

Disclaimer

- ◆ **The materials of this seminar are intended to provide general information and guidance on the subject concerned. Examples and other materials in this seminar are only for illustrative purposes and should not be relied upon for technical answers. The Hong Kong Institute of Certified Public Accountants (The Institute), the speaker(s) and the firm(s) that the speaker(s) is representing take no responsibility for any errors or omissions in, or for the loss incurred by individuals or companies due to the use of, the materials of this seminar conference.**
- ◆ **No claims, action or legal proceedings in connection with this seminar brought by any individuals or companies having reference to the materials on this seminar will be entertained by the Institute, the speaker(s) and the firm(s) that the speaker(s) is representing.**



MD Taxation



Module Preparation Seminar – Agenda

- Ascertainment of property tax liability (Ch 6)
- Distinction between capital receipts/ expenditure and revenue receipts/ expenditure under profits tax (Ch 3)
- Common profits tax deduction items (Ch 3)
- Profits tax implications on transactions with non-resident persons (Ch 4)
- Anti-avoidance provisions under the IRO (Ch 9)



Ascertainment of property tax liability (Ch 6)

MD Taxation

Scope of property tax charge [DIPN14 (Revised)]



The charging **section (s.5)** provides that property tax shall be charged for each year of assessment on the **owner of land or buildings and land and buildings** wherever situated in Hong Kong, and shall be computed at the standard rate on the net assessable value of such land or buildings.

“**Owner**” is defined in **s.2** to include beneficial owner, a life tenant, a mortgagor, a mortgagee in possession, and a person who **holds land or buildings subject to a ground rent or other annual charge**. “Land or buildings or land and buildings” is defined in s.7A to include piers, wharves and other structure.

The definition of “owner” under section 2 of the Inland Revenue Ordinance (“the Ordinance”) has been clarified to include an owners’ corporation and expanded to cover a person who receives rental income on **any common parts of land or/and buildings**.

MD Taxation



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

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.

MD Taxation

Property tax computation format

Taxpayer's name

Year of assessment 2017/2018

Basis period: Year ended 31 March 2018



	\$
Rent	A
Premium	B
Bad debt recovered	C
	<hr/>
	D
Less: Bad debts (irrecoverable rent)	(E)
	<hr/>
Assessable value	F
Less: Rates (paid by owner)	(G)
	<hr/>
	H
Less: Statutory deduction 20% of H	(I)
	<hr/>
Net assessable value	J
	<hr/>
Property tax thereon @ 15%	K

Notes: F – if negative, relate back – s.7C(3); D, F, H, – if negative, no property tax;
I – no other deduction eg management fees and repairs
(exception re mortgage interest under PA).

MD Taxation



Consideration' includes any consideration payable in respect of the provision of any services or benefits connected with or related to the right of use (e.g. management or service fees payable to the owner).

A deposit with the landlord which is refundable upon the termination of a lease is not a consideration chargeable to property tax.

Any consideration previously deducted as irrecoverable and recovered during any year of assessment (i.e. bad debt recovery) shall be treated as consideration payable in that year of assessment **(i.e. taxable in the year of recovery)**.



MD Taxation



Under s.5B(4), the '**premium**' shall be deemed to be payable in equal monthly instalments, either:

- during the period of the right of use, or
- during a period of three years commencing at the start of the period of the right of use to which the consideration relates, whichever is the shorter.

Allowable deductions under property tax

Allowable deduction	Conditions
Rates	If the owner agrees to pay the rates in respect of the 'land or buildings' or 'land and buildings', the rates paid by him/her are deductible from the assessable value.
Bad debts	Any consideration proved to the satisfaction of an Assessor to have become irrecoverable during the year of assessment is deductible in ascertaining the assessable value. If there is no or insufficient assessable value for the deduction of the bad debts, the amount of unrelieved bad debts in that year can be carried backward and deducted from the assessable value in the latest year of assessment.
Statutory outgoings	There is a notional deduction for repairs and outgoings of 20% of the assessable value after deduction of any rates agreed to be borne and paid by an owner. Actual expenses incurred on repairs and maintenance are ignored for property tax purposes.

Ascertainment of property tax liability



Past Paper Practice - Jun 2016 Qu6

Honour Estate comprises five blocks of residential buildings with 500 residential units. The deed of mutual covenants (“the DMC”) of Honour Estate provides, inter alia, that the common area of the estate includes the roof of each residential building. It is common ground that the owners of those 500 residential units (“the Landlords”) have undivided share in the common area of Honour Estate. The DMC also provides that each of the Landlords has the full and free right to use the common area.

Excellent Service Company Limited (“Excellent Service”) was appointed as manager of Honour Estate to manage the estate. It entered into an agreement with a telecommunication company to let out the roofs of the residential buildings for the latter’s setting up of mobile base stations. The estate management accounts of Honour Estate show that its income comprises fees derived from the roofs (“the Receipts”) and management fees collected from the Landlords. The above incomes are disbursed for the payment of the estate management expenses which include salaries, maintenance, refurbishment and rates.

Ascertainment of property tax liability



Past Paper Practice - Jun 2016 Qu6 (Cont'd)

Required:

On the facts now available, analyse (a) whether the Receipts are chargeable to tax in Hong Kong, and if so, the type of tax to which the Receipts are chargeable; (b) the identity of the chargeable person; and (c) the chargeable amount and the available deductions.

(6 marks)

Ascertainment of property tax liability



Past Paper Practice - Jun 2016 Qu6

Answer

- (a) The owners of those 500 residential units (“the Landlords”) are the owners of the common area, which includes the roofs (hereinafter collectively referred to as “the Properties”), of Honour Estate. As s.7A of the IRO provides that buildings includes any part of a building, it follows that the roofs of the residential buildings also fall into s.5(1) of the IRO – the charging section of property tax. The Receipts are the consideration paid for the use of the Properties. Hence, they are chargeable to property tax.
- (b) As to the chargeable person, the Landlords are the owners of the Properties. They are the relevant chargeable persons. (Relevant authority: Board of Review Decision No. *D80/02* 17 IRBRD 984). Alternatively, as “owner” includes a person who, on behalf of another person, receives any consideration in respect of the right of use of any common parts (s.2 of the IRO), Excellent Service Company Limited is also the chargeable person as it receives the Receipts on behalf of the Landlords.

Ascertainment of property tax liability



Past Paper Practice - Jun 2016 Qu6

Answer (Cont'd)

- (c) The net assessable value of the Properties is the Receipts less (i) rates paid by the owners in respect of the Properties (s.5(1A)(b)(i) of the IRO) and (ii) 20% statutory deduction (s.5(1A)(b)(ii) of the IRO). The disbursement of the Receipts on estate management expenses other than rates has no relevance on the computation of net assessable value of the Properties.

Ascertainment of property tax liability



Past Paper Practice - Jun 2015 Qu9a,b

Mrs Chan has been a housewife since getting married to Mr Chan. As she had no property, Mr Chan specifically set out in his will that a residential property was to be passed to her after his death. Mrs Chan inherited that property upon the passing away of Mr Chan in September 2012. She subdivided that residential property into three cubicle rooms. Through the introduction of the neighbours, Mrs Chan knew Adrian, Benjamin and Clive and licensed the cubicle rooms to them on the following terms:

Ascertainment of property tax liability



Past Paper Practice - Jun 2015 Qu9a,b (Cont'd)

	Adrian	Benjamin	Clive
	("Licence A")	("Licence B")	("Licence C")
Dates of the written licence	1/12/2012	1/4/2013	The terms of the licence were verbally agreed on 1/4/2013
Terms of the licence	Two years from 1/12/2012 to 30/11/2014	Six months from 1/4/2013 to 30/9/2013	Six months from 1/4/2013 to 30/9/2013
Monthly licence fees	HK\$5,000	HK\$4,000	HK\$3,000
Rates, Government rent and management fees	To be paid by Mrs Chan		
Deposit	Equivalent to one month's licence fee to be paid by Adrian, Benjamin and Clive on the commencement of their respective licences. The deposits were to be held by Mrs Chan over the tenure of the licences. The licensees agreed that the deposits would be forfeited to set off their outstanding licence fees and the cost of repair if there was damage to the cubicle rooms.		
Usage	To be possessed exclusively by the respective licensees. As it is a residential property, the cubicle rooms can only be used for residential purposes.		
Provision of furniture by Mrs Chan	Nil		

Ascertainment of property tax liability



Past Paper Practice - Jun 2015 Qu9a,b (Cont'd)

On its expiry, Licence B was renewed for a further two months to 30 November 2013 (“Licence B1”) at the same monthly licence fee. No written licence was entered into in respect of Licence B1. Benjamin did not pay the licence fee for the month of November 2013. He asked Mrs Chan to use the deposit to offset the licence fee of that month.

Clive did not pay his licence fee from June 2013 onwards. He moved out of the property on 30 November 2013. The Assessor of the IRD accepts that Mrs Chan is unable to recover the licence fees from July 2013 and after.

Ascertainment of property tax liability



Past Paper Practice - Jun 2015 Qu9a,b (Cont'd)

Mrs Chan handled the subdividing and the licensing matters on her own as the issues were simple and straightforward. She appointed a decoration company and incurred renovation costs of HK\$10,000 in the year of assessment 2012/13 in subdividing the property into three cubicle rooms and reconstructing the sewerage system. That aside, she paid the following expenses in the year of assessment 2013/14 in licensing the cubicle rooms:

Rates	HK\$3,500 (after rates concession)
Government rent	HK\$7,000
Management fees	HK\$12,000

Ascertainment of property tax liability



Past Paper Practice - Jun 2015 Qu9a,b (Cont'd)

Required:

- (a) Determine, with explanations in support, the type of tax which Mrs Chan was chargeable to and compute her tax liability for the year of assessment 2013/14 with respect to the licence fees income. Mrs Chan does not elect to have her income assessed under Personal Assessment (ignore provisional tax and tax reduction for the year, if any).
- (6 marks)
- (b) Discuss whether, and if so, how, the tax liability of Mrs Chan will be different if she was a head tenant of the property. In this regard, she entered into a head lease with the landlord and then entered into the licences with Adrian, Benjamin and Clive on the same terms and paid the same expenses as set out above. She also incurred the rental expense on the head lease.

Note: No tax computation is required.

(8 marks)

Ascertainment of property tax liability



Past Paper Practice - Jun 2015 Qu9a,b

Answer (a)

Mrs Chan was the owner of the property as defined in s.2 of the IRO. The licence fees were the consideration for the use of the property. Unless there was substantial evidence that Mrs Chan carried on a letting business, Mrs Chan should be chargeable to property tax.

Her property tax liability in respect of the licence fees income is computed as follows:

Ascertainment of property tax liability

Past Paper Practice - Jun 2015 Qu9a,b



Answer (a) (Cont'd)

Year of assessment 2013/14

HK\$

Licence fee income from

Adrian (HK\$5,000 x 12 months)

60,000

Benjamin (HK\$4,000 x 8 months)

32,000

Clive (HK\$3,000 x 8 months)

24,000

116,000

Less:

Irrecoverable rent (HK\$3,000 x 5 months)

15,000

Assessable value

101,000

Less:

Rates

3,500

97,500

20% statutory deduction

19,500

Net assessable value

78,000

Tax at

15%

Property tax payable

HK\$11,700

Ascertainment of property tax liability



Past Paper Practice - Jun 2015 Qu9a,b

Answer (b)

Although Mrs Chan entered into “licences” with Adrian, Benjamin and Clive, Mrs Chan was in effect letting or sub-letting, as the case may be, the three cubicle rooms to them. In the event that Mrs Chan was a head tenant, she was chargeable to profits tax under s.14 of the IRO as the definition of “business” in s.2 of the IRO includes the sub-letting by any other person of any premises or portion of any premises under a lease or tenancy other than from the Government.

As to the expenses, if Mrs Chan was the owner of the property, she would be allowed a deduction of irrecoverable rent (s.7C of the IRO), rates (s.5(1A)(b)(i) of the IRO) and 20% statutory allowance (s.5(1A)(b)(ii) of the IRO). In the event that Mrs Chan was the head tenant, apart from irrecoverable rent (s.16(1)(d) of the IRO) and rates (s.16(1) of the IRO), she would also be allowed deductions of the rental expense incurred on the head lease, Government rent, management fee (s.16(1) of the IRO) as well as commercial building allowance (s.33A of the IRO) on the renovation costs which she incurred. Nevertheless, no 20% statutory deduction would be allowed to Mrs Chan as that in the case of an owner.



Distinction between capital and revenue receipts under profits tax (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 – Dec 2016 Qu 10

Infinity Beauty Limited (“Infinity”) is a company established in Hong Kong engaging in the car beauty business with various car beauty outlets in different locations locally. Customers of Infinity have been required to pay a lump sum amount upfront as a deposit. Subsequent utilisation of the beauty services by the customers would be charged with a specific pre-determined service fee. The service fee would then be debited against the abovesaid pre-paid deposit accordingly.

During the year ended 31 December 2015, Infinity disposed of its business entirely to an unrelated third party namely Finite Care Limited (“Finite”) by transferring its whole customer base and the physical car beauty outlets to Finite. The sale considerations consisted of (i) HK\$3 million payable by Finite to Infinity, and (ii) waiver of the transfer of the unrealised customer deposits, which had not yet been booked in the accounts of Infinity, by Infinity to Finite. As at the date of disposal of the business, the accumulated utilised deposits amounted to HK\$2 million.

Distinction between capital and revenue receipts under profits tax



Past Paper Practice – Dec 2016 Qu10 (Cont'd)

Upon preparation of its financial statements for the year ended 31 December 2015, Infinity recognised the sales considerations of HK\$5 million (consisting of (i) and (ii) as discussed above) as income in its accounts. Subsequent to the disposal of the business, Infinity ceased its business and became inactive thereafter.

Required:

Evaluate the taxability of the sale considerations (i) and (ii) derived by Infinity by analysing whether they are capital or revenue in nature.

(9 marks)

Distinction between capital and revenue receipts under profits tax



Past Paper Practice – Dec 2016 Qu10

Answer

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.

Distinction between capital and revenue receipts under profits tax



Past Paper Practice – Dec 2016 Qu10

Answer (Cont'd)

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.



Common profits tax deduction items (Ch 3)

Common profits tax deduction items

MD – General Deduction Rule



s.16(1)	General Deduction Rule	All outgoings and expenses to the extent to which they are incurred by the taxpayer during the basis period of the year of assessment in the production of chargeable profits shall be deducted.
s.17		The expenses must: <ul style="list-style-type: none">• not be of domestic or private nature [s.17(1)(a)],• not being money expended for the purpose of producing non-chargeable profits [s.17(1)(b)],• not of capital nature or loss or withdrawal of capital [s.17(1)(c)], and• not of cost of any improvements [s.17(1)(d)].
[Lo & Lo case].	incurred	Expense must be paid.
IRR 2A	Apportionment	Basis of apportionment of general expenses
IRR 2B	Apportionment	Basis of apportionment on interest on money borrowed for dual basis in share investment and share dealing.
IRR 2C	Apportionment	Adjustment to expenses of supervision and management attributable to substantial investment portfolio.

Common profits tax deduction items



Profits Tax – Interest expenses

Borrowing expenses include interest expenses, legal fees and bank charges in connection with the borrowing. **Sections 16(1)(a) & 16(2)** require all claims for deductions in respect of these borrowing expenses payable on moneys borrowed for the **purpose of producing chargeable profits** to be supported by sufficient details together with documentary evidence if required to satisfy at least one of the six conditions under s.16(2).

Common profits tax deduction items

Profits Tax – Interest expenses

6 Conditions of Section 16(2)

- s. 16(2)(a) – borrowed by a financial institution
- s. 16(2)(b) – borrowed by a public utility company
- **s. 16(2)(c) – borrowed not from a financial institution**
- **s. 16(2)(d) – borrowed from a financial institution**
- **s. 16(2)(e) – borrowed for purchase of machinery or trading stock and not borrowed from associated parties**
- s. 16(2)(f) – money is raised by through issue of listed debentures or marketable instruments



Common profits tax deduction items



Profits Tax – Deductions

s.16(2)(c) – The money has been borrowed from a **person other than a financial institution ("F.I.")** or an overseas financial institution and the sums payable by way of interest are chargeable to tax under the IRO.

In effect, the IRD wishes to make sure while the borrower claims interest deduction, **the interest recipient** (i.e. the general lender in this case) **shall be subject to tax in Hong Kong.**

s. 16(2)(d) – The money has been borrowed from a **F.I. or an overseas F.I.**, and the loan is **not secured or guaranteed by any deposits** the income of which there from is not subject to tax under the IRO. For example, if the loan is used for producing chargeable profits (s.16 (1)(a) satisfied) and the loan is secured by a deposit that **earns taxable income** (hence not secured by deposits that earn non-taxable income), the interest on the loan **is then deductible.**

In effect, the IRD wishes to make sure that the borrower will not claim deduction for interest on a loan that is secured by a deposit while the deposit (may be available due to the provision of the loan) is used to earn non-taxable interest income.

Common profits tax deduction items

Profits Tax – Deductions



s. 16(2)(e) – The money has been borrowed **wholly and exclusively** for capital expenditure on **plant and machinery or for purchase of trading stock** while the lender is not a connected person like relative, partner, director and associated corporation of the borrower

s.16(2A): “Secured Loan Test”

Tests in Section 16(2A) and Section 16(2B) are also required to be examined before deduction can be allowed. The interest will not be deductible if the loan is secured by a deposit or loan by an associate person of the taxpayer and the interest on **which is not subject to tax** in Hong Kong (Section 16(2A)).

s.16(2B): “Interest flow back test”

The interest will also not be deductible if the interest on the principal of the loan will be paid **directly or indirectly to an associate person** of the taxpayer and the interests are not subject to tax in Hong Kong.

Profits Tax - Deductions



s.16(2)(f)	Qualified Debenture	Interest relates to corporate borrowings by way of certain qualified debentures or other marketable debentures . In case the borrowing is from associated corporation and the moneys of the subject loan arise entirely from the proceeds of the qualified debentures or marketable instruments, the interest deduction would be restricted to the amount of interest paid by the associated corporation to the holders of the debentures or instruments.
s.16 (2C)	Qualified Debenture	Section 16(2C) provides that if arrangements are in place whether between the borrower and the holders of the listed debentures or marketable instruments concerned or otherwise, whereby any sum payable by way of interest on the debentures or instruments concerned or on any interest in the debentures or instruments concerned is payable, whether directly or through any interposed person, to the borrower or to a person who is connected with the borrower, the amount of interest deduction shall be reduced by an amount

Common profits tax deduction items



Deductible interest under ss.16(2)(g), 16(2CA) and 16(2CC)

When an **'in-house bank'** in a group borrowed money from a non-Hong Kong associated corporation and on-lent the money to another associated corporation in Hong Kong, the in-house bank might be taxed on the interest income under s.15(1)(f), but might not be allowed a tax deduction for the interest expense due to the failure to satisfy any of the conditions in ss.16(2)(c) –(f).

To rectify the asymmetrical tax treatment of interest income and interest expense for **genuine intra-group borrowing and lending transactions**, **s.16(2)(g)** was introduced.

Effective from 1 April 2016, interest incurred on money borrowed by a corporation in the ordinary course of its intra-group financing business carried on in Hong Kong is deductible if the following conditions are all satisfied:

Common profits tax deduction items



Deductible interest under ss.16(2)(g), 16(2CA) and 16(2CC)

- (a) Interest is payable on money borrowed from a non-Hong Kong associated corporation (s.16(2)(g)(i));
- (b) The lender is subject to tax on the interest in a territory outside Hong Kong which is similar to profits tax at a rate that is not lower than the reference rate (16.5% or 8.25% for a QCTC) – the **'subject to tax'** condition in s.16(2)(g)(ii); and
- (c) The lender's right to use and enjoy that interest is not constrained by a contractual or legal obligation to pass that interest to any other person, unless the obligation arises as a result of a transaction between the lender and a person other than the borrower at arm's length – the **'beneficial ownership'** test in s.16(2)(g)(iii).

The term 'carrying on an intra-group financing business in Hong Kong' has the same meaning as that for a CTC.

Common profits tax deduction items



Deductible interest under ss.16(2)(g), 16(2CA) and 16(2CC)

A non-Hong Kong associated corporation means a corporation not carrying on a trade or business in Hong Kong (s.14C(1)). An associated corporation which merely maintains a bank account in Hong Kong without any other business operation would generally not be regarded as carrying on a trade or business in Hong Kong (DIPN 52, para 8).

Interest must be paid to a corporation. Interest paid to a non-corporate associate (e.g. partnerships, trust) will not be allowed for tax deduction.

Interest paid in the ordinary course of an intra-group financing business

Interest must be payable by a corporation on money borrowed from a non-Hong Kong associated corporation in the ordinary course of its intra-group financing business. Interest payable on money borrowed for purposes other than on-lending the same to other associated corporations is not money borrowed in the ordinary course of an intra-group financing business and the relevant interest will not be allowed for tax deduction.

Profits Tax – Other Deductions



s.16B	Research and development	<p>General expenditure/ expenditure on plant and machinery fully deductible in the year of assessment it is incurred.</p> <p>Expenditure on buildings/ structure qualifies for IBA</p> <p>Proceeds from sale of rights in relation to research and development to the extent not yet subject to profits tax and not exceeding the amount previously allowed for the research and development would be treated as trading receipts at time of completion of sale</p>
--------------	---------------------------------	---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

Profits Tax – Other Deductions

s.16E	Purchased patents	Purchase of patent rights or know-how rights for use in Hong Kong in the production of chargeable profits. The purchase shall not be made from associate . The subsequent sale of such rights is nevertheless taxable.
s.16EA(11), s.16E(4) [Refer to DIPN 49]	IPRs	<p>Intellectual property rights (“IPRs”), viz. patents, rights to any know-how, copyrights, registered designs and registered trade marks that qualify for the above tax deduction</p> <ul style="list-style-type: none"> • Only allowable for “registered designs” or “registered trade marks”. • Taxpayer must have proprietary interest and uses in the production of chargeable profits. • Apportionment available. • Spread over five succeeding years on a straight-line basis starting from the year of purchase ie 20% each year. • Where a relevant IPR is subsequently sold, the sale proceeds to be treated as trading receipts are capped at the amount of the deduction as previously allowed. • Apportionment available. • Spread over five succeeding years on a straight-line basis starting from the year of purchase ie 20% each year. • Where a relevant IPR is subsequently sold, the sale proceeds to be treated as trading receipts are capped at the amount of the deduction as previously allowed.

Profits Tax – Other Deductions



s.16F	Building refurbishment	<p>Allows deduction of capital expenditure on the renovation and refurbishment of non-domestic building.</p> <ul style="list-style-type: none">• 20% each year <p>No deduction for:</p> <ul style="list-style-type: none">• The subject building or structure is a domestic building or structure.• The non-domestic building or structure is first used substantially by the taxpayer.• The non-domestic building or structure is to be used for a purpose different from that for which it was used immediately before the capital expenditure was incurred [s.16F(4)].
-------	------------------------	------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

Profits Tax – Other Deductions



s.16G	Prescribed fixed asset	<p>100% deduction in respect of capital expenditure incurred on “prescribed fixed asset” used for the production of chargeable profits. [N/A on hire purchased assets]</p> <p>Sale of prescribed fixed asset are taxable to the extent of deduction already granted</p>
s.16H-K	Environmental Protection Machinery / Environmental Protection Installation	<p>Specified capital expenditure incurred in a year of assessment on the provision of EPM is wholly deductible in the year of assessment.</p> <p>EPM covers environment-friendly vehicles – 100% deductible</p> <p>Sale of proceeds of EPM are taxable limited to amount of deductions already granted.</p> <p>Capital expenditure incurred on construction of an environmental protection installation EPI is deductible in equal instalment over 5 years of assessment. 20% per year.</p> <p>Sale of EPI – if unallowed expenditure exceeds the proceeds, the excess is deductible; if proceeds exceed unallowed expenditure, the excess is taxable.</p>

Profits Tax – Other Deductions



Past Paper Practice – Dec 2016 Qu 9a

Cambridge Holdings Limited (“Cambridge”) is a group holding company established in Hong Kong with subsidiaries engaging in various businesses locally. Since the year of assessment 2004/05, Cambridge has employed senior management executives and incurred substantial overheads for providing strategic management and administrative services to the subsidiaries. Yet due to adverse market sentiments and other economic factors, the operating performance of Cambridge’s subsidiaries was generally not satisfactory, and Cambridge did not charge nor derive any management fee income from the subsidiaries notwithstanding the provision of the abovementioned management services up to the year of assessment 2014/15. Cambridge did not derive any other income during the relevant years either.

In preparing the profits tax returns for the years of assessment from 2004/05 to 2014/15, Cambridge stated its principal business activity as “investment holding” and claimed tax loss for each year, which substantially resulted from the expenditure incurred in connection with the salaries of its management executives and other essential overhead expenses. However, the IRD consistently refused to allow any tax loss to Cambridge, and only issued notices with a remark “no trading, no loss agreed” as the tax position of Cambridge for the respective years.

Profits Tax – Other Deductions



Past Paper Practice – Dec 2016 Qu9a (Cont'd)

In the year of assessment 2015/16, the subsidiaries of Cambridge experienced favorable business performances. Cambridge charged and derived management fee income from its subsidiaries, and generated a substantial amount of assessable profits for the year. Cambridge would like to utilise its tax loss brought forward from prior years to set off the assessable profits, notwithstanding that the tax loss was not agreed by the IRD as indicated above.

Required:

From the perspectives of (i) Cambridge and (ii) the IRD, analyse the deductibility of the expenses incurred by Cambridge during the years of assessment from 2004/05 to 2014/15 in the contexts of the IRO.

(8 marks)

Profits Tax – Other Deductions



Past Paper Practice – Dec 2016 Qu9a

Answer

(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.

Profits Tax – Other Deductions



Past Paper Practice – Dec 2016 Qu9a

Answer (Cont'd)

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.

Profits Tax – Other Deductions



Past Paper Practice – Dec 2016 Qu 9a

Answer (Cont'd)

(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.

Profits Tax – Other Deductions



Past Paper Practice – Dec 2015 Qu 6

Suckling Pig Limited (“Suckling”) is a company established in Hong Kong engaging in a restaurant business under the trade name Suckling Pig Restaurant. During its financial year ended 31 March 2015, Suckling incurred the following capital expenditure:-

- i) Renovation works were conducted during the year on the company’s existing restaurants, office premises and directors’ quarters, and were for the following amounts:-

	HK\$
– Replacement of old carpet in the existing restaurants	500,000
– Renovation work in the existing restaurants	4,000,000
– Renovation work in the existing office premises	850,000
– Renovation work in the existing directors’ quarters	380,000

Profits Tax – Other Deductions



Past Paper Practice – Dec 2015 Qu 6 (Cont'd)

- ii) Suckling replaced its computer hardware and software system to achieve better cash and inventory control. The price of the system was HK\$130,000. Suckling finally paid HK\$100,000 to the vendor after deducting the HK\$30,000 trade-in value of the old computer system sold to the same vendor.
- iii) Suckling acquired wastewater treatment machinery and an environmental protection solar water heating installation in one of its restaurants for the amounts of HK\$760,000 and HK\$600,000 respectively. It has been confirmed that the machinery and installation are in compliance with the relevant regulations stipulated by the Environmental Protection Department and Electrical and Mechanical Services Department.

Profits Tax – Other Deductions



Past Paper Practice – Dec 2015 Qu 6 (Cont'd)

- iv) Suckling acquired various items of office furniture for the total amounts of HK\$253,000 and a motor vehicle for business purposes for the amount of HK\$500,000. The motor vehicle was specifically acquired under a hire purchase scheme with a bank with an initial payment of HK\$100,000 made upfront on 10 July 2014, followed by 40 monthly installment of HK\$11,000 each commencing on 1 August 2014. The hire purchase interest was evenly spread across each installment.

All of the abovesaid assets have been put into use during the year.

It is also noted that the tax written down values of fixed assets ranked into 20% and 30% pools claiming depreciation allowances brought forward from the prior year are HK\$1,276,000 and HK\$96,000 respectively.

Profits Tax – Other Deductions



Past Paper Practice – Dec 2015 Qu 6 (Cont'd)

In the context of the commercial building allowance, the total ranking costs brought forward and the respective tax written down value are HK\$6,354,000 and HK\$4,652,400 respectively. The ranking cost of the building structure demolished during the year and the respective residue of expenditure are HK\$500,000 and HK\$300,000 respectively.

Required:

Calculate the allowable deductions under Part 4 of the IRO and the capital allowances under Part 6 of the IRO attributable to Suckling for the year of assessment 2014/15 based on the above information.

(15 marks)

Profits Tax – Other Deductions



Past Paper Practice – Dec 2015 Qu 6

Answer

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

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

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

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

Profits Tax – Other Deductions



Past Paper Practice – Dec 2015 Qu 6

Answer (Cont'd)

Depreciation allowance attributable to Suckling for the year:-

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

Profits Tax – Other Deductions



Past Paper Practice – Dec 2015 Qu 6

Answer (Cont'd)

Depreciation allowance for hire purchase asset (motor vehicle):

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

Profits Tax – Other Deductions



Past Paper Practice – Dec 2015 Qu 6

Answer (Cont'd)

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

Commercial building allowance attributable to Suckling for the year:

	HK\$
Ranking cost b/fwd	6,354,000
Less: Disposal during the year	(500,000)
Add: Addition during year (renovation of directors' quarters)	380,000
Ranking cost c/fwd	<u>6,234,000</u>

Profits Tax – Other Deductions



Past Paper Practice – Dec 2015 Qu 6

Answer (Cont'd)

	HK\$	Total allowances HK\$
T.W.D.V. b/fwd	4,652,400	
Less: Balancing allowance (Residue of expenditure)	(300,000)	300,000
Add: Addition during the year as per above	380,000	
	<hr/> 4,732,400	
Less: A.A. @ 4% of ranking cost c/fwd	(249,360)	249,360
	<hr/> 4,483,040	<hr/> 549,360



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.

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.

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”) 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



Past Paper Practice - June 2015 Case (Extract)

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



Past Paper Practice - June 2015 Case (Extract)

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



Past Paper Practice - June 2015 Case (Extract)

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



Past Paper Practice - June 2015 Case (Extract)

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



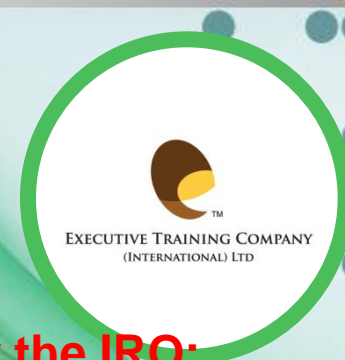
Past Paper Practice - June 2015 Case (Extract)

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 ($\$6,000,000 \times \frac{2}{3} \times 15\%$). Abas is required to withhold the amount on behalf of Ms Minos for tax payment purposes under s.20B(2) of the IRO.

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 (Ch 9)

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 - Dec 2015 Q9b

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 above said arrangement from an anti-avoidance perspective in the context of the IRO.

(8 marks)

Anti-avoidance provisions under the IRO



Practice Question - Dec 2015 Q9b

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 - Dec 2015 Q9b

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 - Dec 2015 Q9b

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