THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2024

MODULE 2.04 – HONG KONG OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Hong Kong Profits Tax position for CHKL's provision of consultancy service in mainland China is set out below:

CHKL carried on business in Hong Kong and the service income would be chargeable to profits tax if the income were derived from Hong Kong.

Some relevant principles laid down in DIPN No. 21 need to be considered:

- locality of profits is a hard, practical matter of fact.
- no universal rule will cover every case.
- the source of profits depends on the nature of profits and transactions giving rise to them.
- The broad guiding principle is "one looks to see what the taxpayer has done to earn the profits in question and where he has done it" (established from Hang Seng Bank and HK-TVBI cases).
- to ascertain what were the operations which produced the relevant profits and where those operations took place.
- only operations which directly produce the profits are relevant (not the whole of taxpayer's activities), i.e. to focus on effective causes for earning the profits without being distracted by activities that are antecedent or incidental (see Kwong Mile Services Ltd v CIR and ING Barring Securities (Hong Kong) Ltd v CIR).
- Profits can be apportioned as arising partly in and partly outside Hong Kong in certain situations, normally only apply to service income and manufacturing income.
- The place where day to day investment decisions taking place is generally irrelevant.
- Absence of an overseas permanent establishment of a Hong Kong business does not of itself mean that all profits are derived from Hong Kong.

The place where the service orders were received and processed was irrelevant in ascertaining the source of the service income. Also not relevant are the directors' approval of the orders and place of receiving the service income, both of which occurred in Hong Kong. The arrangement of travelling and accommodation of the relevant managers and the receipt of the service income are also not to be considered. These activities were incidental and antecedent.

The fact that CHKL did not maintain any office outside Hong Kong would not be decisive in ascertaining whether the service income was derived outside Hong Kong.

The source of service income should be the place of provision of services (DIPN No. 21 and Whampoa Dock referred). As the services were provided outside Hong Kong, the service income was derived outside Hong Kong and not chargeable to profits tax.

Part 2

CHKL would be subject to enterprise income tax for the consultancy service fee if the provision of services amounted to a PE, that is more than 183 days within any 12-month commencing and ending in a tax year.

The serving period for respective managers are set out below:

Manager A	1 July 2022 – 30 September 2022	92 days (31 + 31 + 30)
Manager B	1 December 2022 – 28 February 2023	90 days (31 + 31 + 28)
		59 days (1 January 2023 to 28 February 2023) = 31 + 28 = 59 days)
Staff C	15 August 2023 to 31 December 2023	139 days (17 + 30 + 31 + 30 + 31)
		108 days (15 August 2023 to 30 November 2023 = 17 + 30 + 31 + 30 = 108 days)

For the 12-month period from 1 July 2022 to 30 June 2023 (Period 1), the total servicing days are 182 days, being (92+90).

For the 12-month period from 1 December 2022 to 30 November 2022 (Period 2), the total servicing period are 198 days, being (90+108).

For the 12-month period from 1 January 2023 to 31 December 2023 (Period 3), the total servicing period are 198 days, being (59+139).

As it is more than 183 days for Period 2, which commenced in 2022 and ended in 2023, CHKL has maintained a Service PE in Mainland for both 2022 and 2023 and would be subject to income tax for both years.

Part 3

China Enterprise Income Tax for the dividend income

In 2022, the dividend paid to CHKL by SL shall be subject to withholding tax at not more than 5% rate in China, according to Art.10(2) of China-HK Tax Arrangement, because CHKL owned directly 60% (>= 25%) shareholding of SL. CHKL has substantial business activities and could satisfy the requirement of being the beneficial owner of the dividend.

In 2023, the dividend paid to CHKL by SL shall be subject to withholding tax at 10% rate in China, according to Art.10(2) of China-HK Tax Arrangement, because CHKL owned just 10% (less than 25%) shareholding of SL.

Hong Kong Profits Tax for the dividend income

The dividend received for the years 2022 and 2023 from SL should be offshore in nature and non-taxable.

Question 2

Part 1

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 Hang Seng Bank, 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 royalty income, for the case where the taxpayer developed an intellectual property and licensed the right to use such intellectual property for a royalty income, the source of the royalty income is the place of development (DIPN 21). For the case where the taxpayer acquired the right to use an intellectual property and sub-licensed the right to use for a royalty income, the source should be the place where the relevant license agreement and sub-license agreement were effected (DIPN 21; TVBI).

Type A royalty income was derived from Hong Kong and chargeable to Profits Tax as the place of development was Hong Kong. The place of use is irrelevant.

Type B income was also derived from Hong Kong and chargeable as the license agreement and sub-license agreement were effected in Hong Kong. The place of use and the place where Type B was developed are not relevant.

Part 2

Royalty fee to HL $5 million and VAT in Country B $500,000

Since the Type B royalty income 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 VAT $500,000 paid in County B would also be deductible under section 16(1) as it was charged on the gross royalty amount 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 VAT payment.

The royalty of $5 million paid to HL was for the right to use Type B know-how in mainland China. The royalty expense paid to HL 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 2022/23 is calculated as follows:

	$
Royalty 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 $6,000	6,000
Tax payable after tax reduction	819,000

* Under section 21A, the deemed assessable profit is 100% of $5 million. BL and HL are associated corporations, Type B know-how is owned by HL, which has carried on a business in Hong Kong previously by maintaining a branch in Hong Kong. Under section 20B, BL has the obligation to withhold and pay tax for and on behalf of HL.

** HL would not elect for the two-tiered tax rate and hence will be subject to the normal rate of 16.5%.

Interest expense on the bank loan for purchase of a 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 overseas deposit, which generated non-taxable interest income.

The disallowed amount is calculated as below:

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

SL's Profits Tax computation for the year of assessment 2022/23 is as follows:

Basis Period: Year ended 31 December 2022

	HK$	HK$
Net profit before tax		17,000,000
Add:		
Interest expense – Loan 2	400,000	
Forfeited deposit	100,000	
		500,000
		17,500,000
Less:		
Initial allowance of the research laboratory	1,000,000	
		1,000,000
Assessable profits		16,500,000
Profits Tax @8.25% x 2,000,000 + 16.5% x (16,500,000 - 2,000,000) = 165,000 + 2,392,500		2,557,500
Less: Tax reduction (100%, limited to $6,000)		6,000
Profits Tax payable after-tax reduction		2,551,500

Part 2

Exchange gain from the renminbi deposit

The purchase of foreign currency for speculative purposes can be trading in nature. The issue is whether Smart Ltd purchased Renminbi with the intention of re-selling it at a profit. If it did, the profit would arise from an adventure in the nature of trade and subject to profits tax.

In this case, the transaction giving rise to the profit was wholly financed by borrowed fund and entered into on a short-term basis for the purpose of making a profit from the purchase and sale of foreign currency. It could therefore be concluded that when Smart Ltd purchased Renminbi, it was not investing in foreign currency on long term basis but trading in the currency. The profits of $230,000 should be revenue in nature and chargeable to profits tax.

Interest expenses on Loan 1

The interest expense of $37,000 was incurred in producing chargeable profit. It is deductible under ss.16(1)(a) and 16(2)(d), and the deduction is not restricted by ss.16(2A) and 16(2B).

Interest income from the renminbi deposit

SL carried on business in Hong Kong and the RMB deposit was placed in Hong Kong. Therefore, the interest should be deemed taxable under s15(1)(f). However, under the Exemption from Profits Tax (Interest Income) Order, interest income derived from a deposit made with a financial institution in Hong Kong can be exempt. But there will be no exemption if the deposit is used to secure any borrowing where the interest expense on such borrowing satisfies the condition for deduction under ss.16(2)(c), (d) or (e), and the deduction of which is not restricted under S.16(2A).

As the RMB Deposit has been used as a security for Loan 1 and the Loan 1 interest expense is deductible, the interest income of $14,000 from the RMB Deposit cannot be exempt under the Exemption from Profits Tax (Interest Income) Order.

Interest expenses on Loan 2 and construction costs of the research laboratory

Interest on Loan-2 for financing construction of the research laboratory is prohibited from deduction under s16(1)(a) by virtue of s17(1)(c) as it was capital in nature (Wharf case). The construction costs including the interest expense would be regarded as qualifying expenditure ranking for industrial building allowance. An initial allowance of 20% on the qualifying expenditure incurred during the year would be allowable (i.e. for the year 2022/23).

Also, an annual allowance of 4% on the qualifying expenditure would be deductible under s18F if SL makes assessable profit (/s19E if SL sustains allowable loss) for a year of assessment during which the research laboratory is in use and not yet sold by BL (i.e. for each year from the year 2023/24 onwards in which the laboratory is put into use and not yet sold). Initial allowance of $1,000,000 [20% x (400,000+4,600,000)] would be allowable for the year 2022/23.

Question 4

Part 1

The sale and leaseback of plant and machinery 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) was enacted 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 Modest's case, if Modest has never used the machines or has never held the machines ready for use. S.39E also not applicable if Modest has not sold the machines to the finance company at a price higher than that it paid to the supplier. In addition, s.39E does not operate to deny the lease rental deduction to the lessee. The lease rental 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.

Ss.16 and 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 also an inflated rental fee, s.16(1) may disallow the deduction of excessive rental payment. However, if the rental 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 the extent that they are present, to be considered as a whole and each factor is not necessarily given equal weight.

In the case, the financing arrangement is for the purpose of business expansion. If there is tax benefit to Modest, say by way of inflated rental payment, s.61A risk may exist. However, if the argument that the main purpose of the finance arrangement is for expansion can be supported by evidence, arguably s.61A may not be easily applicable to the case.

PART C

Question 5

Part 1

Richard Lam's Property Tax computation is as follows:

Year of Assessment 2022/23	$
Rent - old lease ($15,000 x 3)	45,000
Rent - new lease ($16,000 x 8)	128,000
Lease premium ($60,000 x 8 / 24)	20,000
Repair expense paid by tenant	800
Irrecoverable rent ($15,000 x 4 - $30,000)	(30,000)
Assessable value	163,800
Less:	
Rates paid by the owner ($2,600 x 4)	(10,400)
	153,400
Less:	
20% statutory deduction	(30,680)
Net assessable value	122,720
Property tax at 15%	18,408

Part 2

A repayment of tax may occur in the following circumstances:

- excessive tax payment due to error;
- tax was paid but subsequently reduced by the election of personal assessment;
- tax was paid but subsequently reduced upon determination of an objection or appeal;
- tax was paid on invalid assessment;
- assessment was re-opened by error or omissions claim under section 70A; or
- application of setting off of the property tax paid against profits tax payable under section 25.

Time limit for the repayment is the later of:

- 6 years after the end of the year of assessment concerned; or
- 6 months after the date of notice of assessment issued.

Question 6

RL's warehouse in Hong Kong

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).

Facilities or fixed place of businesses performing merely the following functions would not be regarded as PE:

(a)
- storage, display or delivery of goods belonging to the enterprise,
- maintenance stock of goods belonging to the enterprise solely for storage, display or delivery,
- maintenance stock of goods belonging to the enterprise solely for processing by another enterprise,
- purchasing goods, and collecting information or
- any other activities of the enterprise, AND

(b)
- the above activity is of preparatory or ancillary
- "preparatory" means preparing for essential or significant activity
- "ancillary" means supporting the essential or significant activity

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).

RL's Office R

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 (i.e. storing goods in one place in Hong Kong for the purpose of delivering these goods as part of the obligations resulting from the sale of these goods through another place in Hong Kong).

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

If RL is treated as maintaining a PE in Hong Kong, profits attributable to such PE based on AOA, would be taxable in Hong Kong.

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:

a) the domestic nature condition is met;
b) either the no actual tax difference condition or the non-business loan condition is met; and
c) the actual provision does not have a tax avoidance purpose.

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

RL's profit attributable to Office R 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 7

Ms Fung's Salaries Tax computation for Year of Assessment 2022/23 is as follows:

	$	$
Salary		600,000
Insurance premium ($6,000 x 12)		72,000
Holiday journey		25,000
Share award (10,000 x $12 x 0.95)		114,000
		811,000
Rental value (811,000 – 25,000 -72,000) x 10%	71,400	
Less:		
Rent suffered ($1,200 x 12)	(14,400)	57,000
Share option gain [($10-$5) x 30,000 - $10,000]		140,000
Assessable income		1,008,000
Less:		
Motor car expenses ($50,000 x 50%)	(25,000)	
Depreciation allowance ($144,000 x 50%)	(72,000)	
Self-education expense	(50,000)	(147,000)
Net assessable income		861,000
Less concessionary deductions:		
Elderly residential care expenses	(70,000)	
Contribution to retirement scheme	(18,000)	(88,000)
		773,000
Less personal allowances:		
Married person's allowance	(264,000)	
Child allowance	(120,000)	
Dependent parent allowance - aged 56	(25,000)	(409,000)
Net chargeable income		364,000

Question 8

Berry Investment Ltd, 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 s40(1).

Under s40(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

The owner is not entitled to any industrial building allowance because the "polishing and tuning" activities, even being regarded as "process", were only incidental to the car trading business of the tenant. There is no provision in the Inland Revenue Ordinance for making an allowance where only part of a trade qualifies (see Tai On Machinery Works Ltd v CIR (1969)). The whole trade must qualify not just part of the trade.

Also, it seems "polishing and tuning" could not be regarded as "process. "Process" connotes a substantial measure of uniformity of treatment or system of treatment (Vibroplant Ltd v Holland (1982) and CIR v Aberdeen Restaurant Enterprises Ltd (1988) refer). In Vibroplant, it was held that repairs have no uniformity and were not "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).

It seems that "polishing and tuning" are similar to "repairs" and have no uniformity and are not continuous and regular actions which are carried on in a definite manner. How a car is polished and tuned depends on the particular situation and condition of the car. Therefore, "polishing and tuning" could not be regarded as process.

First floor

The owner is entitled to industrial building allowance as appliances were manufactured in the premises.

Second floor

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

In Tai On, allowances were refused to a retail distributor of goods who claimed to have subjected the goods to a process. It was held that the alleged processing (sorting, repackaging, remedying defects of imported leather goods) was, at best, part of the trade and not the trade itself.