Answer-to-Question-_1_

(1)

Hong Kong profits tax's chargeability is determined according to the Inland Revenue Ordinance ("IRO"), where section 14(1) states that a person carrying on trade, business or profession in Hong Kong is chargeable to profits tax for the profits derived from or arisen in Hong Kong (excluding capital gains).

Based on the facts given, Muffin HK Ltd (MHKL) was incorporated in Hong Kong and it carries on a business in distributing dairy products in both Hong Kong and mainland China. As such, it is considered "carrying on trade/business in Hong Kong", satisfying the first condition of section 14(1) of the IRO.

To determine the locality of the sales income, the Inland Revenue Department ("IRD") of Hong Kong uses the "contract effected test" as guided by DIPN No 21 (Revised) for sales profits being a kind of trading profits. No apportionment is allowed. In the simplest understanding, if either one of an entity's contract of purchase or contract of sales is effected in Hong Kong, the relevant sales profits will be fully subject to Hong Kong profits tax.

It is worth noting that in MHKL's case, its related PRC-incorporated company Ready China Ltd (RCL) is responsible for attracting business and negotiating with customers in mainland China on MHKL's behalf. Therefore, MHKL's contracts of sales to customers in mainland China are in fact effected outside Hong Kong (i.e. in mainland China).

Then we have to consider the contracts of purchase as well. As given, MHKL purchases products from Japanese and Korean suppliers. Specifically, purchase orders are sent from MHKL's Hong Kong office via email. Although the overseas nature of the suppliers may suggest that MHKL's contracts of purchase are effected outside Hong Kong, the IRD may consider the fact that MHKL's staff can place purchase orders without having to travel as an indicator of the contracts of purchase being effected in

Hong Kong.

With reference to the analysis above, notwithstanding that the contracts of sales to customers in the mainland is outside Hong Kong, since the contracts of purchase is likely to be considered as being effected in Hong Kong, MHKL's sales profits arising from customers in mainland China will be fully taxable to Hong Kong profits tax.

(2)

Based on the facts given, Ready China Ltd (RCL) attracts business and negotiating with customers in mainland China for Muffin HK Ltd (MHKL). This kind of the arrangement may trigger the formation of an agency permanent establishment ("PE") in mainland China. According to Article 5 of the China and Hong Kong Avoidance of Double Taxation Arrangement ("HK/PRC DTA"), a person exercising an authority to conclude contracts on behalf of an enterprise in one side will make the enterprise regarded as having a PE in that side. The fact that RCL is given the authority to conclude sales contracts makes it a general agent of MHKL instead of an independent agenet. As such, MHKL's sales profits arising from customers in mainland China will be taxable to mainland China's Enterprise Income Tax through this agency PE.

As a PE is created, MHKL cannot reply on Article 7 of the HK/PRC DTA to claim nil taxable income in mainland China. Therefore, sales profits derived from RCL's general authority as MHKL's agent will be subject to mainland China's Enterprise Income Tax. If the PE does not have a set of financial statements that give a true view of the state of affairs for determining profts, the tax authority in mainland China is able to use other customary methods to determine taxable profits for the PE (as explained in DIPN No 44, para 62). That said, expenses that are incurred for the purposes of producing the relevant sales profits will be generally allowed to be tax-deductible.

On a side note, MHKL may be able to rely on Article 21 of the HK/PRC DTA to receive tax relief benefits. Further explained in DIPN No 44, if a qualifying income is subject to tax in mainland China and the same income is subject to tax in Hong Kong, the mainland China tax paid will be credited against the Hong Kong tax payable without exceeding the Hong Kong tax payable amount.

(3)

The fact that Muffin HK Ltd (MHKL) makes arrangement to send three marketing managers to provide training to Ready China Ltd (RCL)'s staff in various hotels in Shenzhen and Guangzhou may create a permanent establishment ("PE") in mainland China for MHKL. Unlike the situation of (2), the PE created in this siutation is a kind of service PE. Article 5 of the China and Hong Kong Avoidance of Double Taxation Arrangement ("HK/PRC DTA") states that PE includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, etc. for more than six months within any 12-month period commencing or ending in a taxable year. As such, we need to consider the duration of stay for the three managers.

It is given that Manager A stayed in mainland China from 1 July 2018 to 30 September 2018, Manager B stayed from 1 December 2018 to 28 February 2019 while Manager C from 15 August 2019 to 31 December 2019. Therefore, for the 12-month period from 1 July 2018 to 30 June 2019, MHKL would have staff in mainland China providing training services at a fixed place (i.e. the hotel) for 6 months. Similarly, for the 12-month period from 1 December 2018 to 30 November 2019, MHKL would have staff in mainland China providing training services for 6.5 months. Because of this, a service PE is created in mainland China and the relevant training profits will be Enterprise Income Tax chargeable.

The rest of the tax implication will be similar with (2), where all profits attributable to MHKL's PE in mainland China so created will be chargeable to Enterprise Income Tax under the HK/PRC DTA with relevant expenses being tax deductible. MHKL may also rely on Article 21 to claim tax credit against Hong Kong profits tax chargeable on the same income not exceeding the amount of Hong Kong tax payable.

---------DO-NOT-EDIT-THIS-DIVIDER----------

Answer-to-Question-_2__

(1)

The net royalty income of $2 million is derived from $3 million paid to Avocado UK Ltd (AUKL) for the right to use a trademark being subtracted from the $5 million proceeds received from Carrot China Ltd (CCL) as sub-licencing income.

To determine whether the net amount of $2 million is taxable to Hong Kong profits tax, we have to refer to DIPN No 49 para 72 to 76. It is stated that in a case where a taxpayer only obtains a licence to use an intellectual property right and then sub-licences the right to another party for use outside Hong Kong, the Inland Revenue Department ("IRD") will take the place of acquiring and granting the licence as the place for ascertaining the source of income.

It is given that Banana HK Ltd (BHKL) negotiated and concluded the relevant licence contracts with CCL in Hong Kong. As such, the place of acquiring and granting the licence will be considered to be in Hong Kong. Thus, the sub-licensing income earned by BHKL from CCL of $5 million is taxable to Hong Kong profits tax under section 14(1) of the Inland Revenue Ordinance ("IRO") for it being Hong Kong-sourced.

Following the logic above, the 3 million BHKL paid to AUKL to get the right to use a trademark will be tax deductible since it is incurred in the production of assessable profits, pursuant to section 16(1) of the IRO.

On a side note, the 3 million earned by AUKL will be caught by the IRD as deemed receipt under section section 15(1)(b) and section 15(1)(ba) for the profits being Hong Kong-sourced even though AUKL does not carry on a business in Hong Kong. BHKL has the withholding responsibility pursuant to IRO's section 20B(3).

(2)

Section 14(1) of the Inland Revenue Ordinance ("IRO") states that any person carrying on a trade, business or profession in Hong Kong should have their profits derived from or arisen in Hong Kong chargeable to Hong Kong profits tax. Theoretically, since Banana Hong Kong Ltd (BHKL) carries on a business in Hong Kong, its interest incme earned from its deposit account in Hong Kong should be Hong Kong profits tax chargeable. The determination of source of interest income follows the "provision of credit test" of DIPN No 13(Revised).

However, as a special exemption under Exemption from Profits Tax (Interest Income) Order 1998, interest income from any deposit placed within an authorised institution in Hong Kong which is accrued to a taxpayer on or after 22 June 1998 is exempt from profits tax. As such, the $80,000 interest income earned from a bank deposit in Hong Kong is non-chargeable to Hong Kong profits tax. This does not matter whether or not the deposit is used to secure any loan.

For the $2 million capital gain, we once again need to consider the nature of the profits. Section 14(1) of the IRO specifically excludes capital gains from being charged to Hong Kong profits tax. Therefore, as long as BHKL is able to satisfy the Inland Revenue Department ("IRD") that the Australian property was not held for trading purposes, the gain on disposal will not be taxable in Hong Kong. Even if the IRD considers that the property was held for too short (i.e. 2 years) before it was disposed of and considers the disposal receipt to be revenue in nature, it is unlikely that the disposal gain is taxable to Hong Kong profits tax. DIPN No 21 (Revised) has a location test for income arising from sales of real estate. Since the property involved is located in Australia, the disposal gain should be offshore-sourced and non-taxable in Hong Kong.

(3)

When Banana HK Ltd (BHKL)purchased the intellectual property ("IP") right from Avocado UK Ltd (AUKL), such amount is non-deductible in Hong Kong profit tax for it being a capital expense pursuant to section 17(1)(c) of the Inland Revenue Ordinance ("IRO"). Although section 16EA(2) of the IRO provides specific deduction on a 5-year installment on the purchase of IP rights, since AUKL is a subsidiary of BHKL, no deduction in this respect will be allowed under section 16EC(2) of the IRO. Becauase no deduction is claimed at the initial purchase of the IP right, the subsequent gain from sales of $300,000 and proceeds of $2,300,000 is not chargeable to Hong Kong profits tax for them being capital in nature pursuant to section 14(1) of the IRO.

The $500,000 feasibility study costs however may be able to be claimed deduction for under section 16B of the IRO. The study costs will be classified as research and development costs and must be untaken by an approved research institute satisfying the condition of section 16B(4) and related to trade in order to be deductible before Hong Kong profits tax.

(4)

Interest expenses incurred in the production of assessable profits to Hong Kong profits tax are normally tax deductible under sectin 16(1)(a) of the Inland Revenue Ordinance ("IRO") but they are subject to various conditions.

For Loan 1, $100,000 was paid as interest expense on a loan borrowed from Avocado UK Ltd (AUKL). The loan was for the purchase of machine and is therefore regulated by section 16(2)(e). However, since the loan was borrowed from AUKL, which is considered an associate under the IRO, the entire interest expense for loan 1 is therefore non-deductible before Hong Kong profits tax.

For Loan 2, $240,000 is the interest expense paid to a bank loan . This is regulated by section 16(2)(d) where money was borrowed from a bank regardless of it being a Hong Kong bank or an overseas bank. Since section 16(2)(d) is satisfied, we move forward to the secured-loan test in section 16(2A) and interest flow-back test of sections 16(2B) and 16(2C). The interest flow-back test is however irrelevant to this case.

Based on the secured-loan test, full deduction of interest may not be obtained and shall be reduced by an amount calculated in the most reasonable and appropriate basis if the payment of any sum by way of principal or interest in respect of the money borrowed is secured or guaranted by a deposit or loan made by the borrower or an associate of the borrower to the lender.

In this case, AUKL secured BHKL's loan with its UK bank deposit of $2 million, generating $200,000, a UK property of $2 million, generating $80,000. Given that AUKL's deposit interest income and rental income are UK-sourced and non-taxable to Hong Kong profits tax, at least $280,000 of the interest expense generated by BHKL under loan 2 will be non-deductible. Therefore, the interest expense for Loan 2 is entirely non-deductible (for $280,000>$240,000).

---------DO-NOT-EDIT-THIS-DIVIDER----------

Answer-to-Question-_3__

(1)

The new rules being referred to is the Inland Renvenue (Amendment) (No. 6) Bill 2017 ("the Bill"). The Bill is applicable to the transactions made between EHKL and ROL.

Included in the Bill, Rule 1 regulates the arm's-length principle for provision between associated persons. In EHKL and ROL's case, the Inland Revenue Department ("IRD") is likely to not be able to find their transaction being coherent with any domestic nature condition. Since ROL is located in a country where the tax rate is significantly lower than Hong Kong's, there will be tax differences created if profits are largely shifted to ROL. Under this scenario, the Bill will catch BHKL and RCL and demand ROL to pay a compensating adjustment.

Also, the Bill has a Rule 2, where the IRD will use the separate enterprises principle for attributing income or loss of non-Hong Kong resident person. In this case, ROL's PE in Hong Kong and RCL's head office in Country A will be treated as two separate entities when the IRD tries to quantify ROL's compensating adjustment payable to Hong Kong. This is effectively from the year of assessment 2019/20.

Given that EHKL and ROL have frequent related party transactions, if EHKL's total revenue exceeds HK$400 million or if the annual consolidated group revenues of the EHKL group exceeds HK$6.8 million, EHKL is liable to prepare a master and local files within 9 months after the end of its accounting period and to file a CbCR return pursuant to the requirement of the Bill. This is applicable to accounting periods after 1 January 2018.

(2)

Before the new rules become effective, the Hong Kong Inland Revenue Department ("IRD") can rely on the existing provisio in the Inland Revenue Ordinane ("IRO") to deal with transfer pricing.

First, the IRD can rely on section 61 if it considers that ROL is not operating on a reasonable commercial basis and the transactions involving it are artificial and ficticious. Also, section 61A can be relied upon if the IRD considers the transactions between EHKL and ROL to be for the sole or dominant purpose of obtaining a tax benefit. Upon the breach of the 2 provisio, the IRD has the power to disregard the transactions (for section 61 breach) and impose additional tax assessment (for section 61A breach).

Also, the IRD may choose to raise assessment on ROL even though it is a non-resident not deriving assessable profits in Hong Kong. This authority is given by section 20(2) where the non-resident will be deemed to be carrying on business Hong Kong. The IRD will use this authority when it suspects ROL is producing less than ordinary Hong Kong-sourced profits.

---------DO-NOT-EDIT-THIS-DIVIDER----------

Answer-to-Question-_5__

The tax implications are as follows.

(i) Proposed acquisition of WSL

The acquisition of WSL may be questioned by the Inland Revenue Department as being for the sole or dominant purpose of obtaining a tax benefit since WSL has accumulated a large tax loss of $20 million that can be credited against future tax payment. This seems to be further supported by MGL's plan to further reduce its selling prices to WSL by 30%, where the arm's length principle of transfer pricing is at risk. The IRD will question what the commercial role of WSL is in the MGL's group.

Therefore, if MGL proceeds with the acquisition plan above, the IRD may use the authority of section 61A of the Inland Revenue Ordinance ("IRO") to revise MGL's selling prices back to the pre-acquisition selling prices or to prices comparable to the market. Also, the $20 million plus the $5 million possible tax-deducitble bad debt expense may be forfeited.

(ii) Establishment of the new overseas sourcing company

Based on the facts given, MGL is going to set up a new overseas sourcing company where overseas suppliers will first sell products to the new company and the new company will charge a 30% mark-up to MGL. This arrangement may be considered "articial and ficticious" without actual commercial purpose under section 61 of the IRO. The IRD must be convinced that the new overseas sourcing company has actual commercial operation, e.g. storing goods and monitor their conditions before re-sales to MGL. Otherwise, if the new company is just a "stopping point" for the goods to shift part of MGL's profits to a regime of a lower tax rate, the IRD will use the authority of section 61 of the IRO to disregard the transaction and treat the sales arrangement as though MGL purchases goods directly from the overseas suppliers. If this really turns out to be the case, the MGL group will have to pay both Hong Kong profits tax and income tax in Country A.

Also, the 30% mark-up is questionable. The IRD may question whether such a mark-up is at arm's length. If not, it will use the authority of section 61A of the IRO to bring the mark-up back to a percentage comparable to the market, which will lead to additional assessment to MGL's Hong Kong profits tax liability.

---------DO-NOT-EDIT-THIS-DIVIDER----------

Answer-to-Question-_6__

Tax advice for Ms Murdock regarding the captioned fringe benefits are as follows.

(i) a domestic helper

This is a kind of payment to third parties. Ms Murdoch should be aware that the liability test will follow. If the domestic helper signs a contract with the employees of THKL and THKL will refund the employees, such fringe benefits are taxable. However, if THKL directly signs the contracts with the domestic helpers where THKL bares the sole and primary liability, such fringe benefits enjoyed by the employees are not taxable.

As such, contracts with domestic helpers should be signed by THKL.

(ii) a low interest loan

Interest-free and low interest loans are accepted as non-taxable benefits as it is the sole liability of the employer and it is not convertible to money.

(iii) an education allowance

An education allowance is convertible to money and the employer cannot restrict the use of that actual money in the hands of the employers. As such, this allowance is taxable.

To be tax efficient, THKL should directly be the debtor of the employees' education expense, instead of giving reimbursement to the employees. If education expense is directly settled by THKL, they are not taxable.