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THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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MODULE 2.04 – HONG KONG OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Hong Kong profits tax for MHKL's trading operation in China

MHKL's trading profits from sales to Mainland customers would be subject to profits tax if the profits were derived from Hong Kong

The Inland Revenue Department (IRD) expresses its view on determining the locality of profits in its Departmental Interpretation and Practice Notes (DIPN) No. 21. The general principle is the "operation test" (F.L. Smidth & Co. v Greenwood) which asks the question "where did the operation take place from which profits in substance arise?" According to the Hang Seng Bank case, the broad guiding principle is that one looks to see what the taxpayer has done to earn the profit in question and where he has done it.

For trading profits, the IRD would generally regard the important determining factor as where the contracts for purchase and sale were effected. Moreover, relying on the Magna's decision, all relevant operations must be considered in ascertaining where the contracts were effected.

It is the IRD's practice that, subject to review of "totality of facts", if either the purchase contracts or sale contracts are effected in Hong Kong, the initial presumption will be that the profits are fully taxable.

The IRD takes the view that there is no apportionment of trading profit, which is either wholly taxable or wholly non-taxable.

As regard to the case, as MHKL placed purchase orders from its Hong Kong office via emails, the IRD will take view that the purchase contracts are effected in Hong Kong. Also, the marketing works, trade financing, and sales order processing were carried out in Hong Kong. On this basis, the trading profit derived from the sales through RCL in the Mainland would likely be regarded by the IRD as sourced from Hong Kong.

MHKL may rely on the Magna case to argue that the sales activities done by RCL in the Mainland are more important in generating the trading profit or on the ING Baring case that the activities done by the agent are more critical in generating the trading profit. RCL's activities done for MHKL should be taken in account even the two entities had not entered into any agency agreement, but just a service agreement (ING Baring case). However, it may be hard to convince the IRD to accept this argument because the IRD would look at all relevant operations to ascertain source of profits. Given that (i) the purchase orders were placed from Hong Kong office, (ii) the marking and financing functions were also carried out in Hong Kong, and (iii) the sale orders were processed in Hong Kong, it would be hard to convince the IRD the sales activities were more critical in generating the trading profits.

China enterprise income tax for MHKL's trading operation in China

Notwithstanding the showroom would be excluded as a permanent establishment (PE) in Mainland, the activities done by RCL in Mainland for MHKL are likely to be regarded as a PE (Mainland-Hong Kong Double Taxation Arrangement (DTA)) as RCL has the general authority to accept orders for and on behalf of MHKL and habitually exercised such authority. If MHKL is recognized as maintaining a PE, the relevant trading profit attributable to the PE would be subject to income tax in Mainland. Nonetheless, if both Hong Kong profits tax and China income tax are payable, tax credit for China income tax paid against profits tax payable is available under DTA. Under section 50, the tax credit should be claimed within 6 years after the relevant year of assessment or 6 months after the issue of the relevant assessment, whichever is later, effective 1 April 2018.

China enterprise income tax for marketing services to RCL

MHKL would be subject to enterprise income tax for the marketing service fee if the provision

of services amounted to a PE, that is more than 183 days within any 12-month commencing and ending in a tax year.

The serving period for respective staffs are set-out below:

Staff A	1 July 2018 – 30 September 2018	92 days (31+31+30)
Staff B	1 December 2018 – 28 February 2019	90 days (31+31+28)
		59 days (1 January 2019 to 28 February 2019 = 31 + 28 = 59 days)
Staff C	15 August 2019 to 31 December 2019	139 days (17+30+31+30+31)
		108 days (15 August 2019 to 30 November 2019= 17+30+31+30= 108 days)

For the 12-month period from 1 July 2018 to 30 June 2018 (Period 1), the total servicing days are 182 days, being (92+90).

For the 12-month period from 1 December 2018 to 30 November 2019 (Period 2), the total servicing period are 198 days, being (90+108).

For the 12-month period from 1 January 2019 to 31 December 2019 (Period 3), the total servicing period are 198 days, being (59+139).

As it is more than 183 days for Period 2, which commenced in 2018 and ended 2019, MHKL have maintained a servicing PE in Mainland for both 2018 and 2019 and would be subject to income tax for both years.

Question 2

Broadly, there are two issues to BEL: whether the royalty income received from CL of $5 million is taxable, and whether the royalty expense of $3 million paid to AL is deductible.

There is one tax issue to AL: whether the royalty income received from BEL is taxable.

For the taxability of the royalty of $ 5 million received by BEL, operation test should be applied to determine whether such income is arising in or derived from Hong Kong. Operation test refers to "one looks to see what the taxpayer has done to earn the profit, and where it has done it" (Hang Seng bank case). Per DIPN 49 and TVBI case, where a taxpayer acquires a license to use an intellectual property and sub-licenses such right to another person for a royalty fee income, the royalty fee income is derived from the place where the license right is acquired and sub-licensed. The place of use is irrelevant. BEL negotiated and concluded the relevant license contracts with AL and CL in Hong Kong, hence the royalty income of $5 million received from CL was derived from Hong Kong and hence taxable under section 14.

As to the deductibility of the royalty expense, it is analysed as follows. BEL used the trademark in running its Hong Kong trading business and the trading profit derived therefrom is taxable. The royalty income derived from sublicensing the right to AL is taxable. Since both the royalty income and trading profits of BEL is taxable, the royalty expense paid AL was incurred in the production of assessable profits and deductible under section 16(1). The corporate income tax paid in mainland of $350,000 can be credited against the Hong Kong tax payable on the royalty income under section 50. The mainland value added tax of $300,000 is charged on the gross amount of the royalty and hence was incurred in the production of assessable profits and should be deductible under section 16(1).

The royalty of $3 million paid to AL was for the right to use the trademark in Hong Kong and mainland China. The portion of the royalty for using the trademark in Hong Kong should be deemed taxable under section 15(1)(b). The portion of the royalty for using the trademark outside Hong Kong should be deemed taxable under section 15(1)(ba) because such royalty payment is deductible to BEL. The tax liability to AL is calculated as follows:

	$
Royalty fee	3,000,000
Deemed assessable profit at 30% thereon*	900,000
Tax payable before tax reduction @8.25%#	74,250
Tax reduction of 75% capped at $20,000	20,000
Tax payable after tax reduction	54,250

Under section 21A, the deemed assessable profit is 30% of $3 million. Though BEL and AL are associated corporations, the trademark has never been owned by any person carrying on a business in Hong Kong previously. Under section 20B, BEL has the obligation to report, withhold and pay tax for and on behalf of AL (assuming AL has no connected party in Hong Kong, which would apply for the reduced tax rate of 8.25%).

Interest from bank deposit in Hong Kong, $80,000

Interest income derived from a bank deposit in Hong Kong is exempt from payment of profits tax under the Interest Exemption Order in general. However, there will be no exemption if the deposit has been used to secure for borrowing and interest expenses on such borrowing is deductible. The deposit in the case has been used to secure for a loan of AL, which did not carry on business in Hong Kong. The interest expense of the AL's loan should not be deductible. Hence, the deposit interest should still be exempt from profits tax.

Property disposal gain, $2,000,000

As the property is located outside Hong Kong, the gain was derived outside Hong Kong. The gain is not taxable even it is likely be trading in nature in view of BEL's short period of ownership

Cost of acquiring the proprietary interest of the know-how is NOT deductible under section 16E as BEL and AL are associated companies. Hence, the sale proceed of the know-how was not taxable. Profits on disposal of the know-how is capital in nature and non-taxable.

The cost of feasibility study should be deductible under section 16B though it is capital in nature. The fact that the new products' life is not more than ten years would not affect full deduction under section 16B.

Interest on Loan 1 for purchase of a machine is deductible under section 16(1)(a) and 16(2)(f) because the loan fund was raised by AL through issue of instruments marketed in a recognised stock exchange. The interest deduction is restricted to the amount of interest paid by AL to the instrument holders, which in fact was higher then what was paid by BEL to AL. Section 16(2B) restriction does not apply because there is no flow-back of non-taxable interest income.

Interest on Loan 2 for purchase of trading stock is deductible under section 16(1)(a), (2)(d) and (2)(e). However, restriction under section 16(2A) applies as the loan was partly secured by a deposit of AL made with a bank in the UK. The interest income derived from such deposit would not be taxable in Hong Kong. The non-deductible interest expense would be computed on a reasonable basis (DIPN 13A). Section 16(2B) does not apply as there was not flow-back of any interest.

Non-deductible interest expense is calculated as follows:

$200,000 (matched with non-taxable interest income)
x $2 million (overseas deposit)
/ [$2 million (overseas deposit) + $2 million (overseas property)]
= $100,000.

PART B

Question 3

Part 1

Section 50AAE is the transfer pricing rule for transactions between associated persons for sale/transfer/use of assets and provision of services. The rule is effective from the year of assessment 2018/19 strictly (however, transactions effected before 13 July 18 could be grandfathered, i.e. the new rule does not apply).

Section 50AAE allows the Inland Revenue Department to adjust profits or losses of a person where a transaction between two associated persons departs from the transaction that would have been entered into between independent persons, in cases in which this has created a tax advantage.

Domestic related party transactions are exempted from the new rules if the transaction is:

- domestic in nature;
- does not give rise to an actual tax difference; and
- not utilized for tax avoidance purposes.

Two persons are associated where one person participates in the management, control or capital of the other person, and controls the other person.

Control includes the situation where a person has the power to secure that the affairs of the other person are conducted in accordance with the wishes of the person:

- due to a direct or indirect beneficial interest in the other person of more than 50%, or
- entitlement to exercise more than 50% of the voting rights in the other person or powers conferred by constitutional documents regulating the other person.

Part 2

- Before 2018/19, i.e. Before the new transfer pricing rule comes into effect, the Inland Revenue Department could rely on the following provisions/principles to attack transactions which are not carried out on arm's length basis:

- Section 16(1) - Deduction rules: payment made to related parties which are inflated and hence not "to the extent" in the production of assessable profits. Such inflated payment would be disallowed,

- Section 20(2) – A Hong Kong resident carries on a business with a closely- connected non-resident which results in the Hong Kong resident deriving less than normal or no chargeable profits in Hong Kong. The overseas resident would be deemed carrying on business in Hong Kong and chargeable to profits tax in respect of profits derived from the business carried on with the Hong Kong resident.

- Section 61 - Artificial and fictitious transactions which reduce tax liability would be disregarded.

- Section 61A - Tax-motivated transactions could be disregarded and re-characterized (including prices adjustment) so as to counteract the tax benefit.

- Sharkey rule – disposal of trading stock not at arm's-length could be replaced by market prices.

PART C

Question 4

AVD payable

Since the provisional sale and purchase agreement (PASP) was executed on or after 23 February 2013 and the agreement for sale and purchase was executed after 14 days from the date of the PASP, the provisional sale and purchase agreement is chargeable with AVD at the original Scale 1 rates.

The AVD payable is $1,500,000 ($20,000,000 x 7.5%). Provided that the PASP is duly stamped, the ASP and the assignment will each be chargeable with fixed duty of $100.

Section 45 exemption does not apply even Chan Ltd is wholly owned by Mr Chan, as Mr Chan is not a corporate.

No special stamp duty and buyer's stamp duty as the subject property is not a residential property.

AVD payable

The residential property and the two car parking spaces will be regarded as separate and distinct matters.

As Ms Wong holds a Hong Kong permanent identity card, she is a Hong Kong permanent resident (HKPR), notwithstanding she only lives in Hong Kong for 150 days every year.

As Ms Wong is a HKPR, Scale 2 rates will apply to the acquisition of the residential property. Part 2 of Scale 1 rates will apply to the acquisition of the two car parking spaces.

The applicable duty rates are determined by reference to the total consideration of $15,000,000. The total amount of stamp duty payable on the chargeable agreement for sale is $637,500 which is computed as follows:

AVD payable on the residential unit: $13,000,000 x 3.75% = $487,500

AVD payable on the car parking spaces: $2,000,000 x 7.5% =$150,000

SSD payable

SSD will be chargeable if the holding period for the residential property is 36 months or less. The date of ASP will be taken to count the holding period of Mr Cheung for the residential property. From 1 January 2016 to 1 January 2019, the holding period is 36 months and 1 day. Hence no SSD is chargeable for the acquisition of the residential property. No SSD apply on acquisition of non-residential properties, i.e. the two car park spaces.

BSD

Ms Chan is a HKPR and hence, no BSD is chargeable for her acquisition of the residential property. No BSD applies for acquisition of the car park spaces.

On 14 December 2016, M Limited owned 98.05% of the issued share capital of K limited (100% x 80% + 95% x 95% x 20%) and 90.25% (95% x 95%) of the issued share capital of L Limited.

K Limited and L Limited were therefore associated companies under section 45(2) of the Stamp Duty Ordinance.

The relief of section 45(1) applied to the transfer of the factory premises from K Limited to L Limited and no stamp duty was chargeable.

The transfer value and the market value were irrelevant. However, adjudication was required under section 45(3) for this exemption.

Following M Limited's disposal of 15% of the share capital of N Limited to Q Limited, M Limited owned 86.05% of the share capital of K Limited [85% x 80% (through N Limited) + 95% x 95% x 20% (through P Limited and L Limited)], and 90.25% of the share capital of L Limited [95% x 95%].

K Limited and L Limited were then no longer associated companies on 1 December 2018. However, such cessation of association relationship was not due to change in shareholding of the transferee in the factory premises transfer transaction, i.e. L Limited. Therefore, the exemption was still valid as section 45(4)(c) was not applicable to deny the exemption under section 45.

Question 5

There are two general anti-avoidance provisions in the IRO, namely s.61 and s.61A. S. 61A is applicable when the sole or dominant purpose of a transaction is to enable a person to obtain a tax benefit. In applying s.61A, the Commissioner can assess the taxpayer as if the transaction had not been entered into or in such a manner as the Commissioner thinks appropriate to counteract the tax benefit. S. 61 is applicable when the transaction is artificial or fictitious. In applying s.61, the Commissioner can disregard the transaction. "Artificial" means the transaction lacks commercial reality. "Fictitious" means the parties to the transaction never intend to carry out the transaction.

If the main purpose for acquisition of WSL is to utilize WSL's tax loss, whereas the main purpose for establishing the new overseas company is to shift profit away from MGL, s.61 and s. 61A should be applicable to the proposed transactions. Certainly, if it can convince the IRD that the main reason to acquire WSL is not for obtaining any tax benefit, these two sections might not apply. The non-tax reason may include avoiding liquidation of WSL and hence consequential un-collection of the outstanding trade debt. It can also argue the main reason for setting-up the new sourcing company is to streamline the existing sourcing operation of MGL. However, the non-tax reason must be well substantiated by proper documentation, such as feasibility studies, financial reports, etc.

Other than ss. 61 and 61A, specific anti-avoidance provisions are also applicable as outlined below.

Acquisition of WSL

Pursuant to s. 61B of the IRO, the commissioner shall disallow the set-off of any-loss or balance of loss if he is satisfied that:

- Any change in the shareholding in any corporate, as a direct or indirect result of which profits have been received by or accrued to that corporation during any year of assessment; and

- The sole or dominant purpose of the change was for the purpose of utilizing any loss or any balance of any loss sustained in a trade, profession or business carried on by a corporation, in order to avoid liability on the part of that corporation or any other person for the payment of any tax or to reduce the amount thereof.

Based on the information provided, it seems that the intention of MGL for the acquisition of WSL is to utilize WSL's tax loss by lowing selling prices to WSL and thus mitigate tax liability. If the tax reason outweighs the commercial reason, S. 61B of the IRO is applicable. Consequently, Commissioner would disallow the utilization of tax loss of WSL to set-off its future profits.

Setting-up a new overseas sourcing company

With regard to s. 20 of the IRO, 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, and such non-resident person shall be assessable and chargeable with 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.

Under the proposed arrangement, after interposing the new company between MGL and the suppliers, part of the profit now earned by MGL would be transferred to the overseas company and hence reduce the tax liability of MGL and the group as a whole because the income tax rate of the new company is only 5%, which is lower than that in Hong Kong. In this regard, s.20

should be applicable to deem the profit of the new company taxable in Hong Kong in the name of MGL.

Question 6

Under section 9(1)(a), chargeable income from any office or employment also includes any perquisite. However, not all fringe benefits provided by the employer are taxable. A "liability test" is provided under section 9(1)(a)(iv) which excludes from chargeability any benefit where the relevant payment to a party other than the employee is one for which the employer has the sole and primary liability and there is no surety made by any person. The exclusion does not apply to any benefit which is capable of being converted into money by the recipient. It is irrelevant whether the employee actually converts the benefit into cash.

Furthermore, education benefits for employee's children remain as chargeable to salaries tax, even if the employer has the sole and primary liability for the relevant payment.

Provision of a domestic helper

If the employer, THKL enters into an employment contract with the domestic helper and pays the salaries to the domestic helper directly, the salaries will be tax free if the following two conditions are satisfied:

1. No one provides any guarantee for the salaries payment, and
2. The employee cannot convert such benefit into cash, for instance, the employee cannot forsake the benefit for additional salaries.

But if the employee signs the employment contract with the domestic helper, and THKL reimburses the domestic helper's salaries payment to the employee, the payment is taxable to the employee.

Low interest loan

If the low interest loan is provided by the employer to the employee and it is the employer's sole and primary liability to provide such benefit, the benefit should be exempt under section 9(1)(a)(iv). To ensure such exemption is available, the benefit should not be convertible into cash.

On the above basis, the benefit i.e. interest differential should not be taxable. To ensure such exemption is available, the employer should impose restriction on the application of the loan, for example, the employee is prohibited from sub-lending the loan fund at an interest rate higher than that charged by the employer, the employee can only apply the loan on acquiring property for residential purpose and such property cannot be re-sold within a particular period of time, etc. In doing this, the benefit would not be regarded as convertible into cash, nor a discharge of employee's liability.

Education fee of child

Amount paid by an employer in connection with the education of a child of an employee are by virtue of section 9(2A) not subject to the "liability test", and accordingly the amount will be treated as chargeable income of the employee irrespective of whether the employee or the employer is the party liable for the relevant expense. This would include not only tuition expenses but also payment for incidental expenses such as boarding fees.

However, in accordance with the decision in an English case (Barclays Bank v Naylor), the IRD in DIPN 16 states that payment in respect of education expenses provided by a genuine discretionary trust funded by the employer will not be regarded as a chargeable benefit because such benefit is not derived from employment.

Question 7

The Hong Kong profits tax position of BCHKL in respect of the pricing adjustment made by the China tax authority.

- A juridical double taxation would be resulted. Juridical double taxation means an enterprise is charged to tax on the same profit or income in two different states. In this case, BCHKL would be subject to additional income tax as a result of the transfer pricing adjustment.

- In the Double Taxation Arrangement (DTA) between the Mainland China and the Hong Kong SAR, the Associated Enterprise Article provides for primary transfer pricing adjustments by either side. The Associated Enterprises Article also provides a mechanism for relief from the resultant economic double taxation to be given by the other side.

- The DTA also contains a Mutual Agreement Procedure Article that provides for the resolution of cases where a taxpayer is faced with double taxation.

- For the claim to revise the non-taxable offshore profits attributable to the overseas PE of a Hong Kong resident (i.e. to increase the offshore profit), the relevant adjustment is made under the "Business Profits Article" and section 79 of the IRO. The time limit for invocation of section 79 is six years after the end of the relevant year of assessment.

- A retrospective price adjustment would not represent outgoings or expenses incurred in the production of chargeable profits and hence deductible under section 16.

- The assessment, for those years where transfer pricing adjustments have been made, cannot be re-opened under section 70A as the retrospective price adjustment constitutes neither an error nor omission made in the taxpayer's return or statement filed with the IRD for the year concerned.

- The CIR would only be obligated to make corresponding adjustments up to the extent to which the CIR agrees that the tax adjustments made by the other side (the Mainland) represent the arm's length principle.

- If the Commissioner does not fully agree with the adjustments of the other side, it is expected that the two authorities would communicate with each other so as to resolve the issue.

- BCHKL can formally invoke the "Mutual Agreement Procedure Article" of the DTA. BCHKL has to initiate the procedure with the IRD within three years from the time of the first notification to them of the actions giving rise to taxation not in accordance with the DTA (as a result of transfer pricing adjustments or profit re-allocation adjustments). The IRD will then consider and resolve the case on its own if possible or where necessary, endeavour to resolve the issue with the competent authority of the Mainland (however without the obligation of necessarily reaching agreement with the competent authority of the Mainland).