Answers

1 Report to Mr Po of HK-Co

To: Mr Po
From: Tax advisor
Date: 7 December 2009
Subject: **Hong Kong tax positions of HK-Co, BVI-Co and Mr Li arising from the proposals to extract cash out of HK-Co and the sale and lease-back of the warehouse**

We refer to the potential cash extraction problem with HK-Co, which is unable to distribute the surplus cash as dividend all the way up to Mr Li due to the negative reserve of the intermediate holding company, BVI-Co. You are also considering the option to sell and lease-back the warehouse which is currently under construction by HK-Co. You have requested us to address all the Hong Kong tax implications of the above issues to HK-Co, BVI-Co, Mr Li and the Hong Kong leasing company where applicable. Based on the information provided, our comments are as follows:

(a) Cash extraction out of HK-Co

(1) HK-Co distributes the surplus cash as dividend to BVI-Co, and BVI-Co lends the cash to Mr Li interest free.

The distribution of a dividend by HK-Co to its shareholder, regardless of the residency of the shareholder, is tax neutral, i.e. non-taxable to BVI-Co and non-deductible to HK-Co. However, if the dividend is paid directly out of cash drawn from the bank loan on which interest is incurred, that portion of interest attributable to the amount drawn to fund the payment of a dividend may be disallowed by the Inland Revenue Department (IRD) as the loan money is not used for the production of assessable profit. The information provided is not clear as to the source of the surplus cash in HK-Co. If there is evidence to prove that the surplus cash is generated from sources other than directly from the bank loan, e.g. operating funds or from the sale of other assets, and the bank loan originally drawn was wholly used to finance HK-Co's operating business, there is a good case to argue that the bank loan interest would remain deductible.

Tutorial note: See Zeta Estates Limited v *CIR [2005]. Where it can be established that the borrowed funds were required to replenish working capital to be paid out as a dividend, or to provide additional working capital, related interest may still be deductible subject to the satisfaction of other requirements under s.16(2).*

Upon receipt of the dividend from HK-Co, BVI-Co will lend the cash to Mr Li interest free. Irrespective of whether BVI-Co is carrying on business in Hong Kong or not, since BVI-Co is not taxed on the dividend and does not incur any funding cost for the loan, there is no tax implication for BVI-Co. In the case of Mr Li, assuming he is not carrying on business as a money-lender, there is no tax implication for him on receiving an interest-free loan from BVI-Co except that he would not get any interest deduction upon election of personal assessment if he used the money to acquire investment property which earns rental income.

(2) HK-Co lends the surplus cash to BVI-Co interest free, and BVI-Co lends the cash to Mr Li interest-free.

If HK-Co obtains the surplus cash directly by drawing on the bank loan on which interest is incurred, and lends the surplus cash to BVI-Co at no interest, that portion of the bank loan interest attributable to BVI-Co's loan would be disallowed for tax purposes by the IRD. If the surplus cash comes from sources other than the bank loan, there may be a case to argue but the risk of tax disallowance still exists. The non-interest bearing loan receivable would become part of the assets in HK-Co's accounts. It is the normal practice of the IRD to deem a certain part of the bank loan as applied to generate this non-income producing loan asset and thus seek to disallow a portion of bank loan interest based on the ratio that the non-income producing loan asset bears to the company's total assets. This may be defended if there is sufficient evidence to trace that the bank loan is distinguished from the surplus cash, but this is subject to the IRD's agreement and HK-Co may have to prove before the Board of Review if the IRD disagrees.

Upon receipt of the interest free loan from HK-Co, BVI-Co will lend the cash to Mr Li interest free. Similar to option (1) above, there is no tax implication for BVI-Co since no interest income is earned and no interest expense is incurred. The tax implication for Mr Li is also the same as option (1) above, i.e. no tax implication except for the taxation of rental income under personal assessment.

(3) HK-Co lends the surplus cash directly to Mr Li, interest free.

The tax implication for HK-Co of making an interest free loan to Mr Li is the same as if the loan is made interest free to BVI-Co under option (2) above. The tax implication for Mr Li under this option is also the same as that under options (1) or (2) above.

(4) BVI-Co sells HK-Co to Mr Li at book value or at a profit. BVI-Co waives the sale consideration receivable from Mr Li; after the share transfer, HK-Co distributes the surplus cash as a dividend to Mr Li and BVI-Co is liquidated.

Implications for BVI-Co:

Under this option, the sale of HK-Co is transacted at the level of BVI-Co and the waiver of the sale consideration would be recorded as an accounting loss in the accounts of BVI-Co. In assessing whether these transactions give rise to any tax implications, it would be necessary to assess whether BVI-Co would be carrying on business in Hong Kong or not. It is not within the scope of this report to carry out this analysis, but we will be happy to do so when you consider it necessary.

If BVI-Co is not carrying on business in Hong Kong, there is no tax implication (except for stamp duty as discussed below) to BVI-Co at all, both for the sale (regardless of whether at book value or at a profit) and for the waiver of sale consideration. However, if BVI-Co is carrying on business in Hong Kong, the profit, if any, arising from the sale of HK-Co would need to be reported to the IRD but may be claimed as a non-taxable profit on the basis that it arises from a capital transaction. Given that BVI-Co has been holding HK-Co for investment purposes over the years, it is possible that the capital profit argument may sustain. The only risk is that the IRD may take the position that the intention of BVI-Co to hold HK-Co for capital investment purposes has actually changed at some point of time before the sale and the sale is driven by a profit-making motive. In this case, the portion of profit based on the sale value in excess of the fair market value as at the date of change of intention will be taxed. To counteract this challenge, it is advisable to ensure that proper documentation is in place to record the genuine and commercial reasons for the sale by BVI-Co and that its intention of long-term holding of the shares in HK-Co has never changed. As for the loss from waiver of the sale consideration, it would not be allowed as a tax deduction if BVI-Co seeks to claim the sale profit as non-taxable. The ultimate liquidation of BVI-Co will not trigger any tax implication for BVI-Co.

As HK-Co is a company incorporated in Hong Kong, any transfer of its shares is required to be registered in Hong Kong by way of a contract note and an instrument of transfer. The contract note is liable to stamp duty at the rate of 0·1% on the consideration or the value of the shares transferred, whichever is higher. The stamp duty is payable by each of the purchaser (Mr Li in this case) and seller (BVI-Co in this case), i.e. a total of 0·2% is payable for each transaction. The instrument of transfer is subject to a fixed stamp duty of $5. The common group relief for stamp duty (s.45 of the Stamp Duty Ordinance (SDO)) is not applicable in this case on the basis that the group relief only applies where both the transferor and transferee are associated corporations. In this case, the transferee is Mr Li who is an individual, not a corporation, and thus the group relief is not applicable. Stamp duty is therefore payable. Moreover, the subsequent waiver by BVI-Co of the consideration would not have any impact on the stamp duty which remains payable, as s.24(1) of the SDO provides that consideration for stamp duty purposes includes debts waived or assigned.

Implications for Mr Li:

From the perspective of Mr Li, he is the purchaser of the shares in HK-Co but there is no cost to incur due to the waiver of the consideration by BVI-Co, except for the stamp duty payable, as referred to above. He will make a gain from the waiver but the gain will not be taxable on him unless there is evidence to the IRD that Mr Li is carrying on a trade, business or profession in Hong Kong. After the share transfer, Mr Li will receive a cash dividend from HK-Co, which is tax free in the hands of Mr Li. The ultimate liquidation of BVI-Co will have no tax implications for Mr Li.

Implications for HK-Co:

From the perspective of HK-Co, the change in its shareholder from BVI-Co to Mr Li will have no tax implication. After the share transfer, the distribution of the surplus cash as dividend to Mr Li also has no tax implication unless the dividend is directly funded by cash drawn from a bank loan, in which case the potential risk is the interest disallowance as explained in options (1), (2) and (3) above.

(5) BVI-Co is liquidated and the shares in HK-Co distributed to Mr Li; after the share transfer, HK-Co distributes the surplus cash as a dividend to Mr Li.

Implications for BVI-Co:

Unlike option (4), there is no sale or waiver of sale consideration in the books of BVI-Co. The commencement of liquidation of BVI-Co and the distribution of shares in HK-Co will have no tax implications for BVI-Co, regardless of whether it carries on a business in Hong Kong or not. As for stamp duty, the distribution of shares by the liquidators to Mr Li as shareholder would be exempt from stamp duty under s.27(5) of the SDO on the basis that no beneficial interest passes by way of the transaction. Adjudication and other formalities are required to be completed. Other than these, there is no tax cost.

Implications for Mr Li:

Mr Li will receive the shares in HK-Co as distribution from BVI-Co. There is no tax cost or stamp duty cost arising from the distribution. The ultimate cash dividend distributed from HK-Co to Mr Li would not be taxable to Mr Li.

Implications for HK-Co:

The liquidation of its immediate holding company, BVI-Co, will not have any tax implications for HK-Co. The distribution of shares in HK-Co by the liquidator of BVI-Co to Mr Li also will not have any impact on HK-Co. After the liquidation, the cash dividend distributed to Mr Li would not be tax deductible to HK-Co. As in options (1), (2) and (3), if the dividend is funded directly from cash drawn from a bank loan on which interest is incurred, there would be a risk of interest disallowance.

(b) Warehouse sale and lease-back

(i) The tax position of HK-Co in respect of the sale of the warehouse

If the sale gives rise to a profit to HK-Co, the sale profit will be subject to profits tax if the sale is considered by the IRD as one of trading stock. Despite the fact that the initial intention of constructing the warehouse was genuinely for long-term use purposes, the IRD may argue that this intention has changed at some point of time before the sale. In this case, the excess of the sale proceeds over the fair market value as at the date of change of intention would be considered as a revenue/trading profit and taxable.

In the context of tax depreciation allowance, it is stated that the warehouse would not qualify as an industrial building. Thus only the impact on commercial building allowance will be discussed. Section 35(1) of the Inland Revenue Ordinance (IRO) provides that where the relevant interest in a commercial building is sold, a balancing allowance or balancing charge is to be calculated by comparing the sale proceeds with the 'residue of expenditure', which is defined in s.40(1) of the IRO as the total capital expenditure incurred on the construction of the building reduced by any annual or balancing allowance made and increased by any balancing charge made. However, any balancing charge would be restricted to the total of the allowances claimed. In the case of HK-Co, if the building is to be sold to the leasing company before any commercial building allowance is claimed by HK-Co, the residue of expenditure would be equivalent to the total capital expenditure incurred. Even if the sale proceeds exceed the capital expenditure, there would not be any balancing charge. In the event that the building is sold after commercial building allowance has been claimed, the sale of the warehouse would likely give rise to a taxable balancing charge to HK-Co, which is effectively a claw-back of the total allowance that has been claimed before.

Since it was given that part of the construction costs have been identified as 'plant and machinery' on which initial allowance has already been claimed in previous years, the sale of the 'plant and machinery' would constitute a disposal of these pooled assets. The portion of sale proceeds (restricted to cost) attributable to the value of the plant and machinery sold should be deducted from the relevant pools of HK-Co. Unless the deduction is in excess of the written down value brought forward in the respective pools, there should be no balancing charge or balancing allowance on HK-Co.

Tutorial note: Based on DIPN 7 (revised) paragraph 16, the initial allowance is subject to the asset eventually being acquired and used in the trade carried on. As a result, if the plant and machinery is sold before it is used, there is a possibility that the IRD may seek to claw-back and tax the total initial allowances granted in previous years by way of additional assessment under s.60(1).

Upon the sale of the warehouse, stamp duty at *ad valorem* rates ranging from \$100 to 3·75% of the consideration would be payable under s.26(1) of the SDO which provides that a conveyance of sale or an agreement for the sale of an equitable estate or interest in any immovable property shall be chargeable with stamp duty. Assuming that the warehouse would be sold for \$100 million or \$120 million, the stamp duty payable at 3·75% of the consideration would be \$3,750,000 or \$4,500,000.

(ii) The tax position of HK-Co in respect of the lease rentals

The tax deductibility of lease rentals to HK-Co would be subject to the general tax deduction rule under s.16(1) of the IRO. Provided that the leased warehouse (and the plant and machinery incorporated) is being used by HK-Co in the production of assessable profits, the lease rentals would be tax deductible. Given that the leasing company is a third party which is subject to profits tax on its rental income received from HK-Co, the amount charged would generally be regarded as at arm's length. If the IRD has reasons to suspect that the lease rental may have been overstated as a result of the excessive sales price of the warehouse and this is done for the sole or dominant purpose of obtaining a tax benefit, the IRD may seek to apply s.61A to either disallow part of the lease rental or nullify the whole transaction.

Tutorial note: If the transaction is made between unrelated parties, the IRD may find it difficult to challenge the deduction but may seek to tax the sale profit for the reason that it is driven by a profit-making motive.

Stamp duty is payable on the lease agreement as required under Head 1(2) of the SDO. Assuming that the lease term is more than three years (based on the 20 years used by the bank) and only a periodic rental payment is payable without a premium, the stamp duty rate is 1% of the average yearly rent. The duty is collectible from all parties to the lease, and in practice shared equally between the lessor (the leasing company) and the lessee (HK-Co).

(iii) The tax position of the leasing company in respect of the tax depreciation allowance entitlement

The leasing company may be eligible to claim commercial building allowance in respect of the warehouse if the warehouse is used in the production of assessable profits after it is leased by HK-Co: s.18F. Section 33A(2) of the IRO provides that where the relevant interest in a commercial building is sold, the subsequent annual allowance to the buyer is calculated by dividing the residue of expenditure immediately after the sale by the number of years of assessment comprised in the period which begins with the year of assessment in which the sale occurred and ends with the year of assessment which is the 25th year after the year of assessment in which the building was first used. In brief, if the warehouse is acquired by the leasing company before it is first put into use, the leasing company would be entitled to commercial building allowance at the annual rate of 1/25 (or 4%) based on the total construction cost incurred on the building, regardless of the price it paid for it. If commercial building allowance has been claimed by HK-Co before the warehouse is sold to the leasing company, the annual allowance to the leasing company would generally also be based on the total construction cost but the annual rate would be adjusted depending on the year of first use.

Since part of the construction costs has been identified as 'plant and machinery' on which initial depreciation allowance has been claimed by HK-Co, the leasing company would not be entitled to any depreciation allowance on the plant and machinery under s.39E(1)(a) of the IRO. This is because the plant and machinery was previously owned and used by the lessee (HK-Co) or his associate (under a sale and lease-back arrangement). The term 'used' includes 'held for use' or held in reserve. This will in theory apply in the case of HK-Co which constructs the building together with the plant and machinery and has held them ready for use. However, s.39E(2) of the IRO provides an exception to the denial of depreciation allowance described above, if both the following conditions are fulfilled:

(a) the lessor (the leasing company) purchases the plant and machinery from the end-user (HK-Co) at a price not greater than the price paid to the supplier by the end-user (HK-Co); and
(b) no initial or annual allowance has been made to the end-user (HK-Co) in respect of the plant and machinery prior to its acquisition by the lessor (the leasing company).

In the case of HK-Co, since an initial allowance has already been claimed in a previous year, it would seem that the above conditions cannot be met. The leasing company is likely, therefore to be unable to claim the tax depreciation allowance on the plant and machinery bought and leased back to HK-Co.

We hope the above addresses all the relevant tax issues arising. Should you have any questions, please let us know.

End of Report

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ABC Tax consultants
[Firm's address]

Mr Ivan Man
[Address]

[Date]

Dear Mr Man,

Thank you for engaging us to review your tax position for the year of assessment 2008/09. Based on the information you supplied, I outline our advice as follows:

(a) Employment with Real Estate Development Ltd (REDL)

As your employer is a company resident in Hong Kong, your employment is obviously located in Hong Kong and all your remuneration for services under this employment, wherever rendered, is within the scope of salaries tax; unless exempted under s.8(1A)(b) of the Inland Revenue Ordinance where all services are rendered outside Hong Kong. For this purpose, it is further provided in s.8(1B) that services rendered in Hong Kong during visits not exceeding 60 days are ignored.

During the year of assessment 2007/08, you rendered all your services in China. Therefore, you would be exempt from salaries tax under s.8(1A)(b). However, in the year of assessment 2008/09, you rendered services in Hong Kong and stayed in Hong Kong for more than 60 days. You are therefore not eligible for the exemption and all your income would be assessable.

However, if you were present in China for more than 183 days during the year ended 31 December 2008, you would be liable to individual income tax in China in respect of your employment income. This should be clarified, because if you are held not to be eligible for the exemption under s.8(1A)(b), any income taxed in China in respect of services rendered in China would be exempt from salaries tax under s.8(1A)(c) so long as you have paid income tax on it in China.

In addition to your monthly salary, the share option benefit will also not be taxable. Although the option was exercised in the year of assessment 2008/09 when you are liable to salaries tax in Hong Kong, the option was granted in the year of assessment 2007/08 when you were exempted from tax by virtue of s.8(1A)(b). The gain from exercising the option is therefore not assessable: DIPN 38, paragraph 35. Moreover, any gain from subsequent disposal of the shares is not taxable under salaries tax.

Although not paid by your employer, the fees of $50,000 received from the overseas companies that have supplied building materials to REDL are also part of your income from employment. These fees are assessable under salaries tax as they are paid for your services performed in your employment with REDL [*Calvert* v *Wainwright*].

However, the fees of $80,000 received from these suppliers for the introduction of business were received not because of your services under your employment contract with REDL but because of your personal services as agents for them. These fees are likely assessable under profits tax. However, only profits arising in or derived from Hong Kong are assessable under profits tax. Where your services were performed to earn the fees is important in determining the source of the income. Judging from the facts that you represented these overseas suppliers are based in Hong Kong and liaised with other Hong Kong property development companies in Hong Kong, so it is likely that the fees have a Hong Kong source and thus, are subject to profits tax in Hong Kong.

Therefore, your assessable income from the employment with REDL is $890,000 ($840,000 + $50,000). The fees of $80,000 are assessable under profits tax, and you are entitled to deduct expenses incurred in the production of these fees under s.16.

Loss from partnership business

The adjusted loss of the partnership should be allocated to the respective partners (see appendix) and carried forward under the name of the partnership and can only be offset by the partners against their share of future profits from the partnership. You and your wife are therefore advised to elect for personal assessment for 2008/09. Under personal assessment income and losses from different sources are aggregated into one assessment; and tax savings can be achieved by offsetting your wife's share of the partnership loss of $110,000 against your other income from employment and business.

Other available deductions

Both you and your wife will be able to claim a maximum deduction of $12,000 in respect of any contributions to the mandatory provident fund; and this amount needs to be ascertained.

Your tax positions for the year of assessment 2008/09

Based on the personal assessment calculation (see appendix), you and your wife have a net chargeable income of $644,000 for the year of assessment 2008/09. Accordingly, you will pay tax at progressive rates rather than at the standard rate on $860,000. The tax liability will be paid by you as your wife has no chargeable income.

(b) Acquisition and lease of property

If you acquire the property in Central in your own name and receive rental income, you will be subject to property tax at the standard rate on the net assessable value of the property under s.5(1). 'Net assessable value' as defined under s.5B includes any consideration payable in money or money's worth in respect of the right to use the land or/and buildings; as reduced by rates and a statutory allowance of 20% of the assessable value of the property after the deduction of any rates paid by you. There will be no deduction of the actual expenses incurred in respect of the property including the loan interest, service fees paid to your agent or other expenses incurred in connection with refurbishing the property and providing the necessary furniture. If you wish to claim a deduction of loan interest, you would have to elect for personal assessment jointly with your wife.

As stated above, under personal assessment, all your and your wife's assessable income from various sources is aggregated, including rental income from property. It is specifically provided that when property income is included under personal assessment, the related loan interest can be deducted against the property income. This is the only way to obtain a tax deduction for the loan interest incurred if the property is owned in your own name. However, the deduction is limited to the 'net assessable value' of the property, i.e. 80% of the total rental received.

If you acquire the property in the name of a limited company, s.5(1) is still applicable on the basis that the company will still be considered as 'owner' of the property. Any rental income will be subject to property tax, calculated in the same manner as for an individual as explained above. However, according to s.2, 'business' is defined to include the letting or sub-letting of property by a corporation. Moreover, under s.14, any person who carries on a trade, profession or business in Hong Kong and derives assessable profits in Hong Kong will be subject to profits tax. Therefore, the rental income will also be subject to profits tax. If no such exemption has been allowed, s.25 allows the property tax paid to be offset against the profits tax chargeable and any excess to be refunded.

The double taxation of a limited company that is subject to both property tax and profits tax, can be eliminated by the application of s.5(2)(a). Under this section, any corporation which is subject to profits tax in respect of rental income can apply for an exemption from property tax in relation to the same rental income. It is advisable for a limited company to claim the exemption so that the rental income is only subject to profits tax.

Profits tax under s.14 is imposed on assessable profits, which take into account all relevant expenses and outgoings that are incurred in the production of the assessable profits (s.16). The limited company is therefore able to deduct the service fees paid to the agent and loan interest as they are incurred to produce the chargeable rental income. Moreover, as the loan will be obtained from a bank and is not secured by any deposit, the conditions in s.16(2)(d) should be satisfied; and the restrictions in ss.16(2A), (2B) and (2C) should not apply. The expenses incurred on refurbishing the property are capital in nature and non-deductible under s.17(1)(c). However, the company will be entitled to commercial building allowance on the expenditure incurred on refurbishing the property and depreciation allowance for plant and machinery in respect of the cost of the furniture. In a situation where total deductible expenditure exceeds total income, the excess can be carried forward as a loss to subsequent years and is eligible for deduction against any future taxable income.

As compared to holding the property in your own name, although the applicable tax rate for a company (16·5%) is higher than that applicable for an individual (15%), the company's taxable profit should be lower, possibly even zero, as more expenses are now allowable and no limitation is imposed for the tax deductibility of the loan interest incurred. However, the company's loss is not eligible to be included under personal assessment to offset other income earned by you. This is because an incorporated company is a separate legal person and its tax position is on its own account.

Irrespective of whether the property is acquired in your name or in the name of a limited company, the acquisition and lease of the property are subject to stamp duty. Under Head 1(1A) of the Stamp Duty Ordinance the agreement for the sale and purchase of the property is liable to *ad valorem* duty. Stamp duty payable is 3·75% on $9 million, i.e. $337,500. The formal assignment executed in conformity with the stamped agreement will only be liable to duty at the fixed rate of $100. A lease agreement in respect of the property is chargeable under Head 1(2) in the First Schedule and must be stamped within one month. As the lease will be for less than three years, the stamp duty payable is 0·5% of the yearly rent of $300,000, i.e. $1,500.

I hope the above is clear and helpful to you. Should you require further discussions on any aspects mentioned above or any other aspects not identified by us, please let me know.

Yours sincerely,
For and on behalf of ABC Tax consultants

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Appendix

Allocation of partnership's loss

	Flora	**Mary**	**Total**
	$	**$**	**$**
Salaries	180,000	60,000	240,000
Balance 1:1	(290,000)	(290,000)	(580,000)
Adjusted loss	(110,000)	(230,000)	(340,000)

Computation of net chargeable income

	Ivan	**Flora**	
	$	**$**	
Net assessable income	890,000		
Business profit	80,000		
Partnership loss	–	(110,000)	
Reduced total income	970,000	(110,000)	860,000
Married person's allowance			(216,000)
Net chargeable income			644,000

Tutorial note: If the amount of contributions to the MPF is ascertained, it will be deducted from the net chargeable income.

3 (a) The basic principles governing liability to profits tax are authoritatively set out in the Privy Council's decision in *CIR* v *Hang Seng Bank Ltd*. In considering the principles relating to the source of profits from a business carried on in Hong Kong, the Privy Council emphasised that this 'is always in the last analysis a question of fact depending upon the nature of the transaction' and that although 'it is impossible to lay down precise rules of law by which the source of profits is to be determined', nevertheless there is a 'broad guiding principle'. The principle is that 'one looks to see what the taxpayer has done to earn the profits in question'. This is an express recognition that the source of profits should not be determined by reference to all the taxpayer's operations which give rise to the profits but only by reference to the specific acts that were more directly responsible for generating the relevant gross profits.

When applying those principles to the source of trading profits, the Privy Council indicated that profits arise where the contracts of sale and purchase are 'effected'. There has been some uncertainty as to the meaning of 'effected'. It may, but should not, mean where the contract is made. This test would be too easily manipulated and would not satisfy the hard, practical matter of fact test: *Nathan's* case. It could also mean performance of a contract, i.e. putting it into effect. It is, however, thought that a better approach is that the word 'effected' means the process whereby the contract is brought into existence, namely the negotiating, bargaining and exchange of information which eventually leads to striking a deal.

(b) The Commissioner's practice for determining the source of trading profits is found in para 8 of DIPN 21 and can be summarised as follows:

In accordance with the *Hang Seng Bank* case, the locality of trading profits 'is the place where the contracts of sale and purchase are effected'. 'Effected' means not only the formal execution but also the actual steps leading to the existence of the contracts including the 'negotiation and, in substance, conclusion of the contracts'. Although the purchase and sale contracts are important factors, a better approach is to consider the totality of facts: *CIR* v *Magna industrial Co Ltd*. Where both the contract of purchase and contract of sale are effected in Hong Kong, profits are sourced in Hong Kong and fully taxable. Profits are also presumed to be sourced in Hong Kong and no apportionment will be accepted where (1) a contract of sale is effected in Hong Kong; (2) a contract of purchase is effected in Hong Kong; (3) the sale is made to a Hong Kong customer; or (4) the goods are purchased from a Hong Kong supplier or manufacturer. Where the effecting of the purchase or sale contract does not require travelling outside Hong Kong but is carried out in Hong Kong by telephone, fax, etc; the contracts will be considered to be effected in Hong Kong.

(c) The general charging provision, s.14, requires various cumulative conditions to be satisfied, that is (1) a business being carried on in Hong Kong, (2) profits from that business and (3) those profits arising in or being derived from Hong Kong. However, the fact that a company carries on business in Hong Kong does not of itself indicate that its profits must have a Hong Kong source. Also, the facts that management of the business and decisions as to trading (i.e. decisions as to sales and purchases) are made in Hong Kong are not relevant in determining the source of a taxpayer's profits *(Mehta's* case; *Hang Seng Bank* case). As stated in (b) above, in determining the source of profits, the broad guiding principle is that one looks to see what was the activity that gave rise to the profits (*Hang Seng Bank* case). Put another way, one looks to see what were the operations that in substance gave rise to the profits (*HK-TVB International Ltd* v *CIR*).

Tutorial note: In the ING case, the Court of Final Appeal appeared to put more emphasis on the 'transaction' that gave rise to the profits. The IRD apparently takes the position that the ING case only applies to the industry of securities brokerage and not to any other industries though some commentaries thought the practice should apply to all cases under s.14. This discrepancy of view has yet to be resolved possibly by a subsequent court. The following comments follow the approach taken by the IRD.

In the present case, Apple is incorporated in Hong Kong and has an office in Hong Kong. The only reasonable conclusion is that it carries on business in Hong Kong. Further, there is no doubt that its profits are derived from such business. The only issue to consider is whether its profits arise in or are derived from Hong Kong.

Apple is a trader, i.e. its profits are made from the purchase and sale of goods. A trader's profits are made where the purchase contracts and the sale contracts are 'effected' (*Hang Seng Bank* case). The question indicates that:

(i) both the supplier and customer were located outside Hong Kong;
(ii) communication with both supplier and customer were followed up outside Hong Kong;
(iii) both the sale and purchase contracts were entered into outside Hong Kong; and
(iv) the goods will be shipped direct from the supplier to the customer; and no stock of merchandise will be maintained in Hong Kong.

It appears that both the contracts of purchase and of sale are effected outside Hong Kong and the profits are not subject to profits tax.

However, it should be noted that the Hong Kong office will perform the functions of issuing orders to the supplier and accepting orders from the customer. Based on case law, the Commissioner considers that where the Hong Kong business accepts or issues sale or purchase orders in Hong Kong, the profits will be taxable in Hong Kong (para 9 of DIPN 21): *Exxon Chemical International Supply SA* and *Euro Tech (Far East) Ltd*.

Therefore, to ensure that the profits would be exempt from profits tax, the Hong Kong office should limit its activities to issuing and accepting invoices, not orders, on the basis of contracts of sale or purchase already effected by the directors outside Hong Kong (see Advance Ruling No. 8).

4 (a) Based on the prevailing case law and accounting practice in Hong Kong, the tax treatment of bank loan interest incurred on a loan used to finance construction of a building would depend on the date when the building is eligible for being put into income-generating use, rather than the completion date of the construction. It is commonly accepted that the issuance of the occupation permit, or the date of first receipt of rental income, would be used to determine the relevant date of the income-producing eligibility.

Tutorial note: The analysis is based on the prevailing practice of the IRD drawn from the Privy Council ruling in the Wharf Properties Limited v *CIR and as mentioned in DIPN 1 (revised); although there are other overseas court cases and schools of thought that may suggest a different view.*

Before the building is capable of generating income:

Pursuant to prevailing case law and accounting practice which are summarised in DIPN 1 (revised), Part B paragraph 29, the IRD requires that all overhead expenditure attributable to the acquisition of the site and the construction of a property used for investment purposes are properly capitalised, including finance expenses up to the date when the property is capable of being used for the production of assessable profits. After that date, interest is correctly a revenue charge. In the present case, the bank loan interest incurred up to either the date of the occupation permit or the date from which the godown is put into use would be regarded as capital expenditure and not tax deductible under s.17(1)(c) of the IRO. Since this portion of interest would be capitalised, it would then be included in the definition of capital expenditure under s.40(1) for the purpose of calculating the depreciation allowance. However, it is worth noting that the portion of loan interest relating to the acquisition of land would be excluded for depreciation allowance purposes under s.40(3).

After the building is capable of generating income:

Loan interest incurred after the godown is being used to produce assessable profits would be accepted as a revenue expense for tax purposes. The general tax deduction rule under s.16(1) for an expense would apply, i.e. a deduction would be allowed to the extent that the outgoings or expenses are incurred in the production of profits chargeable to profits tax. It is also specifically provided under s.16(1)(a) that interest on money borrowed, together with other expenditures relating to the borrowings, for the purpose of producing assessable profits are deductible provided that the conditions under s.16(2) are satisfied.

Applying s.16(2) to the present case, on the basis that the loan was obtained from a local financial institution, the loan interest would be tax deductible if both the following conditions are satisfied:

(1) the bank loan is not secured by any deposits or loans which derive non-taxable income in Hong Kong (s.16(2A)(c)); and
(2) there is no arrangement in place such that the interest payment is ultimately paid back to the company or any connected person (s.16(2B)).

(b) The portion of capital expenditure incurred on both the acquisition of land and construction of the godown, before or after the completion of construction, would not be tax deductible under s.17(1)(c). The portion of capital expenditure incurred on the construction of the godown may qualify for either industrial building allowance or commercial building allowance. To qualify for the former, the godown must be put into one of the 'qualifying uses' as follows:

(1) use in a trade carried on in a mill, factory or other similar premises;
(2) use in a transport, tunnel, dock, water, gas or electricity undertaking or a public telephone or telegraph service;
(3) use in a trade consisting of the manufacture of goods or materials or the subjection of goods or materials to any process;
(4) use in a trade which consists of the storage of goods or materials to be used in the manufacture, to be subjected to a process, or on their arrival into Hong Kong;
(5) use in a farming business;
(6) use in research and development.

In the case of a company which operates as a supermarket retailer, if the godown is to be used to store goods on their arrival into Hong Kong pending resale, the godown would not qualify under (4) above or any other conditions above, and thus it is not qualified as an industrial building.

(Note to marker: Candidates are not required to recite all the conditions, but need to demonstrate the knowledge and understanding that qualifying uses are subject to conditions and the godown is not necessarily qualified.)

Since the godown is not qualified as an industrial building, the capital expenditure relating to the construction of the building should qualify for commercial building allowance, at an annual rate of 4% based on the total construction costs excluding the cost of the site and the cost of preparation and levelling of the land, but including expenditure on the ordinary work done preparatory to laying foundations, laying drains, sewers and water-mains to serve the building or structure. Bank loan interest would be included. Since there is no initial allowance for commercial building, no commercial building allowance would be granted in any basis period in which the construction is not completed. However, the capital expenditure incurred during these periods would be accumulated until completion and would be qualified for commercial building annual allowance for the year of assessment where at the end of the basis period for the year of assessment, the company is entitled to an interest in the godown, which has been put into income-generating purpose.

Where appropriate, it is common that part of the construction cost may qualify for allowances as 'plant and machinery' instead of 'building', such as plumbing fixtures, fire extinguishing equipment, air conditioning and lifts. As plant and machinery attracts much more generous allowances (including 60% initial allowance and 10% to 30% annual allowance), it is advisable to identify those assets that fall within the definition of plant and machinery, and to classify these assets separately. There is no definition for plant and machinery in the IRO and various case law principles must be referenced. In general, plant and machinery relates to the 'tools' with which the business is carried on, while building is the 'environment' in which the business is carried on.

5 **(a)** An estimated assessment may be issued by an assessor under s.59 of the IRO under any of the following circumstances:

(i) Where the taxpayer fails to file the required tax return after the expiry of the specified period but the assessor is of the opinion that the taxpayer has income chargeable to tax under the IRO. Such estimated assessment will not affect the liabilities of the taxpayer to be subject to a penalty by reason of the failure or neglect to file the return.

(ii) Where the taxpayer has submitted the tax return but the reported profits are not accepted by the assessor. Examples include those returns that may contain insufficient information to enable the tax to be ascertained or that may contain certain income or deduction items that are disagreed with by the assessor. The assessor may then make an estimate based on the information available or by reference to his/her past experience or the results of similar taxpayers.

(iii) Where the assessor finds or considers that the books and accounts of the taxpayer have not been satisfactorily or adequately kept, leading to the concern that the tax return may not be reliable. In these circumstances, the assessor may make reference to the industry practice and its usual rate of profit for that type of trade or business to the turnover for the relevant period.

In the case of Late Ltd it is obvious that the issuance of an estimated assessment was driven by the failure to file the 2008/09 profits tax return issued in April 2009. In the absence of the tax return as well as any response from the company to apply for an extension for filing etc the assessor has chosen to issue the estimated assessment. However, given that the estimated assessment was issued with a significant profit, it is likely that there should be other information available to the assessor leading to the belief that Late Ltd has such an amount of profit chargeable to tax.

(b) On behalf of Late Ltd, Mr Chan should immediately file a valid objection against the estimated assessment under s.59(3) of the IRO. To ensure that the objection is valid, Mr Chan must observe the following:

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

(ii) The objection must state precisely the grounds for the objection, such as the estimated profits being too excessive and why.

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

(iv) In Late Ltd's case, since the estimated assessment was issued under s.59(3), i.e. in the absence of a valid return, the objection must also be lodged together with a valid return of income, including all the documents required to be submitted with the tax return such as the income statement and relevant documents in support thereof.

In lodging the objection, Mr Chan may consider applying for the tax to be held over pending the determination of the objection. It is of course subject to the agreement of the Commissioner who will consider the application and determine whether and how the holdover would be granted. There are various choices of tax holdover to be considered by Mr Chan:

(1) Unconditional holdover – i.e. the amount of tax assessed will not be payable until the objection is determined. This would usually be granted if it is quite obvious that the objection would be allowed (e.g. a mistake has been made by the assessor, new facts are presented or the assessment is estimated and a return has been supplied with adequate and correct information), or where a highly contentious point of law is involved. However, Mr Chan should take note that, in the event that the tax becomes ultimately payable, it would carry interest from the later of the original due date or the date of the holdover notice to the date that the objection is determined.

(2) Holdover with tax reserve certificate – i.e. a tax reserve certificate of an amount equivalent to the tax amount assessed is required to be purchased as a condition for granting the holdover. It is the usual practice to specially earmark the certificate with the objection lodged, so as to distinguish this from other tax reserve certificates that may also be bought by the same taxpayer. This earmarked certificate will only bear interest if the tax is ultimately held not to be payable and this certificate is therefore surrendered for cash.

(3) Holdover with bank guarantee – i.e. a bank guarantee or undertaking is required to be issued by a local bank to cover the tax in dispute plus any interest that may accrue. This is usually granted only when the taxpayer may have financial difficulty in purchasing the tax reserve certificate. Interest would be charged in the same manner as for unconditional hold-over on the amount that has been held over but becomes payable upon settlement of the objection.

In the case of Late Ltd Mr Chan should first consider which holdover option he would prefer based on his assessment of the present case in dispute. If he is confident that the estimated assessment must be an error and will be annulled ultimately, he should apply for an unconditional holdover. However, if there is a possibility that a certain amount of tax is ultimately found payable, he may consider applying for a holdover with tax reserve certificate. As noted above, the preferred option suggested by Mr Chan will still be subject to agreement by the Commissioner.

	Marks Available	Maximum
1 (a) Cash extraction out of HK-Co		
(1) Dividend to BVI-Co and interest free loan to Mr Li		
Dividend non-deductible in HK-Co and non-taxable in BVI-Co	1	
Risk of interest disallowance in HK-Co	1	
No tax impact on BVI-Co and Mr Li	1	
		3
(2) Interest free loans all the way up		
Risk of interest disallowance in HK-Co	2	
No tax impact on BVI-Co and Mr Li	1	
		3
(3) Interest free loan from HK-Co to Mr Li		
Same risk of interest disallowance in HK-Co	1	
No tax impact on Mr Li	1	
		2
(4) Implications of transfer of shares in HK-Co to:		
BVI-Co		
Section 14 – carrying on business in HK?	1	
No impact if not assessed under s.14	1	
If assessed under s.14 – capital profit non-taxable	1	
Change of intention?	1	
Proper documentation	1	
Waiver of consideration non-deductible	1	
Stamp duty on transfer of shares	1	
Section 45 group relief not applicable	1	
Waiver has no impact on stamp duty value	1	
Mr Li		
Stamp duty on transfer of shares	0·5	
Gain on waiver not taxable unless trading	1	
Dividend non-taxable	0·5	
HK-Co – no tax impact	1	
	12	10
(5) Implications of liquidation of BVI-Co and distribution *in specie* to:		
BVI-Co		
No tax impact on liquidation	1	
Exempt from stamp duty under s.27(5)	1	
Mr Li		
BVI-Co's liquidation has no tax impact	1	
Dividend from HK-Co not taxable	0·5	
HK-Co – no tax impact	1	
	4·5	3
		21

	Marks Available	Maximum
(b) Warehouse sale and leaseback		
(i) Tax implications for HK-Co re sale of warehouse		
Sale profit taxable or not?	1	
Change of intention?	1	
Basis of tax if change of intention	1	
Sale of commercial building – residue of expenditure	1	
Balancing charge?	1	
Sale of plant and machinery	1	
Deduction of sale proceeds from pool	1	
Stamp duty on sale of warehouse	1	
Calculation of stamp duty payable	1	
	9	8
(ii) Tax implications for HK-Co re lease rentals		
Tax deductibility under s.16(1)	1	
Risk of challenge if excessive	1	
Stamp duty on lease	1	
Stamp duty rate at 1% on yearly average rent	1	
		4
(iii) Tax implications for leasing company re depreciation allowance		
Commercial building annual allowance if put into use	1	
Dividing the residue of expenditure by 25 years	1	
4% if never claimed, or different ratio if claimed before	1	
Plant and machinery		
No entitlement to allowance under s.39(E)(1)(a)	1	
Section 39E exception and conditions	2	
Conclusion: denial of depreciation allowance, with reason	1	
	7	5
		17
Appropriate format and presentation	1	
Effectiveness of communication	1	
		2
Total		**40**

		Marks Available	Marks Maximum
2	**(a)** Employment with REDL:		
	Hong Kong employment	1	
	Exempt under s.8(1A)(b) for 2007/08	0·5	
	No exemption under s.8(1A)(b) for 2008/09	0·5	
	Possible exemption under s.8(1A)(c)	1	
	Share option benefit not taxable, with reasons	1·5	
	Gain from disposal of shares not taxable	0·5	
	Taxability of fees from overseas suppliers	1	
	Taxability of fees as agent for overseas suppliers under salaries tax	0·5	
	Taxability of fees as agents under profits tax	2	
	Calculation of assessable income	0·5	
		9	8
	Loss from partnership business		
	Allocation and treatment of partnership loss	2	
	Loss relief under personal assessment	1	
			3
	Available deductions:		
	MPF contributions	0·5	
	Tax position 2008/09		
	Tax position under personal assessment	1	
	Calculation of net chargeable income	1	
		2·5	2
			13
	(b) Acquisition and lease of property:		
	In name of Ivan Man		
	Subject to property tax	0·5	
	NAV and loan interest	1·5	
	Taxability and deduction under personal assessment	2	
	In name of a limited company		
	Subject to both property tax and profits tax	2	
	Exemption under s.5(2)(a)	1	
	Taxability and deductions under profits tax	3	
	Comparison of tax position under property and profit tax	1	
	Acquisition and lease of property		
	Stamp duty payable on purchase of property	2	
	Stamp duty payable on lease	2	
		15	13
	Appropriate format and presentation	1	
	Effectiveness of communication	1	2
	Total		**28**

			Marks Available	Marks Maximum
3	(a)	Broad guiding principle in *Hang Seng Bank* case	1·5	
		'Contract effected' test for trading profits	1·5	
				3
	(b)	CIR's practice:		
		Meaning of 'effected'	0·5	
		Totality of facts	0·5	
		Both contracts of sale and purchase effected in HK – HK source	0·5	
		Both contracts of sale and purchase effected outside HK – offshore	0·5	
		Either contract effected in HK – HK source	0·5	
		Sale to HK customer/purchase from HK supplier – HK source	0·5	
		Contract effected *via* telephone, fax etc – HK source	0·5	
		No apportionment for trading profits	0·5	
				4
	(c)	Conditions in s.14(1)	1	
		Management and trading decisions in HK – not relevant	1	
		Broad guiding principle in *Hang Seng Bank* case	1	
		Condition (1) & (2) satisfied	1	
		Contracts effected outside Hong Kong?	2	
		Issue of orders by HK office – profits taxable	2	
		Advice to Apple	2	
			10	9
	Total			**16**
4	(a)	Loan interest treatments does not depend on completion of construction	1	
		Depends on when it is income-generating	1	
		Practice to use occupation permit or receipt of income	1	
		Before capable of generating income – interest capitalised	1	
		Capitalised interest not deductible under s.17(1)(c)	1	
		Section 40(1) capital expenditure to include interest	1	
		After capable of generating income – revenue expense	1	
		Section 16(1) and s.16(1)(a) deduction rules	1	
		Section 16(2) conditions and s.16(2A) and s.16(2B)	1	
			9	8
	(b)	Capital expenditure not deductible under s.17(1)(c)	1	
		Qualifying use for industrial building allowance	1·5	
		Cold storage godown not qualified	1	
		Eligible for commercial building allowance at 4%	1	
		Nature of qualifying expenditure	1·5	
		Can claim only once put into use	1	
		Some costs as plant and machinery qualifying for pool	1	
		More generous initial and annual allowance	1	
		No definition, generally 'tools' vs 'environment' principle	1	
			10	8
	Total			**16**

			Marks Available	Marks Maximum
5	**(a)**	Estimated assessment when failed to file return	1	
		Estimated assessment when profits not accepted	1	
		Estimated assessment when improper books and accounts	1	
		Estimated based on industry practice or usual profit ratio	0·5	
		Late Ltd's case due to absence of return	1·5	
				5
	(b)	Objection lodged immediately	0·5	
		Objection in writing to the Commissioner	0·5	
		State precise grounds of objection	1	
		Within one month after date of assessment	1	
		With a valid return and other documents	1	
		Holdover of tax subject to Commissioner's discretion	1	
		Unconditional holdover and consequence	2	
		Holdover with TRC and consequence	2	
		Holdover with bank guarantee and consequence	2	
		Suggestion for Mr Chan	1	
			12	11
	Total			**16**