

Answer-to-Question-\_1\_

(1) Provision of technical services in HK

Dandelion Limited (DL) has provided technical services to Sakura HK Ltd (SHK) by using its training rooms.

It may be regarded as running a permanent establishment in HK and therefore the provision of technical service to HK clients will therefore be subjected to HK Profits Tax.

Permanent establishment normally is a fixed place of management, branch, an office, where to provide service for more than 183 days.

However, the new definition of permanent establishment (PE) with a wider scope is established in 2020/21 and replaces the original definition. The rule of 183 days or more than 6 months is removed. It is consistent with the OECD guidelines.

In this case, the technical manager travels to HK once per month, which does not exceed 183 days. But under the new definition, it will result in PE in HK as the technical manager plays the principal role leading to the conclusion of contracts.

It is unlikely that the technical manager is an independent agent, as he acts exclusively on behalf of DL to which it is closely related.

If this place of business whose activities are purely of a preparatory or auxiliary nature, it can be exempted from the PE arrangement. However, the Technical Manager provides technical service in SHK training room, which is not preparatory activities but for profit-generating activities with 10% of service fee shared.

Therefore, 10% of service fee shared will be subjected to HK Profits Tax.

(2) Sales of Machine A units to buyers in HK

Under Board Guiding Principle, one looks to see what the taxpayer has done to earn the profits in question and where he has done it, to determine the source of taxpayer's profits.

For determining the sales income, where the sales contracts take place is important. In this case, the buyer has directly process the order with DL in Country D. It seems the generating the sales income is in Country D (sales contracts are concluded in Country D), which is outside HK and should not be subjected to HK Profits Tax.

IRD will collect all relevant factors to review the case (i.e. totality of facts). So, IRD may still attack by considering SHK solicits and negotiates with potential buyers in HK is a crucial step to obtain profits in HK. The profits are therefore derived from HK and subjected to HK Profits Tax.

(3) Maintenance of Machine B warehouse in HK

When the warehouse is only for storage, it may not be considered as profits generating activities. But, DL repairs the Machine B units in this warehouse and sold to HK clients. Then, the profits are derived from HK and subjected to HK Profits Tax.

At the same time, the repair costs for bringing back the machine to the original status will be deductible for producing the assessable profits under s16(1)(e) of IRO.

(4) Leasing of Machine C units in HK

The proposed tax liabilities

Leasing income: \$10 million

Machine C acquisition costs: \$20 million

Annual allowance: \$20 million x (1-20%-20%) x 20% = \$2.56 million

Therefore, the proposed tax payable

Leasing income	\$10.00 million
Less: Depreciation allowance	<u>\$2.56 million</u>
Assessable profits	\$7.44 million

First 2 million @8.25%	\$165,000
Remaining \$5.44 million @16.5%	<u>\$897,600</u>
<b>Total tax payable</b>	<b>\$1,062,600</b>

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Answer-to-Question-\_\_2\_\_

(1) Net trading profits in Country B of \$50 million

Considering whether BL has generated profits in HK and subjected to HK Profits Tax.

BL has been instructed by HL to issue invoices to the customers only. The contracts negotiation and conclusion is done by HL directly which is outside HK.

The goods are also directly delivered from Country A to Country B and never pass through HK.

Price setting and risk bearing are taken by HL instead of BL. It seems BL has only done the administrative work rather than the profit generating activities in this arrangement.

If so, the trading profits in Country B will not be subjected to HK Profits Tax.

However, IRD will consider all the relevant factors in this case to determine the source of profits and make decision for the offshore profits.

(2) Royalty fee of \$5 million to HL and \$500,000 sales tax in Country B

Royalty payment of \$5 million to HL is to be withheld.

BL has an obligation to inform HK IRD for such royalty payments by filing the IR form 54 and calculating the withholding amounts

to be paid. (S21A)

Assuming the HL develop the trademark in its own country and not in HK, the withholding tax rate would be 30% rather than 100% even if HL and BL are related companies under s20B.

Therefore, BL should withhold \$247,500 (\$5 million x 30% x 16.5%) to IRD.

Sales tax of \$50,000 is incurred in producing the Company's assessable profits and therefore it is deductible under HK Profits Tax.

(3) Interest expenses of \$900,000 on the bank loan

Normally, interest expenses paid is allowable under s16(1)(a) when it is incurred for producing assessable profits.

However, in this case, which is subjected to s16(2A) - Secured Loan Test. The full deduction of interest expenses are not allowed. The interest expenses in respect of money borrowed is secured in this case and the interest income are not sourced in HK, which is not subjected to HK Profits Tax.

Allowable interest expenses will be reduced by

$$\$900,000 \times \$20,000,000 / (\$20,000,000 + \$10,000,000) = \mathbf{\$600,000}$$

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Answer-to-Question-\_3\_

HK Profits Tax implications of the proposed arrangement

Under Rule 1 in Section 50AAF, IRD has the effect of requiring the tax adjustment where 2 associated company has entered a transaction where differ from an arm's length price and that difference results in potential tax advantage in HK.

From the **current arrangement**, we can see AL has performed the crucial steps of generating the profits and BL is only responsible for preparation work and administrative work in this case.

However, the profits are split equally between 2 companies.

It is obviously that AL has performed more senior and crucial duties to earn the profits. It is not reasonable that AL has equally shared the profits with BHK. BHK is only function as administrative work.

Such arrangement may considered as obtaining tax benefit for sole and predominant purpose (S61 and S61A). Unless the strong documentary evidence can be provided to prove this is purely commercial arrangement.

Otherwise, it will be considered as profits shifting activities by shifting the profits in low tax jurisdiction (i.e. HK) at 16.5% from high tax jurisdiction (i.e. Country A) at 40%.

The price setting should be in arm's length basis and it is determined by the function performed, risk assumed and assets

managed.

In this case, we can see BHK has less functions and risk taken comparing with AL. However, it can be shared equal profits with AL which is not reasonable.

The transfer pricing adjustment will be made by IRD. Also, there is a risk that the penalty will be imposed according to S82A with the additional tax as the Companies have not complied with Rule 1.

In the **proposed new business arrangement**, X-Co is to set up in Country X. It acts as re-invoicing vehicle and managing the bank accounts in Country X. It looks like X Co takes over the duties of AL. However, it acts on behalf of AL with AL instruction. 2 nominee directors of X-Co has not independently exercise its authority.

Under the arrangement, the 80% of profits has been shifted to X-Co as it is a low tax jurisdiction at 5%.

In case, X-Co has not contributed much during the whole profit generating process but get most of the profits among the Group.

IRD will consider such arrangement is not at arm's length and solely for obtaining the tax benefits (S61 and S61A).

Transfer pricing adjustments will be taken by IRD. Also, the penalty will be imposed under S82A with additional tax (maximum at treble of undercharged tax).

Proper documentation should be prepared for explaining this arrangement is purely for business reason rather than obtaining the tax benefits.

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Answer-to-Question- 6

(1) Mortgage loan interest

The mortgage loan interest of \$100,000 paid by Ms So can be claimed as deductions (Home Loan Interest) by electing personal assessment.

The home loan must have been obtained for dwelling which used by the taxpayer (Ms So), at any time during the relevant year of assessment, either exclusively or partly as her place of residence (s26E(1)).

(2) Travelling and entertainment expenses and refund of these expenses

When the benefit can be converted into money, such amount should be included in Ms So taxable income.

Given that, the employer (Pacific) exercise proper control for such reimbursement claim. Then, the entertainment and travelling expenses can be claimed as business nature. In case, IRD has agreed 60% of the travelling and entertainment was business purpose.

As Ms So received a full refund from Pacific, 40% of them should be included in Ms So taxable income.  $(\$2,000 + \$26,000) \times 40\% =$   
**\$11,200** should be included in Ms So taxable income.



(3) Medical insurance premium, expenses and refund

Pacific has paid the insurance premium of \$2,500, which is not discharge of Ms So's liabilities - it is the Company's medical insurance scheme. Therefore, \$2,500 should not be included in her chargeable income.

The medical expenses of \$5,600 cannot be deducted from her chargeable income as it is her personal expenses.

The refund of \$4,500 directly from insurance company is not related to Ms So employment and should not be included in her chargeable income.

(4) Tuition fee and refund

All salaries taxpayers are eligible for a deduction up to \$100,000 for self-education expenses paid during the year of assessment.

The tuition fee of \$40,000 paid can be deducted as Self-education expenses.

When the benefit can be converted into money, such amount should be included in Ms So taxable income.

The refund of \$10,000 from Pacific will be included in Ms So chargeable income.

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Answer-to-Question- 7

(1) Property Tax Liabilities for 2020/21

Rent from 1 Jun 2020 to 31 Mar 2021 (\$40,000x10months)

\$400,000

Premium (\$96,000/24x10 months)                      \$40,000

Less: Bad debts (\$180,000-\$80,000) (\$100,000)

Less: Rates paid by the owner                      (\$6,000/quarter x 3)

(\$18,000)

\$322,000

Less: Repairs and Outgoing allowance

(\$84,400)

Net Assessable Value                                      \$237,600

Property tax liabilities

\$237,600 x 15% = **\$35,640**

(2) Tax efficiency reporting strategy

Mr Ling can inform IRD that he has chargeable to Property Tax only by filing the letter and Property Tax Return.

Also, he can elect personal assessment as a whole to enjoy the mortgage loan interest deduction after the assessing his property tax.