
Answers

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1 Report to the management of Sweetie (HK) Co Ltd:

To: The management of Sweetie (HK) Co Ltd
From: Tax advisor
Date: 7 February 2008
Subject: New licence business in the PRC

It is my understanding that Sweetie-HK has successfully obtained the PRC licence from Confectionaries Inc to operate Sweetie-HK shops in the PRC. I am instructed to address the following aspects from the Hong Kong tax perspective:

(a) The form of operation in the PRC

Two alternatives have been identified: (i) as a branch of Sweetie-HK and (ii) as a wholly owned subsidiary of Sweetie-HK incorporated in the PRC.

- (i) If the PRC operation (i.e. shops) is run as a branch of Sweetie-HK, the branch operation is part of the legal entity of Sweetie-HK. All income/expenditure from both the HK and PRC shops will be aggregated. From the HK tax perspective, if the Inland Revenue Department (IRD) is satisfied that any profit attributable to the PRC operation is sourced outside HK, it is possible for Sweetie-HK to claim that part of the profit is not subject to HK profits tax. The determination of 'source' is not straightforward and there is no general rule. The Inland Revenue Ordinance (IRO) does not provide any comprehensive guidance, however, Departmental Interpretation and Practice Note (DIPN) No. 21 highlights the IRD's approach and interpretation of some relevant case law. The general principle is the so-called 'operations test' (*F.L. Smidth & Co v Greenwood*), where the question to ask is 'where do the operations take place from which the profits in substance arise?' As established in subsequent cases including the *Hang Seng Bank* case, the broad guiding principle is that one looks to see what the taxpayer has done to earn the profit in question and where s/he has done it. In the case of Sweetie-HK, if profits come from sales in retail shops situated in the PRC, the source of profits is likely to be regarded as located in the PRC and thus not taxable in HK. By the same token, any loss incurred from such sales will not be tax deductible in HK.

I should remind you that the shops operated by Sweetie-HK in the PRC are very likely to be regarded as 'permanent establishments' in the PRC. Hence, despite its HK residency, Sweetie-HK is likely to be subject to PRC tax in respect of the profits arising from these shops. The definition of 'permanent establishment' is included in the PRC-HK Double Tax Agreement (DTA) and it is not within the scope of this report to cover PRC tax. Nonetheless, if both HK and PRC tax are payable, tax credit is generally available under the DTA to save the same item of profits from being taxed by both authorities.

- (ii) If Sweetie-HK sets up a subsidiary in the PRC and all the candy shops are being run by the PRC subsidiary, the only income to Sweetie-HK would be dividends distributed as and when the PRC subsidiary makes profits in the future. Dividends received from the PRC subsidiary are not taxable in Hong Kong on the basis that they are offshore in nature. Under this scenario, any PRC tax payable on the shop operating profits will be accounted for by the PRC subsidiary and there are no HK tax implications.

Please also note that dividends payable by the PRC subsidiary to the HK parent company are subject to a 5% PRC withholding tax.

(b) The structure of the licence

(i) Directly from the US licensor to the PRC subsidiary

Under this scenario, since the royalty will be paid directly from the PRC subsidiary to the US licensor, there are no HK tax implications for either the US licensor or Sweetie-HK. From the perspective of the US licensor, the royalty will be subject to a 10% withholding tax in the PRC. This is already given in Ms Stuart's email.

(ii) From the US licensor to Sweetie-HK and then to the PRC subsidiary

Under this scenario, there are HK tax implications to both Sweetie-HK and the US licensor as follows:

Sweetie-HK – Since the PRC licence is to be licensed from the US licensor to Sweetie-HK, Sweetie-HK will be making royalty payments to the US licensor. At the same time, the same licence is sub-licensed to the PRC subsidiary. Sweetie-HK has the choice of charging or not charging a royalty to the PRC subsidiary. From the HK tax perspective, based on the general tax deduction rule under section (s.)16(1), Sweetie-HK would not be able to deduct the royalty expense paid to the US licensor if the PRC licence does not generate HK taxable profits to Sweetie-HK. In other words, if Sweetie-HK does not charge a royalty to the PRC subsidiary, or if there is a charge but the royalty income is regarded as offshore and non-taxable in HK, no tax deduction can be claimed.

Assuming that a royalty is charged to the PRC subsidiary, whether the royalty income received by Sweetie-HK is taxable in HK or not depends on whether the 'source' of the royalty income is in Hong Kong. The PRC residency of the PRC subsidiary is not relevant. The 'source' of the royalty income should be determined by the place where the licensing agreement is 'effected' and/or by the place where the licence is 'used' or 'exploited'.

Based on the *Emerson Radio* case, the source of royalty income should be determined by the place where the intellectual property (or the subject for which the royalty is paid) is exploited or used or registered for use. The fact that Sweetie-HK is granted the right to use the tradename pursuant to the licensing agreement with the US licensor should not be relevant if there is no right to use or actual use in HK. Only payments for the right to use and actual use would be taxable in HK. If these case law principles are followed, there is a case for Sweetie-HK to argue that the royalty income from the PRC subsidiary is not taxable in HK on the basis that the licence is being used in the PRC.

One important point to note is that these court cases are effectively discussing royalties assessed under s.15(1), not s.14(1), and the scope of charge under s.14(1) is wider than that under s.15(1). In this case, on the basis that Sweetie-HK is carrying on business in HK, the taxing authority of the royalty is primarily s.14 and hence s.15 does not apply. It is therefore not certain whether the above said case law principles are applicable in the case of Sweetie-HK.

Under DIPN No. 21, paragraph 20, the IRD suggests that the locality of a 'royalty other than those deemed chargeable under s.15(1)(a) or (b)' is to be determined on the same basis as trading profits. Such a position was taken in 1998 by the IRD subsequent to the *TVB International* case but before the *Emerson Radio* case (hence s.15(1)(ba) which was legislated after the *Emerson Radio* case, was not mentioned therein). In the *TVB International* case, the taxpayer acquired intellectual property by a contract negotiated and entered into in HK. It then licensed the use of the property outside of HK. The Privy Council decided that the royalties paid by the overseas licensees were derived by the taxpayer from a source in HK and chargeable to profits tax. As per paragraphs 6–8 of DIPN No. 21, trading profits are generally determined by the place where the contracts of purchase and sale are effected. In general, all the steps leading to the existence of the contracts including the negotiation, conclusion and execution are taken into account. If some of such steps are carried out in HK and the others outside HK, it is necessary to compare which steps are more important in deriving the profits. If the more important steps are carried out in HK the profits are derived from a source in HK and chargeable to profits tax. Otherwise, the profits are not chargeable to profits tax. DIPN No. 21 also stated that no apportionment would be allowed in relation to trading profits.

If DIPN No. 21 is followed, which is likely to be the case, the source of the royalty income from the PRC subsidiary may be determined by the place where the US-Sweetie licence and the Sweetie-PRC sub-licence are effected. Only if both contracts are effected outside HK could the related royalty income be regarded as offshore and non-taxable in HK. If either of the contracts is negotiated, concluded and executed in HK, the royalty income will likely be fully taxable in HK. No apportionment will be allowed.

The US licensor – The US licensor will be receiving a royalty from Sweetie-HK pursuant to the licensing agreement between the two. It appears that the licensing agreement was not negotiated and concluded in HK. Accordingly, the US licensor is not carrying on business in HK and s.14(1) does not operate to tax the US licensor. However, the US licensor may still be assessed to HK tax under s.15(1)(b) if the royalty is received for the use, or the right to use, the tradename in HK. If the licensing agreement aforesaid specifies that the tradename is to be used in the PRC only, s.15(1)(b) does not apply and no HK tax is payable on the royalty income received from Sweetie-HK.

With effect from 25 June 2004, an additional provision s.15(1)(ba) was introduced to the effect that if a royalty payment is tax deductible in HK, the same royalty payment would be deemed to be HK-sourced income subject to HK profits tax, regardless of the fact that the right to use or the use of the intellectual property for which the royalty is paid, is not in HK. In the case of the US licensor, even though the right to use and the use of the tradename are not in HK, if the royalty paid by Sweetie-HK is tax deductible by Sweetie-HK, the royalty payment received by the US licensor would be deemed as taxable in HK. This would be the case if the royalty income received by Sweetie-HK from the PRC subsidiary has to be taxed in HK and hence, Sweetie-HK needs to claim a tax deduction for the royalty expense against the taxable royalty income.

If the US licensor is taxable in HK under s.15(1)(ba), only 30% of the royalty payment would be deemed as assessable profits under s.21A. It is assumed here that the tradename has not been owned by any person carrying on business in HK. With the current profits tax rate of 17.5%, the effective tax rate for the royalty is 5.25%. Based on the projected figures, the estimated HK tax payable on the royalty payable to the US licensor would be \$5,250 for 2008, \$15,750 for 2009 and \$26,250 for 2010. Please note that these calculations have excluded the effect of the PRC withholding tax and the gross-up effect.

In summary, if the royalty received from the PRC subsidiary is not taxable in HK, it is possible that the US licensor will not be taxed on the receipt of the royalty from Sweetie-HK and the only tax cost would then be the PRC withholding tax of 7%. However, if it is taxable, the US licensor would have suffered tax at 12.25% (ignoring the gross-up effect), representing a 7% PRC withholding tax plus another 5.25% HK deemed profits tax. This is less tax effective than direct licensing from the US licensor to the PRC subsidiary, in which case only 10% PRC withholding tax is payable.

(iii) From the US licensor to Sweetie-HK running the PRC operation as a branch

Under this scenario, the existing licensing agreement between the US licensor and Sweetie-HK for the use of the tradename in HK, will be revised to expand the use of the tradename to include the PRC territory. The royalty payment from Sweetie-HK to the US licensor will be calculated based on sales both in HK and the PRC. The royalty payment will

only be tax deductible 'to the extent' that it is incurred in the production of assessable profits. Therefore, if the profit attributable to the PRC shops is offshore and non-taxable, the royalty payment under the PRC licence will not be tax deductible.

As to the HK tax position of the US licensor, if the IRD accepts that the royalty is paid for the use of the tradename outside HK and the royalty is not claimed as tax deductible by Sweetie-HK in HK, it is possible that the US licensor would not be liable to HK profits tax in respect of the royalty from the PRC licence. However, this is practically difficult and a challenge from the IRD would be expected (as above). If the IRD insists that the royalty is taxable in HK, the US licensor may be taxed at the effective rate of 5.25%.

(c) The funding for the PRC operation

It is the intention of Sweetie-HK to obtain bank borrowings to fund the operation in the PRC. Interest would be incurred on the bank loan. From the HK tax perspective, Sweetie-HK would be able to obtain a tax deduction for the interest if it is incurred in the production of assessable profits (i.e. the bank loan money is being used to produce HK taxable profit) and the following two conditions are satisfied:

- (1) The payment of any interest or the repayment of any principal of the bank borrowing is not secured or guaranteed, directly or indirectly, by any deposit or loan made by Sweetie-HK or its associate, to or with the bank or its associate; where such deposit or loan generates non-taxable interest income; and
- (2) There is no arrangement under which the interest payable by Sweetie-HK to the bank will be paid, directly or through an interposed person, back to Sweetie-HK or its associate, unless the interest flowed back is subject to tax in HK.

(i) Funding injected as equity

If funding is injected in the form of equity, no interest would be payable by the PRC subsidiary and there are no HK tax implications to Sweetie-HK. Dividends received from the PRC subsidiary will not be taxable in HK. Any bank borrowing cost incurred by Sweetie-HK would not be tax deductible.

(ii) Funding injected as an interest bearing loan

If funding is injected in the form of an interest bearing loan, interest income would be received from the PRC subsidiary. Based on the projected figures given, the annual interest income is estimated as \$80,000 for 2008, \$160,000 for 2009 and \$40,000 for 2010. As advised by Ms Stuart, any interest paid by the PRC subsidiary to Sweetie-HK would be subject to a PRC withholding tax of 7%. The PRC withholding tax payable for the three years would thus be \$5,600 for 2008, \$11,200 for 2009 and \$2,800 for 2010.

From the perspective of Sweetie-HK, the taxability of the interest income in HK would depend on the 'source' of interest income. Based on DIPN No. 13, the IRD used to adopt a 'provision of credit' test to ascertain the source of interest income, i.e. the place where the credit is first made available to the borrower. If the loan is first made available to the PRC subsidiary in the PRC, such as remitting the loan money to the subsidiary's bank account in the PRC, the loan interest may be regarded as sourced outside HK and not taxable. However, based on the *Orion Caribbean* case, the IRD has sought to apply the 'operations test' to determine the source of interest income if the IRD considers that the lending of money is part of the money lending business of the taxpayer, rather than simply earning passive interest income out of idle surplus cash. If this principle is to apply, due to the fact that Sweetie-HK borrows from a bank to finance the loan to the PRC subsidiary, it is possible, although not highly likely, that Sweetie-HK may be regarded as carrying on a money-lending business in HK. If all activities leading to the earning of loan interest from the PRC subsidiary are conducted in HK (including negotiation and conclusion of loan agreement, arranging the bank loan etc), it is possible that the loan interest is taxable in HK.

Whether the loan interest is taxable in HK or not does not affect the 7% PRC withholding tax payable in the PRC. However, if the loan interest is taxable in HK, Sweetie-HK should rely on the DTA to obtain a tax credit or rely on s.16(1)(c) to avoid double-taxation.

As mentioned above, the bank borrowing cost can be tax deductible only if the bank loan money is used in the production of assessable profit. Therefore, if the loan interest from the PRC subsidiary is taxable in HK, the bank borrowing cost may be tax deductible subject to the fulfillment of the two conditions stated above. However, if the loan interest from the PRC subsidiary is not taxable in HK, the bank borrowing cost would not be tax deductible at all.

(iii) Funding injected as an interest free loan

If funding is injected in the form of an interest free loan to the PRC subsidiary, no interest is received from the PRC subsidiary. As Sweetie does not have taxable income in HK, the bank borrowing cost incurred to finance the loan to the PRC subsidiary would not be tax deductible.

It is worth noting that interest-free loans may not be effective for PRC tax purposes and further consultation may be required. If the loan interest is tax deductible by the PRC subsidiary and the subsidiary makes profits, charging interest on the loan is an effective way of repatriating pre-tax profits out of the PRC.

(d) The losses from the PRC branch and the holding over of the HK provisional profits tax

If the PRC business is run as a branch of Sweetie-HK, any profit or loss would be taxable or deductible, as the case may be, for HK tax purposes only if the profit or loss is regarded as sourced in HK. As discussed in (a)(i) above, it is likely that the profit or loss derived from the PRC branch would be sourced in the PRC where the retail shop operation is located. As a result, the loss would not be tax deductible. Despite the fact that the PRC branch would operate at a loss in the first few years, it would not be wise to treat the loss as sourced in HK and claim it as tax deductible against the HK profit. This is legally not correct.

On the basis that the loss from the PRC branch is not tax deductible against the HK business income, Sweetie-HK may not be able to rely on the PRC branch loss to apply for the holding over of the HK provisional profits tax. Under s.63J(2), provisional profits tax may be wholly or partly held over if any of the following grounds is valid and applicable:

- (i) where the estimated assessable profits for the year are or are likely to be less than 90% of the amount assessed to provisional profits tax;
- (ii) where a loss brought forward under s.19C has not been taken into account or is incorrect;
- (iii) where the taxpayer has ceased business or will cease business before the end of the year and the estimated assessable profits for that year are or are likely to be less than the amount assessed;
- (iv) where the taxpayer has elected for personal assessment which is likely to reduce his liability to tax; or
- (v) where the final assessment for the preceding year upon which the provisional profits tax is based on, is under objection.

Since the loss from the PRC branch is sourced from business outside HK, the loss would not reduce the estimated assessable profits for the year. As a result, ground (ii) above cannot be relied upon. Nevertheless, this would not stop Sweetie-HK from applying for hold-over if any of the other grounds is applicable.

(e) Recommendations

From the above analysis, it is recommended that the PRC operation is carried on as a wholly owned subsidiary of Sweetie-HK so that HK and PRC tax are separately dealt with. The PRC licensing should be licensed directly from the US licensor to the PRC subsidiary and PRC withholding tax at 10% is payable. Funding from Sweetie-HK into the PRC subsidiary should be interest bearing at market rate. 7% PRC withholding tax is payable on the interest but tax savings may be obtained in the PRC by means of an interest deduction (subject to confirmation with the PRC tax expert). Subject to further consultation with the PRC tax expert and lawyer, consideration may be given to waive the interest in the first few years until the PRC subsidiary starts to make profits.

(Notes to markers: marks will be given for any reasonable recommendations drawn from the earlier analysis, which are not necessarily the same as this suggested answer.)

End of Report

2 Memorandum

To: Tax manager
From: Tax assistant
Date: 3 June 2008
Client: Alice Chu

As requested, this memorandum advises on the tax position of Alice Chu for the year of assessment 2007/08.

(i) Personal assessment

Alice should be advised to elect for personal assessment for 2007/08 because her aggregate tax liabilities could then be reduced. As Alice resided in Hong Kong for more than 180 days in 2007/08, she qualifies as a temporary resident and is eligible for personal assessment election. Potential tax savings may be achieved by claiming the loan interest as deductible against the assessable property income; however, this treatment is only available if personal assessment is elected, as under personal assessment, income from different sources would be aggregated into one assessment. Details are as follows:

(ii) Employment with ATM

The main issue is the location of Alice'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 tests 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.

In the DIPN the IRD stated that it may take into account other factors, if necessary, but emphasis would be placed on the above three factors, particularly the first two. There appear to be no other relevant factors in this case. When applying these three factors to Alice, her employment should be treated as being a non-Hong Kong employment as ATM appears to be resident outside Hong Kong and Alice was originally employed by ATM outside Hong Kong. This suggests that her contract of employment was negotiated and entered into, and is enforceable, outside Hong Kong. In these circumstances, the third factor identified by the IRD (where she receives her remuneration) is not particularly significant.

However, as Alice performed some of her duties in Hong Kong, she is still subject to Hong Kong salaries tax in respect of her income derived from services rendered here under s.8(1A)(a), including leave pay attributable to such services. In ascertaining her tax liabilities, the time apportionment basis will be used, i.e. employment income will be apportioned according to the number of days that she is present in Hong Kong. As Alice's income is already assessed on a time basis, the exemption under s.8(1A)(c) is not applicable, assuming all her tax paid in other Asian countries is attributable to her services in those countries.

The air tickets to relocate Alice to Hong Kong are not for holiday purposes and are, therefore, not taxable. However, the holiday allowance is taxable under s.9(2A)(c), subject to time apportionment.

The amount paid as a 'housing allowance' would be subject to favourable salaries tax treatment if it constitutes a 'refund' of rent. The taxable value would be only 4% of Alice's taxable income from her employment: see ss.9(1)(b), 9(1A)(b) and 9(2). In this case, however, the allowance cannot be regarded as a rent 'refund' because it is paid to her as a cash allowance, with no control or supervision by the employer as to how it is spent. This is evidenced by the fact that ATM does not require Alice to spend the whole of the housing allowance on rent. Therefore, the housing allowance is taxable in full as ordinary income from employment and is subject to time apportionment.

There are three tranches of share options that need to be considered. The gains from the first two tranches were realised in 2007/08, the total gain being \$1,440,000 (18,000 shares at \$80 each). The IRD's position as expressed in DIPN No. 38 is that such gains will not be taxable, even if realised in Hong Kong, if the options were both granted and fully vested while the employee was working outside Hong Kong prior to commencing employment in Hong Kong. The gains from tranche A (\$800,000) are therefore completely exempt. With respect to the gains from tranche B, the vesting period was two years, of which Alice spent one year in Hong Kong. Therefore, half of the gain from tranche B (\$320,000) is subject to salaries tax, subject to time apportionment. There is no taxable income arising from tranche C, as no gains have yet been realised.

However, the gain from tranche C will be taxable on Alice when she exercises it, even if she has left Hong Kong at the time she realises the gain. This is because, under the IRD's DIPN No. 38, Alice's liability to tax on the gain will be determined by whether she had a Hong Kong employment during the period from the date of the grant of the option to the date of vesting. The option was granted on 1 October 2007 when she was clearly working in Hong Kong and will become vested in October 2010. Even if she has left Hong Kong by that date, the relevant portion (being the proportion of time she works in Hong Kong between these two dates) of the gain will nevertheless remain subject to tax. By concession, under the practice note, she can elect to pay salaries tax upon her actual departure from Hong Kong on any notional gain as at the date of filing her salaries tax return immediately prior to her departure from Hong Kong; and this will shelter any future gains from salaries tax.

With respect to the utilities payments, the utilities payments are taxable in full as it appears that the utilities accounts are in Alice's own name. Therefore, this amount is not exempt under s.9(1)(a)(iv). It represents an ordinary cash payment designed to reimburse Alice for expenses for which Alice herself is legally liable.

The PRC individual income tax and other Asian countries' income tax paid by ATM are not taxable, assuming all her tax paid in other Asian countries is attributable to her services in those countries.

The assessable income to be aggregated under personal assessment is \$985,672 (see workings below).

	\$
Salary	1,080,000
Housing allowance	360,000
Holiday allowance	50,000
Share option benefit	320,000
Reimbursement of utility payments	12,000
	<u>1,822,000</u>
Time apportionment:	
HK: 184 days + 26 days x 184/(366 – 26 days) = 198 days	
Assessable income (\$1,822,000 x 198/366)	<u>985,672</u>

(iii) Property income

Alice earned \$180,000 in rent which is *prima facie* subject to property tax. After the automatic statutory deduction of 20%, the taxable amount is \$144,000: s.5(1A) of the IRO. (There is no evidence that she paid government rates.) 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: s.42(1). Because this allowance for interest is determined under the personal assessment rules and not under the profits tax rules, she is entitled to the allowance even though her brother might not be subject to tax on the interest he receives. The total interest paid is \$187,500 for the year, but the interest allowance cannot exceed the amount that would ordinarily be subject to property tax (i.e. \$144,000). The result is that Alice is not charged to tax with respect to the flat.

(iv) 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 donations are paid qualifies for charitable status under s.88. Assuming that the Hong Kong charities are approved organisations (the US charities

will not qualify), Alice can deduct the donations of \$25,000, which does not exceed 25% of her assessable income, upon election of personal assessment.

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

Although her husband and daughter are not residents of Hong Kong, the married person's allowance and child allowance are still available. However, because her aged parents live outside Hong Kong, they are not ordinarily resident in Hong Kong and therefore no dependent parent's allowance is available: s.30(1)(a).

(v) Acquisition and lease of property

Under Head 1(1A) to the Stamp Duty Ordinance (SDO) the agreement for the sale and purchase of the property is liable to *ad valorem* duty at the rate of 3%. Stamp duty payable is 3% on \$5,000,000, i.e. \$150,000. However, if the market value is higher than \$5,000,000, the Collector of Stamp Revenue can substitute the market value in calculating the stamp duty payable. The formal assignment executed in conformity with the stamped agreement will only be liable to duty at the fixed rate of \$100.

A lease for a term exceeding three years must be evidenced in writing. Therefore, Alice 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 SDO. Stamp duty payable is 1% on the yearly rent of \$240,000, i.e. \$2,400.

(vi) Alice's tax positions

Based on the personal assessment calculation (see workings below), Alice has a net chargeable income of \$708,672 for the year of assessment 2007/08. Accordingly, she will be charged to tax at progressive rates on this amount, rather than at the standard rate of 16% on \$948,672.

	\$
Net assessable value of property	144,000
Net assessable income	985,672
Loan interest	(144,000)
Donations	(25,000)
Contributions to MPF	(12,000)
Reduced total income	948,672
Married person's allowance	(200,000)
Child allowance	(50,000)
Net chargeable income	<u>698,672</u>

End of Memorandum

- 3** From the briefing, it would seem that Target Co has maintained a satisfactory level of tax compliance in terms of profits tax return filing and tax payments. There is no record of tax queries raised by the IRD in prior years. This may indicate that the tax returns have been prepared at a very good standard and/or no major and contentious tax adjustments have been made in the tax returns filed. However, it is assumed that all tax records are made available for due diligence purpose or requests for information for inspection have been properly and completely made. To avoid unnecessary misunderstanding or disputes on unintentional non-disclosure, the seller, i.e. the shareholder of Target Co, should give an undertaking that all tax related records have been fully disclosed and made available during the due diligence.

The question states that all prior years' assessments were issued per the tax returns lodged. The shareholder also agreed to undertake that these assessments were finalised (clause 4.1). Unfortunately, this undertaking is not practically effective. Under the IRO, s.60(1) empowers the assessor to raise any assessment within six years after the end of the year of assessment in which the transaction or event occurs. In the case of fraud or willful evasion, the six-year time limit prescribed for raising an assessment is extended to 10 years. The power also extends to additional assessments in respect of any year of assessment for which an assessment has already been issued, if the assessor is of the opinion that the taxpayer has been under-assessed for that year of assessment.

Moreover, under s.70, an assessment is final and conclusive only if:

- (i) no valid objection or appeal has been lodged;
- (ii) an objection or appeal has been withdrawn or an appeal has been dismissed;
- (iii) the assessment under an objection has been agreed; or
- (iv) the assessment is determined upon objection or appeal and no further appeal has been lodged.

Based on the proviso to s.70, the assessor can still raise an additional assessment to a final and conclusive assessment provided that it does not involve re-opening any question or matter which has previously been determined on an objection or appeal.

Further, Target Co has a number of obligations to comply with pursuant to the IRO, e.g. complete and correct filing of employer's returns for pension and remuneration accrued to its officers and employees. The briefing did not represent or warrant that Target Co has fully complied with such obligations.

Therefore, instead of asking for an undertaking, Expansion Co should ask for an indemnity from the seller to shelter any additional tax liabilities that may arise as a result of additional assessments being raised by the assessor within the time limit of six years, or ten years in the case of fraud or willful evasion plus the penalty thereon, if any, as well as all liabilities arising from failing to comply with any of the obligations under the IRO.

Any notice of additional assessment will be issued to Target Co as a separate and independent legal entity. It will not be issued to the seller (i.e. the current shareholder of Target Co) nor to Expansion Co. It is not affected by the fact that the company's management or shareholding has been changed. Target Co cannot use this as an excuse to avoid responding to any queries raised by the assessor. It may be possible for the company to request for additional time to submit the information required on the basis that the change in the company's management might have an impact on the collection of information. However, when queries and additional assessments are raised, the management of Target Co is responsible for handling them with the IRD. Although Target Co may appoint the seller or Expansion Co or any other person if appropriate as its representative in dealing with the IRD, the primary responsibility is still on Target Co. As such, the inclusion of clause 4.2 in the Share Sale and Purchase Agreement to hold the seller as well as the previous management persons responsible is not practically effective. Moreover, should there be any tax payments to be made, it would be for the account of Target Co but not the seller or any individual person.

To protect Expansion Co against any potential additional tax liability, penalty and costs arising to Target Co from any event occurred before the change in shareholding, an indemnity should be obtained from the seller, i.e. the current shareholder of Target Co, so that any additional tax cost including penalty, costs for failing to comply with the said obligations and surcharge may be compensated by them.

Another risk to Expansion Co is that if the conduct of handling any tax query or assessment is being placed in the hands of the persons who are no longer the current management of the company, the company's interests may not be well protected. In the event that an additional (or estimated) assessment is issued and disagreed by the company, objection should be lodged in writing within one month, addressed to the CIR, stating clearly the ground of objection. If no objection is lodged before the due date, the assessment will become final and conclusive after that date and cannot be challenged further. Other courses of action may include whether tax payment should be made or held-over. These courses of actions would involve a great deal of management decisions to be made in the best interests of Target Co. Expansion Co should ensure that Target Co retains the rights and controls over the conduct of these tax disputes after the acquisition and secure an undertaking from the seller that it would provide necessary information and other assistance to Target Co in attending to these disputes.

- 4 (a)** Cargo Shipping Ltd is a Liberian company and all its ships are registered in Liberia. As a non-resident ship-owner, Cargo Shipping Ltd will not be subject to the normal profits tax provisions in Hong Kong, but instead to the special rules set out in s.23B of the IRO.

Generally, under this section, Cargo Shipping Ltd is regarded as an 'owner of ships'. It will be subject to profits tax if its ships call at a Hong Kong port. In this case, it will be regarded as carrying on business in Hong Kong.

Cargo Shipping Ltd would not be subject to profits tax if any visit by its ships to Hong Kong is of a casual nature and if further calls to Hong Kong are unlikely. However, it appears from the facts that its ships visit Hong Kong regularly. Even so, as a Liberian company deemed to be carrying on a business as an owner of ships in Hong Kong, Cargo Shipping Ltd will be exempt from profits tax provided that under the laws of Liberia (its home territory), it is entitled to an exemption from a tax which is of substantially the same nature as profits tax: s.23B(4A).

Because it is recognised that ship-owners who operate internationally cannot be expected to prepare specific accounts for Hong Kong, a formula is applied to determine their liability to profits tax. This formula is designed to calculate an appropriate percentage of a ship-owner's total worldwide shipping profits during the relevant basis period. The percentage is the ratio that its 'total shipping profits' bear to its 'total shipping income' during the relevant basis period. Generally, these figures would be extracted from its worldwide accounts for the relevant basis period. That ratio is then applied to the aggregate of the 'relevant sums' that it earns from its Hong Kong operations: s.23B(3).

Generally, 'relevant sums' that are subject to profits tax comprise any sums that a ship-owner receives in respect of carrying goods by sea, other than goods in transit, out of Hong Kong. Any fees it receives for bringing goods to Hong Kong are excluded from this calculation, as are goods that are uplifted in Hong Kong but only in the course of transit (but note that this exemption for goods in transit applies only if freight charges for the uplifting of transit goods are not paid or payable in Hong Kong).

If for any reason the formula cannot be satisfactorily applied, it is possible to apply to the IRD to compute a non-resident ship-owner's taxable income on the basis of a fair percentage of the carriage fees received for uplifting goods out of Hong Kong: s.23B(4).

Note that a ship-owner's 'total shipping profits' can be adjusted for tax purposes if the amounts set out in its accounts are likely to differ materially from those profits that would be calculated by way of application of normal Hong Kong tax principles: s.23E. The most common adjustment made is usually with respect to depreciation allowances relating to ships owned or held under a hire-purchase arrangement.

- (b) (i)** Under Head 1(1A) to the SDO the agreement for sale and purchase of the residential property will be liable to *ad valorem* duty at the rate of 3.75% on the greater of the consideration or the unencumbered value of the property. The formal assignment executed in conformity with the stamped agreement will only be liable to duty at the fixed rate of \$100.

Notwithstanding the statements above, s.45 should apply to exempt those instruments from duty because they are made between 'associated corporations'. The fact that the parent is incorporated outside Hong Kong does not mean that the

exemption does not apply. However, to enjoy the exemption, it is essential that the consideration for the purchase is not provided by an unassociated company unless it is a bank lending money in its ordinary course of business, the consideration is not received by an unassociated company and the beneficial interest in the property was not previously conveyed, transferred, purchased or sold, directly or indirectly by an unassociated person; and that the transferor and the transferee would not cease to be associated as a result of a change in shareholding of the transferee, within two years after the date of execution of the instrument (s.45(4) and (5A)). Adjudication is required under s.45(3).

- (ii) The lease is dutiable in accordance with the provisions of Head 1(2). As the s.45 exemption for transfers between associated companies is not applicable to leases chargeable under Head 1(2), it is irrelevant whether B Ltd and C Ltd remain associated after the change in shareholding of B Ltd. Stamp duty is payable on the lease upon the 'average yearly rent' payable thereunder. Clearly, the annual amount of \$600,000 can be ascertained and is subject to stamp duty. However, stamp duty can be paid only upon amounts that can be ascertained at the time that the stamp duty liability arises. If there is no data (e.g. profit and loss forecast) from which the turnover from the business to be carried on in the property could reasonably be forecasted, i.e. it is not possible to ascertain B Ltd's gross turnover during the four year period of the lease, then any additional rental payable under the turnover provisions will not be subject to stamp duty. Stamp duty payable will thus be $\$600,000 \times 1\% = \$6,000$.
- (iii) Under s.19 and Head 2(1) the contract notes for the sale and purchase of Hong Kong stock will be liable to duty at the rate of 0.2% (in total) on the consideration or market value of the shares, whichever is the greater. The formal instrument of transfer is only stamped at the fixed rate of \$5: Head 2(4). Stamp duty payable is $\$50 \text{ million} \times 0.2\% + \$5 = \$100,005$.

The purchase consideration is settled by an issue of shares in D Ltd, which does not attract any stamp duty.

- 5 If Mr So liquidates the Company, runs the business in sole proprietorship and owns the property in his own name, his tax position will be affected as follows:

Profits tax liability and tax rate

Under s.14, any person carrying on a trade, profession or business in Hong Kong will be subject to Hong Kong profits tax in respect of profits arising from that trade, profession or business in Hong Kong. This applies regardless of whether the business is being carried on by a limited liability company or by a sole proprietorship. However, the applicable tax rate is different. The current statutory tax rate for the Company is 17.5% whereas after the change, the tax rate for the sole proprietorship will be only 16%.

Tax treatment of salary

Currently, the salary payable to Mr So will be tax deductible in calculating the Company's profits tax liability on the basis that the salary is incurred in the production of assessable profits. The Company is a separate legal entity which may enter into an employment contract with Mr So. The fact that Mr So is the shareholder of the Company is not relevant. On the other hand, when the business is being run as a sole proprietorship, the salary would be regarded as a withdrawal of profit from the business and not considered as tax deductible in calculating the assessable profits. This principle applies to all other payments made to Mr So including interest on loans and rental. Therefore, the assessable profits of the business will be increased.

To Mr So, the salary he currently receives as an employee is subject to salaries tax on the basis that the salary is income arising in or derived from an employment sourced in Hong Kong. As the annual salary is \$100,000, which is equal to the statutory basic allowance of \$100,000, there should be no salaries tax payable by Mr So. After the change, the salary received from the sole proprietorship is deemed as withdrawal of profit and will not be subject to salaries tax.

Profit repatriation

At the end of each year, any after-tax profits can be declared by the Company and distributed to Mr So in the form of dividend. This dividend will not be taxable in the hands of Mr So. After the change, any after-tax profits of the sole proprietorship business may be withdrawn by Mr So when required. From a tax perspective, this is neutral since such withdrawal is also not taxable in the hands of Mr So.

Loss utilisation

Under the current limited liability company scenario, any loss incurred by the Company can be carried forward to future years and offset against any future assessable profits of the Company. This is valid even if the Company is engaged in another type of business which earns profits. However, the loss can only be carried forward in the name of the company and cannot be used by Mr So.

Under the sole-proprietorship business, any loss incurred by the business can be carried forward to future years and offset against any future assessable profits, but only from that same business carried on by the sole proprietor. If there is more than one business being carried on by Mr So, the loss of one business cannot be offset against the profits from another business, unless 'personal assessment' is elected, as explained below.

Property income and mortgage interest

Currently, the property owned by the Company is let out for rental. Under ss.2 and 14, the Company is subject to profits tax in respect of the income earned from 'letting or sub-letting' of the property. Expenses incurred in the production of assessable profits would be deductible against assessable profits under s.16(1), including depreciation, property management fees, rates and bank mortgage interest provided that s.16(2) is satisfied.

Although the Company is by law also subject to property tax under s.5 in respect of the rental income received, the Company is eligible under s.5(2)(a) to apply for exemption from property tax on the basis that rentals from the property are part of the profits of the Company subject to profits tax.

Following the change, the property will be transferred to Mr So in his own name. The transfer will trigger stamp duty based on the market value of the property. However, if the property is transferred to Mr So upon liquidation of the Company as a distribution *in specie*, it is exempt from stamp duty.

As the property is now owned by Mr So, only s.5 applies, but not s.14. Mr So will be subject to property tax at the rate of 16% on the net assessable value, based on the total rentals receivable less eligible deductions which are restricted to rates paid only by Mr So and 20% of the total rentals as reduced by rates. No other deductions including bank mortgage interest and management fees would be allowed, unless personal assessment is elected.

Personal assessment

Personal assessment allows an individual taxpayer to be assessed on his or her total income from different sources including salary, business income (for unincorporated business only) and property income. Profit/loss from the Company is not eligible for transfer to personal assessment. After the change, it would be more beneficial for Mr So to elect for personal assessment so that the loss from the sole proprietorship business will be aggregated with the rental income and more importantly, the bank mortgage interest (limited to the amount of the net assessable value of the property) can be deducted against the total aggregated income. As a result, the overall tax liability may be reduced.

Professional Level – Options Module, Paper P6 (HKG)
Advanced Taxation (Hong Kong)

June 2008 Marking Scheme

	<i>Available</i>	<i>Maximum</i>
1 (a) Form of operation in the PRC		
(i) Branch in the PRC:		
Determination of source of profit	3	
Treatment of PE in the PRC	1.5	
(ii) Subsidiary in the PRC:		
Tax implications of profits made by subsidiary	1.5	
Withholding tax on dividends payable by subsidiary	1	
	<u>7</u>	6
(b) Structure of the licence		
(i) From US licensor to PRC subsidiary:		
HK tax implications	0.5	
Withholding tax in the PRC	0.5	
	<u>1</u>	1
(ii) From US licensor to Sweetie and then to PRC subsidiary:		
Deductibility of royalty paid to US licensor	1.5	
Taxability of royalty received from PRC subsidiary		
Source of royalty income	1	
Application of s.15(1)(b)	1	
Application of s.14(1)	1	
DIPN 21	2	
Conclusion	1	
Taxability of royalty received by US licensor		
Application of s.14(1) and s.15(1)(b)	1	
Application of s.15(1)(ba)	2	
Tax payable under s.21A	2	
Conclusion	1.5	
	<u>14</u>	14
(iii) From US licensor to Sweetie running the PRC operation as a branch:		
Deductibility of royalty paid to US licensor	1	
Taxability of royalty received by US licensor	1	
	<u>2</u>	2
(c) Funding for the PRC operation		
Deduction rules applicable to interest expense	2	
(i) Funding injected as equity:		
Deductibility of bank borrowing cost	1	
(ii) Funding injected as interest bearing loan:		
PRC withholding tax on interest income	1	
Taxability of interest income in HK	3	
DTA or tax credit under s.16(1)(c)	1	
Deductibility of bank borrowing cost	0.5	
(iii) Funding injected as interest free loan:		
Deductibility of bank borrowing cost	0.5	
Replaced by interest bearing loan	1	
	<u>10</u>	8
(d) Losses from the PRC branch and holding over of provisional profits tax:		
Source of loss	1	
Grounds for holdover under s.63J(2)	2	
Conclusion	1	
	<u>4</u>	4

	<i>Available</i>	<i>Maximum</i>
(e) Recommendations	<u>2</u>	2
Appropriate format and presentation	1	
Effectiveness of communication	<u>1</u>	
	<u>2</u>	<u>2</u>
Total		<u>39</u>
2 (i) Personal assessment:		
Eligibility for and effect of election	1.5	
(ii) Employment with ATM:		
Location of employment		
Test in Goepfert's case	0.5	
Determining the source	2	
Time apportionment under s.8(1A)(a)	2	
Taxability of air ticket and holiday allowance	1	
Taxability of housing allowance	2	
Taxability of share options	3	
Practice under DIPN 38	3	
Taxability of utilities payment	1	
Taxability of tax paid by ATM	0.5	
Calculation of assessable income	1.5	
(iii) Property tax:		
Treatment of rent, loan interest and statutory deduction	2	
(iv) Other available deductions:		
Approved charitable donations	1	
MPF contributions	0.5	
Personal allowances	1	
(v) Acquisition and lease of property:		
Stamp duty payable on sale and purchase agreement	1	
Stamp duty payable on lease	1.5	
(vi) Alice's tax position:		
Tax position under personal assessment	0.5	
Calculation of net chargeable income	<u>1.5</u>	
	<u>27</u>	27
Appropriate format and presentation	1	
Effectiveness of communication	<u>1</u>	
	<u>2</u>	<u>2</u>
Total		<u>29</u>
3 Full disclosure of tax records	2	
Assessor's power to raise assessment under s.60(1)	2	
Final and conclusive assessments under s.70	2	
Other compliance obligations	1	
Effectiveness of clause 4.1 and indemnity	1.5	
Effectiveness of clause 4.2	3	
Indemnity from seller	1.5	
Handling of tax disputes and undertaking	<u>3</u>	
	16	16
Total		<u>16</u>

	<i>Available</i>	<i>Maximum</i>
4 (a) Special rules for shipping companies under s.23B	2	
Exemption under s.23B(4A)	1	
Determining the assessable profits under s.23B	1.5	
Meaning of 'relevant sums'	1.5	
Alternative computation of assessable profits under s.23B(4)	1	
Adjustments to total shipping profits	1	
	<u>8</u>	7
(b) (i) Stamping of sale and purchase agreement	1.5	
Exemption under s.45	2.5	
(ii) Stamping of lease	2	
Calculation of stamp duty payable	1	
(iii) Stamping of contract notes and instrument of transfer	1.5	
Purchase consideration settled by issue of shares	0.5	
	<u>9</u>	<u>9</u>
Total		<u>16</u>
5 Profits tax liability and tax rate	1	
Tax treatment of salary payable to Mr So under:		
Profits tax	1.5	
Salaries tax	1.5	
Profit repatriation	2	
Loss relief for corporations	1.5	
Loss relief for sole proprietorship business	1.5	
Treatment of property income and mortgage interest under:		
Profits tax	1.5	
Property tax	1.5	
Exemption from property tax	1	
Stamp duty on transfer of property	1	
Effect of personal assessment election	2	
	<u>16</u>	<u>16</u>
Total		<u>16</u>