THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2022

MODULE 2.04 – HONG KONG OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Technical services to Hong Kong clients

The technical services were provided at the training room of Sakura (HK) Limited (SHK). If the provision of technical services in the said manner constitutes a permanent establishment (PE), Dandelion Ltd (DL) would be regarded as carrying on business in Hong Kong. For a resident of a non-double taxation agreement territory, the definition of PE is contained in Part 3 of Schedule 17G of the Inland Revenue Ordinance (IRO). The PE definition in Schedule 17G in general is consistent with the OECD's Model Tax Convention 2017, except for the servicing PE. In the definition, there is no mentioning of 183 days of services in Hong Kong would constitute PE. The Inland Revenue Department (IRD) issued Departmental Interpretation and Practice Notes No. 60 (DIPN 60) setting out its interpretation and practices in this regard. By virtue of Schedule 17G, a PE includes "a fixed place of business", which means a certain amount of place at the disposal of the enterprise.

And "at the disposal" means has "effective power to use", whether rented or owned the place, does not matter.

"Fixed" comprised of two critical components:

- a certain degree of permanence at geographical point (the duration test); and
- a specific geographical point (the location test).

A place of business may, however, constitute a PE even though it exists, in practice, only for a very short period of time because the nature of business is such that it will only be carried on for that short period of time (DIPN 60, paragraph 42).

An enterprise is allowed to use an office of another enterprise for a continuous period of time may constitute a PE. However, if the work at the place is intermittent or incidental, it would not be a PE.

DL provided the services at the training room, which was at the disposal of DL, pursuant to the agreement between DL and SHK. The managers provided the services at the room on a regular basis, i.e. 1 week a month. It is likely that the IRD would take the view this manner of rendering services was the nature of DL's services provision in Hong Kong. Even though the servicing period was just 1 week per month, the IRD would opine that a PE existed in this regard. It should note that even if the service provision does not constitute PE, it does not necessarily follow DL was not carrying on business in Hong Kong or does not have profits chargeable to profits tax (DIPN 60, paragraph 12). The provision of services of 1 week per month in Hong Kong should constitute carrying on business activities here. The services were provided in Hong Kong and hence the service fee was derived from Hong Kong based on the "operation test" (DIPN 21 and Hang Seng Bank case). Therefore, it can conclude that DL carried on business in Hong Kong and derived the service fee from Hong Kong. The service fee would be chargeable under s.14.

Part 2

Sales of Machine-A

The first question we need to consider is whether there is any PE in this regard, more specifically any agency PE existed. An agent's activities would constitute a PE if the agent habitually concludes contracts, or plays a principal role leading to conclusion of contracts that are routinely concluded without material modification by the subject enterprise. SHK solicited buyers in Hong Kong for DL. The standard trading terms were given to SHK before any solicitation. The marketing staff of SHK solicited customers and negotiated them based on the

standard terms. Buyers would place orders, pursuant to the standard trading terms, without materials modification, directly to DL. It seems SHK played a principal role leading to conclusion of contracts without much modification by DL. Hence a PE existed in this regard. As the sale contracts were effected in Hong Kong, the IRD would have an initial presumption the trading profits were derived from Hong Kong, subject to review of the totality of facts (Magna case). That is unless it can prove that the purchase operation is more critical in generation of the trading profits, the profits would be subject to profits tax in Hong Kong.

Part 3

Maintaining the warehouse in Hong Kong

The issue is whether in respect of its function performed, the warehouse constitutes a PE. For a fixed place of business for storage and delivery of goods belonging to the enterprise and where the storage and delivery activity is of preparatory or ancillary nature, the fixed place of business is excluded as being regarded as a PE. However, if the function performed at the fixed place is not of preparatory or ancillary nature, a PE exists. The word "preparatory" means preparing for essential or significant activity. The word "ancillary" means supporting the essential or significant activity.

For DL's situation, the warehouse was not just for storage and delivery of goods. Some machines would be repaired there. These after-sale activities constitute an essential and significant part of the services of DL vis-à-vis customers, hence no exception from PE will be available. Profit attributable to the after-sale repair services would be subject to profits tax in Hong Kong.

Part 4

Leasing of Machine-C

Under s.15(1)(d), sums received by or accrued to a person by way of hire, rental or similar charges for the use of movable property in Hong Kong or the right to use movable property in Hong Kong shall be deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong.

The lease fee of $10 million shall be deemed taxable for the year ended 31 March 2021. The depreciation allowances of the machines should be deductible under s.18F.

Computation of Profits Tax for DL in relation to lease of Machine-C (year of assessment 2020/21)

	$
Lease fee income	10,000,000
Less: depreciation allowances	2,940,000
Assessable profits	7,060,000
Tax payable before tax reduction @16.5%	1,164,900
Tax reduction (100% reduction, limited to $10,000)	10,000
Tax payable after tax reduction	1,154,900

Computation of depreciation allowances (year of assessment 2020/21)

	30% pool ($)	Total allowances ($)
Value of the Machines-C (see below)	9,800,000	
Annual allowance	2,940,000	2,940,000
Written value c/f	6,860,000	

Calculation of value of Machine-Cs transferred to 30% pool [s39B)(6)]

	$
Acquisition cost in 2018/19	20,000,000
Notional annual allowance for 2018/19 (30%)	6,000,000
	14,000,000
Notional annual allowance for 2019/20 (30%)	4,200,000
Value transferred to 30% pool in 2020/21	9,800,000

Question 2

Part 1

Net trading profits (Country B) $50 million

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 determining factor as where the contracts for purchase and sale are effected. Moreover, the IRD expresses in DIPN 21 that "(in *Magna* case) Litton VP recognized that in case of a trading profit the purchase and the sale were the important factors. He further included in his deliberation all of the relevant operations and not just the purchase and sale of the products".

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, subject to review of the totality of facts. That is whether or not the contract effected outside Hong Kong is more immediately responsible for generation of profits. 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 non-taxable.

Paragraph 27 of DIPN 21 states if a profit is derived from services rendered in Hong Kong, the profit is clearly taxable. Commission income or profit that accrues to a "re-invoicing centre" for services rendered is chargeable to profits tax. Profits derived from the buying and selling of goods are not service income. The transaction involves the taking of commercial risks (e.g. product risks, inventory risks, credit risks, exchange risks, capital risks, etc.) different from those attached to a service. Confirmation of sales and issue of purchase orders are indications that it is a trading transaction. The source of trading profits depends on the locality of the trading operations.

According to *ING Baring* case where a person, including an agent, who acts for on behalf of the taxpayer, such person's act should be taken into account in considering the source of profits of the taxpayer.

As regards to the subject "trading profits", the underlying transactions should be regarded as re-invoicing transactions. Though the legal form is a trading transaction/profit, the real nature is re-invoicing service to overcome the trade restriction. The fact that all trading terms were negotiated and concluded outside Hong Kong is not relevant to determine the source of the trading profit. It was because HL did not act for an on behalf of BL. HL just acted on behalf of itself. BL issued the invoices pursuant to HL's instructions. BL did not receive and accept any orders to sell the goods nor issued any purchase orders to buy the goods. BL did not take up any commercial risk as all losses derived from the transactions would be indemnified by HL. BL performed the re-invoicing services in Hong Kong and hence its "service income", though labelled as trading profit, is sourced in Hong Kong and hence taxable.

Deductibility of the royalty $5 million and sales tax $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.

Taxability of the royalty $5 million

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 2020/21 is calculated as follows:

	$
Royalty fee	5,000,000
Deemed assessable profit at 30% thereon*	1,500,000
Tax payable before tax reduction @16.5%**	247,500
Tax reduction of 100% capped at $10,000	10,000
Tax payable after tax reduction	237,500

*Under section 21A, the deemed assessable profit is 30% of $1.5 million. Though BL and HL are associated corporations, the trademark has never been owned by any person carrying on a business in Hong Kong previously. Under section 20B, BL has the obligation to withhold and pay tax for and on behalf of HL.

**Assuming BL will be nominated for the 2-tiered tax rates (as BL's assessable profits are higher than $2 million and will fully utilize the lower rate), hence HL will be subject to the normal rate of 16.5%.

Part 2

Interest expense on the bank loan for purchase of a manufacturing 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 calculated as follows:

$600,000 (non-taxable interest income) x [$20,000,000 (bank loan)/$20,000,000 (overseas debentures) + $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

The key issue of the proposed arrangement is that 80% of the overall profit will be siphoned off to the new X-Co, while the operation of BHK and AL is more or less remain the same. Such an arrangement is commonly known as a "transfer pricing" scheme – 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, Country X).

The proposal might be subject to attack by the Inland Revenue Department (IRD) in Hong Kong in a number of ways.

Under s.15BA(5), if trading stock of a trade has been acquired otherwise than in the course of trade, then in calculating the profits of the trade, the market value of the stock at the time of acquisition will be taken as the cost of acquisition replacing the actual cost of acquisition. It seems the purchase price to be paid to X-Co by BHK is higher than the market price and hence the profits to be earned by BHK will drop from existing 50% of the overall profits to just 10%. The IRD could invoke s.15BA(5) to replace the actual purchase price to be paid to X-Co by the market price of the stock.

Under s.16, expenses incurred to the extent in the production of assessable profits shall be deductible. "To the extent" means the expense must be relevant for the purpose of production of assessable profits by reference to the market price. Hence, if the price at which BHK will purchase goods from X-Co is excessive by reference to the market level, the IRD may invoke section 16 and disallow the deduction up to the market level.

Under TP Rule 1 (s.50AAF), 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 by the IRD. Penalty at a maximum of 100% of the tax undercharged might also be imposed (ss.82A(1D) and (1F)). The IRD may apply TP Rule 1 to adjust upward BHK's profits to a level consistent with its functions performed and risk assumed. It is because the new company and BHK are associated and the proposed arrangement seems depart from arm's length principle and will result in BHK deriving less than normal level of assessable profits.

Under s.61, the IRD can disregard any transaction which is regarded as artificial or fictitious. A fictitious transaction means one which those who are ostensibly parties to it never intended should be carried out (re Seramco Trustee). Commercial realism of a transaction is a test for artificiality (re Cheung Wah Keung). The transaction may be regarded as artificial because there is not enough commercial realism for the low profit level for BHK. Therefore, the IRD may apply s.61 to disregard the sale of goods from the new company to BHK and assess BHK as if the sale is made directly from AL to BHK.

Under s.61A, where the sole or dominant purpose of a transaction is to obtain a tax benefit, the assistant commissioner can raise an assessment either (1) as if the transaction or any part thereof had not been entered or carried out; or (2) in such a manner as the assistant commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained. It seems that the sole or dominant purpose of interposing the new company between AL and BHK is to obtain Hong Kong tax benefit because AL's has engaged a tax consultant to devise the scheme at the beginning. The intention is likely to reduce BHK's assessable profit. Also, there is no substantial operation of the new company.

In the case of Tai Hing, the sale of land in excess of market price from a holding company to its wholly owned subsidiary (with an intention to reduce assessable profit of the subsidiary) is regarded as tax motivated (re Tai Hing case). Therefore, the IRD may apply s.61A to attack the scheme.

In connection to application of s.61A, the IRD may apply Ramsay principle for a purposive construction of the statue. That is whether under s. 16(1), when it is interpreted purposively and

the transaction is viewed realistically, BHK can be entitled to deduction in respect of the purchase payment made to the new company, which is in excess of the market price (re Arrowtown Assets, Tai Hing). To conclude, the IRD may apply s.61A and allow BHK's purchase payment based on the market price only.

PART C

Question 4

Part 1

Ashwood Ltd (AL) owns 90% ($36 million / ($36 million + $4 million) and 85% ($34 million / ($34 million + $6 million) share capital (ordinary share and preference shares together) in Bee Ltd (BL) and Ceci Ltd (CL) respectively. Mr. Wong owns 10% and 15% share capital in BL and CL respectively.

AL and BL are associated companies in terms of section 45(2) of the Stamp Duty Ordinance (SDO). However, the relief under section 45(1) does not apply because it seems that the conveyance was made in connection with an arrangement, under which the consideration was to be received by a person who is not an associated corporation (section 45(4)(a)). That is AL would apply the sales proceeds for repayment of a loan borrowed from Mr. Wong, who is not an associated corporation to AL and BL.

Ad valorem duty (AVD) payable:

The total consideration is cash and loan waiver (section 24(1)):

$(5,000,000 + 15,000,000) x 15%* = $3,000,000

However, relief can be applied under section 24(2) which allows using the property value for stamp duty purposes. The instrument must be adjudicated by the Collector of Stamp Duty. If section 24(2) applies, AVD payable is:

$16,000,000, x 15%*=2,400,000

*Scale 1 rate applies, as the property is not acquired by a Hong Kong permanent resident (HKPR).

Special stamp duty (SSD) is not applicable as the property was acquired by AL on 1 November 2018 and it was as assigned on 1 November 2021, i.e. 36 months and 1 day.

Buyer's Stamp Duty (BSD) is payable as the property is not acquired by HKPR.

BSD payable: $16,000,000 x 15% = $2,400,000

Part 2

BL and CL are not associated companies in terms of section 45(2) of the SDO. The relief under section 45(1) does not apply.

AVD payable on the sale agreement: $25,000,000 x 15% = $3,750,000.

AVD payable on the deed of assignment: $100

The market value of Property-1 on date of sale agreement of $25 million is higher than the consideration of $22 million. Hence the market value will be used for calculating the AVD as the transaction will be deemed as a voluntary disposition under section 27 of the Stamp Duty Ordinance.

SSD would be chargeable: $25,000,000 x 20% = $5,000,000

The holding period was 6 months (1 November 2021 to 30 April 2022).

BSD payable: $25,000,000 x 15% = $3,750,000

Question 5

Part 1

The relevant rules for RL's warehouse operation:

- 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). Under Schedule 17G, inter alia, a fixed place of business for storage of goods only would be excluded from being regarded as a PE. However, fragmented business activities carried out by different related parties would be considered together in ascertaining if a PE exists where such activities are complementary to each other

- 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 warehouse operation:

- RL and SL are closely related enterprises

- SL's store constitutes a PE of SL (the definition of PE is not limited to situations of non-resident, it also applies to a Hong Kong resident)

- The business activities carried on by RL at its warehouse and by SL at its store constitute complementary functions that are part of a cohesive business operation

- Function of the warehouse and SL should be considered together, no exception from PE applies to the case.

- RL would be regarded as carrying on business in Hong Kong by maintaining a Hong Kong PE. Such PE provided services in Hong Kong to complement SL's retailing function. By virtue of s.50AAK, an arm's length amount of profits would be attributed to the PE and chargeable to profits tax as the profits were derived from Hong Kong.

Part 2

The relevant rules re 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:

- the domestic nature condition is met;

- either the no actual tax difference condition or the non-business loan condition is met; and

- the actual provision does not have a tax avoidance purpose.

Application of the rules re interest free loan

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

RL's profit attributable to the warehouse operation 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 6

Part 1

Home loan interest is allowed in respect of a loan applied for acquisition of a property, which was used as a place of dwelling for the year (s26E). As the property was leased to Pacific, it was not used as a place of dwelling. Hence no deduction of home loan interest is allowable.

Part 2

To be deductible, expenses must be wholly, exclusively and necessarily incurred in the production of assessable income. However, apportionment of expenses may be allowed by the IRD in practice. In this case, 60% of the travelling and entertainment was for business purposes and the relevant portion of the expenses should be deductible.

Pacific has fully refunded the two expenses to Ms So. The portion (60%) which represents business purpose could be non-taxable, on the basis that Ms So did not claim deduction in respect of such portion (according to the IRD's practice). In such circumstances, only the remaining 40% representing Ms So's private use would be taxable. This is because she received such benefit due to services rendered and it is in money's worth (her personal liability has been discharged by the employer).

Alternatively, if he claimed deduction on the 60% business purpose portion, the whole amount of the reimbursement made by Pacific would be taxable on the basis that it was derived from employment, for services rendered, and in money's worth.

Part 3

The medical insurance policy purchased by Pacific is a contractual obligation between Pacific and the insurance company. Pacific is discharging its sole liability in paying the insurance premium. And there is no surety (guarantee) in respect of Pacific's payment of such premium to the insurance company. The benefit is not convertible into money. Hence, $2,500 paid by Pacific is not taxable.

The medical expenses reimbursed by insurance company in pursuance to the insurance policy under which the employee is a beneficiary is not assessable. This is because the reimbursement arises from the contractual entitlement of the employee under the insurance policy rather than from the employment (see D56/86).

The medical expenses incurred by Ms So was not deductible as the amounts were not incurred wholly, exclusively, and necessarily in the production of assessable income.

Part 4

The tuition fee is deductible only if it is the self-education expense paid for a "prescribed course of education". A prescribed course of education is a course undertaken by the taxpayer at a specified institution to gain or maintain qualifications for use in his employment.

In this case, the Chinese University is a specified institution. However, it is difficult to say that a course in religious study can be used to help Ms So gaining or maintaining qualifications for use in her employment as a sales manager in a food company. Hence, tuition fees paid by her cannot be deducted as a self-education expense.

The refund from Pacific is taxable because the employer has discharged the personal liability.

Question 7

Part 1

Property Tax Computation (year of assessment 2020/21)

	$
Rent ($40,000 x 10)	400,000
Rent (old lease)	30,000
Lease premium ($96,000 x 10/24)	40,000
Repair expense borne by tenant	4,000
	474,000
Less: Irrecoverable rent	(120,000)
Assessable value	354,000
Less: Rates ($6,000 x 4)	24,000
	330,000
Less: 20% statutory deduction	66,000
Net assessable value	264,000
Property tax at 15%	39,600

Part 2

Mr. Ling has paid mortgage interest of $200,000 for the year 2020/21. He is residing in Hong Kong throughout the whole year 2020/21 and hence he is eligible for election of personal assessment (PA). He did not derive any income other than the subject rental income, with net assessable value of $264,000. He should elect for PA, in which the mortgage interest would be deductible, subject to the maximum of the net assessable value (NAV). If he elects for PA, he will be entitled to the basic allowance of $132,000 for the year of assessment 2020/21. Under PA, there will also be a tax reduction of 100% of the tax payable, limited to $10,000.

He will not be required to pay tax in Hong Kong if he elects for PA (basic allowance of $132,000 is higher than the NAV net of mortgage interest ($264,000 - $200,000= $64,000).