Answers

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1 Report to Mr Smart of Smart Ltd

To: Mr Smart
From: Tax advisor
Date: 1 December 2008
Subject: Hong Kong tax position of Smart Ltd – years 2007 and 2008

It was my pleasure to meet with you last week to discuss Smart Ltd's (the Company's) various tax issues. The Company is engaged in general trading business but has also made investments in Hong Kong listed shares during 2007 and 2008. However, due to the global market crisis, the Company's investment strategy has changed from long-term to short-term trading. This gives rise to a change in the accounting treatment and likely a change in the tax position. You have requested me to address all the Hong Kong tax issues arising from each block of shares, and the eligibility to carry forward the tax losses in the Company. Moreover, you also require Hong Kong tax advice on how additional funds may be injected into the Company. My comments and advice are as follows:

(a) Share B

(i) The profit of $2 million from the sale in 2007

Based on s.14(1), profits (or losses) from a 'business, trade or profession' carried on in Hong Kong will be taxable (or deductible) unless the profit (or loss) is derived from a source outside of Hong Kong or the profit (or loss) is proved to be capital in nature. However, it is often difficult to determine whether an isolated transaction or a series of transactions constitutes a 'trade' or not, and the commonly used criteria are the so-called 'badges of trade'. Applying these criteria to the sale of Share B, the analysis is:

(i) Subject matter of the transaction – The subject matter is Hong Kong listed shares, which are capable of being traded easily over the Stock Exchange. Moreover, it is generally considered that an asset (like shares) that does not yield an income or personal enjoyment to its owner merely by virtue of its ownership is more likely to be held for trading.

(ii) The length of ownership period – The shorter the period of ownership, the more likely that the transaction is trading. In the Company's case, Share B was sold within a year of purchase and thus, it is likely to be regarded as held for short-term and trading purposes unless there are justifiable reasons to explain otherwise.

(iii) The frequency of number of similar transactions – The higher the frequency, the more likely it is for trading. In the Company's case, information is not available as to whether the Company has bought and sold similar shares prior to 2007, but the fact that the Company has sold Share A in 2008 would also be relevant for the Inland Revenue Department (IRD) to argue that the Company did have the intention to repeat the buy-sell transactions.

(iv) Supplementary work done – In the case of listed shares, this factor would not be obvious since the owner of the shares would normally not be required to perform any supplementary work on the shares before they are sold. However, if there is any other related work performed in enabling the Company to make a profit from buying and selling shares, such as seeking frequent advice from an investment advisor on market conditions, the Company may be regarded as trading in shares.

(v) Circumstances leading to the sale – Although the intention at the time of acquisition of the shares is important, the reason for the sale would also be relevant in determining whether a particular sale is a 'trade' or not. In the Company's case, Share B was sold within a few months after purchase. The share price has gone up tremendously during these months and thus the sale gave rise to a huge profit. Unless there are other justifiable reasons to explain that the sale of Share B was not for profit-making and unrelated to the market conditions, it is likely that Share B would be regarded as acquired and sold for trading purposes.

(vi) Motive – This factor is generally dependent on the intention of the Company in acquiring, holding and selling the securities. Again, if the Company wishes to claim that Share B was held for long-term purposes it must have evidence to show that the motive for its buying, holding and selling Share B is not for profit-making purposes.

In determining whether there is an intention to trade in a transaction, one must look at all the circumstances, not only limited to the above six badges of trade. Examples are funding of acquisitions and utilisation of sale proceeds. Based on the facts given, it is not optimistic that Share B would be accepted by the IRD as held for long-term purposes and thus, that the profits arising from the sale are capital in nature and non-taxable.

(ii) Whether the 2007/08 assessment is final and conclusive

Although the assessment for 2007/08 has been issued per the Company's tax return, it does not confirm that the claim for the Share B disposal gain to be non-taxable has become finally and conclusively agreed by the IRD. If in a subsequent year the assessor considers that the disposal gain should be taxed, he/she is empowered under s.60(1) to raise an

assessment within six years after the end of the year of assessment in which the transaction or event occurred. In the case of Share B, the deadline for raising the additional assessment for 2007/08 is 31 March 2014. In the case of fraud or wilful evasion, the time limit is extended to ten years.

(b) Share A

(i) The $1·5 million revaluation gain in 2007
As of 31 December 2007, the value of Share A had increased by $1·5 million. However, since the share was not yet disposed of, the excess of the year-end market value over the acquisition cost was not taken to the Company's profit and loss account, but instead, it was credited to the Company's equity account. For the purpose of the 2007/08 assessment year, the $1·5 million would not be taxable based on either of the following reasons: (a) Share A was disclosed in the 2007 accounts as an investment held for long-term purposes and thus it was claimed to be not trading in nature; or (b) the change in fair value taken to the equity account would not be taxable or deductible (if a loss) until Share A is disposed of. Based on DIPN No. 42 (para 13), the IRD will generally follow the accounting treatment stipulated in HKAS 39 for the recognition of profits or losses in respect of financial assets of a revenue nature. In the Company's case, should the unrealised profit arising from the change in fair value have been credited to the Company's 2007 profit and loss account, the profit would have been taxable for 2007/08. This is not the case here. When Share A is subsequently disposed of, the cumulative change in fair value as recognised in the profit and loss account in the year of disposal may then be taxable (or deductible in the case of a loss) if Share A is regarded by the IRD as a trading asset.

(ii) The net loss of $600,000 from the sale in 2008
The taxability of Share A in the year of assessment 2008/09 depends on whether Share A is regarded by the IRD as a trading or a capital asset and whether there has been a change in intention of its holding throughout 2007 and 2008. Based on the information provided, Share A was disclosed in the 2007 accounts as an investment held for long-term purposes. Share A was acquired together with Share B, which was disposed of in 2007. The fact that the Company has made a capital claim for the profit from Share B may support the same intention for holding Share A. If this long-term capital intention is accepted by the IRD and continues up to the disposal of Share A, the loss of $600,000 in 2008/09 would not be deductible. However, you now claim that the long-term intention of holding Share A has actually been changed to one of short-term trading as of 1 July 2008. If there is sufficient evidence to prove the change of intention and the timing of the change, part of the profit (or loss) attributable to the period in which Share A was held as a trading asset would be taxable (or deductible). The timing of the change of intention is important. Based on the *Sharkey* v *Werner* principle, Share A would be deemed to be disposed of at its open market value of $490,000 as at the date of the change in intention, i.e. 1 July 2008. Against the acquisition cost of $1,000,000, there would be a deemed loss of $510,000 attributable to the holding of Share A as a capital asset and thus, non-deductible. The deemed disposal proceeds of $490,000 would then become the cost base of Share A held as a trading asset, since 1 July 2008. The difference in value between the ultimate sale proceeds upon disposal ($400,000) and this cost base ($490,000) would be a trading loss of $90,000, which would be deductible. Generally speaking, it would be very difficult to convince the IRD to accept a capital transaction when it is profitable, and to further accept that the transaction has subsequently been changed to trading when it makes a loss; unless the Company has good and justifiable reasons, together with sufficient evidence, to convince the IRD that the change of intention was not to take advantage of a deductible loss derived from ultimate sale.

(c) Revaluation of Share C in 2008
Assuming that Share C is recognised as an investment held for trading in the 2008 accounts, and the year-end revaluation loss of $1,600,000 is taken to the Company's profit and loss account, the Company should be able to claim the tax loss as deductible on the basis that (i) Share C is disclosed and claimed as a trading asset, (ii) the loss, though unrealised, based on the year-end fair market value is recognised in the profit and loss account and (iii) it is the IRD's practice to follow the general accounting treatment and to recognise the change in fair value including a loss, in the Company's profit and loss account (see DIPN No. 42, para 24). That having been said, as the Company makes a loss instead of a profit from Share C but has the history of claiming a capital profit out of other shares, it is expected that the IRD would be more stringent in investigating the Company's intention of holding investments before the loss is agreed.

(d) Tax losses to be carried forward
It is the intention of the Company to claim the loss derived from the sale of Share A and the unrealised loss arising from the year-end revaluation of Share C in 2008 to be tax deductible and carried forward to future years. Based on the information available, the Company has also made losses from its general trading business. Under the 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 been disallowed. Tax losses are attributable to the company, regardless of the fact that the shareholding in the company 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.

However, there is an anti-tax avoidance provision in the Inland Revenue Ordinance, s.61B, which governs that in the case where there is a change in shareholding in a company with accumulated tax losses, 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 are 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.

In the case of the Company, it will be necessary to justify that the sale of shares in the Company is for commercial reasons, and not solely or dominantly for the benefit of the tax losses. Moreover, after the sale, should there be any intention to inject profit making business into the Company with a view to utilising the tax losses, it must also be commercially justifiable 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 the set-off of tax losses would be denied.

(e) (i) Bank interest deductibility

Based on the information provided, the Company obtained a bank loan to wholly fund the acquisitions of Hong Kong listed shares. Whether or not the interest is tax deductible by the Company depends on whether the profit arising from the share transactions is taxable, and whether all the tax deduction conditions are satisfied.

In Hong Kong, dividends received from listed shares are not taxable. Hence, if the listed shares are held for the long-term with a view to generating non-taxable dividends and profit, the related bank interest would not be tax deductible. In the Company's case, Share B was disposed of in 2007 and the profit was claimed as non-taxable. If this profit is ultimately accepted by the IRD as capital in nature, all the bank interest expense in 2007 would not be tax deductible. Information provided is not available to show whether the bank interest in 2007 has been claimed as a tax deduction in the 2007/08 tax return. Please let me know if you wish me to review the tax return.

On the other hand, if the IRD considers that the shares are held for trading purposes and the profit on disposal is taxable, the related bank interest would be deductible, provided the following conditions are satisfied:

(1) the bank borrowing 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 borrower or any connected person (s.16(2B)).

In the case of the Company, condition (1) should be satisfied if the bank loan was granted only under your personal guarantee and there is no other security given in the form of deposits or loans that would derive non-taxable income. In respect of condition (2), assuming there is no such arrangement in place that would generate an interest payment which ultimately flows back to yourself or any connected person, this condition is also satisfied. If both of these conditions are satisfied, the interest on the bank loan should be tax deductible.

(ii) Effect of additional fund injection

By equity

If you obtain a personal bank loan and inject the additional funds into the Company as equity, interest will be payable by you on the personal bank loan but there will not be any tax deduction, because your return out of the capital injection would only be dividend income which is not taxable under the Hong Kong tax regime. From the perspective of the Company, the existing bank loan is repaid by additional equity. No interest expense would be incurred. Even if the shares are regarded by the IRD as trading assets in future, there would be no tax deduction for any funding cost. This is not tax effective to the Company.

By interest-free loan

If the additional funds are injected into the Company as an interest-free loan, the tax positions of yourself and the Company are the same as the above scenario where the funds are injected by way of equity. No tax deduction would be available to either yourself or the Company in respect of the funding cost for the loan. This is also not tax effective.

By interest-bearing loan

In this scenario, interest is payable by you on the personal bank loan and interest is also paid by the Company to you. In your case, the interest received from the Company would not be taxable since you are not carrying on a business as a money-lender. As a result, the interest paid on the personal bank loan would also not be tax deductible.

From the Company's perspective, interest is paid to you as an individual shareholder. However, even if the shares are accepted by the IRD as trading assets and the profits arising therefrom are taxable, the interest payment would still not be tax deductible for the reason that the loan was obtained from you, being a non-financial institution or non-money lender, and the interest received in your hands is not taxable in Hong Kong (s.16(2)(c)). Moreover, as you are also closely connected with the Company, s.16(2)(e) is not satisfied. As a result, the interest paid to you by the Company is not deductible and this is again not tax effective to the Company.

(iii) Recommendation

If additional funds are required, it would be advisable for the Company to try to obtain a new loan from another bank, under your personal guarantee, and use the new loan money to repay the existing bank loan. In this case, the Company incurs an interest payment to the new bank which is a financial institution and thus, if the shares are accepted by the IRD as a trading asset, interest would be tax deductible provided the loan is not secured by any deposits/loans that generate non-taxable interest income, and the interest does not flow back to the Company or yourself.

I hope the above addresses all your concerns regarding the Hong Kong tax implications of the matters raised. Should you have any questions, please let me know.

End of Report

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Xxx Tax Advisors
[Firm's address]

[Date]

Mr and Mrs Chiu
[Address]

Dear Mr and Mrs Chiu,

I refer to our recent meeting discussing your tax position for the year of assessment 2007/08 and the compliance obligations under the Inland Revenue Ordinance (IRO) in respect of Diana Ltd. Based on the information you supplied, I outline our advice as follows:

Employment with Champion Ltd

Section 8(1) of the IRO only taxes employment income arising in or derived from a source in Hong Kong. In this regard, the relevant tests for determining the location of an employment as set out in *Goepfert's* case and DIPN No. 10 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.

Since Champion Ltd is a Hong Kong company, 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.

However, s.8(1A)(b) provides an exemption where all the services are rendered outside Hong Kong. Whether there is any employment service rendered in Hong Kong is a matter of fact. It is usually not sufficient merely to demonstrate that the most important aspects of the employment are rendered abroad or that only incidental or minor duties are undertaken in Hong Kong. If any duties at all are rendered in Hong Kong in the relevant year of assessment, the exemption will be lost. The purchase of spare parts could be considered as providing services under the employment. However, in a Board of Review case *D27/03*, the Board found the occasional purchase of spare parts by a production technician while in Hong Kong could not be considered as performing services for the employer and it was done very rarely. The Board considered this was on the thin borderline of (a) on the one hand, services to the employer and (b) on the other hand, convenience to himself so that he could perform his services easier. Although the Board opted for the explanation that the purchase of spare parts was not part of the employment services and all employment services were rendered outside Hong Kong, this is a unique situation. Your case may not be treated the same. In particular, you are the production manager and you may have provided services of an administrative nature in Hong Kong, which cannot be ignored. In this respect, please provide us with further information.

It is further provided in s.8(1B) that only services rendered in Hong Kong during visits of not more than a total of 60 days are ignored. The duration of visits only matter when there are some services performed during the visits. If the purchase of the spare part is considered to be employment services, then you would not be exempted under s.8(1A)(b) as you did perform services in Hong Kong during visits of more than 60 days.

Since you were present in She Kou for more than 183 days during the year, you would be liable to individual income tax in China in respect of at least part 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 the income tax in China. Alternatively you can claim the tax you have paid in China as a tax credit against your salaries tax liability under the provisions of Article 21 of the 'Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income'.

Other than the monthly salary, certain benefits received from your employer will also be taxable. The flat provided by Champion Ltd is considered as a place of residence, which includes representative occupation. Rental value equivalent to 10% of your income derived from Champion Ltd during the year will therefore be included as a taxable benefit under s.9(1)(b). Reimbursement of the medical expense is taxable under s.9(2A)(a), while the cost of the holiday journey is taxable under s.9(2A)(c) even if you actually spent the full amount on a holiday. However, the cost of the trip to Japan is a private expense and is not deductible.

The cost of the meals provided is not taxable as the benefit cannot be converted into cash. The travelling costs between Hong Kong and She Kou are also not taxable, as these costs are incurred by Champion Ltd directly and the journey is not a holiday journey. The $50,000 payment represents a compensation for your personal loss; it is not income for services rendered and is not taxable.

Therefore, your assessable income from the employment with Champion Ltd is $972,400 (see workings below).

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Salary	840,000
Allowance for holiday journey	20,000
Reimbursement of medical expenses	24,000
	884,000
Rental value at 10%	88,400
Assessable income	972,400

Director's fee from Diana Ltd

As the director of a Hong Kong company managed and controlled in Hong Kong, the director's fee of $60,000 is chargeable to salaries tax. Since this amount is below the basic allowance of $100,000, it is to your advantage to elect joint assessment under salaries tax. Under joint assessment, income from both your employment and Diana's office would be aggregated into one assessment. You would be entitled to a married person's allowance of $200,000 and tax savings could be achieved.

Available deductions

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

You are also entitled to claim dependent parent allowances in respect of your parents as they are resident in Hong Kong. However, no dependent parent allowance is available in respect of your parents-in-law as they are not ordinarily resident in Hong Kong.

Your salaries tax positions

Based on the salaries tax calculation under joint assessment (see workings below), you have a net chargeable income of $712,400 before deduction for any MPF contributions, for the year of assessment 2007/08. Accordingly, you will be charged to tax at progressive rates on this amount, rather than at the standard rate of 16% on $1,032,400.

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Assessable income – Mr Chiu	972,400
– Mrs Chiu	60,000
Total assessable income	1,032,400
Married person's allowance	(200,000)
Dependent parent allowance	(60,000)
Additional dependent parent allowance	(60,000)
Net chargeable income	712,400

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

Lease of property

A lease for a term exceeding three years must be evidenced in writing. Therefore, you must prepare a lease agreement in respect of the property and have it stamped within one month. The lease agreement is chargeable under Head 1(2) in the First Schedule of the Stamp Duty Ordinance. Stamp duty of 1% on the yearly rent of $180,000, i.e. $1,800 is payable.

Tax compliance obligations in respect of Diana Ltd

As a company carrying on business in Hong Kong and as an employer, Diana Ltd has to comply with the following compliance obligations:

Since Diana Ltd has received income chargeable to tax in Hong Kong, under s.51(2) it has to notify the Inland Revenue Department (IRD) within four months after the end of the basis period for the relevant year of assessment in which the chargeable income is received, unless it has been required to file the tax return by the IRD.

If the first accounts are closed on 30 November 2008, the first relevant year of assessment would be 2008/09. The basis period for this year of assessment is 1 January 2008 to 30 November 2008. Four months from the end of the basis period would be 31 March 2009. Therefore, Diana Ltd will have to notify the IRD of its chargeability to tax on or before 31 March 2009, unless a tax return has been issued to it before that date.

If the first accounts are closed on 31 March 2008, the first relevant year of assessment would be 2007/08. The basis period for this year of assessment is 1 January 2008 to 31 March 2008. The due date for notifying chargeability would have been 31 July 2008, i.e. four months from 31 March 2008. It is obvious that this deadline has been missed without giving proper notification. Failing to notify may result in a penalty to the company.

If issued with an annual tax return by the IRD, Diana Ltd is obliged under s.51(1) to complete and submit the return within the period stipulated, together with its audited accounts. Normally, one month is allowed for filing purposes but in practice, an extension would be given upon application depending on the situation.

If Diana Ltd has employed any staff and incurred salary expenses, it is obliged under ss.52(2) and 52(4) to complete and submit notifications of commencement of employment within three months of commencement, as well as an annual employer's return in respect of each member of staff, giving details of the staff involved and the remuneration paid. It is also required to submit notification of any employee who is about to cease to be employed within one month before cessation (s.52(5)); notification of any employee who is about to leave Hong Kong for more than one month other than for a business purpose, one month before the employee's departure (s.52(6)); and to retain money payable to any employee who will cease employment and leave Hong Kong for one month from the date of the notice (s.52(7)).

Under s.51C, Diana Ltd has to maintain proper business records in respect of transactions conducted for a period of seven years.

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 behalf of Xxx
Xxxx

3 **(a)** The general principles for determining the source of manufacturing profits are set out in DIPN No. 21, paragraphs 13 to 19.

The Inland Revenue Department (IRD) considers that, where goods are manufactured in Hong Kong, the profits arising from the sale of such goods will be fully taxable because the profit-making activity is considered to be the manufacturing operation carried out in Hong Kong. Where goods are manufactured partly in Hong Kong and partly outside Hong Kong, then that part of the profit which relates to the manufacture of goods outside Hong Kong will not be regarded as arising in Hong Kong; and apportionment is generally done on a 50:50 basis unless compelling circumstances dictate otherwise.

Where a company manufactures goods outside Hong Kong and sells them to Hong Kong customers, the manufacturing profits are not liable to profits tax. However, in the exceptional case where the sale activities in Hong Kong are so substantial as to constitute a retailing business, profits attributable to the retailing activities are fully taxable.

The IRD provides a concession where a Hong Kong manufacturing business enters into a processing arrangement with a Mainland entity, under which the Mainland entity provides the factory premises, the land and labour while the Hong Kong manufacturing business provides the raw materials, technical know-how, management, production skills, design, skilled labour, training and supervision for the local labour and the manufacturing plant and machinery. The Mainland entity is responsible for processing the goods, for which it is paid a processing fee by the Hong Kong manufacturing business. This kind of arrangement is called 'contract processing'. Strictly, the profits of the Hong Kong manufacturing business should be fully taxable, as the manufacturing is carried out by an independent contractor and the question of apportionment does not arise. However, recognising that the Hong Kong manufacturing business is involved in the manufacturing activities on the Mainland, the IRD is prepared to allow an apportionment of profits on a 50:50 basis.

If, however, manufacturing on the Mainland has been contracted to a sub-contractor and paid for on an arm's length basis, with the minimal involvement of the Hong Kong business, this will not be a case of manufacturing profits but rather a case of trading profits. Profits of the Hong Kong business will be calculated by deducting from its sales the cost of the goods sold, including any sub-contracting charges paid to the sub-contractor on the Mainland. Taxation of such trading profits will be determined on the same basis as for a commodities or goods trading business.

In recent years, the IRD has discovered that many of the manufacturing arrangements made by Hong Kong businesses are not by way of contract processing. Instead, the Hong Kong business sells raw materials to the Mainland entity, which processes the raw materials into finished goods and then sells the finished goods back to the Hong Kong business. This kind of arrangement is called 'import processing'. In such cases, the Hong Kong business will be treated by the IRD as a trading business and no apportionment will be granted.

(b) To be chargeable to profits tax, s.14(1) requires various cumulative conditions to be satisfied, that is (1) a business is carried on in Hong Kong, (2) profits are from that business and (3) those profits arise in or are derived from Hong Kong. Both conditions (1) and (2) are satisfied in the present case and condition (3) is therefore critical.

Hong Kong operates on a 'territorial' concept. To determine the source of profits, the broad guiding principle is that one looks to see what the taxpayer has done to earn his profits and where he has done it: *Hang Seng Bank* case and *HK-TVB International* case. In the case of manufacturing profits, the profit-making activity is considered to be the manufacturing operation and profits are made where it is carried out.

Excel commenced business in Hong Kong as a manufacturer and exporter of electronic products. Profits arising from the sale of such goods were fully taxable because the manufacturing operation was carried out in Hong Kong. But from April 2007, manufacturing is carried out by Sino on the Mainland. Excel and Sino adopt the import processing method to import the raw materials into the Mainland by way of purchase and to export the finished goods out of the Mainland by way of sale. The transactions between Excel and Sino is that Sino carries on an import processing business, the transfers of raw materials and finished products between Excel and Sino are by way of sale and purchase and the consideration for such sales and purchases is satisfied by Excel's payment of money to Sino. Excel purchases the raw materials and sells the raw materials to Sino. Subsequently, Excel purchases the finished goods from Sino and sells the finished goods to outside customers. Excel thus earns its profit from the buying and selling of finished goods. It is therefore a trading company.

The concession under paragraph 16 of DIPN No. 21 is only available to 'contract processing' and not to 'import processing'. Paragraph 17 of DIPN No. 21 states that the IRD's concession of 50:50 apportionment does not normally apply to a case where manufacturing on the Mainland has been contracted to a sub-contractor (whether a related party or not) and paid for on an arm's length basis, with the minimal involvement of the Hong Kong business. The IRD will therefore treat Excel not as a manufacturer but as a trader. The profits of Excel's trading business will be calculated by deducting from its sales the cost of the goods sold, including any sub-contracting charges paid to Sino. The taxation of such trading profits will be determined on the same basis as for a trading business; and trading profits are made where the purchase contacts and sales contracts are 'effected' (*Hang Seng Bank* case). On the basis that either the contract of purchase or sale or both are effected in Hong Kong, the profits will be 100% taxable as trading profits. This approach has been adopted by the Commissioner in *D43/06*.

However, by providing Sino with all the machinery, design, technical know-how, product specifications and quality control standards, training and supervision of local labour, it could be argued that Excel had also undertaken operations in the PRC which were important and attributable to the profits in question. Since that part of the profits was sourced outside Hong Kong, the same is not chargeable to tax. In line with paragraphs 21 and 22 of DIPN No. 21, an apportionment of profits on a 50:50 basis would be allowed. Similar conclusions have been reached by the Board of Review in *D43/06*, although it should be noted that both the taxpayer and the Commissioner have appealed to the Court of First Instance.

Tutorial note: Based on the six months' rule, the *Datatronic* case is not examinable. However, candidates may note that the Court of First Instance handed down its judgement on 13 June 2008, confirming the assessment determined by the Board of Review.

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

In ascertaining the basis period for the year of change and the year preceding the year of change, the general principles to be applied are:

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

(2) to make sure that

- for a new business (commencing on or after 1 April 1974), none of the profits arising during the life of the business fall out of the profits tax net; and
- for an old business (commencing before 1 April 1974), the period left out of assessment is not one of high profit;

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

(4) to ensure fairness to both the Inland Revenue Department (IRD) and the taxpayer.

(b) If Swallow changes its accounting date from 31 December to 30 June such that accounts for 18 months are drawn up for the period 1 January 2008 to 30 June 2009, accounts will not be made up to the corresponding day of 31 December 2008 in 2008/09. Thus, the year of change will be 2008/09 and the year preceding the year of change will be 2007/08.

Because it is normal for a basis period to comprise a period of 12 months, there will be a duplication of profits assessed if a change of accounting date results in an accounting period of less than twelve months. However, in the case of a business which commenced after 1 April 1974 (a new business), the Commissioner is normally prepared to limit the basis period to the period of less than twelve months, by concession, if the change of accounting date is for a 'compelling reason' and is not tax-motivated.

In the case of Swallow, the basis period for the year of change 2008/09 is six months only, from 1 January 2008 to 30 June 2008 Since the reason for the change is to conform to the accounting date of the holding company, it is very likely that the Commissioner will apply the concession and adopt a basis period of six months, from 1 January 2008 to 30 June 2008 for the year of assessment 2008/09 (see Advance Ruling Case No. 20).

For the preceding year 2007/08, the basis period will be adjusted to the equivalent 12 months, i.e. 1 July 2006 to 30 June 2007 only if this would result in an additional assessment. However, in the case of a new business an adjustment to the preceding year will not normally be required because no profits will fall out of assessment (see Advance Ruling Case No. 20).

The normal basis period will apply for the year following the year of change. Thus, the basis period for the year of assessment 2009/10 will be 1 July 2008 to 30 June 2009 .

(c) From 1 April 1998, s.88A of the Inland Revenue Ordinance (IRO) provides for advance rulings to be obtained on the interpretation of statutory provisions in certain circumstances. The purpose of the advance ruling system is to provide an increased level of certainty to taxpayers, to promote consistency in the application of the IRO and to minimise disputes between the IRD and taxpayers.

In the case of Swallow, it can apply for an advance ruling in respect of the application of s.18E on the basis period for the years of assessment 2007/08, 2008/09 and 2009/10 and pay the prescribed fees. There are very specific rules as to the contents of an application and these are contained in s.8 of Schedule 10 of the IRO. In particular, the advance ruling application must:

(i) identify the applicant;
(ii) disclose all relevant facts and documents in connection with the arrangement to which the application relates;
(iii) state the provision of the IRO upon which a ruling is sought;
(iv) state the provision of law which is relevant to the issues raised in the ruling;
(v) provide any other information which the IRD may specify in writing for the purposes of the ruling application; and
(vi) be accompanied by a draft ruling.

(d) If Swallow had commenced business in 1973, it would be an old business for change of accounting date purposes. Therefore, the Commissioner's concession to limit the basis period to a period of less than 12 months does not apply. So, there will be a duplication of profits assessed as the change of accounting date results in an accounting period of less than 12 months. The basis period for 2008/09, the year of change, will be 1 July 2007 to 30 June 2008 and profits for the period 1 July 2007 to 31 December 2007 will be double assessed.

For the preceding year 2007/08, an adjustment will not normally be required because no profits will have fallen out of assessment. For the following year 2009/10, the normal basis period will apply, i.e. as in (b), 1 July 2008 to 30 June 2009.

5 **(a)** For Hong Kong tax purposes, income is taxable if it has already 'accrued' to the taxpayer. Income is regarded as accrued to a taxpayer in a year of assessment when he is entitled to receive it, regardless of whether he actually receives it or not (s.11D(b)) during that year of assessment, but the assessment to tax on that income cannot be made until the taxpayer has actually received it. Moreover, if a taxable income relating to an employment is 'paid by the employer' after the taxpayer has ceased that employment, the income is deemed to have accrued to the taxpayer on the last day of that employment (s.11D(b)(ii)) and is accordingly assessed for the year of assessment in which the employment ceased.

In the case of the discretionary bonus to which the Chief Executive Officer (CEO) is contractually entitled, the bonus is to be regarded as accrued during the financial period to which it relates (i.e. the year ended 31 March 2008), even though the amount may not have been quantified and paid until later (*D46/98*). Although the bonus is discretionary, the fact that the boss has agreed to pay him the estimated figure before the last day already indicates that his entitlement to the bonus is notified or confirmed. As a result, the bonus is deemed to have accrued on the last day of his employment, i.e. 31 March 2008, and should be subject to tax for the year of assessment 2007/08.

If he agrees to accept the estimated bonus figure and receives the sum before the last day of employment, the bonus will be included in the 2007/08 tax assessment issued to him before he departs Hong Kong in May. However, if he chooses to wait until July 2008 to receive the bonus, the bonus will not be assessed at the time his 2007/08 tax assessment is issued in May; but when he actually receives it in July, an additional assessment for 2007/08 will then be issued to demand the additional tax payable. The Company is obliged to report the additional payment of the bonus to the Inalnd Revenue Department (IRD) after the payment is made. In conclusion, the ultimate tax position of the CEO between accepting the estimated bonus and waiting to receive the actual bonus in July is the same, except that the timing of the tax payment on the bonus is deferred in the latter case.

(b) The taxable value of housing benefit provided by an employer in the case of rent-free accommodation is ascertained by way of 'rental value'. 'Rental value' is calculated by applying 10% (in the case of a residence which is not a hotel, hostel or boarding house) on the assessable income from employment for the period during which the accommodation is provided, but reduced by any share option benefit, certain withdrawals from a retirement scheme, any lump sum or gratuity paid upon retirement and any eligible outgoings / expenses / depreciation allowances.

In the case of the CEO, since he derives no assessable income from employment during the period from 1 April 2008 to the date he departs Hong Kong in May, the rental value relating to his housing benefit provided during this period will be zero. In other words, there is no additional tax cost arising from the free use of the quarters after 1 April 2008. However, if he chooses to receive the $50,000 cash allowance and moves out of the quarters on 1 April 2008, the allowance will be fully taxable in his tax assessment for 2007/08. It is obvious that, from a tax perspective, the maximum tax saving can be achieved from staying in the quarters until departure.

(c) The taxability of a share option is governed by s.9(1)(d) under which any gain realised on the exercise, release or assignment of any option to acquire shares which are acquired by the taxpayer by reason of an employment sourced in Hong Kong is deemed as taxable income. It is not relevant whether or not the taxpayer is still employed by the same employer who granted the option at the time the option is exercised, released or assigned. The taxable gain is simply calculated as the consideration received less the amount paid for the option. However, any gain arising from the subsequent sale of the shares is not taxable if the shares are regarded as for personal investment.

In the case of the CEO, since the share options were granted during his employment in Hong Kong for services rendered in Hong Kong, any gain arising from his exercise, release or assignment of the options would be taxable; regardless of whether he is or is not in Hong Kong at the time of exercising the option. However, any loss, if arising, is not allowed to be deducted.

The timing for assessing the gain, if any, will depend on the timing of the exercise, release or assignment. Section 11D(b)(ii) which deems any taxable income paid by an employer after the cessation of employment to accrue on the last day of employment does not apply in the case of a share option gain, because the gain is not a payment made by the employer. Therefore, if the CEO makes a gain from exercising the option (for the first batch), or assigning the option (for the second batch) during the period from 1 April 2008 to 31 March 2009, the gain will be assessed under Hong Kong tax for the year of assessment 2008/09, not the year of assessment 2007/08. However, the CEO may elect to have his tax liability ascertained based on a notional exercise of the option at the time when the 2007/08 assessment is finalised before he departs from Hong Kong in May 2008, in which case any actual gain arising from the subsequent exercise of the option will not be brought into tax again.

If the CEO believes that the share price will not rise significantly before the end of June 2008, he should not make a notional exercise election, and should exercise the first batch of options after 1 April 2008, so that any gain from the exercise will fall within the year of assessment 2008/09, as a full year of statutory personal allowance will be granted before tax is charged. As for the second batch of options, no tax liability will arise if the CEO simply allows it to fall lapsed. If it is to be sold (i.e. assigned) at a price, any gain arising therefrom will be taxed in the year in which the option is sold/assigned.

(d) The tax reduction, if enacted, will be brought into the tax assessment for 2007/08 to reduce the final tax payable for 2007/08. Any taxpayer who is subject to tax for 2007/08 and who has paid tax for 2007/08 will be entitled to the rebate. In the case of the CEO, if the law is only enacted after his 2007/08 assessment is issued in May before his departure, the Commissioner is empowered under s.62(3) to make any subsequent necessary amendments and send a notification or revised assessment to the CEO advising him of the ultimate tax payable after the tax rebate. Any payment made in excess thereof is then refunded. To facilitate the communication of any changes after he departs from Hong Kong, the CEO is advised to notify the IRD of his correspondence address in Singapore.

			Marks
1	Smart Ltd		
(a)	Share B		
(i)	Profit from the sale of Share B in 2007		
	S.14(1)	1	
	Six badges of trade (1 mark each)	6	
	Conclusion	1	8
(ii)	Whether 2007/08 assessment is final and conclusive		2
(b)	Share A		
(i)	The revaluation gain in 2007		
	Not taxable in 2007/08, with reasons	2	
	DIPN No. 42 position	2	4
(ii)	The net loss from the sale in 2008		
	Long-term capital intention	1·5	
	Change of intention to short term	2·5	
	IRD may be difficult to convince	1	5
(c)	Revaluation of Share C in 2008		2
(d)	Tax losses to be carried forward		
	Loss relief for corporations	1·5	
	S.61B	1·5	
	Application in this case	2	5
(e) (i)	Bank interest deductibility		
	Incurred to earn chargeable profits	2	
	S.16(2A) and (2B)	2	
	Application in this case	1	5
(ii)	Additional fund injection		
	By equity	2	
	By interest-free loan	1	
	By interest-bearing loan	2	5
(iii)	Recommendation		2
	Appropriate format and presentation	1	
	Effectiveness of communication	1	2
	Total		**40**

		Available marks	Maximum marks
2	**Jimmy and Diana Chiu**		
(a)	Employment with ATM:		
	Location of employment		
	Test in Goepfert's case	0·5	
	Determining the source	0·5	
	Exemption under s.8(1A)(b) and its application	4	
	S.8(1B) and its application	1·5	
	Exemption under s.8(1A)(c)	2	
	Tax credit under Article 21 of the DTA	1	9
	Taxability of rental value	0·5	
	Taxability of reimbursement of medical expense	0·5	
	Taxability of holiday journey	0·5	
	Deductibility of trip expense	0·5	
	Taxability of cost of meals	0·5	
	Taxability of travelling cost	0·5	
	Taxability of compensation	0·5	3
	Calculation of assessable income	1	1
	Director's fee from Diana Ltd:		
	Taxability of director's fee	0·5	
	Effect of joint assessment	1	1·5
	Available deductions:		
	MPF contributions	0·5	
	Dependent parent allowances	1	1·5
	Salaries tax position:		
	Tax position under joint assessment	0·5	
	Calculation of net chargeable income	1	1·5
	Lease of property:		
	Stamp duty payable on lease	1·5	1·5
		20	19
(b)	Tax compliance obligations:		
	Under s.51(2)	1	
	Accounts closed on 30 November 2008	1·5	
	Accounts closed on 31 March 2008	1·5	
	Under s 51(1)	0·5	
	Under s.52(2)	0·5	
	Under s.52(4)	0·5	
	Under s.52(5)	0·5	
	Under s.52(6)	0·5	
	Under s.52(7)	0·5	
	Under s.51C	0·5	
		7·5	7
	Appropriate format and presentation	1	
	Effectiveness of communication	1	
		2	2
	Total		**28**

				Marks
3	(a)	Source of manufacturing profits, including apportionment	1	
		Taxation of retailing business	0·5	
		IRD's concession of 50:50 apportionment	2	
		Where involvement of HK business is minimal	1·5	
		Tax treatment of import processing	1	6
	(b)	Conditions of s.14(1)	1	
		Source of manufacturing profits	1	
		Nature of transactions makes Excel a trading company	3	
		Concession does not apply	2	
		Basis of taxation of trading profits	1	
		Counter-arguments and effect	2	10
	Total			**16**
4	(a)	When a change of accounting date occurs	1	
		Principles to be adopted	2	3
	(b)	Identifying the year of change and the preceding year	1	
		Principles and whether there is a compelling reason	2	
		Basis period for the year of change	1·5	
		Basis period for the preceding year	1	
		Basis period for the following year	0·5	6
	(c)	Ability to apply for an advance ruling	1	
		Contents of an application for an advance ruling	3	4
	(d)	Basis period for the year of change	2	
		Basis period for the preceding year	0·5	
		Basis period for the following year	0·5	3
	Total			**16**
5	(a)	S.11D(b)	1	
		Treatment of discretionary bonus	1	
		Application depending on when bonus paid	2	4
	(b)	Taxation of housing benefit	1	
		Application depending on whether quarters vacated	2	3
	(c)	Taxability of share options	2	
		Whether in HK at time of exercise	0·5	
		Timing for taxing the share option	2·5	
		Advise deferral of sale to 2008/09, with reasons	2	7
	(d)	The tax rebate	2	2
	Total			**16**