessable profits from deemed trading receipts under ss.15(1)(a), (b) or (ba) are taken to be either 30% or 100% of the sum as follows:

| Situation | Deemed profits |
|--|----------------|
| Payment is made by an associate and the intellectual property was previously owned by a person carrying on business in Hong Kong | 100% |
| Other cases | 30% |

Note: In DIPN 22 (Revised), the IRD accepts that the word 'owned' refers to direct ownership.

The provisions deeming 100% of the payment made by an associate as profits of the non-resident for the use of an intellectual property previously owned by a person carrying on business in Hong Kong were enacted in 1993. The purpose of the amendment is to prohibit persons within the same group from obtaining a tax benefit by entering into a sale and lease back transaction of intellectual property.

The withholding tax rate is also dependent on whether Hong Kong has signed a comprehensive double taxation agreement with the territory of which the recipient is a resident.

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Profits tax implications on transactions with non-resident persons



Withholding obligations on Hong Kong agents

A non-resident person may be assessed directly, or in the name of his agent jointly or severally. An assessment can be raised on an agent irrespective of whether or not he has receipt of the profits, and the tax shall be recoverable by all means provided in the IRO out of the assets of the non-resident person or from the agent. The agent is required to deduct, at the time he or she pays or credits the non-resident person, a sum sufficient to meet the non-resident person's tax liability in Hong Kong. The agent is statutorily indemnified against any person in respect of such withholding.

DIPN 17 (Revised) provides guidance on the taxation of persons chargeable to profits tax on behalf of non-residents.

Profits tax implications on transactions with non-resident persons



Withholding obligations on resident persons paying or crediting certain payments to non-resident persons

Section 20B imposes a withholding obligation on a resident person who pays or credits a non-resident person (not necessarily the one who is chargeable) the following sums:

- (a) Sums chargeable under ss.15(1)(a), (b) or (ba);
- (b) Sums which are derived from a performance given in Hong Kong by a non-resident entertainer or sportsman in his or her character as an entertainer or sportsman on or in connection with a commercial occasion or event including:
 - (i) Any appearance made in connection with the promotion of a commercial occasion or event; and
 - (ii) Any participation in or for sound recording, films, videos, radio, television or similar transmissions (whether live or recorded).

Profits tax implications on transactions with non-resident persons



Goods on consignment

Under s.20A(3), when a person sells goods in Hong Kong on behalf of a non-resident person, he or she must furnish quarterly returns (Form BIR 52B) to the Commissioner showing the gross proceeds from the sales. The person is also required to pay 1% of the sale proceeds (the so-called 'consignment tax') to the Commissioner. A lesser sum may be paid if the Commissioner agrees. In practice, only 0.5% is payable.

From the assets that come into the person's possession or control on behalf of the non-resident person, the person must retain an amount that is sufficient to meet the tax liability of the non-resident person. The person is indemnified against any person in respect of the retention of the non-resident person's assets (s.20A(2)).

Profits tax implications on transactions with non-resident persons



Goods on consignment

Whilst s.20A(3) covers sale of goods in Hong Kong by an agent on behalf of a non-resident principal, if the agent constitutes a PE, the non-resident principal may be chargeable under s.14; and its assessable profits will be ascertained in accordance with IRR 5. Nevertheless, in practice, 'consignment tax' is usually regarded as the final liability. It is, however, open for a non-resident principal to produce financial statements to show that his liability is less than the consignment tax.

Profits tax implications on transactions with non-resident persons



Past Paper Practice

June 2015 Case (Extract) – Zeus Corporation

Zeus Corporation (“Zeus”) is a company established in Greece engaging in the entertainment business exclusively in the local Greek market, and has various subsidiaries incorporated worldwide engaging in similar entertainment businesses. In Hong Kong, Zeus set up a wholly-owned subsidiary in the prior year, namely Abas Entertainment Company Limited (“Abas”), carrying on concert production, publication and media businesses for the Hong Kong local market. To facilitate the promotion of its business for customers from the Mainland, Abas also established a representative office (“Abas RO”) in Guangzhou of the People’s Republic of China (“PRC”) for providing marketing and liaison services.

Profits tax implications on transactions with non-resident persons



June 2015 Case (Extract) – Zeus Corporation

During the year ended 31 March 2014, Mr Hercules spent a considerable period of time in Hong Kong to review the business of Abas from a tax perspective. Specifically Mr Hercules has identified the following matters to report to the Board which are either relevant to the tax regime in Hong Kong, or may have cross-border tax implications with respect to the specific business activities carried on by Abas:

According to a licensing agreement entered into between Zeus and Abas, a royalty fee in the amount of 5% on the annual turnover of Abas is required to be paid by Abas to Zeus in connection to the use by Abas in Hong Kong of a trademark owned by Zeus. During the year ended 31 March 2014, Zeus received HK\$1,000,000 in royalty income from Abas in this regard.

Profits tax implications on transactions with non-resident persons



June 2015 Case (Extract) – Zeus Corporation

Abas planned to organise concerts in Hong Kong performed by a renowned Greek vocalist Ms Metis Minos. Based on the preliminary discussions between Ms Minos and Abas, Ms Minos will be present in Hong Kong for a week to perform four concerts. As the concert organiser, Abas will pay HK\$6,000,000 in total to Ms Minos for her performances in Hong Kong.

Question 3

Discuss the Hong Kong tax implications and treatment of the income earned by Zeus under the licensing arrangement between Zeus and Abas and, where appropriate, compute the associated Hong Kong tax liability (ignore provisional tax and tax reduction for the year, if any).

(7 marks)

Profits tax implications on transactions with non-resident persons



June 2015 Case (Extract) – Zeus Corporation

Question 4

Discuss the Hong Kong tax implications and treatment of the income payable to Ms Metis Minos with respect to the proposed concerts organised by Abas and, where appropriate, compute the associated Hong Kong tax liability (ignore provisional tax and tax reduction for the year, if any).

(5 marks)

Profits tax implications on transactions with non-resident persons



June 2015 Case (Extract) – Zeus Corporation

Answer 3

As Zeus is a non-resident from a Hong Kong tax perspective, its royalty income should not be subject to profits tax under s.14(1) of the IRO notwithstanding that it is derived from Hong Kong. However, the income is deemed as a taxable trading receipt under s.15(1)(b) of the IRO as the amount was received by or accrued to Zeus from the use of a trademark in Hong Kong by Abas. Zeus is therefore chargeable to tax as a non-resident and under the name of Abas who paid these sums under the licensing agreement in accordance with s.20B(1)(a) & (2) of the IRO.

Under s.21A(1) of the IRO, the assessable profits of the deemed trading receipts attributable to Zeus would be either (i) 100% of the sum derived by Zeus as an associate of Abas, unless no person carrying on business in Hong Kong has at any time wholly or partly owned the respective trademark, or (ii) 30% of the sum derived thereon in any other case. Subject to the application of s.21A(1) of the IRD, the respective profits tax liability is either HK\$165,000 (HK\$1,000,000 x 16.5%) or HK\$49,500 (HK\$1,000,000 x 30% x 16.5%). Abas is required to withhold the respective amount on behalf of Zeus for tax payment purposes under s.20B(2) of the IRO.

Profits tax implications on transactions with non-resident persons



June 2015 Case (Extract) – Zeus Corporation

Answer 4

As the entertainment performance of Ms Metis Minos is exclusively conducted in Hong Kong, income received by her in connection to the singing concerts is derived in Hong Kong and should be chargeable to profits tax as a non-resident under s.20B(1)(b) of the IRO. Under s.20B(2) of the IRO, Ms Metis Minos would be chargeable to tax as a non-resident person in the name of Abas as the sum paid or credited to her is from Abas in accordance to the concert arrangement.

In ascertaining the assessable profits of Ms Minos as a non-resident with respect to the entertainment performance in Hong Kong, s.21 of the IRO does not specify any percentage of the income to be computed accordingly. In this regard, the IRD usually adopts 2/3 of the gross income as the assessable profits chargeable to profits tax (para. 14, DIPN No.17, Revised January 2005). Accordingly, the profits tax payable of Ms Minos is HK\$600,000 (\$6,000,000 x 2/3 x 15%). Abas is required to withhold the amount on behalf of Ms Minos for tax payment purposes under s.20B(2) of the IRO.



Anti-avoidance provisions under the IRO (Ch 9)

Profits tax implications on transactions with non-resident persons



The following are the major anti-avoidance provisions under the IRO:

| Section | Scope | Enforced by |
|--------------------------|--|------------------------|
| 61 | Certain transactions and dispositions to be disregarded | Assessor |
| 61A | Transactions designed to avoid liability for tax | Assistant Commissioner |
| 61B | Utilisation of losses to avoid tax | Commissioner * |
| 9(1)(b) & (c) | 9(1)(b) & (c) Residence provided by an employer or associated corporation | Not specified |
| 9A | Remuneration under certain agreements treated as income derived from an employment of profit | Not specified |
| 15(1)(m) & 15A | Transfer of right to receive income | Not specified |
| 16(2), (2A), (2B) & (2C) | Deduction of interest expenses | Not specified |
| 16E(8) and 16EA(9) | Commissioner's power to determine the true market value of intellectual property rights | Not specified |
| 16EC | Deduction under s.16E or 16EA not allowable under certain circumstances | Not specified |

Profits tax implications on transactions with non-resident persons



The following are the major anti-avoidance provisions under the IRO:

| Section | Scope | Enforced by |
|------------|--|----------------|
| 16G (3)(c) | Commissioner's power to determine the true market value of a prescribed fixed asset on sale | Commissioner * |
| 16J (4) | Commissioner's power to determine the true market value of environment protection facilities on sale | Commissioner * |
| 18D (2A) | Relevant profit of an old business to be assessed | Not specified |
| 20 | Liability of certain non-resident persons | Not specified |
| 20AE | Assessable profits of non-resident persons regarded as assessable profits of resident persons | Not specified |
| 21A | Computation of deemed assessable profits under ss.15(1)(a), (b) or (ba) | Not specified |
| 22B | Limited partner loss relief | Not specified |
| 38B | Commissioner's power to determine the true value of an asset on sale | Commissioner * |
| 39E | Depreciation allowances for leased machinery and plant | Not specified |

Anti-avoidance provisions under the IRO



Section 61 – Certain transactions and dispositions to be disregarded

Pursuant to s.61, where an assessor is of the opinion that:

- (a) Any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious, or that
- (b) Any disposition is not in fact given effect to; he may disregard any such transaction or disposition and the person concerned shall be assessed accordingly.

Anti-avoidance provisions under the IRO



Section 61 – Certain transactions and dispositions to be Disregarded

'Artificial' is not defined in the IRO. 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.

'Fictitious' also is not defined in the IRO. A fictitious transaction refers to a transaction which is 'not genuine or unreal', or a transaction which the parties to it never intend to make or carry out (i.e. a 'sham').

A transaction which has been effectively carried out cannot be fictitious but can be artificial.

Anti-avoidance provisions under the IRO



Section 61A – Transactions designed to avoid liability to tax

The scope of s.61 has been considered to be narrow as it only applies to artificial or fictitious transactions or dispositions not in fact carried out; and that the only action that can be taken by the IRD is to disregard such transactions or dispositions.

Section 61A was enacted in 1986 to extend the scope of the anti-avoidance provisions to any transaction entered into or effected after 13 March 1986. For s.61A to apply,

- (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 (the relevant person); and
- (c) Having regard to the following matters, 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.

Anti-avoidance provisions under the IRO



Section 61A – Transactions designed to avoid liability to tax

The seven specific matters under s.61A(1) are:

- (1) The manner in which the transaction was entered into or carried out;
- (2) The form (the legal rights and obligations created) and substance (the practical end result) of the transaction;
- (3) The result in relation to the operation of the IRO that, but for s.61A, would have been achieved by the transaction;
- (4) Any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result, from the transaction;
- (5) Any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant person, being a change that has resulted or may reasonably be expected to result from the transaction;
- (6) Whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm's length under a transaction of the kind in question; and
- (7) The participation in the transaction of a corporation resident or carrying on business outside Hong Kong.

Anti-avoidance provisions under the IRO



Section 61B – Utilisation of losses to avoid tax

Section 61B was enacted in 1986 to deter arrangements in which a profit making company purchased the shares in a company with carry-forward tax losses and then the profit making company attempted to utilise such available tax losses by diverting profits to the loss company.

Section 61B applies if:

- (a) change in shareholding in a corporation has been effected after 13 March 1986;
- (b) The Commissioner is satisfied that as a direct or indirect result of the change in shareholding, profits have been received by or accrued to that corporation during any year of assessment (i.e. not necessarily in the year subsequent to the change); and
- (c) Utilisation of the loss of that corporation to avoid or reduce the tax liability of that corporation or any other person is the 'sole or dominant' purpose of the change in shareholding.

Anti-avoidance provisions under the IRO



s.20 - Business with closely connected resident persons

Under s.20(2), where a non-resident person carries on business with a resident person with whom he is closely connected and the course of such business is so arranged that it produces to the resident person either no profits which arise in or derive from Hong Kong, 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 his connection with the resident person shall be deemed to be carried on in Hong Kong. The non-resident person shall then be chargeable to tax in respect of his profits from such business in the name of the resident person as if the resident person were his agent, and all the provisions of the IRO shall apply accordingly.

A person is closely connected with another person where the Commissioner in his discretion considers that such persons are substantially identical, or that the ultimate controlling interest of each is owned or deemed to be owned by the same person or persons (s.20(1)(a)). The controlling interest of a company shall be deemed to be owned by the beneficial owners of its shares, whether held directly or through nominees, and shares in one company held by or on behalf of another company shall be deemed to be held by the shareholders of the last-mentioned company (s.20(1)(a)). However, the term 'substantially identical' is not defined in the IRO.

Anti-avoidance provisions under the IRO



s.20 - Business with closely connected resident persons

Section 20 is designed **to counteract the diversion of profits** from Hong Kong to a closely connected non-resident person. It is different from most of the transfer-pricing provisions in other jurisdictions, as it does not seek to substitute an arm's-length price for the transaction between related parties.

Specifically, it deems the business done by the non-resident person to be carried on in Hong Kong and the profits arising therefrom are to be taxed in the name of the resident person as if the resident person were the agent of the non-resident person.

Anti-avoidance provisions under the IRO



Section 38B – Commissioner's power to determine the true market value of an asset on sale

Section 38B empowers the Commissioner to determine the value of machinery and plant when they are being disposed of at a price other than the true market value in the following circumstances:

- (a) The buyer is a person over whom the seller has control; or
- (b) The seller is a person over whom the buyer has control; or
- (c) Both the seller and the buyer are persons over both of whom some other person has control; or
- (d) The sale is between a husband and a wife, not being a wife living apart from her husband.

Anti-avoidance provisions under the IRO



Section 39E – Depreciation allowances for leased machinery and plant

Section 39E was enacted in 1986 to deny depreciation allowances to the lessor of machinery and plant acquired under a contract entered into after 13 March 1986 in the following circumstances:

- (a) The machinery or plant was acquired under a sale and lease back arrangement; or
- (b) The machinery or plant, other than a ship or an aircraft, is, while the lease is in force,
 - (i) Used wholly or principally outside Hong Kong by a person other than the taxpayer; or
 - (ii) The whole or a predominant part of the cost of acquisition or construction of the machinery or plant was financed directly or indirectly by a non-recourse debt; or
- (c) The machinery or plant is a ship or aircraft or any part thereof and
 - (i) The lessee is not an operator of a Hong Kong ship or aircraft; or
 - (ii) The whole or a predominant part of the cost of acquisition or construction of the ship or aircraft was financed directly or indirectly by a non-recourse debt.

Anti-avoidance provisions under the IRO



Practice Question Practice Dec 2015 Question 9b - Qu

Mr Lee is a finance manager of a local trading company and lives together with his mother, Ms Wong, in Hong Kong. His income has been subject to salaries tax and he has also claimed both Dependent Parent and Additional Dependent Parent Allowances in filing his annual Individual Tax Returns towards maintaining and living with his mother in prior years. Ms Wong has retired and has not derived any income for years. Recently Mr Lee planned to personally acquire a residential flat in Hong Kong to capture possible long term appreciation of such capital asset. He envisaged that he has busy working and living schedules and may not have the spare time to arrange routine leasing matters for the acquired property in the leasing market. In this regard, Mr Lee would use a nominal value of say HK\$100 to lease out the property to his mother. Ms Wong would then lease out the flat in the property market as the sub-tenant to generate rental income.

(b) Discuss the possible IRD's challenge to the abovesaid arrangement from an anti-avoidance perspective in the context of the IRO.

(8 marks)

Anti-avoidance provisions under the IRO



Practice Question Practice Dec 2015 Question 9b

Answer

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.

Anti-avoidance provisions under the IRO

Practice Question Practice Dec 2015 Question 9b



Answer

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

Anti-avoidance provisions under the IRO

Practice Question Practice Dec 2015 Question 9b



Answer

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.

Passing MD – Basic Techniques



Expectations from Students:

- Quote correctly sections (sub-sections), DIPN and cases
- Correct application of the tax rules; do not just copy
- Reasonable conclusion given – answer the question
- Count marks for each question ie 5 marks question – at least 7 minor points
- Present your answer in a logical manner
- Use assumptions
- Give tax evidence

Answer Plan for each question



- Step 1 –** Which kind of tax?
Profits Tax, Salaries Tax and Property Tax?
Involve Stamp Duty?
- Step 2 –** Is the question related to income or expense?
- Step 3 –** Consider the charging section or the general rule first? Then consider any DIPN & cases in support.
- Step 4 –** Apply to the question's facts
- Step 5 –** Discuss different applications under different assumptions
- Step 6 –** Suggest further evidence and give a reasonable conclusion

MD Preparation



Only got 2 and ½ months left – What shall you do?

- Do past papers with updated answers
- Practice writing out
- Write as many questions out as possible
- Practice using your critical file
- Time yourself

Final Advice



- The time to look-up the textbook is limited during an open-book exam
- Students should:
 - ❑ have a good understanding of the topics before going into the exam
 - ❑ read the case and questions carefully
 - ❑ answer what is being asked, not what they wanted to be asked
 - ❑ identify the core issues of the question and allocate their time accordingly
 - ❑ analyse the facts of the case and apply the tax rules or principles to arrive at the conclusion
 - ❑ not copy large passages from the textbook
 - ❑ use logical thinking to understand and respond to the questions

At **ETC**, it is our aim to encourage you. Thank you!



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