Answers

Cases are given in the answers for educational purposes. Unless specifically requested, candidates are not required to quote specific case names to obtain the marks, but are required only to provide the general principles involved.

1 (a) (i) Whether a trade is carried on in respect of the disposal of 'DD Dog' by Mr Man

The brand 'DD Dog' is currently owned by Mr Man in his individual name. Mr Man intends to sell it via the internet platform for a profit of around $1·5 million. The facts that the sale is made through the internet and Mr Man does not have a business registration in Hong Kong do not in themselves determine that a trade is not carried on in Hong Kong by Mr Man.

Under s.14(1) of the IRO, profits from a 'business, trade or profession' carried on in Hong Kong are chargeable to profits tax unless the profits are derived from a source outside Hong Kong or the profits are proved to be capital in nature. In this case, it is necessary to determine if Mr Man carried on a trade when he acquired and subsequently sells the brand of 'DD Dog' in order to conclude if he is chargeable to profits tax. An isolated transaction may constitute a trade, as well as a series of transactions.

Whether a 'trade' exists is a matter of fact to be determined according to the merits of each case. It is therefore necessary to examine the facts in Mr Man's case to see if what he has done and plans to do in respect of the brand 'DD Dog' amount to the carrying on of a trade. To determine if a trade exists, the commonly used criteria are the so-called 'badges of trade'. If a trade exists, then the taxability of the profit would depend on whether or not the locality of the profit is in Hong Kong. (**Note:** *This is discussed in part (b) below.*)

Based on the 'badges of trade', Mr Man's sale transaction of 'DD Dog' would be analysed as follows:

(1) Subject matter of the transaction – the subject matter is the branded design 'DD Dog'. Intellectual property of this type is not a commonly traded or marketable property. It is generally considered that a property which does not yield an income or personal enjoyment to its owner merely by virtue of its ownership is more likely to be held for trading purposes. In the case of Mr Man, more information is needed to ascertain whether the brand has been yielding royalty income for Mr Man since acquisition, and whether the brand provides personal enjoyment to Mr Man through its ownership (e.g. he has the habit of collecting similar designs).

(2) The length of ownership period – the shorter the period of ownership, the more likely that the transaction is trading. More information is required as to the date of acquiring the brand in order to ascertain whether the length of ownership is too short, thus indicating a trading intention.

(3) The frequency of similar transactions – the higher the frequency, the more likely that the transaction is trading. Further information is required to ascertain whether Mr Man has been holding and selling similar brands for profit before.

(4) Supplementary work done – if additional work has been performed in enabling the property to be sold at a better profit, a trading intention would be implied. Further information is required as to whether Mr Man has performed additional value-added work to increase the market value of the brand, such as advertising and promotion or re-branding.

(5) Circumstances leading to the sale – While the intention at the time of acquiring the brand is important, the reason for the sale is also relevant in determining whether the sale is a 'trade' or not. If the sale is solely driven by realising a profit from the appreciation of market value, it is likely that a trading intention exists. More information on the reasoning behind the disposal is required.

(6) Motive – Any motive to make a profit from the transaction would constitute a 'trading' purpose. More information is needed to show Mr Man's motive in acquiring, holding and selling the designs.

In addition to the above six badges, the IRD would normally look at other factors, such as the funding of the acquisition cost and the utilisation of the sale proceeds. Further information on these is also required.

The facts given in the question are not sufficient to determine if Mr Man is carrying on a trade in acquiring and disposing of the brand of 'DD Dog'.

(ii) Source of profits from the disposal of 'DD Dog' by Mr Man to a third party via the internet

If the sale of 'DD Dog' via the internet is regarded as a 'trade', the profit would be taxable in Hong Kong only if the profit is considered as sourced in Hong Kong and not a capital gain. The IRO does not provide comprehensive guidance on 'source' and one has to look to case law in order to identify the relevant factors contributing to the determination of the place from which a profit arises. The general guidelines from the IRD are provided in DIPN 21 (revised 2012) and the broad guiding principle of 'one looks to see what the taxpayer has done to earn the profits in question and where he has done it' (based on *CIR* v *Hang Seng Bank Ltd* and *CIR* v *HK-TVB International Ltd*). This is the so-called 'operations test'. However, it can be difficult in practice to identify the activities which produced the relevant profits.

In the case of a sale transaction via the internet, the position taken by the IRD toward the application of the general source rule on electronic commerce is outlined in DIPN 39, in which the IRD indicates that, in general, the tax consequences of electronic commerce transactions will be determined on the same basis as the conventional forms of business, and profits tax provisions under the IRO, and that DIPN 21 would continue to apply. Moreover, the IRD will look beyond the place where the automated server-based activities are carried out. These activities would be weighed against the core business operations required to conduct the electronic commerce transactions which are usually carried out within a physical place. Therefore, it is generally the location of the physical business operations, rather than the location of the server alone, which determines the source of profits.

In the case of Mr Man selling the brand 'DD Dog' over the internet, despite the server used being located outside Hong Kong, the IRD would likely be interested in examining Mr Man's activities in managing and controlling the sale transaction in Hong Kong. Based on DIPN 21 (revised 2012) and the general principles from the *Hang Seng Bank case* and *ING Baring case*, the source of trading profit is the place where the contracts of sale and purchase are effected. Profits would be presumed to be sourced in Hong Kong if either the purchase or sale is effected in Hong Kong, or either the purchaser or customer is resident in Hong Kong. Only transactions which directly give rise to the profits are to be accounted for, and antecedent or incidental activities are considered as irrelevant. Moreover, the activities of an 'agent' performed on behalf of the taxpayer, regardless of whether a legal agent or not, would be attributable to the acts of the taxpayer, and thus the location of any agent who performed the activities would also need to be considered. However, for this purpose, the IRD in DIPN 39 clarified that a 'server' is not regarded as an 'agent' of the taxpayer.

In conclusion, the profits earned by Mr Man would likely be sourced in Hong Kong and taxable in Hong Kong, unless he has evidence to prove that both his purchase and sale contracts have been negotiated, concluded and effected outside Hong Kong.

(b) Report to Newco

To: Board of directors of Newco
From: Tax advisor
Date: 7 June 2013
Subject: Hong Kong tax implications for Mr Man arising from the proposed internet sale; and for Newco re the Type A and B designs

We refer to our earlier meeting with you on the proposed operating structure of Newco in relation to the holding and licensing of the Type A and B designs, and the related Hong Kong tax implications. As requested, we provide below our comments on the respective issues.

(i) Deductibility of the acquisition cost of 'BB Bug' by Newco

Branded designs such as 'BB Bug' are intellectual property which is acquired by Newco as a capital asset. Under Hong Kong tax law, capital expenditure is by general principle not tax deductible. However, by virtue of s.16EA, capital expenditure incurred for designs registered under s.25 of the Registered Designs Ordinance (Cap. 522) or under the law of any place outside Hong Kong is tax deductible (effective from the year of assessment 2011/12). The tax deduction is to be granted over the five successive years (or a shorter period when the design is due to expire at the end of its maximum period of protection) on a straight-line basis starting from the year of acquisition. To qualify for the deduction, the following conditions must be fulfilled:

(1) The design must have been registered by Mr Man (or the previous owner), in Hong Kong or overseas, on the date of acquisition by Newco. Moreover, documentary evidence must be submitted to substantiate that a change of ownership has been applied.

(2) The acquisition must be an outright purchase of both the legal and economic ownership (or proprietary interest) in the design. No deduction is allowed if the payment is only for acquiring the right to use the design for a specified period.

(3) The design must have been used, in Hong Kong or by Newco outside Hong Kong, for the production of profits chargeable to tax in Hong Kong in each of the years of assessment in which the deduction is claimed. If the design is not put into use during any intermittent year after acquisition, some deductions may be lost. Moreover, in the event that the design is only partly put into use to produce Hong Kong chargeable profits, apportionment is required. If the design is registered in more than one jurisdiction but has only been used in some, not other, jurisdictions, full deduction of the acquisition cost would only be granted if there is evidence to prove that the design registered in those other jurisdictions has direct and actual impact on the production of profits chargeable to tax in Hong Kong.

(4) The design is NOT acquired wholly or partly from an 'associate', irrespective of whether or not the price is at arm's length. Under s.16EC(8), an 'associate' includes an associated corporation of Newco, any person (and his/her relatives) who controls Newco, any partner (and his/her relatives) of a person who controls Newco, any director or principal officer (and his/her relatives) of Newco or its associates.

In this case, even if conditions (1) to (3) might have been satisfied, condition (4) is clearly not satisfied, as Mr Man is the shareholder of Newco, being a person in control of Newco, and so is regarded as an 'associate' of Newco. The cost of acquiring the brand 'BB Bug' will not, therefore, qualify for a tax deduction under s.16EA.

(ii) 'Type A' designs acquired from Japan/Korea

(1) Cost of acquisition to Newco

Costs incurred in acquiring the potential designs from Japan/Korea would also be capital expenditure but specifically tax deductible under s.16EA if the conditions under (1) to (4) (as stated under (i) above) are all satisfied.

Although the cost of acquiring 'BB Bug' may not be deductible for the reason that it was acquired from an associate of Newco, the costs of acquiring other brands from non-associates in Japan/Korea could qualify for tax deduction if, as would seem likely, all the conditions under (1) to (4) are satisfied.

(2) Licensing income

When Newco licenses Type A designs to earn income, such licensing income (or royalty) would be taxable in Hong Kong if it is sourced in Hong Kong. As Newco is carrying on business in Hong Kong and its profit is subject to tax under s.14, the general source principles should apply in determining the source of profits. Based on DIPN 21 (revised 2012) and DIPN 49 Part B, the licensing income earned from Hong Kong customers would be regarded as sourced in Hong Kong and taxable. As for the licensing income earned from customers in Mainland China, if the designs are used outside Hong Kong, the licensing income would generally be regarded as non-Hong Kong sourced and thus not taxable in Hong Kong. However, it should be noted that if part of the licensing income is returned as offshore non-taxable income, the relevant portion of the acquisition cost of the related designs would not then be tax deductible under s.16EA.

Tutorial note: *DIPN 21 (revised 2012) stipulates that the source of royalties not chargeable under s.15 would be determined by the place of the acquiring and granting of the licence to use; but DIPN 49 Part B mentions that the source of royalties earned from purchased property is determined by the place of use. As a result, this remains an ambiguous and uncertain area.*

(3) Subsequent disposal proceeds

Where tax deductions have been claimed under s.16EA in respect of the cost of acquiring the designs, and these designs are subsequently sold, the excess of the relevant sale proceeds over the balance of disallowed acquisition costs will be treated as taxable trading receipts. The amount of the taxable receipt cannot exceed the amount of the tax deductions previously allowed. However, if the relevant sale proceeds are smaller than the balance of the disallowed acquisition costs, the unclaimed cost balance can be deducted in the basis period during which the sale occurs.

(iii) 'Type B' designs self-developed by Newco

(1) Costs incurred in self-developing the designs

The costs incurred in self-developing the Type B designs by the in-house expert team would not be tax deductible under s.16EA on the basis that the costs were not incurred to 'acquire' the asset. Instead, Newco may be able to seek a tax deduction for general expenses under s.16(1) or as research and development expenditure under s.16B.

Staff and related office expenses for the R&D division would generally be deductible under s.16(1) if the expenses are incurred in the production of assessable profits, subject to any other specific provisions as applicable (e.g. restriction on retirement contributions). Capital expenditure incurred on plant and machinery (but not land or buildings) used in the research and development activities would be deductible in full under s.16B, provided that the research and development is appropriately related to the business of Newco. In the event that any grant or subsidies are obtained by Newco in support of its research and development activities, only the net expenditure would be allowed as a deduction under s.16B.

(2) Licensing income

Based on DIPN 49 Part B, the IRD takes the view that where royalty income is earned from the licensing of intellectual property which is created or developed by the taxpayer carrying on business in Hong Kong, such royalty income is primarily generated by the taxpayer using his wits and labour to create and develop the property in Hong Kong. As a result, the royalty income is considered as sourced in Hong Kong and taxable, irrespective of the place where the licence is used. In the case of Newco, since the R&D division is to be maintained and operated in Hong Kong, the Type B designs would be regarded as developed using 'wits and labour' in Hong Kong, leading to the source of all the related licensing income (whether from Hong Kong, Mainland China or elsewhere) to be in Hong Kong and so taxable here.

(3) Disposal proceeds

If the capital expenditure incurred in developing the Type B designs has been claimed for tax deduction under s.16B, when the related designs are disposed of, the sale proceeds will be treated as trading receipts and taxable, subject to the total amount of deduction claimed under s.16B, i.e. the tax deduction granted to Newco in relation to the designs prior to the disposal will effectively be clawed back.

We trust that the above addresses all the Hong Kong profits tax implications arising from the proposed transactions. Should there be any questions, please let us know.

End of Report

2 Richard

Richard's employment is obviously a non-Hong Kong employment according to the *Goepfert's* case and the factors specified in DIPN 10 (revised), i.e. (i) the residence of the employer is in the UK; (ii) the place where the employment contract is negotiated and concluded can reasonably be assumed to be in the UK; and (iii) the place of payment is also in the UK. But, Richard will still be subject to Hong Kong salaries tax in respect of the portion of his remuneration attributable to the services he rendered in Hong Kong, including any leave pay attributable to such services. However, the law provides an exception to this charge for anyone who only renders services in Hong Kong during 'visits' and who visits Hong Kong for not more than 60 days during the basis period for the year of assessment. In such cases, the services rendered are disregarded and the income received for the whole year of assessment is exempt from Hong Kong salaries tax: ss.8(1A)(b)(ii) and 8(1B).

In Richard's case, since he is a UK resident and the question does not seem to indicate that he has any work base or family ties in Hong Kong, it is reasonable to assume that he is a 'visitor' when he stays in Hong Kong. It is, therefore, necessary to ascertain the number of days Richard stays in Hong Kong during each of the relevant years of assessment. In calculating the number of days of 'visits' in Hong Kong, the Board of Review in the case *D29/89* held that both the day of arrival and the day of departure are included.

In Richard's case, for the year of assessment 2011/12, he visited Hong Kong for a total of 60 days:

1 December 2011 to 14 December 2011	14	
4 January 2012 to 25 January 2012	22	
1 March 2012 to 24 March 2012	24	
Total	60	days

As Richard's total number of days of 'visits' to Hong Kong for the year of assessment 2011/12 is not more than 60 days, he will not be chargeable to Hong Kong salaries tax for that year.

For the year of assessment 2012/13, Richard visited Hong Kong for a total of 151 days:

6 April 2012 to 17 April 2012	12	
16 May 2012 to 23 July 2012	69	
15 August 2012 to 30 August 2012	16	
7 October 2012 to 19 October 2012	13	
17 November 2012 to 2 December 2012	16	
7 March 2013 to 31 March 2013	25	
Total	151	days

As Richard's total number of days of 'visits' to Hong Kong for the year of assessment 2012/13 is more than 60 days, he will be chargeable to Hong Kong salaries tax in respect of that portion of his remuneration attributable to the services he rendered in Hong Kong, including any leave pay attributable to such services, by reference to the proportion of days spent in Hong Kong in the year of assessment to the total number of days in that year: s.8(1A)(a). This is the so-called 'time-in-time-out' basis and for this purpose only the day of arrival or day of departure is included, but not both (i.e. the basis is different from that used for calculating the number of days for 60-day rule purposes).

6 April 2012 to 17 April 2012	11	
16 May 2012 to 23 July 2012	68	(including 5 leave days)
15 August 2012 to 30 August 2012	15	
7 October 2012 to 19 October 2012	12	
17 November 2012 to 2 December 2012	15	
7 March 2013 to 31 March 2013	24	
Total days spent in Hong Kong	145	
Less: leave days in Hong Kong	(5)	
Total business days spent in Hong Kong	140	(A)
Total business days in the year (365 – 15)	350	
Leave days attributable to Hong Kong service [15 x (140/350)]	6	(B)
Total attributable days in Hong Kong	146	(A + B)
Time apportionment basis	146/365	

Richard's monthly salary is obviously taxable as it represents a reward for his employment. The monthly housing allowance, paid by the Company as a cash allowance, is also treated as assessable income arising from employment and will be added to the other assessable income of Richard and taxed accordingly. The rental paid by the Company for the serviced apartment is not taxable as it is not a 'residence' provided to Richard.

The university fees paid by the Company in connection with the education of the child of an employee are taxable under s.9(2A)(b); even where the Company is liable for the payment of the fees, the exception for amounts paid by the employer in discharge of its sole and primary liability under s.9(1)(a)(iv) is not applicable.

The gains from two tranches of share options were realised in 2012/13, the total gain being $1,440,000 (18,000 shares at $80 each). The IRD's position as expressed in DIPN 38 is that such gains will not be taxable, even if realised in Hong Kong, if the options were both granted and fully vested while the employee was working outside Hong Kong. The gains from tranche A ($800,000) are therefore completely exempt as they were both granted and vested prior to Richard's first visit to Hong Kong. With respect to the gains from tranche B, the two-year vesting period covers the years of assessment 2011/12 and 2012/13, in both of which Richard spent time in Hong Kong. Since Richard is exempt from salaries tax for the year of assessment 2011/12, only half of the gain from tranche B, $320,000 ($80*8,000*1/2), is, subject to time apportionment, taxable in 2012/13.

Richard is also subject to property tax in respect of the rental income received from letting the flat. Property tax in Hong Kong is imposed on rental consideration from the letting of property situated in Hong Kong, regardless of whether the landlord is resident in Hong Kong or not. Since rental is first received in July 2012, the relevant year of assessment for property tax purposes is 2012/13; and the property tax payable is calculated as follows:

	$
Assessable value (12,000 x 9)	108,000
Less: 20% statutory deduction	(21,600)
Net assessable value	86,400
Property tax at 15%	12,960

For property tax purposes, there are no provisions available to allow tax deductions for loan interest, renovation costs, air-conditioners/refrigerator/washing machine costs or management fees.

Richard would be able to deduct the mortgage loan interest of $60,000 payable on the money borrowed to acquire the property under personal assessment, but only to the extent of the income earned from that property. Further, the loan interest of $3,000 on the money borrowed may also be deductible under personal assessment if it can be shown to be incurred in producing the rental income.

To be eligible to elect for personal assessment, the individual taxpayer must be either a permanent or temporary resident in Hong Kong; or his or her spouse is a permanent or temporary resident. Permanent resident refers to an individual who ordinarily resides in Hong Kong. Based on *R* v *Barnet London Borough Council*, a person is resident in a place 'where a person lives and conducts his daily life in circumstances which lead to the conclusion that he is living there as an ordinary member of the community would live for all the purposes of his daily life'. A temporary resident refers to an individual who is present in Hong Kong for a period or periods during the year of assessment amounting to more than 180 days or for more than 300 days over two consecutive years, one of which is the year for which an election is sought.

Richard is not a permanent resident of Hong Kong and only travelled to Hong Kong to visit the Company's operations and to meet clients. However, as Richard has stayed in Hong Kong for 151 days during 2012/13, if he stays in Hong Kong for another 149 days during 2013/14, he would qualify as a temporary resident and so be eligible to elect for personal assessment in 2012/13. Only if he does so, will he be able to deduct his loan interest from the property income earned.

Richard will be entitled to a married person's allowance and a child allowance. His salaries tax liability for the year of assessment 2012/13 is calculated as follows:

Computation of Richard's Hong Kong salaries tax liability
Year of assessment 2012/13

	$	$
Salary ($100,000*12)	1,200,000	
Housing allowance ($20,000*12)	240,000	
Daughter's university fees	120,000	
Share option gains	320,000	
Total subject to time apportionment	1,880,000	
Net assessable income (x 146/365)		752,000
Less: Married person's allowance		(240,000)
Child allowance		(63,000)
Net chargeable income		449,000
Tax payable at progressive rates on $449,000		64,330
Tax payable at standard rate of 15% on $752,000		112,800
Therefore, the tax payable is		64,330

3 Expanding Co Ltd

(a) Under the Stamp Duty Ordinance in Hong Kong, stamp duty is payable on instruments which give effect to the transfer (or lease) of immovable property located in Hong Kong (Head 1) or the transfer of stocks and shares which need to be registered in Hong Kong (Head 2).

Under the initial offer of Expanding Co Ltd (Expanding), the building would be directly acquired from Retiring Co Ltd (Retiring) for $20 billion. The chargeable instrument for stamp duty is the conveyance on sale. Consideration for stamp duty purposes is usually based on the price for the transaction unless there is evidence that the consideration is well below the market value, in which case the market value would be used for stamping purposes. Based on the offer price of $20 billion, which is consistent with the market value, the stamp duty payable at the *ad valorem* rate of 4·25% would be $850 million. The law stipulates that both parties to the transaction are jointly and severally liable for the payment of the stamp duty, but in market practice, the stamp duty for the transfer of immovable property is normally payable by the purchaser. If this practice is followed, the stamp duty cost to Expanding of a direct property sale will be $850 million.

Under the counter-offer, the shares in Retiring are transferred instead of the building. In this case, the chargeable instrument for stamp duty is the contract note (comprising a bought note and sold note) and stamp duty is payable at the rate of 0·2% of the consideration of the share transfer, payable at 0·1% on each of the bought note and sold note respectively. The subsequent instrument of transfer would also be subject to a fixed duty of $5. In determining the consideration for a share transfer, any benefits or money's worth including debts assigned or assumed or waived, securities, commodity or services performed would be included. In the case of Expanding's acquisition of shares in Retiring, the total consideration to be stamped would include both the amount of $12·5 billion payable to the shareholder and the loan amount of $8 billion assumed by Expanding. As a result, the stamp duty payable under this counter-offer is $41 million + $5 ($20·5 billion x 0·2% + $5). The stamp duty cost shared by Expanding is, therefore, $20·5m + $2·5.

Assuming special stamp duty is not payable, the total difference in stamp duty (for simplicity's sake, the $5 fixed duty for the instrument of transfer is ignored) for the share transfer compared to the initial offer of transferring the building is $809m ($850m – $41m). The equal share of the benefit to each party is $404·5m, i.e. circa $0·4 billion, which supports the extra mark-up of $0·5 billion charged by Retiring, although the excess of $0·1 billion would represent room for further negotiation. From a practical perspective based on the actual stamp duty cost to Expanding, the absolute savings would seem to be even more, as follows:

Stamp duty for acquiring the building:	$850m	(100% by purchaser per market practice)
Stamp duty for the share transfer:	$20·5m	(payable on bought note only)
Actual savings:	$829·5m	

Based on the above, simply from a stamp duty perspective, it would seem beneficial for Expanding to consider acquiring the shares instead of the building, even with the extra mark-up of $0·5 billion.

(b) Effective from 20 November 2010, special stamp duty is payable in addition to the normal *ad valorem* stamp duty arising from the transfer of immovable residential property which is acquired on or after 20 November 2010 and resold within 24 months. The rate of special stamp duty depends on the holding period of the property as follows:

– 15% for property held for six months or less;
– 10% for property held between six to 12 months; and
– 5% for property held between 12 to 24 months.

The special stamp duty is chargeable regardless of whether the sale of the property gives rise to a profit to the seller or not. If special stamp duty is payable, both parties to the transaction are jointly and severally liable, unless the sale and purchase agreement specifies otherwise.

In the case of Expanding's acquisition of property from Retiring, it would be advisable for Expanding to obtain information about the date when Retiring acquired the property. If the property was acquired prior to 20 November 2010, it will not fall within the scope of special stamp duty. However, if it was acquired after 20 November 2010, special stamp duty would potentially be payable. Expanding would need to negotiate with Retiring as to how the liability would be split. (**Note:** *The amount of duty payable is not quantifiable at this stage as the date of acquisition is not known.*)

(c) If shares in Retiring are acquired instead of the building, Expanding will become a shareholder in Retiring, which owns the building. All the assets and liabilities of Retiring including any potential tax risks, past or future, would remain with Retiring and be inherited by Expanding as a shareholder. Should any of these risks crystallise after the change in shareholding, any extra tax costs would be accountable by Expanding, even though the costs may be relating to events occurring prior to the shareholding change. Therefore, in order to protect itself, Expanding should conduct a tax due diligence review of Retiring with the aim of identifying any significant potential tax risks and their chance of being crystallised. These risks may be quantified and reflected in the acquisition price, or alternatively a tax indemnity executed by Retiring's current shareholders, to the effect that any future tax costs arising from events occurring prior to the change in shareholding would be indemnified by the seller.

4 DayOne Co Ltd (DayOne)

(a) If DayOne's directors disagree with the assessment, DayOne may file a valid objection against the assessment under s.64(1) of the IRO. An objection will only be valid if all the following conditions are fulfilled:

(i) The objection must be lodged in writing addressed to the Commissioner.

(ii) The objection must state precisely the grounds for the objection. In this case, the ground for the objection would be that the year of commencement of business was in the year of assessment 2012/13 and, thus, the operating expenses are tax deductible. Detailed evidence and reasoning are also required to support that the business was commenced during 2012/13.

(iii) The objection must be received by the Commissioner within one month after the date of the notice of assessment, unless the Commissioner extends the permitted period or accepts a late notice of objection based on a reasonable cause.

(b) Section 88A of the IRO provides for advanced rulings to be obtained on the interpretation of the statutory provisions in certain circumstances. The purpose of the advanced rulings mechanism is to provide an increased level of certainty to taxpayers, to promote consistency in the application of the IRO and to minimise disputes between the IRD and the taxpayers.

However, the Commissioner may decline to issue or is not permitted to make a ruling if:

(i) A question of fact is involved requiring the Commissioner to determine or establish the fact. Facts should be established by taxpayers with evidence before rulings are sought. For example, whether or not the profit from a transaction is taxable, or when a business is commenced.

(ii) Assumptions are required to be made by the Commissioner, although the Commissioner has the right to make reasonable assumptions if he considers it necessary and chooses to do so.

(iii) The issue or matter seeking interpretation is subject to an objection or appeal, in order not to intervene or interrupt the normal objection or litigation procedure.

(iv) The issue or matter seeking interpretation relates to a tax return which has been lodged or is due for lodgement.

(v) Generally accepted accounting principles or commercial practices are involved.

(vi) The issue or matter seeking interpretation is, in the opinion of the Commissioner, not seriously contemplated.

(vii) The issue or matter seeking interpretation is relating to an audit or investigation undertaken by the IRD on the taxpayer.

(viii) The information provided is not sufficient.

(ix) It would be unreasonable to make a ruling in view of the resources available.

(x) The advanced rulings application is frivolous or vexatious.

In the case of DayOne, it would be unlikely that the ruling would be issued for the main reason that the issue of the date of commencement of business is a question of fact. Moreover, it relates to a position which has been taken in a lodged tax return, and an objection is to be made against the assessment.

(c) For tax purposes, the date of commencement of business does not necessarily equate with the date of incorporation of the company. However, the IRO does not contain provisions governing the determination of commencement of business. It is a question of fact which should be determined based on the merits of the case, making reference to case law principles. In *Birmingham & District Cattle By-Products Co Ltd* v *IRC* (12 TC 92), it was stated that preparatory activities such as research, acquisition of plant and machinery and the signing of agreements with suppliers should not be relevant factors to represent commencement of business. For example, a manufacturing business would not commence until raw materials are acquired for processing.

In the case of DayOne:

(i) 1 July 2012 – the date of incorporation would not be regarded as the date of commencement since the incorporation refers to the establishment of the legal entity rather than the business.

(ii) 1 November 2012 – the date of signing the office lease is unlikely to be regarded as the business commencement date since the office was not yet ready for the business.

(iii) 15 December 2012 – the date at which the office renovation was completed and the office was ready for use. However, the business would not be able to commence, as staff was not yet employed.

(iv) 20 December 2012 – the date at which the consulting manager commenced work. There is a likelihood that this will be treated as the date of business commencement for the reason that DayOne's business is property consultancy and thus the date on which the employee with relevant ability and competence was employed to start the business may be sufficient to be the date of commencement of business. Moreover, by *Bartica's* case, when a company put its assets into gainful use, it was in business. The consulting manager could be regarded as DayOne's asset, which was ready, as of 20 December 2012, to provide the intended business.

(v) 1 April 2013 – the date on which the first consulting agreement was signed. There is also likelihood that this date will be recognised by the IRD as the date of commencement of business since entering into the agreement provided the ability for DayOne to start the business and earn the fee income.

(vi) 1 May 2013 – the date on which the first fee income was received. Despite the fact that the date of first receipt of income may be taken as the date of business commencement by the IRD in certain cases where minimal preparatory activities are required, it would not seem reasonable in this case to ignore the efforts and activities performed prior to the receipt of income on 1 May 2013. In particular, the employment of the consultant and subsequent signing of the consultancy agreement are significant and relevant activities leading up to the receipt of income. The date of commencement of business should be prior to 1 May 2013.

On balance, taking into account that the IRD will usually adopt the earliest possible date, the most likely date which will be adopted as the commencement date is 20 December 2012.

(d) Strictly speaking, expenses incurred prior to the date of commencement of business would not be tax deductible since s.16(1) requires that expenses have to be incurred in the production of assessable profits before they are eligible for deduction. In particular, if the expenses incurred before business commences are related to the establishment of the business or incorporation of the entity, these expenses are capital in nature and not tax deductible. However, in practice, the IRD would consider allowing pre-commencement expenditure for tax deduction if the expenditure is in the nature of revenue and recurring which would be allowable if incurred after business commencement. Examples are operating expenses such as office rent and staff wages. In the case of capital expenditure such as plant and machinery incurred prior to the date of commencement, the expenditure would be deemed as incurred on the date of commencement for depreciation allowance purposes under s.40(1).

5 (a) Company A

If Company A extends an interest-bearing loan to its overseas subsidiary and earns interest income thereon, the taxability of the interest income in Hong Kong will depend on the 'source' of the interest income. Based on DIPN 13, the IRD used to adopt the 'provision of credit' test to ascertain the source of interest income, i.e. the place where the credit is first made available to the borrower. In this case, if the loan is first made available to the subsidiary overseas, such as remitting the loan money to the subsidiary's bank account outside Hong Kong, the loan interest may be regarded as sourced outside Hong Kong and not taxable. However, the IRD has expressed that the 'provision of credit' test would be restricted to the situation when the loan is extended from idle surplus cash and the interest earned is in the nature of passive income. Based on the *Orion Caribbean* case, the IRD has sought to apply the 'operations test' to determine the source of interest income if the IRD considers that the lending of money is part of a money lending business being carried on by the lender. In this case, the general rule determining the source of interest income would be the place where the lending activities are carried out, e.g. the place of negotiation and conclusion of the loan agreement ('contract effected' test). In the case of Company A, if there is evidence to prove that the funding for the loan to the subsidiary is sourced from Company A's idle fund, and the lending activity is not regular and recurring in nature, the interest income would be regarded as passive income and it would be offshore sourced and non-taxable if the loan money is first made available to the subsidiary outside Hong Kong. However, if the IRD does not consider that the funding from the bank overdraft constitutes idle funds and argues that the interest income is not a passive income, then the interest income arising from the loan may be taxable in Hong Kong unless there is evidence to prove that the loan contract has been negotiated, concluded and effected outside Hong Kong.

In terms of the interest cost payable on the bank overdraft used to fund the loan, the interest expense would be tax deductible if it satisfies the following conditions:

(i) the interest is incurred in the production of assessable profits (s.16(1));

(ii) the interest payable to the bank is on an overdraft facility which is not secured by any deposits or loans which derive non-taxable income in Hong Kong (s.16(2)(d) and s.16(2A)); and

(iii) there is no arrangement in place such that the interest payment is ultimately flowed back to the company or any connected person (s.16(2B)).

Therefore, in the case of Company A, the bank interest would only be tax deductible if the interest income from the overseas subsidiary is taxable in Hong Kong (condition (i)), subject to the fulfilment of conditions (ii) and (iii) above. However, if the interest from the overseas subsidiary is not taxable in Hong Kong, the bank overdraft interest would not be tax deductible.

(b) Company B

Under s.18E(1), when a taxpayer's accounts are not made up to the corresponding day in the following year of assessment or to more than one day in the following year of assessment, the CIR is empowered to compute the assessable profits for the year of change of accounting date, and to recompute the assessable profits for the previous year if the CIR thinks it appropriate.

The general principles to be followed in ascertaining the basis period for the year of change and the year preceding the year of change are:

(i) to adopt the new accounting date as soon as possible;

(ii) to make sure that, in the case of a new business (commenced on or after 1 April 1974), none of the profits arising during the life of the business fall out of the profits tax net; and in the case of an old business (commenced before 1 April 1974), the period left out of the assessment is not one of high profit;

(iii) to amend the basis period for the preceding year to the new accounting date only if this gives a larger profit; and

(iv) to ensure fairness to both the IRD and the taxpayers.

Based on the above principles, Company B's basis period for the year of change would very much depend on the date of commencement of its business. If it commenced business before 1 April 1974, it is regarded as an old business. If it commenced business on or after 1 April 1974, it is a new business. Different rules apply to old and new businesses.

In the case of Company B, the year of change is 2012/13 on the basis that it fails to make up accounts based on the corresponding day in the year, i.e. it fails to make up accounts to 31 December 2012 for 2012/13. The year preceding the year of change is 2011/12. The year 2013/14 is the first assessment year which adopts accounts made up to the new accounting date.

Year of assessment (Y/A) 2013/14 – Based on the principle that the new accounting date is to be adopted as soon as possible, the normal basis period for the year following the year of change, i.e. 2013/14, would simply be the 12 months from 1 July 2012 to 30 June 2013. Apportionment of profits and expenses would be required based on the 18-month accounts drawn up to 30 June 2013.

Y/A 2012/13 – This is the year of change and different rules apply to determine the basis period depending on whether the business is a new business or an old business, and the reason for the change of accounting date.

Assuming that Company B is a new business and there is a compelling reason for the change of accounting date (such as conformity in the group's practice, as in the case of Company B), the CIR is normally prepared to limit the basis period to a period of less than 12 months, by concession. Therefore, the basis period for 2012/13 is likely to be the six months from 1 January 2012 to 30 June 2012.

However, if there is no compelling reason to change the accounting date, or if Company B is an old business, the CIR would not apply the concession but choose to follow a period of 12 months for the year of change, i.e. from 1 July 2011 to 30 June 2012. In this case, there would be double assessment of the profits arising from 1 July 2011 to 31 December 2011.

Y/A 2011/12 – This is the year preceding the year of change of accounting date. If Company B is a new business and a six-month basis period is adopted for the year of change 2012/13, then it is likely that the basis period for 2011/12 would remain unchanged because no profits have fallen out of assessment.

If Company B is an old business and an adjusted 12-month basis period has been adopted for the year of change 2012/13 giving rise to duplication of the profits assessed, it is unlikely that further adjustment to the basis period for 2011/12 would be made since profits have been doubly assessed and there have been no other profits falling out of the assessment during the business life.

Thus, in both cases the basis period for 2011/12 is likely to remain that from 1 January 2011 to 31 December 2011.

					Available	*Maximum*
1	**(a)**	**(i)**	**Disposal of 'DD Dog'**			
			Internet sale is not relevant for non-taxability		0·5	
			No business registration is not relevant for non-taxability		0·5	
			Section 14 scope of profits tax – trade, profession or business		1	
			Trade includes isolated transaction or series of transactions		0·5	
			Six badges of trade – description of badges and further information needed (1 mark for each badge)		6	
			Other factors taken into account by the IRD		1	
					9·5	9
		(ii)	**Source of profits**			
			General guidelines under DIPN 21 – broad guiding principle		0·5	
			Operations test		0·5	
			E-commerce treated same as conventional business		0·5	
			Focus on location of the physical business operation		0·5	
			Location of server is less important		0·5	
			Place where sale and purchase contracts are effected		0·5	
			Direct profit producing activities		0·5	
			Antecedent and incidental activities are irrelevant		0·5	
			Agent's activities are attributable to taxpayers		0·5	
			Server is not an agent		0·5	
			Mr Man is likely taxable		0·5	
					5·5	5
	(b)	**(i)**	**Acquisition of 'BB Bug'**			
			Capital expenditure not tax deductible by general rule		0·5	
			Specific deduction under s.16EA		0·5	
			Deduction over five years, straight-line		1	
			Design must be registered on date of acquisition		0·5	
			Outright purchase of both legal and economic ownership		0·5	
			Used in producing HK assessable profits		0·5	
			If not used in any year, deduction is lost		0·5	
			Partial use results in apportionment		0·5	
			If registered in more than one jurisdiction, proof of impact on HK profits required		0·5	
			Design is not acquired from associate, including definition		1	
			Mr Man is an associate		0·5	
			No deduction is allowed under s.16EA		0·5	
					7	6
		(ii)	**(1)**	**Type A designs – cost of acquisition**		
				Capital expenditure but deductible under s.16EA	0·5	
				Conditions under (b)(i) also apply	0·5	
				Condition (4) will be satisfied if not acquired from associate	0·5	
				Expenditure deductible if all conditions are met	0·5	2
			(2)	**Type A designs – licensing income**		
				General source rules apply – DIPN 21 and 49	0·5	
				Income from HK customers is sourced in HK and taxable	0·5	
				Income from China customers may be non-taxable if used outside HK	0·5	
				But relevant portion of acquisition cost is then not deductible	0·5	2
			(3)	**Type A designs – disposal**		
				If a deduction is claimed under s.16EA, sale proceeds are taxable	1	
				Limited to the amount of tax deduction allowed	0·5	
				If sale proceeds smaller than cost balance, unclaimed amount is fully deductible	0·5	2

		Available	Maximum
(iii) (1)	**Type B designs – cost of R&D**		
	Not deductible under s.16EA as asset is not acquired	0·5	
	Staff and general expenses deductible under s.16(1)	0·5	
	Capital expenditure on R&D machinery deductible under s.16B	0·5	
	Used in R&D relating to the business of Newco	0·5	
	Only net expenditure after grant and subsidies is deductible	0·5	
		2·5	2
(2)	**Type B designs – licensing income**		
	DIPN 49 – IRD's different view if the designs are created and developed by taxpayer in HK	1	
	Generated by taxpayer's wits and labour in HK	0·5	
	Therefore if created in HK, income sourced in HK	0·5	
	Newco's R&D division is in HK, all licensing income is sourced in HK	0·5	
	Taxable in HK	0·5	
		3	2
(3)	**Type B designs – disposal**		
	If deducted under s.16B, disposal proceeds are trading receipts and taxable	0·5	
	Subject to total deductions claimed before	0·5	1
	Appropriate format and presentation	1	
	Logical development	1	
	Effectiveness of communication	2	4
			35

		Available	Maximum
2	Employment with the Company		
	Not a HK employment, with reasons	1	
	Remuneration attributable to HK services rendered still taxable	0·5	
	60 day exemption under ss.8(1A)(b)(ii) and 8(1B)	0·5	
	Richard is a visitor, with reasons	1	
	Counting the days of visits – both arrival and departure counted	1	
	Exempt under s.8(1A)(b) for 2011/12	1·5	
	No exemption under s.8(1A)(b) for 2012/13	1·5	
	Counting the days for time apportionment – either day of arrival or departure counted	1	
	Time apportionment under s.8(1A)(a)	3	
	Taxability of salaries and housing allowance	1	
	Taxability of rent paid for the serviced apartment	0·5	
	Taxability of university fees	1	
	Taxability of share option gains – practice under DIPN 38	3·5	
	Letting of property		
	Subject to property tax in 2012/13	1	
	Property tax payable	1	
	Treatment of rent, loan interest, renovation and other costs	1·5	
	Personal assessment		
	Eligibility for election	0·5	
	Definition of permanent and temporary resident	1·5	
	Whether Richard is eligible	1·5	
	Personal allowances	1	
	Salaries tax payable	2	
		27	
			25

			Available	Maximum
3	**(a)**	Transfer of immovable property (Head 1)	0·5	
		Transfer of HK stock (Head 2)	0·5	
		Shares of HK company registered in HK are HK stock	0·5	
		Conveyance on sale of property	0·5	
		Consideration or market value if higher	1	
		Ad valorem rates	0·5	
		$20 billion x 4·25% = $850 million	1	
		Both parties are jointly and severally liable	0·5	
		In practice, borne by purchaser	0·5	
		Transfer of stock stamp duty of 0·2% plus $5	1	
		Stamping of contract notes and instrument of transfer	1	
		Consideration includes debts waived or assigned or assumed	1	
		Dutiable value is $20·5 billion ($12·5 bn + $8 bn)	0·5	
		Duty is $41m (0·2% x $20·5 bn) + $5	1	
		Share of Expanding is $20·5m + $2·5	0·5	
		Savings in stamp duty is $809m ($850m – $41m)	0·5	
		Equal share of benefit from savings by each party is $0·4 billion	0·5	
		Excess of $0·1 billion negotiable	0·5	
		Practical savings to Expanding is $829·5m ($850m – $20·5m)	1	
		More beneficial to acquire shares than building	1	
			14	12
	(b)	Special stamp duty if property is acquired after 20 November 2010	1	
		And resold within 24 months	1	
		Rate of duty depends on the holding period	1	
		Payable on top of normal stamp duty	1	
		Regardless of whether a profit or loss on sale	0·5	
		Both parties jointly and severally liable unless specified otherwise	1	
		Application/effect dependent on the acquisition date	1	
		Expanding should check the property acquisition date	0·5	
			7	6
	(c)	All assets and liabilities remain with Retiring	0·5	
		All potential risks inherited by Expanding	0·5	
		Tax risks and costs may relate to events prior to shareholding change	0·5	
		Potential costs to be reflected in acquisition price	0·5	
		Tax due diligence review to protect interests of Expanding	0·5	
		Tax indemnity as an alternative	0·5	
			3	2
				20

			Available	*Maximum*
4	**(a)**	Objection to be lodged	0·5	
		Conditions for valid objection:		
		In writing and addressed to Commissioner	0·5	
		State precise grounds	0·5	
		Date of commencement of business	0·5	
		Received by Commissioner within one month	0·5	
		Unless extension is granted or reasonable cause for late objection	0·5	3
	(b)	Purposes:		
		Provide certainty to taxpayers	0·5	
		Promote consistency in IRO application	0·5	
		Minimise disputes	0·5	
		CIR may decline:		
		Question of fact	0·5	
		Assumptions	0·5	
		Issue under objection	0·5	
		Tax return filed	0·5	
		Accounting principles or commercial practices	0·5	
		Not seriously contemplated	0·5	
		Issue under audit or investigation	0·5	
		Insufficient information	0·5	
		Resource constraints	0·5	
		Frivolous or vexatious application	0·5	
		This case: ruling is unlikely	1	
			7·5	7
	(c)	Date of incorporation not date of business commencement	1	
		No statutory provision in IRO	0·5	
		A question of fact based on merits of cases	0·5	
		Preparatory activities to be ignored	1	
		1 July 2012 – not likely	0·5	
		1 November 2012 – not likely as office was not ready	0·5	
		15 December 2012 – not likely as no staff	1	
		20 December 2012 – likely as consulting manager started work	1	
		1 April 2013 – likely as agreement was signed	1	
		1 May 2013 – not reasonable to ignore activities prior to receipt of income	1	
		Conclusion	1	
			9	7
	(d)	Not deductible under s.16(1), with reason	1	
		Expenses relating to incorporation are capital in nature	0·5	
		In practice, allowable if revenue and recurring nature	0·5	
		If such revenue expenses, allowable if incurred after commencement	0·5	
		Capital expenditure deemed incurred on the date of commencement	1	
			3·5	3
				20

			Available	Maximum
5	(a)	Depends on source of interest income	0·5	
		Provision of credit test for source of interest income	0·5	
		Place where the credit is first made available to borrower	0·5	
		If remit the loan money overseas, offshore sourced and non-taxable	1	
		Restricted to passive interest income	0·5	
		Operations test if money lending business	0·5	
		Contract effected test	1	
		Conclusion for Company A	1	
		Interest cost tax deductible if in the production of assessable profits	0·5	
		Interest cost payable to bank not secured by deposits deriving non-taxable interest income	1	
		No arrangement for interest to flow back	0·5	
		Conclusion for Company A	1	
			8·5	8
	(b)	Definition of change of accounting date	1	
		Principles:		
		Adopt the new accounting date as soon as possible	0·5	
		New business: no profits falling out	0·5	
		Old business: profit left out is not high	0·5	
		Amend the preceding year	0·5	
		Ensure fairness	0·5	
		1 April 1974 to define new and old business	0·5	
		2013/14:		
		New accounting date	0·5	
		Normal basis period 1 July 2012 to 30 June 2013	1	
		Apportionment based on 18-month accounts	0·5	
		2012/13:		
		Year of change	0·5	
		Depending on old or new business	0·5	
		And depending on compelling reason or not	0·5	
		Conformity of group's practice is compelling reason	0·5	
		Six-month basis period 1 January 2012 to 30 June 2012	1	
		If no compelling reason, 12-month basis period 1 July 2011 to 30 June 2012	1	
		Double assessment for profits 1 July 2011 to 31 December 2011	0·5	
		2011/12:		
		Year preceding the year of change	0·5	
		New business, no change as no profits fall out	0·5	
		Old business, no change, with reasons	1	
		Both cases: basis period 1 January 2011 to 31 December 2011	0·5	
			13	12
				20