
Answers

		Marks
1	Report to the management of the Dealing Group	
	To The management of the Dealing Group	
	From Tax advisor	
	Date 2 December 2007	
	Subject The acquisition of the Losing Group – Tax issues	
	It is my understanding that the management has the intention to acquire the shares of the Losing Group, comprising Losing Ltd and its wholly owned subsidiary, Gain Ltd. Both companies are incorporated in Hong Kong. Based on the information supplied by the Losing Group, the following tax issues are identified:	
	(a) (i) The tax deductibility of the management fee by Losing Ltd	
	Losing Ltd entered into a management contract with Dogging in 2000 and has been paying an annual management fee to Dogging in return for the services since that date. Hong Kong does not have any general transfer pricing rules thus, the general arm's length principle is followed.	1
	The deduction of management fees is primarily governed by the general deduction rule under s.16(1), i.e. the expense or outgoing has to have been incurred in the production of assessable profits. Where this is not the case, deduction will be denied. In the case of Losing Ltd, the fee would be tax deductible to Losing Ltd only if the services of Dogging are rendered in order to produce assessable profits of Losing Ltd. However, since 2002/03 all the operations have been shifted from Losing Ltd to Gain Ltd. From the 2006 accounts of Losing Ltd, it would appear that Losing Ltd was only engaged in securities trading and intra-group financing. It is, therefore, not clear what kind of services have been provided by Dogging to Losing Ltd since 2002/03; and whether the fee expense was commensurate with the benefit received by Losing Ltd. If Dogging only provides services to Gain Ltd, despite the fee being calculated based on the profits of Gain Ltd, deduction of the fee is likely to be challenged by the IRD as not incurred in the production of Losing Ltd's assessable profits and hence not tax deductible in Losing Ltd.	3
	Even assuming that Dogging has provided services to Losing Ltd, the following criteria will also need to be satisfied:	
	1. The transaction between Losing Ltd and Dogging is on an arm's length basis, i.e. arranged as if both parties are unrelated third parties. It is, however, not clear whether Dogging is related to the Losing Group. If it is, this factor becomes even more relevant.	1
	2. The transaction is commercially justified, i.e. not entered into for the sole or dominant purpose of avoiding tax or shifting out profits from the Losing Group. The detailed nature of the management services and the genuine purpose of the fee arrangement are relevant.	1
	3. The amount charged is substantiated with calculations and the basis reflects the costs and mark-up of Dogging directly attributable to the services provided. Since the basis of the fee charged by Dogging is by reference to the profitability of the Losing Group, in particular only Gain Ltd, it indicates that Dogging's services would only be rewarded if the Losing Group makes a profit; and the value of the services are proportionately associated with the amount of profit made. Unless this kind of basis can be justified with facts or industry practice, the IRD may take the view that the fee arrangement is for profit-shifting purposes.	1
	4. The basis of the charge is commensurate with the benefits accrued to Losing Ltd and consistently applied.	0.5
	5. The quantum of the fee is realistic, reasonable and not excessive.	0.5
	6. Documentation is properly put in place, including a service agreement, relevant board minutes or resolutions, invoices, receipts, payment records and working papers to substantiate the calculations.	0.5
	7. The transaction is not artificial and fictitious.	0.5
	In an extreme case where the IRD suspects that the transaction is entered into with a view to obtaining certain tax benefit and/or avoiding tax, it may seek to challenge the transaction under either or both of the anti-avoidance provisions in s.61 and s.61A of the IRO. The possible consequence is the fee charged would be either disregarded or adjusted.	1
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- (ii) On the assumption that the management fees paid to Dogging are not tax deductible to Losing Ltd, the prior years' tax loss position would be affected and adjusted as follows:

	Profit/loss per tax return	Management fee added back	Adjusted profit/loss
2002/03	Loss \$0.5 m	\$0.2m	Loss \$0.3m
2003/04	Loss \$0.7m; c/f \$1.2m	\$0.6m	Loss \$0.1m; c/f \$0.4m
2004/05	Loss \$0.4m; c/f \$1.6m	\$0.8m	Profit \$0.4m; c/f \$0
2005/06	Loss \$0.1m; c/f \$1.7m	\$0.6m	Profit \$0.5 m; c/f \$0
2006/07	Loss \$1m; c/f \$2.7m	\$0.8m	Loss \$0.2m; c/f \$0.2m

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Based on the above, Losing Ltd has actually made adjusted profits for the years of assessment 2004/05 and 2005/06, before loss set-off. Under s.5 1(2) of the IRO, Losing Ltd is actually obliged to inform the Commissioner in writing that it is so chargeable, before any loss set-off, within four months after the end of the basis period for those years of assessment. This obligation is required because Losing Ltd has received no tax returns from the IRD; and it obviously has not been complied with. A penalty may thus arise in the absence of reasonable excuse. We need further facts to assess if there was a reasonable excuse.

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On the other hand, the assessor has the right to issue an additional assessment for any year of assessment within six years after the end of that year of assessment, if he is of the opinion that the company has been under-assessed. From the above, if the management fee is disallowed, Losing Ltd should be subject to tax for 2004/05 and 2005/06 and assessments for these two years may be issued.

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- (iii) If the contract between Dogging and Losing Ltd has to be continued, the only way to secure a tax deduction at the level of Losing Ltd is for Losing Ltd to recharge the fee to Gain Ltd. The recharge would reflect the fact that Losing Ltd is appointed by Gain Ltd to provide the management services to Gain Ltd through the services of Dogging. Since Losing Ltd would receive a fee from Gain Ltd, the fee payable to Dogging would be tax deductible to Losing Ltd, provided that the fee collected from Gain Ltd is able to cover the fee expense to Dogging. As regards Gain Ltd, provided that the fee payable to Losing Ltd is justified and commensurate with the benefits received by Gain Ltd, a tax deduction would be secured. A contract or memorandum should be entered into between Losing Ltd and Gain Ltd.

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Tutorial note: Given the potential risks above, the management fee arrangement with Dogging needs to be reviewed. If Dogging's services are required by Gain Ltd, rather than Losing Ltd, it would be more tax effective to revise the contract such that the contract is one between Dogging and Gain Ltd. The fee expense would then be incurred and expensed by Gain Ltd in return for the services rendered by Dogging. As long as all other criteria for deduction as mentioned above are satisfied, Gain Ltd should be able to get tax deduction for the fee incurred.

- (b) (i) The tax deductibility of the interest expense by Gain Ltd and Losing Ltd

From the 2006/07 accounts, Losing Ltd incurred an interest expense to a bank in the amount of \$1.2m. At the same time, it also earned interest income from Gain Ltd of \$1.8m. During the year, other than this intra-group financing activity, Losing Ltd was only engaged in securities trading. The information on hand is not clear enough to explain whether the borrowings acquired from the bank was actually used to fund the securities trading or to fund the lending to Gain Ltd. However, regardless of the usage of the money, since both the profits from the securities trading and interest income from Gain Ltd are assessable, the interest expense would likely be tax deductible. However, this deduction may be denied if any of the following situations occurs:

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- (1) The payment of any interest or the repayment of any principal of the bank borrowing is secured or guaranteed, directly or indirectly, by any deposit or loan made by Losing Ltd or its associate, to or with the bank or its associate; where such deposit or loan generates non-taxable interest income.
- (2) There is an arrangement under which the interest payable by Losing Ltd to the bank will be paid, directly or through an interposed person, back to Losing Ltd or its associate (i.e. Gain Ltd), unless Gain Ltd is subject to tax on this interest flowed back.

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Since Gain Ltd also earns interest income from a Singapore company, it is not clear whether the lending to the Singapore company is actually funded by the borrowing from Losing Ltd, which actually acquired the money by borrowing from the bank. In the circumstances where the Singapore company is associated or related to the Losing Group, the IRD may take the view that the interest paid by Losing Ltd to the bank actually flowed back to the Losing Group. As a result, the tax deductibility of the interest expense to the bank by Losing Ltd and the interest expense to Losing Ltd by Gain Ltd would be at risk.

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In the case of Gain Ltd, the interest expense paid to Losing Ltd would not be tax deductible on the basis that the interest income from the Singapore company is not taxable; unless it can be proved that the loan to the Singapore company is not funded to any extent by the loan from Losing Ltd. In the absence of evidence, the IRD may disallow a portion of the interest expense by reference to the ratio of the interest income from the Singapore company to the total income for the year.

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(ii) In order to be satisfied that all the tax deduction criteria mentioned in paragraphs (b)(i)(1) and (2) above are satisfied, it is necessary to request further information as follows:

- (1) What is the purpose of the borrowing from the bank and how was the money used by Losing Ltd.
- (2) Whether the loan made by Losing Ltd to Gain Ltd is funded by the bank borrowing.
- (3) How the loan made by Gain Ltd to the Singapore company was funded.
- (4) Whether the Singapore borrower, from which Gain Ltd earns the interest, is associated with Gain Ltd or Losing Ltd and if so, how.

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(c) Taking into account the above-mentioned potential tax risks, the adjusted estimated tax positions of both companies for the year of assessment 2007/08 are as follows:

	Gain Ltd	Losing Ltd
	\$	\$
Profit/(loss)	4,000,000	(1,000,000)
Add: management fee	–	800,000
Add: interest expense	1,800,000	1,200,000
Less: offshore interest income	(2,300,000)	–
Adjusted profit/(loss)	<u>3,500,000</u>	<u>1,000,000</u>

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(d) (i) The value of Losing Ltd

Under Hong Kong tax law, tax losses agreed by the IRD may be carried forward indefinitely, to offset against future assessable profits; provided that the tax losses have not been used before to offset other profits or disallowed. Tax losses are attributable to the corporation, regardless of the fact that the shareholding in the corporation may have changed. The carry-forward of tax losses to offset against future profits is also not affected, even if the future profits are derived from a different source of income from that which the prior years' tax losses were incurred.

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However, there is one anti-avoidance provision in the IRO, s.61B, which provides that, in a case where there is a change in shareholding in a company with accumulated tax losses, the tax losses brought forward in the company cannot be set off against future profits if the Commissioner believes that:

- (1) the profits subsequently arising to the loss-making company is a direct or indirect result of the change in shareholding of this loss-making company; and
- (2) the sole or dominant purpose of the change in shareholding was for the purposes of using the losses to avoid a tax liability of the company or any other person.

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In the case of the Losing Group, the management will be required to justify that the acquisition of Losing Ltd is for commercial reasons and not solely or dominantly for the purpose of obtaining the benefit of the tax losses. The fact that Losing Ltd is the holding company of Gain Ltd could help to justify that the acquisition is by way of the whole group. Moreover, after the acquisition, should there be any intention to inject profit making business into Losing Ltd, it must also be commercially justified and not be seen to be solely or dominantly for the use of the tax losses. In the absence of these commercial justifications, there is a potential risk that s.61B may apply and that the tax losses would be denied.

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(ii) Under Hong Kong tax law, repatriation of after-tax profits is not subject to a further level of taxation in the hands of shareholders. From a tax perspective, there is no extra value to establishing a Hong Kong holding company on top of a Hong Kong operating subsidiary in terms of profit repatriation. In the case of the Losing Group, any after-tax profits earned by Gain Ltd can be freely distributed to Losing Ltd, subject to the availability of distributable retained earnings, free from any further tax. Losing Ltd will not be taxed again in respect of the dividends received. Further, should Losing Ltd distribute the dividends to its upper level of shareholders, the distribution will not be subject to tax in Hong Kong. Therefore, simply from the perspective of profit repatriation, the role played by Losing Ltd is neutral, i.e. there are no added value benefits and no adverse tax implications.

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However, from an accounting perspective, the management may need to consider whether the negative retained earnings position of Losing Ltd would hinder the capability of Losing Ltd to distribute any dividends upwards, including dividends receivable from Gain Ltd. This is not a tax issue.

Marks

Bonus 1

End of Report

Appropriate format, style and presentation of the report.
Effectiveness of communication.

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2 Peter Man

(a) Memorandum

To: Tax manager
From: Tax assistant
Date: 3 December 2007
Client: Peter and Mary Man

As requested, this memorandum advises on the tax positions of Peter and Mary Man for the year of assessment 2006/07.

1. Personal assessment

Peter and Mary should be advised to elect for personal assessment for 2006/07, because their aggregate tax liabilities under personal assessment could be reduced. As they are both ordinarily resident in Hong Kong and they derive more than one source of income, they are eligible for personal assessment election. Potential tax savings may be achieved by claiming the loan interest as deductible against the assessable property income. This treatment is only available if personal assessment is elected. Under personal assessment income and losses from different sources would be aggregated into one assessment. Details are as follows.

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2. Employment with HKAL

The main issue here is the location of Peter's employment, because s.8(1) only taxes employment income arising in or derived from a source in Hong Kong. In this regard, the relevant factors for determining the location of employment are set out in *Goepfert's* case and DIPN No. 10. They are:

- (i) the place where the contract of employment was negotiated and concluded;
- (ii) the residence of the employer; and
- (iii) the place where the remuneration was paid.

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Applying these factors to Peter, it is clear that payment and potentially the place of negotiation of the contract point to a non-Hong Kong employment. However, his contract is with a Hong Kong employer – and this factor apparently carries the greatest weight with the Commissioner.

On the basis that (a) he is the regional manager of a Hong Kong company; (b) he has a contract of employment with a Hong Kong employer; and (c) it may be that his contract of employment was formally concluded in Hong Kong (this fact should be ascertained), it is likely that the IRD would seek to tax Peter on the full amount of his employment income without time apportionment.

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It may be the case that Peter has a tax liability outside Hong Kong in respect of at least part of his employment income. This should be clarified, because if Peter is held to have a Hong Kong employment any income taxed overseas in respect of overseas services would be exempt from salaries tax by virtue of s.8(1A)(c). The exemption under s.8(2)(j) is, however, not relevant, as Peter is not a 'crew member'.

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Other than the monthly salary, certain benefits received from the employer, HKAL, will also be taxable. The tuition fees are taxable under a specific statutory provision: s.9(2A)(b). The compensation is derived for services and arises from the employment: *D4/91*. Unlike *Hochstrasser v Mayes*, there is no separate source independent of the employment contract that one can point to as the source of the payment.

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Rental value will, if appropriate, be calculated in accordance with the normal 10% rule under ss.9(1)(b), 9(1A)(b) and 9(2). However, the question here is whether the 'housing assistance' as a matter of law amounts to a rental refund for the purposes of ss.9(1)(b) and 9(1A)(b). In this regard, it will be necessary to show that the employer, HKAL, exercised sufficient control over the payment of the amount (at least it should have received a copy of the lease as well as rental receipts to verify the payments of rent) so as to make it capable of being considered a rental refund, as distinct from a mere allowance which Peter could spend in whatever way he liked: see *D33/97*.

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However, the difference between the price of the tickets and the discounted value is not taxable, provided that the tickets cannot be converted into full-fare refundable tickets: s.9(2A)(a). It is assumed that there would be restrictions placed on their endorsement and refundability (this fact should be ascertained).

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Although it could be argued that the operation was necessary for his job, it is essentially a private expenditure incapable of apportionment and thus, not deductible under s.12(1)(a): *Fahy's* case. On the other hand, the reimbursement of this private expenditure is taxable in full.

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The assessable income to be aggregated under personal assessment is \$1,372,000 (see workings below).

	\$	\$	
Salary		1,200,000	
Tuition fees		35,000	
Compensation		30,000	
Reimbursement of medical expenses		15,000	
		<u>1,280,000</u>	
Rental value at 10%	128,000		
Rent suffered (3,000 x 12)	<u>(36,000)</u>	92,000	
Assessable income		<u><u>1,372,000</u></u>	

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It is assumed that the housing assistance qualifies as a rent refund.

3. Partnership

Before aggregating any profit/loss under personal assessment, the assessable profits of the partnership should be allocated to the respective partners. Mary's share of the partnership profits can be offset by her share of prior years' losses and the excess profits, if any, would be aggregated under personal assessment. However, in Mary's case, her share of partnership profits will be fully offset by her prior years' losses (see workings below), leaving an unutilised balance of prior years' losses of \$20,000. Based on the information provided, personal assessment was not elected for the year 2005/06. As a result, any loss unused in the partnership can only be carried forward under the partnership and cannot be transferred to Mary's personal assessment. In other words, the balance of the loss of \$20,000 will be carried forward under the name of the partnership and can only be offset by Mary against her share of future profits from the partnership. In respect of 2006/07, no profit or loss from the partnership would be aggregated under personal assessment.

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Assessable profits of the partnership: $\$460,000 - (\$30,000 + \$10,000) \times 12 = \$20,000$

Allocation of partnership's profits:

	Mary \$	Paul \$	Total \$
Salaries	360,000	120,000	480,000
Balance 1:1	<u>(230,000)</u>	<u>(230,000)</u>	<u>(460,000)</u>
Assessable profit/(loss)	130,000	(110,000)	20,000
Reallocation	<u>(110,000)</u>	<u>110,000</u>	
Share of profit	20,000	0	
Loss brought forward	<u>(40,000)</u>	<u>(280,000)</u>	<u>(320,000)</u>
Loss carried forward under partnership	<u>(20,000)</u>	<u>(280,000)</u>	<u>(300,000)</u>
Net profits transferred to personal assessment	<u><u>0</u></u>		

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4. Property income

For property tax purposes, the assessable value is based on the consideration payable under the lease. The half-month rent-free period is not assessable since no consideration was received. The rental deposit is not assessable on the basis that it is capital and returnable in nature. The premium is spread over the lease period, subject to a maximum of three years. The management fee paid by the tenant directly to the management company is not assessable, as it is not consideration received by the landlord. Rates paid by the owner are statutorily allowed as a deduction before the 20% statutory allowance. Loan interest is not tax deductible for property tax purposes. However, if personal assessment is elected, the loan interest (limited to the amount of the net assessable value of the property) would be allowed as a deduction against the related property income.

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The net assessable value to be aggregated under personal assessment is \$137,200 [(\$20,000 x 8.5 + \$24,000 x 9/36 - \$1,500 x 3) x 80%].

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As the apartment is owned jointly by Peter and Mary, they will each be assessed on 50% of the net assessable value under personal assessment. Moreover, the loan interest incurred on the acquisition of the property is also equally split between the couple and deducted against their respective share of the net assessable value.

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5. Other available deductions

Charitable donations will be deductible as a concessionary deduction. They are generally restricted to 25% of assessable income: see s.26C. As a general rule, it is important to check whether the organisation to which the donation is paid qualifies for charitable status under s.88. Assuming that the charities are approved organisations, Mary can deduct the monthly donation upon election of personal assessment, but this will be limited to \$2,150, being 25% of her assessable income net of the loan interest of \$8,600 (\$68,600 – \$60,000). The excess amount of \$9,850 (\$12,000 – \$2,150) can be transferred to Peter and claimed as a deduction against Peter's assessable income.

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Peter will also be able to claim a maximum deduction of \$12,000 in respect of his contribution to the mandatory provident fund; and this amount needs to be ascertained.

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The married person's allowance and a child allowance in respect of their daughter are available. However, the couple are not eligible to claim any child allowance in respect of the son, who, although under 25, is not a full-time student.

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6. Acquisition and lease of property

Under Head 1(1A) to the SDO the agreement for sale and purchase of the property is liable to *ad valorem* duty at the rate of 1.5%. Stamp duty payable is 1.5 % on \$3,000,000, i.e. \$45,000. The formal assignment executed in conformity with the stamped agreement will only be liable to duty at the fixed rate of \$100

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The lease agreement in respect of the property is chargeable under Head 1(2) in the First Schedule of the SDO. Stamp duty payable is 1% on the yearly rent of \$240,000 and 3.75% on the premium of \$24,000, i.e. \$3,300.

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7. Peter and Mary's tax positions

Based on the personal assessment calculation (see appendix), the couple has a net chargeable income of \$1,125,200 for the year of assessment 2006/07. Accordingly, it will be better to pay tax at progressive rates rather than at the standard rate on \$1,365,200. The tax liability will be split between the couple based on the proportion of their share of the reduced total income.

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End of Report

Appendix

Computation of net chargeable income

	Peter \$	Mary \$	
Net assessable value of property	68,600	68,600	
Net assessable income	1,372,000	0	
Loan interest	(60,000)	(60,000)	
Donations	(9,850)	(2,150)	
Contributions to MPF	(12,000)	0	
Reduced total income	1,358,750	6,450	1,365,200
Married person's allowance			(200,000)
Child allowance			(40,000)
Net chargeable income			1,125,200

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Appropriateness of format and presentation of the memorandum.
Effectiveness of communication.

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3 (a) Based on the information provided, the funding arrangements for both properties are different. From the perspective of Properties Co Ltd (the company) both properties are funded by interest-bearing loans and thus, interest is incurred on the respective loans. However, from a tax perspective, the tax deductibility of the interest incurred is different. Whether or not the interest is tax deductible by the company depends on whether the income arising from the property is taxable, under what tax regime it is taxed and whether all the tax deduction conditions are satisfied. 1

As stated in the question, in respect of Tower Rental the rental income arising has been assessed under profits tax, not property tax. It is not, therefore, necessary to consider the tax implications under the property tax regime.

Given that the rental income is subject to profits tax and the loan was acquired to fund the income generating property, any interest incurred on the loan will be tax deductible if all the following conditions are satisfied:

- (a) the bank interest is incurred in the production of assessable profits (s.16(1), s.16(1)(a) and s.16(2)(d));
- (b) the bank borrowing is not secured by any deposits or loans which derive non-taxable income in Hong Kong (s.16(2A)(c)); and
- (c) there is no arrangement in place such that the interest payment is ultimately paid back to the borrower or any connected person (s.16(2B)). 1.5

In the case of the company, condition (a) should be satisfied in the case of Tower Rental, since the property generates rental income which is taxable. As regards condition (b), the question specifically states that the bank loan was granted under a personal guarantee from Mr Ho. It is, therefore, reasonable to assume that there is no other security given in the form of deposits or loans that would derive non-taxable income. Condition (b) should be satisfied. In respect of condition (c), the question is silent, but assuming there is no such arrangement in place that would generate an interest payment which ultimately flows back to Mr Ho or his connected person, this condition will also be satisfied. As a result, the interest on the bank loan should be tax deductible against the company's assessable profits for profits tax purposes. 3

In respect of Tower Trade, the loan is obtained from the company's shareholder, Mr Ho. The tax deductibility of the interest incurred on this loan thus depends on:

- (i) whether the loan interest is incurred in the production of assessable profits (s.16(1) and s.16(1)(a));
- (ii) whether the borrowing, being a loan from a person other than a financial institution, generates interest income which is taxable in Hong Kong in the hands of the recipient, i.e. Mr Ho (s.16(2)(c)). 1

Since Tower Trade is being held as trading stock, it is expected that any profits arising from a future sale will be returned as assessable profits by the company. On this basis, condition (i) should be satisfied. However, condition (ii) could be problematic, for the reason that Hong Kong does not tax interest income in the hands of individual taxpayers, unless the individual lender carries on a business as a money-lender. If Mr Ho is not taxed on the interest received from the company, this condition would not be satisfied. 2

There is another provision under s.16(2)(e) that may allow a tax deduction for the interest incurred if the borrowing is obtained to acquire trading stock or plant and machinery. However, although Tower Trade is held as trading stock the condition under s.16(2)(e) can only be satisfied if the lender is not an associated person of the company. According to the definition of 'associate' under the IRO, Mr Ho, being the person who controls the company, is included in the definition of an 'associate' of the company. Therefore, s.16(2)(e) cannot be relied upon to obtain a tax deduction. 1

Based on the above, it is concluded that the funding arrangement for Tower Trade in the form of a shareholder loan is not tax effective, since the interest incurred on the loan is not tax deductible to the company, despite that the profits arising from any future sale of the property would be included in the taxable income. 0.5

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(b) As a result of the change in the holding purpose of Tower Trade by Mr Ho, the accounting treatment of the property would be different from that of prior years. From a tax perspective, it would be necessary to ascertain whether the change in holding purpose and accounting treatment would give rise to a tax liability and, if so, how much.

As stated in the question, Tower Trade has been held as 'assets held for trading', i.e. trading stock. Any profits arising from its subsequent sale would be included in assessable profits. Assuming that Mr Ho wishes to change the intention of holding this property from trading to investment, the trading stock would be regarded as appropriated to some other use based on the principle established in *Sharkey v Wernher* (36 TC 275) in the UK. The property would be treated as sold at open market value as at the date of the change in use. This principle has been confirmed and adopted in certain Board of Review cases and Court cases in Hong Kong, but there are also some cases where the principle was rejected on the basis that a tax liability could only arise on profits that were realised, i.e. when there was an actual disposal. Generally speaking, therefore, in the case of Tower Trade, there are broadly two issues to be determined:

	Marks
(i) whether the change in intention gives rise to a deemed disposal of the property as trading stock; and	
(ii) if so, whether any notional gain arising from the deemed disposal should be taxed.	2
As regards (i), it is generally accepted that the property in its nature of trading stock has been deemed to be disposed of at the time when the trading nature has been put to an end. Examples include using the trading stock by a proprietor for personal consumption; and putting the trading stock into use by the business as a fixed asset to generate other assessable profits.	1
The practical difficulty normally arises under issue (ii). In <i>D75/96</i> , the Board of Review refused to apply the <i>Sharkey v Wernher</i> principle for the reason that there had been no actual disposal, as the property continued to be held, albeit as a capital asset. The Board held that the profit could not be taxed until the asset was actually traded. In circumstances where there had been an actual sale, the <i>Sharkey v Wernher</i> principle has been applied to substitute the market value as the transaction price (<i>Petrotim Securities Ltd v Ayres</i> (41 TC 389)). However, in the case of Tower Trade there will be no actual sale. Therefore, it is arguable whether the <i>Sharkey v Wernher</i> principle is applicable to support that the notional gain, calculated by reference to the deemed market value at the date of change in intention, should be assessed to profits tax.	2
Regardless of the applicability of the <i>Sharkey v Wernher</i> principle, the issue of the assessability of the notional profit is complicated by the fact that the revaluation profit, as calculated based on the fair value, would be required to be ascertained and recognised in the company's accounts in the year in which the intention of holding the property is changed. In general, assessable profits are to be ascertained in accordance with the normal accounting principles, only subject to statutory adjustments as required by the IRO, such as the exclusion of non-taxable profits and inclusion of deemed business receipts: see <i>Secan Ltd v CIR</i> and DIPN No.42. In the circumstances, when the change of intention gives rise to a profit to be ascertained in accordance with the accounting standard and the profits are required to be recognised in the accounts, it would generally be regarded as assessable profit unless there are statutory provisions to exclude this kind of profit from assessment. As a result, in the case of Tower Trade it is very likely that the accounting profit of \$5m, though not realised, would be regarded as a taxable profit.	2
	<u>7</u>
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- 4 (a) Under the Hong Kong Inland Revenue Ordinance (IRO), the Hong Kong salaries tax position of Siti in respect of the services he renders in Hong Kong depends on various factors including, fundamentally, the location of Siti's employment. Based on the facts given, Siti is and will continue to be employed by Taisan Co, which is a company tax resident in the PRC. Since Siti, himself, is also a PRC citizen, it is reasonable to assume that the employment contract has been concluded in the PRC. Siti is also receiving his remuneration in the PRC. As a result, based on DIPN No. 10 and *Goepfert's* principle, Siti's employment with Taisan Co will be regarded as located outside Hong Kong. 2
- Based on s.8(1A)(a) of the IRO, in the case of a non-Hong Kong employment only remuneration for services rendered in Hong Kong, including leave pay attributable to such services, is taxable in Hong Kong. However, exemption is available if Siti qualifies as a 'visitor' in Hong Kong and stays in Hong Kong for not more than 60 days, despite services being rendered during the stay. To qualify as a 'visitor' the most common criterion is that he must not have any form of permanent base or normal place of residence in Hong Kong. As Siti is only on short term assignment in Hong Kong and he stays in a hotel, the facts indicate that he does not intend to establish a home base in Hong Kong. Therefore, Siti would be accepted as a 'visitor' during his stay in Hong Kong under this assignment. 2
- Since Siti is a visitor in Hong Kong and he renders services in Hong Kong under a non-Hong Kong employment, he will be able to totally escape from Hong Kong salaries tax if he stays in Hong Kong for not more than 60 days. In counting the days both the days of arrival and departure are to be included, i.e. the mid-night rule does not apply. 1
- However, if Siti stays in Hong Kong for more than 60 days he will be subject to tax in Hong Kong under the IRO. The taxable income is based on the portion of remuneration attributable to his services rendered in Hong Kong. Normally, simple time apportionment will apply making reference to the number of days he spends in Hong Kong as a ratio to the total number of days in the year of assessment. If Siti takes any leave days during the year, a portion of the leave days should also be calculated and added to the time apportionment formula. For time apportionment purposes only one of the day of arrival and day of departure is counted, i.e. the mid-night rule applies. 2
- The question also states that any Hong Kong tax if payable would be borne by HK Co. Since the tax liability is the personal liability of Siti, the reimbursement from HK Co or payment on behalf of Siti would be regarded as additional taxable remuneration for Hong Kong tax purposes. The tax amount will then be grossed up in the tax assessment. However, it has been the practice that in grossing up the tax amount no time apportionment is applied, on the basis that the tax reimbursement fully relates to the services rendered in Hong Kong. 1

The payment of a lump sum amount from HK Co to Taisan Co does not affect Siti's Hong Kong salaries tax position under the Hong Kong IRO. In respect of the travelling and hotel accommodation costs paid by Taisan Co, if the payments are for the account of Taisan Co the payments only represent a discharge of Taisan Co's own liability and thus, would not be taxable income to Siti for Hong Kong salaries tax purposes.

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- (b) Pursuant to Article 14 of the double tax agreement (DTA) between Hong Kong and the PRC, Siti's remuneration relating to his services rendered in Hong Kong would be exempt from Hong Kong salaries tax if ALL of the following conditions are fulfilled. For the purposes of the application of the DTA, in the case of Siti, the term 'One Side' refers to PRC, and the term 'the Other Side' refers to 'Hong Kong'.

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The first condition is that the aggregate number of days that Siti stays in Hong Kong in any twelve-month period does not exceed 183 days. In counting the days the rule of 'days of physical presence' applies, i.e. the days when Siti is in Hong Kong and the day of arrival or departure, irrespective of the time and the purpose of the stay, will be counted as two days (DIPN No. 44, para. 114). If Siti stays in Hong Kong for more than 183 days in any twelve-month period, he is not eligible for the tax exemption under the DTA and will thus be taxable in Hong Kong according to the IRO.

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The second condition is that Siti's remuneration is paid by an employer who is not a resident of Hong Kong. As it is stated that Siti's remuneration would continue to be paid by Taisan Co in the PRC, assuming that Taisan Co is not a tax resident in Hong Kong, this condition is also fulfilled.

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The third condition is that the payment of Siti's remuneration is not to be borne by any permanent establishment which the employer, Taisan Co, has in Hong Kong. This condition is arguably fulfilled based on the following:

- (i) The remuneration is paid by Taisan Co to Siti. The subsequent recovery of a lump sum amount from HK Co is arguably not remuneration paid to Siti, but only represents a service fee or compensation in return for the assistance provided by Taisan Co.
- (ii) It is arguable that HK Co is not the permanent establishment 'which Taisan Co has in Hong Kong', unless HK Co does represent Taisan Co in carrying out certain activities in Hong Kong and thus, is acting as a permanent establishment of Taisan Co.

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Provided the above arguments can be made, it is likely that Siti is eligible for the exemption under the DTA as long as he does not stay in Hong Kong for more than 183 days.

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- (c) The objective of avoiding any Hong Kong salaries tax liability for Siti can be met by fulfilling the conditions either under the DTA or under the IRO.

Hong Kong operates on a preferential principle in applying the DTA, i.e. whichever tax treatment is more beneficial to the taxpayer will be adopted. The DTA exemption from Hong Kong salaries tax liability can be achieved by ensuring that the aggregate number of days Siti stays in Hong Kong does not exceed 183 days in any twelve-month period, provided that his remuneration continues to be paid by Taisan Co in the PRC and is not directly recharged to HK Co as salary cost.

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However, if it is the intention of Taisan Co to recharge Siti's remuneration to HK Co, the DTA exemption would not be available, but it would still be possible to rely on the Hong Kong IRO for exemption if Siti stays in Hong Kong for not more than 60 days in a taxable year.

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- 5 (a) (i) The statutory obligation to keep business records is contained in s.51C which requires every person carrying on a trade, profession or business to keep sufficient records, either in English or Chinese, of income and expenditure to enable the assessable profits to be readily ascertained. Further, there is an obligation to retain such records for at least seven years after the transactions to which they relate, subject only to the following exceptions (neither of which is relevant to this case):

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(1) When a corporation has been dissolved all records may be destroyed.

(2) Records may be destroyed in any other case where the Commissioner gives his consent.

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'Records' include books of account (whether in legible form or by computer), receipts and payments, income and expenditure, together with vouchers, bank statements, invoices, receipts and other

	Marks
documents necessary to verify the entries in the accounts. It also includes records of assets and liabilities, goods purchased and sold, details of sellers and buyers, records of stocktakings and records of services provided.	1 <hr/> 4
(ii) With regard to the omission of sales, s.80(2)(a) provides, <i>inter alia</i> , that any person who without reasonable excuse makes an incorrect return by omitting or understating something is guilty of an offence. If prosecuted and convicted, the maximum punishment is a fine at level 3 (\$10,000) for each charge and a further fine of treble the amount of tax that has or would have been undercharged as a result of the omission or understatement. The Commissioner may compound these offences and settle for a monetary penalty under s.80(5).	1.5
In cases of fraud and willful evasion, action may be taken under s.82(1) which can lead to imprisonment in addition to the usual fines. In order for a prosecution under s.82 to succeed, fraud or willful default to evade tax must be proved; and in practice this may be difficult. The following acts, if committed with the deliberate objective of evading tax, fall within the provisions of s.82(1):	
(1) An omission from a return.	
(2) A false entry or statement in a return.	
(3) A false statement in a claim for a deduction or allowance.	
(4) Signing a statement or return without reasonable grounds for believing that it is true.	2
In Ms Lim's case, in view of the magnitude of the understatement, the recurrent omission over eight consecutive years, Ms Lim's wilful intent to evade tax is likely established. Prosecution under s.82(1) may be instituted against Ms Lim. The maximum punishment under s.82 is a fine at level 5 (\$50,000) for each charge and a further fine of treble the amount of tax undercharged and imprisonment for three years. It should also be noted that multiple offences may be committed by Ms Lim under s.82(1), e.g. the omission of sales may amount to both an omission from the return as well as a false entry or statement in a return. The Commissioner may, however, compound these offences under s.82(2).	2
If no prosecution under s.80(2) or 82(1) has been instituted, the Commissioner or Deputy Commissioner may penalise Ms Lim by way of assessment to additional tax under s.82A up to a maximum of treble the amount of tax undercharged. Section 82B provides Ms Lim with a right of appeal to the Board of Review against the imposition and/or quantum of any additional tax assessed.	1
Illiteracy and reliance on bookkeepers may not be sufficient defenses in a prosecution which is a criminal proceeding, nor are they reasonable excuses in terms of ss.80 or 82A. Ms Lim's co-operation and full voluntary disclosure might be considered as mitigating factors when passing sentence or imposing monetary penalties. The time span and magnitude of the understatement, however, are aggravating factors.	1.5
With regard to the failure to keep adequate business records without reasonable excuse, this is an offence under s.80(1A). Under s.80(1A) the court may impose a maximum fine at level 6 (\$100,000) but the Commissioner may, and often does, compound the offence under s.80(5).	1 <hr/> 9
(b) At the outset, you should require <i>inter alia</i> :	
(1) A list of the business books (if any).	
(2) A list of the bank accounts in operation, both business and personal.	
(3) A list of property, investments and other assets, including such items acquired in the name of other persons.	
(4) A list of bank accounts which have been closed and particulars of property etc, sold during the relevant period.	
(5) A list of all liabilities.	
(6) A list of the assets and liabilities on hand at the beginning of the relevant period.	
(7) A copy of the tax returns and assessments raised.	
(8) A list of the name of all family members.	
(9) A list of debtors and creditors at the beginning and end of the period under investigation.	
0.5 marks each, maximum	4
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