THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2023

MODULE 2.04 – HONG KONG OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

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 into 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 the 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 officially accepted and processed in Hong Kong, it would be hard to convince the IRD the sales activities were more critical in generating the trading profits.

Part 2

The warehouse would be excluded as a permanent establishment (PE) in Mainland. However, RCL has played a principal role leading to conclusion of sale contracts for MHKL without material modification by MHKL. The activities done by RCL in Mainland for MHKL are likely to be regarded as a PE (Mainland-Hong Kong Double Taxation Arrangement (DTA)). If MHKL is considered having created a PE in Mainland China, 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.

Part 3

MHKL would be subject to enterprise income tax for the consultancy 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 2021 – 30 September 2021	92 days (31+31+30)
Staff B	1 December 2021 – 28 February 2022	90 days (31+31+28)
		59 days (1 January 2022 to 28 February 2022) = 31 + 28 = 59 days)
Staff C	15 August 2022 to 31 December 2022	139 days (17+30+31+30+31)
		108 days (15 August 2022 to 30 November 2022= 17+30+31+30= 108 days)

For the 12-month period from 1 July 2021 to 30 June 2022 (Period 1), the total servicing days are 182 days, being (92+90).

For the 12-month period from 1 December 2021 to 30 November 2022 (Period 2), the total servicing period are 198 days, being (90+108).

For the 12-month period from 1 January 2022 to 31 December 2022 (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 2021 and ended 2022, MHKL have maintained a Service PE in Mainland for both 2021 and 2022 and would be subject to income tax for both years.

Question 2

Part 1

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 transportation income, the source is the place of uplifting of the goods and passengers (DIPN 21). The place of selling the tickets is not relevant for determining the source of the transportation income. The location of the server is also not relevant as what the server has done would not be taken as human operation for determining the source of the transportation income (DIPN 39).

Type A income was derived from Hong Kong and chargeable to profits tax, while Type B income was derived outside Hong Kong and not chargeable.

According to Article 8, a Hong Kong resident transportation company will only be subject to Hong Kong profits tax unless it solely operates within Mainland China. Such exemption also applies to value added tax in Mainland China. BL did not solely operate within Mainland China. Therefore, it would not be subject to income tax and value added tax in Mainland China.

Part 2

Royalty fee to HL $5 million and sales tax in Country B $500,000

Since the trading profits of BL is taxable, the royalty expense $5 million paid to HL was incurred in the production of assessable profits and deductible under section 16(1). The sales tax $500,000 paid in County B would also be deductible under section 16(1) as it was charged on the gross sales value and hence was incurred in the production of assessable profits. The fact that there is no tax treaty between Hong Kong and Country B would not affect deductibility of the sales tax payment.

The royalty of $5 million paid to HL was for the right to sell goods in Country B. The royalty would be deductible under section 16(1). Thus, the royalty received by HL would be deemed taxable under section 15(1)(ba).

The tax liability to HL for the year 2021/22 is calculated as follows:

	$
Royalty fee	5,000,000
Deemed assessable profit at 100% thereon*	5,000,000
Tax payable before tax reduction @16.5%**	825,000
Tax reduction of 100% capped at $10,000	10,000
Tax payable after tax reduction	815,000

*Under section 21A, the deemed assessable profit is 100% of $5 million. BL and HL are associated corporations, the trademark is owned by HL, which has carried on a business in Hong Kong previously by maintaining a branch in Hong Kong. Under section 20B, BL has the obligation to withhold and pay tax for and on behalf of HL.

**HL would not elect for the two-tiered tax rate and hence will be subject to the normal rate of 16.5%.

$900,000 interest expenses on the bank loan

Interest expense on the bank loan for purchase of a computerized sale system is deductible under ss.16(1)(a), (2)(d) and (2)(e). Restriction under s.16(2A) applies as the loan was secured by overseas listed debentures, which generated non-taxable interest income.

The disallowed amount is calculated as:

$600,000 (non-taxable interest income) x [$20,000,000 (bank loan)/$20,000,000 (overseas debentures) + $10,00,000 (property)] = $400,000.

That is out of the interest expense of $900,000, $400,000 is non-deductible and the remaining $500,000 would be deductible.

PART B

Question 3

Part 1

Development of product design

DHK cannot claim any deduction on the research and development expenses incurred in developing the product design under s16B as the proprietary interest of product design is not vested in DHK.

DHK has developed the product design, but it only received 10% of SOV's royalty income as reimbursement for its research and development expenses incurred in this regard. It seems the payment made by SOV is not at arm's length. Under s15F, a reasonable portion of SOV's royalty income would be deemed attributable and chargeable to DHK. The portion of royalty income attributed to DHK should be commensurate with the function performed, risk assumed, and assets used by DHK.

Change of intention on office building

DHK's original intention of the office building was for trading. At the time of holding the directors' meeting, its intention to hold the property might have changed to long term investment.

Under s15BA, the market value at the time of change of intention would be deemed as taxable trading receipt. That is the value of $110 million would be deemed taxable. The net chargeable amount to DHK would be $10 million ($110 million - $100 million).

The subsequent appreciation in value of the building is a capital gain. Hence, the amount of $200 million would not be taxable to DHK.

The redecoration cost could not be deductible under s16F as the property was originally used for trading and after redecoration it was used as a long-term investment property. The redecoration had put the property into another type of use and s16F would not be applicable. The redecoration cost would be ranked for commercial building allowance, with an annual allowance at 4% on the cost per annum for the year in which the building was put into use and not yet sold.

Part 2

S61B is used to restrict the trafficking of loss companies for purpose of tax avoidance. It disallows losses set-off if the Commissioner of Inland Revenue (CIR) is satisfied that the SOLE or DOMINANT purpose of any change in shareholding in a company was for the purpose of utilising such losses to obtain a tax benefit.

S61B applies if:

1) there is a change in shareholding;
2) the CIR is satisfied that as a direct or indirect result of the changes, profits have been received by or accrued to the company during ANY year of assessment (i.e. not necessarily in the year subsequent to the change); and
3) the utilisation of the loss is the "sole or dominant" purpose of the change in shareholding.

In deciding whether profits have been received, the flow of profits before or after the change will be examined in particular with reference to:

a) nature and conduct of the company's business,
b) income and expenditure patterns,
c) management and control,
d) background of the party to whom shares were transferred.

"Dominant purpose" means the purpose, which outweighs all other purposes combined.

Based on the facts provided, the acquisition of the shares in Brown Ltd by Cheer Ltd may have risk under s61B depending on:

1) whether or not profit arises in Brown Ltd as a result of the change in shareholding; and
2) whether or not the sole or dominant purpose of the acquisition is for utilising the loss of Brown Ltd.

If it can be proved that the acquisition of the 2/3 of shares in Brown Ltd is intended to continue and improve the existing business of Brown Ltd, and there is no profit arising as a result of the acquisition (e.g. change in the nature of business), it can be argued that the sole or dominant purpose of the acquisition is not to utilise the tax loss of Brown Ltd. Any profit attributable to the change in management and control or business strategy or even financial assistance from Cheer Ltd after the acquisition will be considered as commercial reward, not as a result of the share transfer. In the circumstances, losses sustained in the assessments of Brown Ltd in the previous years could be used to set off against the future profits, if any, accrued to Brown Ltd.

It is advisable for Cheer Ltd to obtain an advance ruling on the acquisition proposal in respect of the treatment of the losses brought forward, if it is going to take over the shares of Brown Ltd.

Question 4

Part 1

Loganberry Limited
Profits Tax computation for the year of assessment 2021/22

Basis Period: Year ended 31 March 2022

	HK$	HK$
Net profit before tax		17,000,000
Add:		
Interest expense – Loan-1	400,000	
		400,000
		17,400,000
Less:		
Interest income from Deposit-1	300,000	
Interest income from qualifying debt instruments issued on 1 May 2021 (i.e., after 1 April 2018)	450,000	
Additional deduction for Type B qualifying research and development expenses	2,000,000	
Environmental protection machine	1,000,000	
		3,750,000
Assessable profits		13,650,000
Profits Tax @8.25% x 2,000,000 + 16.5% x (13,650,000 - 2,000,000) = 165,000+1,922,250		2,087,250
Less: Tax reduction (100%, limited to $10,000)		10,000
Profits Tax payable after-tax reduction		2,086,250

Part 2

The interest income from Deposit 1

An interest income derived from a deposit made with a bank in Hong Kong is exempt from payment of profits tax under the Interest Exemption Order. However, there will be no exemption, if the relevant deposit has been used to secure for any borrowing where the condition for the application of section 16(1)(a) is satisfied under sections 16(2)(c), (d) or (e) and section 16(2A) does not apply. Deposit-1 in the case has been used to secure for a bank loan for construction of a shopping mall, which would be put into use in January 2023. The bank loan interest would not be deductible under section 16(1)(a) as it would be capital in nature (see (c) below). Thus, the interest income derived from Deposit-1 would be exempt from profits tax.

The product research expenses

Under section 16B, Type B qualifying research and development expenses are eligible for enhanced deduction, i.e., 300% deduction for the first $2,000,000, and 200% deduction for the amount exceeding $2,000,000. Type A qualifying research and development expenses are 100% deductible, but not eligible for enhanced deduction. The research staff salary and consumables are Type B whereas the research director remuneration is Type A. The additional deduction for Type B expenses is $1,000,000 x 300% - $1,000,000 = $2,000,000.

The interest expenses on Loan 1

Interest on Loan-1 for financing construction of the shopping mall is prohibited from deduction under section 16(1)(a) by virtue of section 17(1)(c) as it was capital in nature (Wharf case). The construction costs including the interest expense would be regarded as qualifying expenditure ranking for commercial building allowance. An annual allowance of 4% on the qualifying expenditure would be deductible under section 18F if BL makes assessable profit (/section 19E if BL sustains allowable loss) for a year of assessment during which the shopping mall is in use and not yet sold by BL.

The repair expenses

Initial repair expense to bring an asset back to operable condition would be capital in nature and non-deductible under sections 16(1) and 17(1) as it was incurred to bring into existence of an asset for the enduring benefit of BL and it was incurred “once and for all” (The Law Shipping Ltd case and British Insulated & Helsby Cables Ltd. case). However, as the acquisition price of the environmental protection machine could be deductible under section 16I, the repair expense which was incurred on provision of the machine should also be deductible under section 16I.

PART C

Question 5

Part 1

Mr Ip
Property Tax Computation

Year of Assessment 2021/22	$
Rent ($16,000 x 11)	176,000
Furniture fee ($1,000 x 12)	12,000
Lease premium ($50,000 x 12/24)	25,000
Repair expense paid by tenant	1,000
Assessable value	214,000
Less: Rates ($2,700 x 4)	(10,800)
	203,200
Less: 20% statutory deduction	(40,640)
Net assessable value	162,560
Property tax at 15%	24,384

Part 2

The lease of an immovable property is subject to stamp duty under Head 1(2). The stamp duty payable is:

On rent portion: ($16,000 x 23) / 2 x 0.5% = $920
On premium: $50,000 x 4.25% = $2,125

Rental deposit and the furniture fee are not included in the stamp duty computation. The duplicate copy is stampable at $5 under Head 4.

The lease must be stamped within 30 days of its execution. For late stamping, the penalty is double the amount of the stamp duty if the delay is not more than 1 month. If the delay is over 1 month but not more than 2 months, the penalty is 4 times the amount of the stamp duty. In any other cases, the penalty is 10 times the amount of the stamp duty.

However, the Collector may remit partly or wholly the penalty payable depending on individual circumstances of each case. In a voluntary disclosure case, if the delay is not deliberate, the Collector will normally adopt the following formula in calculating the reduced penalty, subject to a minimum sum of $500:

Reduced penalty = 14% x Stamp duty payable x (No. of days delayed / 365 days)

Question 6

RL's Office R operation

The relevant rules for RL's Office R:

- RL would be subject to profits tax in Hong Kong if it carried on a business in Hong Kong and derived profits from Hong Kong from such business (s.14).
- RL would be regarded as carrying on business in Hong Kong if it maintained a permanent establishment (PE) in Hong Kong.
- In general, a PE includes a fixed place of business (Schedule 17G).
- Facilities or fixed place of businesses performing merely the following functions would not be regarded as PE:
  (a)
    - storage, display or delivery of goods belonging to the enterprise,
    - maintenance stock of goods belonging to the enterprise solely for storage, display or delivery,
    - maintenance stock of goods belonging to the enterprise solely for processing by another enterprise,
    - purchasing goods, and collecting information or
    - any other activities of the enterprise, AND

  (b)
    - the above activity is of preparatory or ancillary
    - "preparatory" means preparing for essential or significant activity
    - "ancillary" means supporting the essential or significant activity
- Transfer Pricing Rule 2 under s.50AAK would apply to treat a Hong Kong PE of a non-resident person as a separate enterprise for attributing income or loss on an arm's length basis, effective 2019/20.
- The income or loss attributable to a PE will be determined by treating the PE as a separate and distinct entity and by adopting Authorized OECD Approach (AOA).

Application of the rules to RL's Office R

Currently, Office R only performs the delivery function of spare parts, and such delivery function is ancillary in nature to the export sales and no PE exists.

However, if in addition to delivery of spare parts, the fixed place is also used for maintenance or repair of such machinery. The activities then go beyond pure delivery since these after-sale activities constitute an essential and significant part of the services of an enterprise vis-à-vis customers. In such circumstances, Office R would become a PE of RL in Hong Kong.

If RL is treated as maintaining a PE in Hong Kong, profits attributable to such PE based on AOA, would be taxable in Hong Kong.

The relevant rules regarding interest free loan

A related party transaction can be exempt from the TP Rule 1 - s.50AAF, if the actual provision of the transaction is not taken to confer a potential advantage in relation to Hong Kong tax on either of the two affected persons if:

a) the domestic nature condition is met;
b) either the no actual tax difference condition or the non-business loan condition is met; and
c) the actual provision does not have a tax avoidance purpose.

Application of the rules regarding interest free loan

Both RL's Office R and SL's own business are carried on in Hong Kong. Hence, the domestic nature condition is met.

RL's profit attributable to Office R would be deemed chargeable to profits tax in Hong Kong. SL's profits are chargeable to Hong Kong profits tax. The no actual tax difference condition is also met.

SL is not carrying on an intra-group financing business and has applied its own internal fund to finance its interest free loan to RL. The non-business loan condition is met.

Also, there is no indication the interest free loan is made for the purpose to avoid tax.

In view of the above, the provision of interest free loan from SL to RL can be exempt from TP Rule 1 and no imputed interest might be imposed.

Question 7

Part 1

Whether Ms Cheung's income is subject to salaries tax or profits tax depends on whether she provides services under a contract of service as an employee, or under a contract for service as an independent contractor. The question is "Is the person who has engaged himself to perform these services performing them as a person in business on his account?". See Fall v Hitchen.

The factors to consider include control test, economic reality test, integration test, mutuality of obligation test and any other relevant considerations. However, no single test is conclusive. One should apply the totality of facts and get the balance.

Applying these principles, the findings are:

- She is required to perform service to the club and can take outside work only if she is not required to work for the club.
- Although she has her own piano for practice, she uses the piano provided by the club to perform her services.
- She does not hire her own helpers.
- She is paid a fixed monthly fee. There is no financial risk, except that arising in the event of termination of her engagement.
- She has a very limited degree of responsibility for investment and management. All she has invested in are her piano at home and her skills.
- She has no opportunity to profit from sound management in the performance of her task.
- She is obliged to provide services for 20 hours per week, and the club is obliged to provide work and pay her a monthly remuneration.
- She does not hold a business registration, although this factor may not be significant.

Weighing all the above facts together, it is very likely that Ms Cheung has a contract of service, and her income will be chargeable to salaries tax.

Part 2

Bill of the painting

An income or benefit is taxable if it is arising from an employment, it is for services rendered (past, present or future) and it is in money or money's worth. Money's worth means that a benefit is capable of being converted into money (when its resale value is to be assessed); or it represents a discharge by the employer of an employee's personal liability (when the full value of the liability is to be assessed).

Mr Poon purchased the painting and incurred a personal liability of $5,000. Mega has discharged his personal liability by paying the bill on his behalf in recognition of his contribution to the company. This benefit arises from his employment and for his services rendered. The amount of $5,000 is taxable as an income from employment under s9(1)(a). The valuation issue is not relevant as Mega did not provide Mr Poon with the painting directly.

Subscription fees to ACCA and HKICPA

Strictly speaking, the expense is not incurred in the production of assessable income and thus not deductible under section 12(1)(a).

However, the IRD's practice is to allow deduction of one professional membership subscription if the holding of a professional qualification is a pre-requisite of employment and the retention of membership and the keeping abreast of current developments in the particular profession are of regular use and benefit in the performance of the duties.

This concession is applicable to Mr Poon, who is a financial controller and would be required to keep himself abreast of the latest accounting standards and developments in his works. As only one

subscription fee is deductible, the amount that is higher should be claimed, i.e. the annual subscription fee of $2,800 paid to ACCA.

Question 8

To be a valid objection, it must be made in writing with grounds for objection and be received by the CIR within 1 month after the date of the notice of assessment (s64(1)).

Late objection can be allowed by the CIR if the taxpayer has reasonable excuse such as sickness, absence from Hong Kong, etc. (s64(1) proviso (a)).

A taxpayer cannot re-open an assessment which has become final and conclusive which occurs when (s70):

i) no valid objection or appeal has been lodged;
ii) an objection or appeal has been withdrawn or an appeal has been dismissed;
iii) an assessment under objection has been agreed; or
iv) an assessment is determined upon objection or appeal and no appeal or higher appeal is given.

In ZL's case, as the notice of assessment was issued on 28 November 2022, the due date for lodging objection is 28 December 2022. As no valid objection has been lodged during the objection period, the assessment could have been regarded as final and conclusive. It seems there is no reasonable excuse for late objection.

Although a taxpayer cannot re-open an assessment which has become final and conclusive, s70A does provide that if it can be established to the satisfaction of an assessor that the assessment is excessive by reason of:

i) an error or omission in a return or statement submitted; or
ii) an arithmetical error or omission in the calculation of the amount of assessable profits/income or the tax charged

the assessor shall correct such assessment.

The deadline for lodging an "error or omission" claim under s70A is within 6 years after the end of the year of assessment or within 6 months after the service of the notice of assessment, whichever is the later.

The ex-director had overstated BL's chargeable profits by 20% in the profits tax return. The overstatement was done out of the intention for getting a higher amount of bonus. Hence, the overstatement was a deliberate act and thus there was no error or omission made in the return submitted (Moulin Global Eyecare Trading Ltd (in liquidation) v CIR (2014) refers).

In Moulin Global Eyecare Trading Ltd case, it was held by the Court of Final Appeal that:

- the conduct of the fraudulent directors was attributed to the taxpayer; the company was deemed to have knowledge about the false accounts and incorrect returns, are therefore not having a reasonable cause that has prevented it from lodging an objection in time,
- submission of the incorrect tax returns was a deliberate act and could not be an error within the meaning of s.70A

The assessment of ZL was raised based on the return filed. There was no arithmetical error or omission in the calculation of assessable profits. Hence, the "error and omission" claim would not be accepted by the IRD.