THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2025

MODULE 2.04 – HONG KONG OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

If the operation in the Mainland is carried out through an agent or any person who acted on its behalf, the operation of the agent or the person (Fantastic Trading Agency Ltd (FTAL) in this case) should be considered as part of the operation of ML. All income and expenses of the agent/person related to the operation done for and on behalf of ML will be aggregated to ML's account. For Hong Kong profits tax purposes, if the Inland Revenue Department ("IRD") is satisfied that the profit attributable to the operation in the Mainland is sourced outside Hong Kong, the profit will not be subject to Hong Kong profits tax. If the profit is not subject to Hong Kong profits tax, the expenses incurred in the production of the profit will not be deductible (S. 16(1)).

The 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.

As ML is engaged in a trading business, the IRD would generally regard the determining factor as where the contracts for purchase and sale are effected. Moreover, relying on the Magna's decision, the IRD expresses in DIPN 21 that "the totality of facts must be looked at in determining what the taxpayer did to earn the profit".

It is the IRD's practice that if either the purchase contract or sale contract is effected in Hong Kong; the initial presumption will be that the profits are fully taxable. Where the commodities are purchased from a Hong Kong supplier or manufacturer, the purchase contract will usually be taken as having been effected in Hong Kong.

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

DIPN 21 states that normally the activities of an agent or a person who acted on the principal (the taxpayer)'s behalf are accorded the same weight as that done by the principal. The relevant contracts and other documentary evidence will be necessary to support the claim.

As regards the case, as ML purchased goods from Ruby Medicine Company (RMC) with purchase orders placed from ML's office, the IRD will take the view that the purchase contracts are effected in Hong Kong. Also, the strategic marketing function and financing were carried out in Hong Kong. On this basis, the trading profit derived from the sales made by the agent in the Mainland would be initially presumed as sourced from Hong Kong.

ML may rely on the Magna case to argue that the sales activities done by the agent in the Mainland are more immediately responsible for 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. However, it may be hard to convince the IRD to accept this argument because the IRD mentions in its DIPN 21 (2009) that it applies "the totality of facts" approach to ascertain source of profits. It explains that the term "totality of facts" should mean no more than having regard to all the relevant factual "operations" of a transaction to decide the locality of the source of profits.

Part 2

ML carried on business in Hong Kong; the interest income derived from the loan to RMC will be taxable if the interest was derived from Hong Kong (s.15(1)(f)).

The "provision of credit test" will be applied to determine the source of interest income from passive loans.

The loan fund was provided to RMC in Mainland. Hence, the interest income was derived outside Hong Kong and non-taxable.

Part 3

A Hong Kong company carried on business in Mainland China through a permanent establishment (PE) will be subject to China enterprise income tax in respect of the profits attributable to the PE at normal income rate of 25%

PE includes a fixed place of business. Also, an agent who habitually concludes contracts in selling goods or plays a principal role leading to conclusion of contract in selling goods for its principle will be regarded as a PE.

The activities done by the agent in the Mainland for ML should be regarded as a “permanent establishment” in the Mainland (Article 5 of the Mainland – Hong Kong Double Taxation Arrangement (DTA), DIPN No. 44) and hence the relevant trading profit is likely to be subject to Income Tax in the Mainland.

Nonetheless, if both Hong Kong Profits Tax and PRC income tax are payable, tax credit is generally available under Article 21 of the Mainland-Hong Kong SAR Double Taxation Arrangement (DTA) and S. 50.

Part 4

ML has rented a training center to provide the services. Therefore, there is a fixed place of business at its disposal in this regard.

ML has provided the services through a PE, i.e, a fixed-place PE.

Even though ML did not provide the services for more than 183 days, there is still a PE in this regard, as there is a fixed place of business, i.e., the training center, at its disposal

The service fee would be subject to China enterprise income tax at 25%.

Part 5

ML being a non-resident company for the purpose of China income tax would be subject to withholding tax on the interest.

The withholding tax rate would be reduced to 7% according to Article 11 of the Mainland-Hong Kong Double Tax Arrangement.

In order to be entitled to the reduced rate, ML must be the beneficial owner of the interest income.

Question 2

Part 1

Hong Kong Profits Tax

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.

Rental fee. The source of rental income from movable property was the place of use of the movable property (DIPN 21). The place where the rental agreement was negotiated and concluded is not relevant. The scientific equipment was used in Mainland China. The rental income should be regarded as derived from a source outside Hong Kong and is non-taxable.

License fee. For royalty income, where the taxpayer acquired the right to use an intellectual property and sub-licensed the right to use it, the source should be the place where the relevant license agreement and sub-license agreement were effected (DIPN 21; TVBI case).

The license fee was derived from Hong Kong and was chargeable as the license and sub-license agreements were effected in Hong Kong. The place of use is not relevant.

China enterprise income tax

The rental fee should be regarded as a royalty fee under Article 12(3) of the Mainland China and Hong Kong DTA. Thus, it would be subject to withholding enterprise income tax in Mainland China at a rate of 7% charged on the gross receipt of the rental fee.

The license fee should also be subject to withholding enterprise income tax at a rate of 7% charged on the gross receipt of the license fee.

Part 2

$5 million license fee to GHL

Deductibility of the fee:

- Since the license fee received from SCL is taxable to BL, the royalty expense $5 million paid to GHL was incurred in the production of assessable profits and deductible under section 16(1).

Taxability of the fee:

- The $5 million royalty paid to GHL was for the right to use the patent in mainland China. The royalty expense paid to GHL would be deductible under section 16(1). Thus, the royalty received by GHL would be deemed taxable under section 15(1)(ba).
- The tax liability to GHL for the year 2023/24 is calculated as follows:

	$
License 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 $3,000	3,000
Tax payable after tax reduction	822,000

*Under section 21A, the deemed assessable profit is 100% of $5 million. BL and GHL are associated corporations. BL had owned the patent before it was assigned to GHL. BL carried on a business in Hong Kong. Under section 20B, BL has the obligation to withhold and pay tax for and on behalf of GHL.

**Assuming GHL 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 the purchase of scientific equipment is deductible under ss.16(1)(a), (2)(d), and (2)(e). Restriction under s.16(2A) applies as the loan was secured by a deposit, which generated non-taxable interest income. The interest income derived from the Hong Kong bank deposit is not taxable to GHL as it did not carry on business in Hong Kong.

The disallowed amount calculated as below:

$600,000 (non-taxable interest income) x
[$20,000,000 (bank loan)/$20,000,000 (Hong Kong deposit) + $10,00,000 (shares)]
= $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

Salisbury Limited
Profits Tax computation for the year of assessment 2023/24
Basis Period: Year ended 31 March 2024

		HK$	HK$
Net profit before tax			17,000,000
Add:			
	Write off of a staff loan (principal)	19,000	
	General provision for bad debts	10,000	
			29,000
			17,029,000
Less:			
	Profits on sale of trademark	300,000	
	1/4 of product design cost	500,000	
	Additional deduction for Type B research and development expenses	1,000,000	
	Environmental protection installation	1,000,000	
			2,800,000
Assessable profits			14,229,000

Part 2

Product research expenses of $1,500,000

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. Staff salaries and consumables are Type B whereas the equipment cost is Type A. The additional deduction for Type B expenses is $500,000 x 300% - $500,000 = $1,000,000.

$20,000 staff loan write-off

Write-off of a staff loan (principal portion) is not deductible under section 16(1)(d) as it was neither a trade debt previously taxed nor money lent in a money lending business carried on in Hong Kong. The interest should have been included as taxable receipt previously and hence written off of the interest should be deductible.

$1 million acquisition cost and $100,000 initial repair expense of the environmental protection installation

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 SL 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 installation could be deductible under section 16I, the repair expense which was incurred on provision of the installation should also be deductible under section 16I.

Question 4

Part 1

The subject arrangement is a sale and leaseback of plant and machinery. It may give rise to an inflated tax deduction to a lessee if the plant and machinery was sold by the lessee to the lessor at an inflated price and leased back to the lessee at a rent based on the inflated value. The lessor would also be entitled to tax depreciation allowance based on the inflated value. In these circumstances, s.39E(1)(a) is applied to deny any initial and annual allowance to a lessor of plant and machinery where, prior to acquisition by the lessor, the plant and machinery had been owned and used (including held the plant and machinery ready for use) by the person which is then become the lessee or an associated of the lessee.

There is an exception for a genuine lease financing case. Under s.39E(a) and (b), initial and annual allowance can still be available to the lessor if (i) the lessor acquired the asset from the lessee at a price not exceeding the price which the lessee (or its associate) paid to the original supplier; and (ii) no initial or annual allowance has been granted to the lessee in respect of the initial acquisition of the same asset. In this regard, the IRO requires the lessee makes a disclaimer in writing to the IRD within 3 months of the initial acquisition of the relevant asset, to disclaim any initial and annual allowance that would otherwise be available to him.

S.39E may not be applicable to MPL's case, if MPL has never used the machines or has never held the machines ready for use. S.39E also not applicable if MPL has not sold the machines to WHL at a price higher than that it paid to the supplier. In addition, s.39E does not operate to deny the lease fee deduction to the lessee. The lease fee deduction can only be denied by invoking s.16(1), s.61 and s.61A.

Part 2

There are two general anti-avoidance provisions in Hong Kong, s.61 and s.61A.

S.61 empowers an assessor to disregard any transaction or disposition if he or she is of the opinion that the transaction reduces or would reduce a taxpayer's liability and the transaction is artificial or fictitious or is not given effect to.

No definition was given in the IRO of the meaning of "artificial" or "fictitious". One has to look at the literal meaning and cases.

In Seramco Trustees v Income Tax Commissioner (1977): A fictitious transaction is one which the parties to it never intended should be carried out. An "artificial" transaction means a commercially unrealistic transaction in D44/92. A transaction cannot be said to be artificial or fictitious if it was in fact carried out (CIR v Douglas Henry Howe (1977)). Given these case law principles, it seems that it is not easy to conclude that a transaction is artificial or fictitious and hence to apply s.61.

Payments of excessive management fee have been disallowed by various Board of Review cases like D61/91, D110/98 and D32/94 under s.16(1). If the assets are sold to the finance company at an inflated price (taxable balancing charge is restricted to allowance previously granted) and leased back at an inflated rental fee, s.16(1) may disallow the deduction of excessive lease fee payment. However, if the lease fee payment is at an arm's length, ss.16(1) and 61 may not be applicable.

Under s.61A, an Assistant Commissioner is empowered to raise an assessment on a taxpayer if he or she, having regard to the seven factors stipulated in the section, concludes that a transaction has been entered into which has the effect of conferring a tax benefit upon a taxpayer, and the transaction was entered into for the sole or dominant purpose of obtaining that benefit. The assessment can be raised (i) as if the whole transaction or part of it had not been entered into or carried out; or (ii) in any other manner considered appropriate to counteract the tax benefit.

To apply s.61A, there must be a tax benefit and the sole or dominant purpose of the transaction is to obtain such tax benefit.

"Tax benefit" is regarded as being obtained if, a tax liability is being "avoided"; a tax liability is being "postponed" or a tax liability is being reduced.

To determine whether obtaining tax benefit is the "sole or dominant" purpose of entering into the transaction, the following seven factors need to be considered:

1) the manner in which the transaction was entered into or carried out;
2) the form and substance of the transaction;
3) the result that, but for the section, would have been achieved by the transaction;

4) any change in financial position of the relevant person as a result of the transaction;
5) any change in the financial position of any person which has any connection with the relevant person as a result of the transaction;
6) whether the transaction has created right and obligations which would not normally be created between persons dealing with each other at arm's length; and
7) the participation in the transaction of a corporation resident or carrying on business outside Hong Kong.

The seven factors are to be considered as a whole, to the extent that they are present, and each factor is not necessarily given equal weight.

In the case, the financing arrangement is to finance MPL's normal business operation. Given the inflated selling price of the machines to be paid by WHL and the inflated lease fee to be paid by MPL, there is risk that the IRD may invoke s.61A. However, if the argument that the main purpose of the finance arrangement is to finance normal business operations can be supported by evidence, arguably s.61A may not be readily applicable to the case.

PART C

Question 5

Part 1

Samson Lau
Property Tax Computation

Year of Assessment 2023/24	$
Rent - old lease ($17,000 x 3)	51,000
- new lease ($15,000 x 7)	105,000
Lease premium ($42,000 x 8/24)	14,000
	170,000
Less: Irrecoverable rent ($17,000 x 3)	(51,000)
Assessable value	119,000
Less: Rates ($2,300 x 4)	(9,200)
	109,800
Less: 20% statutory deduction	(21,960)
Net assessable value	87,840
Property tax at 15%	13,176

Part 2

Under the Inland Revenue Ordinance, employers have several obligations.

- They are required to furnish the employer’s return within a reasonable time as stated in the notice, according to section 52(2).
- Employers must notify the Inland Revenue Department of the employment of an individual no later than three months after the commencement of employment, as specified in section 52(4).
- Additionally, they must notify the Department of the cessation of an employee's employment no later than one month before the cessation, as outlined in section 52(5).
- Employers are also obligated to notify the Department if an employee is departing from Hong Kong for more than one month, no later than one month before the expected date of departure, as per section 52(6).
- Finally, they must retain the employee's money for one month from the filing of the notice of departure, in accordance with section 52(7).

Question 6

Part 1

If the compensation or any part thereof is for loss of profit for the nine months or temporary loss of capital assets, such amount should be taxable since such compensation will be treated the same way as the profits it replaces, i.e., trading in nature (Burmah Steam Ship Co Ltd case).

If the compensation or any part thereof is for permanent damage to the factory, such compensation should be capital in nature and hence not taxable (Glenboig Union Fireclay Co Ltd case).

If the compensation or any part thereof is for the repairs expenses incurred by WL, such compensation should be used to set off against the expenses incurred by WL, with the balance of the repair expense not covered by the compensation being tax deductible.

The portion of the legal and professional fees attributable to the portion of the compensation, which is capital in nature, would NOT be deductible under s17(1)(c), being capital in nature.

The portion of the legal and professional fees attributable to the portion of the compensation, which is trading in nature, would be deductible under s16(1), being incurred in the production of chargeable profits.

The income tax paid in Country A of $450,000 would not be deductible under s16(1) because it was NOT incurred in the production of the chargeable profits, but was incurred after the production of the chargeable profits.

S16(1)(c) also does not apply to the income tax because it was charged on a net profit basis, rather than on the gross amount received. Hence, the income tax was NOT a “specified tax” as required by s16(1)(c), and thus not deductible.

Part 2

Chan & Co
Depreciation allowance for production machine (30%)
For the year of assessment 2023/24

	$	$	
Cost (400,000 + 54,000)	454,000		
Less: Initial allowance			
(54,000 +100,000 + 20,000* x 6) x 60%	(164,400)	164,400	
	289,600		
Less: Annual allowance	(86,880)	86,880	
WDV carried forward	202,720	251,280	(2023/24)

*Being cash price less down-payment, then spread over 15 instalments = ($400,000 -$100,000) / 15 = $20,000

The hire-purchase interest of ($24,000 – $20,000) x 6 = $24,000 was deductible under sections 16(1)(a) and (2)(e).

Question 7

Industrial building allowance on Factory 1

	$
Deemed qualifying expenditure	1,200,000
Less: Initial allowance (20%) – 2022/23	(240,000)
Annual allowance (4%) – 2022/23	(48,000)
W.D.V. as at 31.12. 2022	912,000
Additions (building extension) – 2023/24	300,000
	1,212,000
Less: Initial allowance (20%) – 2023/24	(60,000)
Annual allowance (4%) – 2023/24 ($1,200,000 + $300,000) x 4%	(60,000)
W.D.V. c/f	1,092,000

Notes:

1) Payments to existing tenants do not quality as capital expenditure on construction – see *D5/79*.

2) As the factory was purchased unused from the developer (whose main business was developing properties for re-sale purpose), the deemed qualifying expenditure as per s.35B should be the purchase price of the building. However, the purchase price of $4 million comprising both the amount paid for the building as well as the land. As a practice, such price will be apportioned (in this case by the cost of construction in proportion to the total costs) to get the price paid for the building as follows:

   $4,000,000 x $900,000 / $3,000,000 = $1,200,000

3) The upper floor is also an industrial building because it was used for research and development related to the drug manufacturing business.

4) The cost of replacing the roof qualifies for deduction as a repair. The roof is, *prima facie,* part of the building and not a separate entirety in itself. Furthermore, the new roof should not be classified as an “improvement” even though different material was used.

Industrial building allowance on Factory 2

	$
Cost of construction	1,100,000
Less: Initial allowance (20%) – 2023/24	(220,000)
Annual allowance (4%) – 2023/24	(44,000)
W.D.V. c/f	836,000

Total IBA for Y/A 2023/24:
$60,000 + $60,000 + $220,000 + $44,000 = $384,000

Question 8

Peter Alexander
Computation of Total Assessable Income
Year of Assessment 2023/24

	$	$
Annual salary		1,200,000
Home-leave travelling allowance		50,000
Entertainment allowance		100,000
Child education subsidy		60,000
Private hospital room ($40,000 x 1/2)		20,000
Club subscription		18,000
		1,448,000
Assessable income under time-apportionment*		
($1,448,000 x 182.5 / 365)		724,000
Hong Kong salaries tax paid by employer		101,000
		825,000
Rental value (4% x $825,000)	33,000	
Less: rent suffered ($140,000 x 5%)	(7,000)	26,000
Share option assigned ($40,000 – $2,000)	38,000	
Share option exercised [(30,000 x ($8 – $5)) – $3,000]	87,000	
	125,000	
Apportioned on the number of days: $125,000 x 182.5/365		62,500
Total assessable income		913,500

* No. of days in Hong Kong:
175 days + [15 days x 175/(365 – 15) days] = 182.5 days