Answer-to-Question-_1_

1. To evaluate the Hong Kong ("HK") Profits Tax ("HKPT") position of CHKL on the consultancy fee income received from the client in China, the main issue is whether the profits (i.e., the consultancy fee income) have arisen in or been derived from HK, i. e., sourced in HK.

The broad guiding principle for determining the source of profits is that "one looks to see what the taxpayer has done to earn the profit in question and where he has done it" (Hang Seng Bank case 1990).

In order words, the proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place.

The transactions must be looked at seperately and the profits of each transaction considered on their own.

The relevant operations do not comprise the whole of the taxpayer's activities carried out in the course of business but only to those which produce the profits in question.

In this regard, notwithstanding that CHKL received the service order via email, processed and aceepted in HK. However, the relevant operations which produce the service fee income were the consultancy services itself and these consultancy services were provided by the IT managers in the client's office in China. Other activities carried out in HK should be considered as incidental. In this regard, CHKL's consultancy fee income

received from the client in China should be sourced in China and not taxable in HK.

However, the Inland Revenue Department ("IRD") might argue that part of the activities carried out in HK was crucial to the production of the captioned fee income and seek to apportion part of the fee income to be sourced in HK and taxable in HK.

2. In accordance to the DTA between HK and China, CHKL, as a HK resident, would only be subject to China Enterprise Income Tax ("EIT") if it has a permenent establishment ("PE") in China.

According to Article 5.3 of the DTA between HK and China, the term PE also emcompassess the furnishing of services, including consultancy services, by a HK enterprise (i.e. CHKL) in China, through employees engaged by CHKL, but only if such activities continue for a period or periods aggregating more than 183 days within any 12 month period.

For CHKL's case, CHKL sent IT managers to provide consultancy services in China from 1 July 2022 to 31 December 2023, we need to count the days within any 12 month period.

From 1 July 2022 to 30 June 2023: 182 days
From 1 December 2022 to 30 November 2023: 197 days
From 1 January 2023 to 31 December 2023: 197 days

Based on the above, CHKL is considered as having a PE in China in year 2022 and 2023, and the relevant consultancy fee income should be subject to PRC EIT.

3. For the dividend income received from SL, it is either sourced outside HK (if SL's operations are carried out wholly outside HK) or exempt under S26(a) and thus not subject to HKPT.

According to Article 10 of the DTA between HK and China, dividend paid by SL to SHKL may be taxed in China, but capped at 10% or 5% if SHKL directly owning 25% of the capital of SL, assuming SHKL is the beneficial owner to the dividend income. To be eligible for the 5% rate, there is also a requirement that the 25% shareholding threshold be met at any time throughout the 12 month period preceeding the entitlement to the dividends.

As SHKL held 30% of shares in SL from 1 January 2021 to 31 December 2022, the $1 million dividend received on 31 December 2022 would be subject to PRC EIT at 5%, assuming SHKL is the beneficial owner to the dividend income.

Since 1 January 2023, SHKL only held 20% of SL, the $500,000 dividend received on 31 December 2023 would be subject to PRC EIT at 10%.

As HK does not tax the dividend income, there is no double taxation on the dividend income even PRC imposes EIT on them. There is no tax credit claim available.

Answer-to-Question-_2__

1. To evaluate the HKPT position of BL on the royalty incomes received from SCL, the main issue is whether the profits (i.e., the royalty incomes) have arisen in or been derived from HK, i. e., sourced in HK.

The broad guiding principle for determining the source of profits is that "one looks to see what the taxpayer has done to earn the profit in question and where he has done it" (Hang Seng Bank case 1990).

For Type A royalty, as the know-how was created or developed by BL in HK, the royalties so derived will generally be regarded as HK sourced and subject to HKPT according to DIPN No. 22. The places of use and where the license agreement was negotiated and concluded, notwithstanding both in China, are irrelevant. As such, the $10 million Type A royalty received by BL is sourced in HK and subject to HKPT.

For Type B royalty, as the know-how was licensed to BL and sub-licensed to SCL, according to HK-TVBI case, the transactions which produced the profits should be the acquisition of the rights and the actual granting of the sub-licence. The license agreement with HL on acquisition of the rights was negotiated and concluded in HK while the license agreement with SCL on actual granting of the sub-licence was also negotiated and concluded in HK, the $15 million Type B royalty received by BL is sourced in

HK and subject to HKPT. The place of development (Country B) and the place of use (China) are irrelevant in this case.

According to Article 12 of the DTA between HK and China, royalty paid by SCL (a Chinese resident) to BL (a HK resident) may be taxed in China, but capped at 7%, assuming BL is the beneficial owner to the royalty income. The term "royalties" includes information concerning industrial, commercial and scientific experience.

In this regard, the $25 million royalty income received by BL would be subject to PRC EIT at 7%. Tax credit can be claimed in accordance with the DTA between HK and China and section 50 of the IRO.

2a. Type B know-how acquired from HL is used both in HK and China, while the type B royalty received from SCL is taxable. The royalty expenses of $5 million paid to HL are thus deductible under S16(1) of the IRO as they are incurred in the production of BL's assessable profits. The VAT of $500,000 paid by BL in Country B should also be deductible under S16(1) of the IRO as it was charged on the gross amount instead of net profits. The fact that HK and Country B does not have a DTA does not affect the deductibility of the VAT.

As the royalty expenses of $5 million paid to HL are deductible, the $5 million received by HL would be deemed taxable under S15(1)(ba) of the IRO. According to S21A of the IRO, the taxable income of HL on the royalty income received from BL is 100% of the sum as BL and HL are associates (HL held 100% of shares in BL), while HL has carried on a business in HK through a branch

before.

The HKPT liability of HL on the royalty income received from BL is as follows:

Royalty received $5 million
Tax at 16.5% $825,000
Less: Tax reduction $6,000
Tax payable $819,000

According to S20B, BL, as the payer of the royalty to a non-resident, has the obligation to withhold and pay the relevant tax for and on behalf of HL.

2b. As the interest expense is in relation to a bank loan for purchasing scientific equipment, it is deductible under S16(1)(a), S16(2)(d) and S16(2)(e) of the IRO. However, as the bank loan was secured by a bank deposit placed by BL's parent in an overseas bank which generate interest income not subject to tax in HK, the interest expenses deduction is limited under S16(2A) of the IRO. The limitation is as follows:

$600,000 x $20,000,000 / ($20,000,000 + $10,000,000)
=$400,000

So $500,000 of the interest expenses can be deductible.

Answer-to-Question-_3__

1. Profits Tax Payable for 2022/23

Profits before Tax	$17,000,000
Add: Non-deductible interest expenses - Loan 2	$400,000
Forfeited deposit	$100,000
Assessable profits	$17,500,000
Tax thereon ($2,000,000 x 8.25%)	$165,000
($15,500,000 x 16.5%)	$2,557,500
	$2,722,500
Less: Tax reduction	$6,000
Tax payable	$2,716,500

2.

a) As SL entered into a series (instead of only one) of one month (short-term instead of long-term) fixed deposit transactions with the same bank in order to earn the exchange gain of $230,000 in the anticipation that the Chinese renminbi would appreciate in value against the HK dollar. With the intention of earning short-term profits from the appreciation of Chinese renminbi, the captioned exchange gain should be considered as revenue gain

instead of capital in nature and thus subject to HKPT.

b) As Loan 1 was borrowed from a bank and for the generation of the taxable exchange gain of $230,000, it should be deductible under S16(1)(a) and S16(2) of the IRO. Section 16(2A) of the IRO does not apply as the interest income on the bank deposit used as security for Loan 1 would be subject to HKPT. There is no clue that there is any interest flow back arrangement and thus S16(2B) does not apply.

c) Interest income derived by a non-financial institution from any deposit placed in HK with an authorised institution is generelly exempt from HKPT, regardless of the currency in which the deposit was denominated. However, the exemption is not applicable to interest income received from any deposit used to secure or guarantee money borrowed, whose interest expenses are deductible under S16(1)(a) and S16(2) of the IRO. Taxpayer cannot give up interest expense deduction and claim interest income exemption.

As the bank deposit was used as security for Loan 1, which is deductible under S16(1)(a) and S16(2)(d) of the IRO, the captioned bank interest income of $75,000 is taxable, being placed with a HK bank and thus sourced in HK and the above exemption does not apply.

d) As Loan 2 was borrowed for the construction of a research laboratory, the interest expense on such a loan is capital in nature and not deductible under S16(1)(a) and S16(2) of the IRO. However, the interest expense, together with the construction costs of $4.6 million, is eligible for 4% annual commercial

building allowances when it is put into use in January 2023. No deduction is allowable under Section 16B in respect of any capital expenditure incurred on land or buildings.

As the interest expense on Loan 2 is not deductible under S16(1)(a) and S16(2) of the IRO, the security provided by UL is not relevant.

Answer-to-Question-_5__

Rental income (Helen, April to June)	$45,000
Rental income (Justin, Aug to Mar)	$144,000
Lease premium ($60,000 / 24 x 9)	$22,500
Repair expenses by Justin	$800
	$212,300
Less: Irrecoverable rent ($60,000+4,800-30,000)	($34,800)
Rates ($2,600 x 4)	($10,400)
	$167,100
Less: 20% statutory deduction	($33,420)
NAV	$133,680

Property tax thereon (@15%) $20,052

Answer-to-Question-_6__

SL is a resident of HK and it sells appliances in HK, the trading profits arisen therefrom should be presumptively sourced in HK and subject to HKPT.

RL is a resident in Country R. RL would only be subject to HKPT if it carries on a business in HK. RL would be considered as carrying on a business in HK if it has a PE in HK. There is no double tax agreement between HK and Country R. Therefore, whether RL has a PE in HK would be determined in accordance with Schedule 17G of the IRO.

RL owns a warehouse in HK. According to Schedule 17G of the IRO, a facility used solely for the purpose of storage, display or delivery of goods or merchandise would not be considered as a PE, provided the overall activity is of preparatory or auxiliary character.

However, frementedbusiness activities carried out by RL and SL would be considered together as SL is a wholly owned subsidiary of RL in considering if RL's warehouse is a PE in HK and if Schedule 17G of the the overall activity is of preparatory or auxiliary character. As the warehouse function and SL's business operations are complimentary to each other, RL's warehouse cannot be excluded as a PE in HK. In this regard, income or loss in relation to the operations of RL's PE should be attributed as if RL's PE were a distinc and separate enterprise and account has to

be taken of the functions performed, assets used and risk assumed by the PE (AOA approach).

As both SL and RL's PE are subject to HKPT, and the loan made from SL to RL are not business loan (SL is not an FI or carryiing on intra group financing business) and there is no tax avoidance motive for not charging interest on the loan. The non-interest bearing loan should not be subject to transfer pricing adjustment under Rule 1 in Section 50AAF of the IRO.