THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2021

MODULE 2.04 – HONG KONG OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

AC carried on a materials sourcing business in Hong Kong. The sourcing agency fee would be chargeable to profits tax if it is derived from Hong Kong.

The broad guiding principle in determining source of profits is the operation test: “one looks to see what the taxpayer has done to earn the profits in question and where he has done it” (Hang Seng Bank case, DIPN 21).

Service income is derived from the place where the services are performed (DIPN 21). For AC’s sourcing agency fee from the Chinese customers, the principles laid down in Li and Fung case would be relevant as the fact pattern of AC is similar to Li and Fung. The relevant principles are set out below:

- the direct profit-producing transactions were sourcing and agency activities which AC carried out through its Chinese affiliates.
- The back-up or support services at Hong Kong was merely antecedent or incidental activities.
- The place where the “brains” or decision-makers of a business are located is irrelevant.
- The source of profits should be determined by the nature and situs of the direct profit-producing transactions, and not by where the taxpayer’s business is administered or its commercial decisions taken.

Based on the Li and Fung case’s decision, the sourcing fee income was derived outside Hong Kong and non-taxable.

However, the Inland Revenue Department (IRD) might argue that AC provided logistics management services in Hong Kong (including overseeing operation of the overseas agents). Based on this argument, the IRD would treat the sourcing agency fee income as wholly taxable or at least partly taxable (because part of the services was done by overseas agents).

Part 2

AC did not maintain any fixed place of business in China in relation to provision of the sourcing service. Hence, there is no permanent establishment (PE) in the form of a fixed place at the disposal of AC in this regard.

However, the Chinese affiliates provided the services in the capacity of AC’s agents in China. Assuming that the affiliates were based in China and hence the services provided in China is very likely for a period of more than 183 days during any 12-month period. If this is the case, there would be a servicing PE in China. The service fee income would be subject to China enterprise income tax, and the relevant expense incurred in production of the income would be deductible. However, if the agents are independent agents, there would be no PE in relation to provision of services.

Part 3

The royalty fee received by AC for licensing the patents to SCMC shall be subject to income tax in China at a reduced tax rate of 7% on gross amount of the fee according to Article 12 of the DTA.

The fee received by AC for the rental of the manufacturing machine to SCMC shall also be subject to income tax in China at a reduced tax rate of 7% on gross amount of the rent according to Article 12 of DTA.

However, if the royalty fee and rental fee are derived from properties forming part of assets of AC's PE in mainland China or otherwise effectively connected to such PE in mainland China, these two types of income would be assessed as part of profit of the PE. On the basis that the servicing PE of the sourcing agency services did not take up the economic ownership of the properties from which the royalty fee and rental fee are derived, the reduced withholding rate would apply.

Part 4

AC developed the patent in Hong Kong. Though the patent was used outside Hong Kong, the royalty received from SCMC should be regarded as derived from Hong Kong and subject to profits tax (re: DIPN 22). The EIT paid in China can be credited against the profits tax payable.

AC could claim deduction on the development costs of the patent under section 16B. The staff costs of $2 million would be regarded as a Type B research and development expense and be entitled to an enhanced deduction of 300%. The equipment cost of $1 million would be regarded as a Type A expense and 100% deductible.

The manufacturing machine was used in mainland China and hence the rental fee should be regarded as sourced outside Hong Kong and non-taxable (re: DIPN 21).

AC cannot obtain any deduction of the acquisition costs of the manufacturing machine of $1.5 million used by SCMC in mainland China under section 16G. They are excluded as prescribed fixed assets as they are "leased" assets", that is they are used by SCMC, rather than AC.

Also, there will be no deduction of depreciation allowances under section 39E for the machine because the machine are leased assets and used outside Hong Kong by SCMC, not AC (re: Braitrim (Far East) Ltd case).

Question 2

Part 1

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

There is one tax issue to HL: whether the royalty income received from SL is taxable.

For the taxability of the royalty of $ 5 million received by SL, 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 22 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. SL negotiated and concluded the relevant license contracts with HL and UL in Hong Kong, hence the royalty income of $5 million received from UL was derived from Hong Kong and hence taxable under section 14.

As to the deductibility of the royalty expense, it is analysed as follows. SL used the videos in running its Hong Kong trading business and the trading profit derived therefrom is taxable. The royalty income derived from sublicensing the right to UL is taxable. Since both the royalty income and trading profits of SL is taxable, the royalty expense paid to HL was incurred in the production of assessable profits and deductible under section 16(1). The enterprise 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 HL was for the right to exhibit the videos in Hong Kong and mainland China. The portion of the royalty for exhibiting the videos in Hong Kong should be deemed taxable under section 15(1)(a). The portion of the royalty for exhibiting outside Hong Kong should be deemed taxable under section 15(1)(ba) (Turner Entertainment case held section 15(1)(ba) applies to media works) because such royalty payment is deductible to SL. The tax liability to HL for the year 2019/20 is calculated as follows:

	$
Royalty fee	3,000,000
Deemed assessable profit at 30% thereon*	900,000
Tax payable before tax reduction @16.5%**	148,500
Tax reduction of 100% capped at $20,000	20,000
Tax payable after tax reduction	128,500

*Under section 21A, the deemed assessable profit is 30% of $3 million. Though SL and HL are associated corporations, the copyright of the videos has never been owned by any person carrying on a business in Hong Kong previously. Under section 20B, SL has the obligation to withhold and pay tax for and on behalf of HL.

**SL and HL are connected entities for the purposes of 2-tiered tax rates. Assuming SL will be nominated for the 2-tiered tax rates, hence HL will be subject to the normal rate of 16.5%.

Deposit interest is exempt from payment of profits tax under the Interest Exemption Order. However, there will be no exemption if the deposit has been used to secure for borrowing and interest expenses on such borrowing is deductible by virtue of section 16(1)(a) and section 16(2). As Deposit-1 in the case has been used to secure a bank loan for purchase of trading stock. The bank loan interest should be deductible (see c) below) and hence the deposit interest is still taxable. The overseas deposit interest income was offshore in nature and non-taxable.

Part 2

Interest on Loan-1 (a bank loan) for purchase of trading stock is deductible under section 16(1)(a), 16(2)(d) and (2)(e). Restriction under section 16(2A) is not applicable as the loan is not secured by deposit generating non-taxable interest. Also, section 16(2B) does not apply because there is no flow-back of non-taxable interest income.

Interest on Loan-2 (a loan from supplier) for purchase of a computer system is deductible under section 16(1)(a), (2)(d) and (2)(e). Restriction under section 16(2A) applies as the loan was secured by an overseas bank deposit (Deposit-2), which generated non-taxable interest income.

The disallowed amount is:

$450,000 (non-taxable interest income) x [$5,000,000 (Loan-2)/$5,000,000 (Overseas Deposit) + $2,500,000 (shares)]

= $300,000.

Part 3

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.

PART B

Question 3

Part 1

HCL cannot claim any deduction on the research and development expenses incurred in developing Patent A under section 16B as the proprietary interest of Patent A is not vested in HCL.

HCL has developed Patent A but did not receive any royalty income. Under s15F a reasonable portion of RCL's royalty income would be deemed attributable and chargeable to HCL. The portion of royalty income attributed to HCL should commensurate with the function performed, risk assumed and assets used by HCL.

HCL's original intention of the housing units was for trading. At the time of executing joint venture agreement with the hotel management company, its intention on holding the property has 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 as taxable. The net chargeable amount to HCL would be $10 million ($110 million - $100 million).

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

The redecoration cost could not be deductible under section 16F as the units were originally used for trading and after redecoration they would be used as guesthouses for leasing. The redecoration had put the properties into another type of use and section 16F would be not 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 guesthouses were put into use and not sold.

Part 2

Proposal 1

The object of this arrangement is that the 30% mark-up of the goods sold to SHK by LC will increase SHK's cost of goods sold and thereby reduce its assessable profits. Conversely, LC's profits will be increased by the amount of such mark up. Such an arrangement, which is commonly known as 'transfer pricing', is a profit shifting device whereby parties who are not at arm's length transfer profits from a relatively high tax jurisdiction (in this case, Hong Kong) to a low (or nil) tax jurisdiction (in this case, the country where LC is situated). This proposal might be subject to attack by the Inland Revenue Department (IRD) in a number of ways.

Firstly, under Transfer Pricing (TP) Rule 1 under section 50 AAF, where a non-resident person carries on business with an associated resident person, and the course of such business is so arranged that it departs from the arm's length principle, the profit or loss of resident person could be adjusted. To ensure compliance with Rule 1, an administrative penalty by way of additional tax is provided under sections 82A(1D) and (1F). Specifically, a person who commits an offence is liable to an additional tax not exceeding the amount of tax undercharged. Section 82A(1G) provides that no additional tax under sections 82A(1D) and (1F) should be imposed on a person who proves reasonable efforts have been made to determine the arm's length amount, i.e. based on sufficient documentation

Furthermore, section 61 and section 61A may also operate to defeat the scheme. Alternatively, in cases like this where a deduction will be claimed, the IRD may refuse to allow it under the general provision of section 16 (see Rico Internationale Ltd case and Tai Hing case).

On the facts, particularly in view of the seemingly high profit margin made by LC, it may be difficult to argue that the implementation of the proposal involves bona fide arm's length pricing and that the Hong Kong assessable profits of SHK are comparable with those it would obtain if it purchased the products from an independent supplier.

The mark up received by LC may, however, be justified as being a reasonable one that would be received by a seller acting at arm's length from the purchaser by performing some value-added activities. Specifically, the terms of trade should be altered so that LC undertakes product testing, warehousing, arranging shipments, providing SHK with a suitable interest-free credit period and product warranty, etc. Sufficient documentation should be prepared and retained to justify the transfer prices between LC and SHK.

Proposal 2

Currently, SHK is likely to be exempt from profits tax in respect of the interest income derived from the bank deposit in Hong Kong. After implementing the proposal, the interest income derived by LC from bank deposit in its home jurisdiction might be taxable at 1%. So, it might not be tax efficient to do so.

Also, the interest free loan made by SHK to LC might be subject to challenge of TP Rule 1. The transaction is clearly non-domestic in nature and hence whether it is non-business loan or not does not matter. By applying TP Rule 1, an imputed interest would be imposed by the IRD. Also, under sections 82A(1D) and (1F), penalty tax of not exceeding the amount of tax undercharged might be imposed if there is no sufficient documentary evidence to prove the non-interest-bearing loan is made on an arm's length basis.

PART C

Question 4

Superb Investment Ltd (SIL), which holds the relevant interest of the building, can claim industrial building allowance if the usage of the individual floors can qualify as an industrial building as defined in section 40(1).

Under section 40(1), industrial building or structure means, among other things, any building or structure used for the purposes of a trade which consists of the manufacture of goods or materials or the subjection of goods or materials to any process.

In the present case, Ground floor SIL is not entitled to any industrial building allowance. The dining area was not used for processing nor manufacturing of goods. For the cooking area, the "cooking" activities, even being regarded as "process" were only incidental to the restaurant business of the tenant.

There is no provision in the IRO for making an allowance where only part of a trade qualifies (Tai On Machinery Works Ltd. v. CIR HKTC 411). The whole trade must qualify not just part of the trade.

Also, "cooking" could not be regarded as "process.

""Process" is defined in the shorter Oxford Dictionary inter alia as "a continuous and regular action or succession of actions, taking place or carried on in a definite manner; a continuous (natural or artificial) operation or series of operations. A particular method of operation in any manufacture." (DIPN No. 2(Revised)).

""Process" connotes a substantial measure of uniformity of treatment or system of treatment" (Vibroplant Ltd. v. Holland (1982) 54 TC 658 and CIR v. Aberdeen Restaurant Enterprises Ltd (1988) 2 HKTC 330 refer).

In Vibroplant case, it was held that repairs have no uniformity and were not "process". In Aberdeen case, it was held that cooking was not a "process". "Cooking" has no uniformity and are not continuous and regular actions which are carried on in a definite manner.

First floor SIL is entitled to industrial building allowance as furniture were manufactured in the premises.

In addition, any building or structure used for the purposes of a trade which consists of the storage of goods or materials is also treated as an industrial building or structure, given that the said goods or materials are to be used in the manufacture or process, or the goods and materials are newly arrived in Hong Kong. In addition, it must be noted that the trade itself must be one of storage.

Second floor SIL is not entitled to industrial building allowance as the trade of the tenant is not one of storage since it is only a food trading company. The storage of goods is only incidental to its trade.

Question 5

Part 1

Under section 9(1)(a), chargeable income from any office or employment also includes any perquisite. Benefits-in-kind are taxable only if they arise from office or employment; are awarded for services rendered (past, present or future); and are in “money” or “in money’s worth”, meaning:

- capable of being converted into money (for this case, the second-hand / market value of the benefit is to be assessed); or

- represents a discharge by the employer of a personal liability of the employee (which is equivalent to money, identifiable for an employee, expended for the benefit of an employee per Glynn case) (for this case, the full value of the liability (money expended) is to be assessed).

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 made to a third party (not 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 liability for the relevant payment. With effect from 1 April 2003, all payments by an employer in connection with a holiday journey are also subject to tax, irrespective of whether it is convertible into cash and whether the primary liability for the benefit is the employee’s own. The amount to be assessed is based on the actual amount paid by the employer, instead of the amount to which the benefit would be converted.

Part 2

Provision of a domestic helper

If an employer pays the wages of a domestic helper who provides services to an employee, the payment is tax free if the domestic helper is employed directly by the employer, and the following conditions are also met:

- No person provides a surety (guarantee) for the payment of salaries to the helper; and

- The benefit is not convertible into cash (e.g. the employee cannot forsake the benefit for additional salaries)

But if the employee signs the employment contract with the domestic helper, it is the employer who discharges the employee's own indebtedness and the payment is therefore 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.

Club membership
Where an employer makes a payment in respect of an individual membership fee or other club expense for which an employee is personally liable, the payment will constitute chargeable income of the employee. However, the cost of acquisition of corporate membership of a club will produce no chargeable benefit as the IRD recognises that the entitlement to corporate membership benefits may be transferred from one employee to another and it is not possible to attribute such expenditure to a particular employee.

Child's education fee

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 Inland Revenue Department (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 as the benefit is not derived from employment.

Question 6

To be a valid objection, it must be made in writing with grounds for objection and be received by the Commissioner of Inland Revenue (CIR) within 1 month after the date of the notice of assessment (section 64(1)).

Late objection can be allowed by the CIR if the taxpayer has reasonable excuse such as sickness, absence from Hong Kong, etc. (section 64(1) proviso (a)).

A taxpayer cannot re-open an assessment which has become final and conclusive which occurs when (section 70):

- No valid objection or appeal has been lodged;
- An objection or appeal has been withdrawn or an appeal has been dismissed;
- An assessment under objection has been agreed; or
- An assessment is determined upon objection or appeal and no appeal or higher appeal is given.

In Emma's case, as the notice of assessment was issued on 25 January 2021, the due date for lodging objection is 25 February 2021. 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, section 70A does provide that if it can be established to the satisfaction of an assessor that the assessment is excessive by reason of:

- an error or omission in a return or statement submitted; or
- an arithmetical error or omission in the calculation of the amount of assessable income or the tax charged;

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 assessor shall correct such assessment.

However, the assessment cannot be re-opened for an error or omission in a return or statement where that return or statement was made on the basis of prevailing practice.

The assessment was issued on 25 January 2021. The deadline for lodging the objection should be 25 February 2021. The objection period has lapsed. Unless she could prove she was absent from Hong Kong or she was sick and such absence or sickness has prevented her from lodging objection in time, the late objection would not be accepted by the Inland Revenue Department (IRD).

She had overstated her annual income by 20% in the tax return. The overstatement was done out of the intention for getting a higher amount of tax demand note and payment in support of her immigration application to Country A. 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). The assessment was raised based on the return filed. There was no arithmetical error or omission in the calculation of assessable income. Hence, the "error and omission" claim would not be accepted by the IRD.

Question 7

Interest expense incurred on money borrowed would be deductible if it was incurred for the purpose of production of chargeable profits (section 16(1)(a)), any one condition laid in section 16(2) was satisfied, and not restricted under section 16(2A), (2B) and (2C) as appropriate. However, interest expense of capital nature is not deductible under section 17(1). But specific deduction may apply for capital nature interest expenses if the relevant conditions are satisfied.

The bank loan is borrowed for two purposes. The portion for construction of the laboratory would be capital nature and not deductible under sections 16(1)(a) and 17(1). The portion for financing general working capital would satisfy the requirement of section 16(1)(a).

The $100 million is for construction of the laboratory, the R&D equipment installed therein, and possible environmental protection installation. However, in the quotation there is no breakdown of value attributable to each item. In respect of the construction costs of the laboratory, industrial building allowance would be available. An initial allowance of 20% is available on the qualifying expenditure incurred during the year, and an annual allowance of 4% on the qualifying expenditure is allowable for the year the research laboratory is in use at the end of the year. As to the R&D equipment costs, 100% deduction would be available under section 16B, being Type A R&D expenditure. Also, there would be 100% special deduction for the environmental protection installation made in the laboratory under section 16H-K.

The interest expense attributable to the construction costs of $100 million should be capital in nature and its deduction, if any, will follow the abovementioned treatments for respective items. That is industrial building allowance for the portion attributed to construction of the laboratory, 100% deduction for the portion attributed to R&D equipment and environmental protection installation.

The interest expense attributable to working capital would satisfy section 16(1)(a) and (2)(d). However, restriction under section 16(2A) applies. Hold-Co does not carry on any business in Hong Kong. The interest income derived from the Singapore listed debentures is offshore in nature and non-taxable in Hong Kong. Out of the total interest expense financing working capital for each year, $50 million x 5% = $2.5 million, the amount of interest expenses attributable to the non-taxable interest income should be disallowed for deduction, $50 million x 3% = $1.5 million. In other words, the deductible interest expense for each year would be $1 million only.

To enhance the tax efficiency, the following measures should be considered:

1. The onus of proof is on the taxpayer. To safeguard appropriate deduction, WL should require Beta Construction Company to re-issue another price quotation to allocate the sum $100 million on a fair basis to the values of the laboratory, R&D equipment, and environmental protection installation respectively. The values should be independently assessed by a professional valuer as documentary evidence. In the absence of such break-down on valuation and independent valuation report from a professional valuer, the Inland Revenue Department (IRD) may regard all the $100 million as qualifying expenditure of the laboratory only. That is just 20% initial allowance and 4% annual allowance will be allowed.

2. To avoid the application of section 16(2A), Hold-Co should use securities other than deposits or loans, where the interest income generated therefrom is not taxable. Other securities might include real property, shares, etc. For instance, Hold-Co might transfer the Singapore listed debentures to another special purpose vehicle, newly established in overseas for this purpose. Hold-Co will then use the shares of the new company as securities for the bank loan. In the circumstance, as the bank loan will be secured by shares rather than deposit, section 16(2A) would not apply. Certainly, the relevant business risk of using shares or other assets as securities instead of the deposit should be carefully considered by WL and negotiated with the bank. If section 16(2A) does not apply, the interest expense attributable to financing of working capital will be fully deductible. The business reason of using other securities should be properly documented to reduce of risk of being challenged by sections 61 and 61A. The business

reason might include the requirement from the bank, the future business plan of setting up a central finance house within the group, etc.

3. To safeguard proper deduction of interest expense, WL should negotiate with the bank for charging different interest rates for different portions of the loan. Alternatively, two loans should be borrowed rather than just one loan for two purposes. The interest rate for the portion financing the construction costs should be lower than that of the working capital, while the overall interest rate is maintained at 5%. The argument for charging different levels of interest rates is the cash flow associated with the usage will not be the same. In general, working capital is associated with operation, which will directly generate cash flow, while there is no direct cash flow generated from the research laboratory and related equipment. This argument should be properly documented by financial studies to reduce the risk of being challenged by the IRD under sections 61 and 61A. If the two-level interest rate is accepted by IRD, after implementing the abovementioned step 2, the interest expense for working capital will be fully deductible.