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# Answers

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1 Report to Mr Mi of Won Co Ltd (Co-1):

To: Mr Mi  
From: Tax advisor  
Date: 1 June 2009  
Subject: Acquisition of Co-2 and business restructuring

I refer to the proposal dated 25 May 2009 prepared by your personal assistant on the subject. You have requested me to review the proposal and address all the Hong Kong tax implications that may arise therefrom. I provide comments as follows:

(a) Acquisition of Co-2

- (i) The shares of a Hong Kong company are Hong Kong stock as defined in section (s.) 2(1) of the Stamp Duty Ordinance (SDO). Therefore the parties effecting the sale and purchase thereof must prepare and stamp contract notes for the sale and purchase and an instrument of transfer: s.19(1) and Heads 2(1) and 2(4) respectively. Duty on the contract notes under Head 2(1) is 0.2% of the consideration or market value if applicable; and duty under Head 2(4) on the transfer is \$5.

Stamp duty should be paid on the total consideration (assuming it is market value) of \$2,000,000 including the \$500,000 shareholder's loan assigned (s.24(1)). No exemption or relief is available as Mr Mi and the seller of Co-2 are not associated. The fact that a separate assignment deed is executed for the loan assignment is not relevant to reduce the stamp duty payable. The SDO stipulates that all the facts and circumstances affecting the liability of any instrument to stamp duty must be fully and truly set forth in the instrument: s.11. This means that the share transfer document should contain a reference to the related assignment of the shareholder's loan, because this would affect the calculation of stamp duty payable. If the parties prepare separate documents without proper and full disclosure with an intent to defraud the Government, they would have committed an offence.

Total duty on the contract notes under Head 2(1) is \$4,000 (\$2,000,000 x 0.2%); and the duty for the instrument of transfer is \$5. It is the usual practice that the vendor and purchaser are each liable to pay one-half of the duty.

- (ii) Based on the due diligence, it would seem that Co-2 has maintained a satisfactory level of Hong Kong tax compliance in terms of Hong Kong profits tax return filing and tax payments. There is no record of tax queries raised by the Inland Revenue Department (IRD) in prior years. This may indicate that the tax returns have been prepared to a very good standard and/or no major and contentious tax adjustments have been made in the tax returns filed. However, this position may not be reliable unless the shareholder of Co-2 undertakes that all tax related records and information have been fully disclosed and made available during the due diligence. Another reservation is in respect of the PRC tax compliance. The proposal did not address whether there are any PRC tax reporting requirements and whether the compliance level is satisfactory. Since Co-2 is also running a business in the PRC, it is important to include this scope in the due diligence exercise.

The proposal mentions that the seller also agreed to warrant/guarantee that all assessments prior to the acquisition date were finalised. Unfortunately, this guarantee is not in practice effective, since an assessor is empowered under s.60(1) of the Inland Revenue Ordinance (IRO) 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 wilful evasion, the six-year time limit prescribed for raising an assessment is extended to ten 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 of the IRO, an assessment is final and conclusive only if:

- no valid objection or appeal has been lodged;
- the objection or appeal has been withdrawn or an appeal has been dismissed;
- the assessment under an objection has been agreed; or
- the assessment is determined upon objection or appeal and no further appeal has been lodged.

In the event that an additional assessment is issued to Co-2, it is the responsibility of Co-2's management to respond to the IRD. Practically, it would be difficult for the seller (being the ex-shareholder of Co-2) to take part and handle any disputes with the IRD on behalf of Co-2. It is also not in the best interests of Co-2 if the conduct of any tax dispute is placed in the hands of persons who are no longer the current management of the company. Hence, the undertaking in 2(c) is also not effective in a practical sense.

Therefore, instead of asking for a warranty/guarantee, you should ask for an indemnity from the seller to shelter or reimburse any additional tax liabilities that may arise as a result of any additional assessments being raised in respect of the pre-acquisition period within the time limit of six years, or ten years in the case of fraud or wilful evasion in the case of Hong Kong tax. Besides, you are also advised to include PRC tax in the indemnity.

**(b) Business restructuring**

- (i) After the acquisition, Co-2 will be using the computer system currently owned and used by Co-1 at no charge until 2012. In the tax return of Co-1, it is expected that the cost of the computer system has either been depreciated under the 30% pool or been fully deductible as a prescribed fixed asset in the year of its acquisition. In either case, tax deduction is allowed only to the extent that the asset is used by Co-1 in the production of assessable profits. If part of the asset is not used by Co-1 to produce assessable profits, it is likely that part of the tax deduction will not be allowed or will be clawed back. There is no guideline on how the disallowed portion will be determined in this situation especially when the non-productive use only occurs after tax deduction has been claimed and is only for a temporary period. However, the risk of challenge exists.

As from 2012 onwards, Co-1 may start to recharge Co-2 based on 2% of Co-2's annual profits. Whilst the recharge may protect Co-1's tax deduction claim of the asset cost, basing the recharge by reference to the profitability of Co-2 is not considered desirable from a tax perspective since no recharge will be made if no profit is earned. Should the intention of the recharge be a compensation for the usage of the asset, it is suggested that the recharge be done either based on usage, or at a lump sum determined by reference to the extent of use of the asset.

- (ii) One of the office buildings owned by Co-1 will be transferred to Co-2 at nominal value. Under Head 1 of the First Schedule to the SDO, any conveyance on sale and certain agreements for the sale/transfer of any immovable property in Hong Kong is subject to stamp duty at the *ad valorem* rates prescribed in Head 1(1). The duty ranges from \$100 to 3.75% of consideration. In the case of Co-1 where the building is transferred at nominal value of \$1, such a transfer would be deemed under s.27(4) of the SDO as a voluntary disposition *inter vivos*, and stamp duty will therefore be payable based on the market value to be determined by the Stamp Office. The fact that both Co-1 (the transferor) and Co-2 (the transferee) are within the same group does not allow an exemption to be granted under s.45 for the reason that the two companies are not held by a corporation but by Mr Mi, and Co-1 is not holding Co-2 or *vice versa*.

In the context of profits tax in relation to Co-1, the transfer out of the office building would likely give rise to a balancing allowance, if the office building is still a commercial building within the definition of the IRO at the time when its interest is sold or transferred out. In this case, since the sale consideration is only \$1, any excess of 'residue of expenditure' over \$1 would be claimed as a tax deduction in the form of a balancing allowance in the tax return of Co-1. However, in the tax return of Co-2, the qualifying expenditure based on which Co-2 may claim the annual allowance would be calculated based on the 'residue of expenditure' adjusted by any initial and annual allowances granted as well as any balancing allowance granted to Co-1. As a result, Co-2 may only be able to claim a negligible amount of annual allowance based on \$1.

Note to marker: Bonus marks will be given if candidates discuss the application of s.38B and the loss on sale of the office building is non-deductible.

- (iii) Despite the fact that the employment terms of the two employees transferred from Co-1 to Co-2 are the same under both employments, by law, their employments have changed. Co-1 is obliged to report the cessation of employment of the relevant employees at least one month before the cessation: s.52(5) of the IRO. In the case of the employee who will be seconded to the PRC, if he is leaving Hong Kong right after the cessation of employment with Co-1, and the departure will be for a period in excess of one month, details of the departure from Hong Kong should also be reported to the IRD. Under s.52(6) of the IRO, Co-1 should not make any payment to the leaving employee within one month of giving notification to the IRD about the departure, unless approval is received from the Commissioner. It is the usual practice of the IRD that, once the Hong Kong final tax liability of the leaving employee is cleared, a notification will be given to Co-1 to release any money due by Co-1 to the leaving employee.

As for Co-2, the commencement of employment should also be reported to the IRD within three months of the commencement. For the employee who is to be seconded to the PRC on a full-time basis, if it is likely that this employee will not be liable to Hong Kong salaries tax, Co-2 is not obliged to report his commencement. Should it be uncertain whether this employee is subject to Hong Kong salaries tax or not, it is advisable that Co-2 include this employee in the reporting, and seek tax advice to clarify the requirement.

- (iv) The tax deductibility of the relevant interest expenses, if any, under the respective options is:

**Option A** – Under this option, Co-2 will obtain a bank loan with guarantee from Mr Mi or Co-1. Before Co-2 starts to make profits, Co-1 will help Co-2 to repay the bank interest. On obtaining the bank loan, Co-2 will incur bank loan interest. If the bank loan money is to be used to produce assessable profits (including the PRC profits) for Hong Kong tax purposes, all the bank loan interest will be tax deductible by Co-2 unless:

- (aa) the payment of any interest or the repayment of any principal of the bank loan is secured or guaranteed directly or indirectly, by any deposit or loan made by Co-2 or its associate, to or with the bank or its associate; where such deposit or loan generates non-taxable interest income; or  
(bb) there is an arrangement under which the interest payable by Co-2 to the bank will be paid, directly or through an interposed person, back to Co-2 or its associate, and the interest flowed back is not subject to tax in Hong Kong.

Therefore, the fact that during the initial period part or all of the bank loan interest may be paid or subsidised by Co-1 will not affect the tax deductibility of the interest by Co-2. Similarly, the giving of a personal guarantee to Co-2 by Mr Mi should not have any tax impact.

However, the assistance offered by Co-1 in repaying Co-2's interest may potentially give rise to a tax disallowance risk to Co-1 if the subsidy has caused Co-1 to incur interest, which may well be the case given Co-1's stated liquidity

problem. If, however, the loan interest repayment is simply funded by Co-1's own surplus cash, this is a balance sheet transaction and should not have any adverse tax impact on Co-1.

**Option B** – Under this option, Co-1 will borrow loans from banks and lend the money on to Co-2, interest free. On obtaining the bank loan, Co-1 will incur bank loan interest. This interest will only be tax deductible to Co-1 if the bank loan money is used in the production of Co-1's assessable profits. However, if the bank loan money is intended to be lent to Co-2 without charging any interest, Co-1 will not be able to get the tax deduction on the bank loan interest incurred: s.16(1)(a) of the IRO. For Co-2, there should not be any tax impact as there is no interest charged.

**Option C** – Under this option, Co-1 will demand repayment from Mr Mi of the amount due of \$1,800,000, and lend it to Co-2, interest free. Mr Mi will fund the repayment by way of a personal loan from a bank. In the accounts of Co-1, there will be no interest incurred to obtain the necessary funds for lending to Co-2. As a result, the loan to Co-2 at no interest will not give rise to any adverse tax implications to Co-1; this is only a cash flow transaction. As for Co-2, there should not be any tax impact as no interest is charged. However, Mr Mi will have to incur bank loan interest on his personal loan. Given that Mr Mi is not carrying on any business on his own, and the bank loan money is not used to generate any chargeable income, no tax deduction will be allowed to Mr Mi.

**Option D** – Under this option, Co-1 will declare a dividend to Mr Mi who will inject the dividend money into Co-2 for its operating funds. However, Co-1 would have to obtain a bank loan in order to finance the dividend payment to Mr Mi. This option would help to release the cash flow burden of Mr Mi such that Mr Mi is not required to obtain a bank loan to finance the additional equity injected into Co-2. However, Co-1 will have to incur bank loan interest on the loan acquired to finance the dividend payment. Based on s.16(1)(a) of the IRO and the recent court case of *Zeta Estates Limited*, if the bank loan has a direct nexus to the payment of the dividend, the bank loan interest would not satisfy s.16(1)(a) and thus not be tax deductible. However, if the bank loan is acquired as part of the regular loan facility used for Co-1's operating fund, and there is no direct nexus between the bank loan and the dividend payment, it is possible that the bank loan interest deduction would not be challenged.

Since the dividend money is injected in the form of equity into Co-2, no interest would be payable by Co-2 and there is no Hong Kong tax implication for Co-2.

I trust that the above addresses all the major Hong Kong tax implications arising from the proposal in relation to the acquisition and business restructuring. Should there be any questions, please let me know.

End of Report

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Tax consultant  
[Address]

[Date]

Mr Chan  
[Address]

Dear Mr Chan,

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

**Employment with Real Estate Investment Ltd (REIL)**

Section 8(1) of the Inland Revenue Ordinance (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 employment as set out in *Goepfert's* case and Departmental Interpretation and Practice Note (DIPN) No. 10 are:

- (i) the place where the contract of employment was negotiated and concluded (China in your case);
- (ii) the residence of the employer (Hong Kong in your case); and
- (iii) the place where the remuneration was paid (Hong Kong in your case).

If not all of the above factors are outside Hong Kong, it appears that the second factor is more important than the other factors. If a person is recruited by an employer resident in Hong Kong, the employment is unlikely to be located outside Hong Kong, even though the contract is concluded outside Hong Kong and his remuneration is paid outside Hong Kong.

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

If the Inland Revenue Department (IRD) accepts that you have two separate and distinct employments under Contract 1 and Contract 2, the monthly salary of \$60,000 accrued to you under Contract 2 will be exempted from tax, as you rendered outside Hong Kong all services in connection with your employment under Contract 2. Your salary accrued under Contract 1 remains taxable.

However, the Commissioner may look behind the appearances to discover the reality: *Goepfert's* case. The Commissioner is entitled to scrutinise all relevant evidence, such as the intent of REIL and yourself, the arbitrary basis for the apportionment of the salary

between Contracts 1 and 2 and the indistinguishable nature of services rendered by you in and outside Hong Kong. It is highly likely that the IRD would conclude that there is in fact only one contract of employment between REIL and yourself. The Commissioner may also invoke the anti-avoidance provisions of ss.61 and 61A to counteract any claim for exemption in respect of the salaries income under Contract 2.

Given the conclusion that there is in fact only one contract of employment, the total monthly salary of \$100,000 is chargeable to salaries tax. Since you had rendered services in Hong Kong in connection with your employment (by reporting to your boss) and stayed in Hong Kong for more than 60 days, you are not eligible for the exemption under s.8(1A)(b).

As you were present in China 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 income tax on it 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 REIL will also be taxable. Any housing allowance received by you by virtue of your employment would be subject to salaries tax under s.9(1)(a). However, by entering into the housing arrangement with REIL, the monthly rental income of \$20,000 was received by you in your capacity as landlord of the property and would not be chargeable to salaries tax. You are only required to pay salaries tax on the rental value, being 10% of your net assessable income. However, the rental income would be subject to property tax, which will be discussed later; and you will not be entitled to the deduction of home loan interest as provided under s.26E.

The medical insurance policy purchased by REIL is a contractual obligation between REIL and the insurance company. REIL is discharging its own liability and hence the benefit is not money's worth and is not taxable.

The personal expenses paid with the corporate credit card are taxable fringe benefits as your personal liabilities were effectively discharged at the time the card was used: DIPN No. 16, paragraph 33. The business expenses paid are not your liabilities and are not taxable.

Although the mobile phone is convertible into cash, it is not income from your employment. It is obtained because of your personal entitlement in the bonus scheme with the credit card company but not because of your employment: *Payne v FC of T (96 ATC 4407)*.

The share option is a taxable benefit under s.9(1)(d) and the amount of taxable benefit is determined in accordance with s.9(4). There is no requirement under s.9(1)(d) that the shares to which the option relates must be in the employer; the option is still taxable even when the relevant shares are in the overseas parent company. The taxable gain is a notional one, calculated at the time when the right is exercised, as the difference between the market value of the shares at the time of exercise and the consideration paid for the option and the shares. The gain is taxable under s.9(1)(d) and is thus excluded from the calculation of rental value. The gain from the subsequent disposal of the shares is not taxable under salaries tax. Therefore, the taxable gain is \$79,000 [(\$30 – \$20) x 8,000 – \$1,000].

Holiday journey benefits are specifically chargeable under s.9(2A)(c), whether or not they are convertible into cash. The amount chargeable is the cost paid by REIL, not the resale value: DIPN No. 41, paragraphs 9 and 10.

Therefore, your assessable income from the employment with REIL is \$1,461,050 (see workings below).

	\$
Salary	1,200,000
Holiday journey benefits	30,000
Personal expenses paid by REIL	36,000
	<hr/>
	1,266,000
Rental value (1,266,000 x 10% x 11/12)	116,050
	<hr/>
	1,382,050
Share option benefits	79,000
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Assessable income	1,461,050
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### Employment with Apple Ltd

Assuming that Apple Ltd is a Hong Kong company, your wife's salaries will be fully chargeable to salaries tax.

### 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. The formal assignment executed in conformity with the stamped agreement will only be liable to duty at the fixed rate of \$100.

A lease agreement in respect of the property is chargeable under Head 1(2) in the First Schedule of the SDO and must be stamped within one month. Stamp duty payable is 0.5% on the yearly rent of \$240,000, i.e. \$1,200.

## Property income

Although you lived in your own property, the tenant of the property is REIL which rented the property from you. Property tax is therefore charged on the rental income you derived from REIL. Rates paid by you as the owner are statutorily allowed as a deduction before the 20% statutory allowance; and this needs to be ascertained. Assuming that you have not paid any rates, the taxable amount (the net assessable value) after the automatic statutory deduction of 20% is \$176,000 (\$20,000 x 11 x 80%): s.5(1A). 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).

## Personal assessment

You are therefore advised to elect for personal assessment for 2008/09. Under personal assessment income and losses from different sources would be aggregated into one assessment, and tax savings can be achieved by claiming the loan interest as deductible against the assessable property income. This treatment is only available if personal assessment is elected.

## Other available deductions

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

Charitable donations will be deductible as a concessionary deduction. They are generally restricted to 35% of assessable income: 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 charities are approved organisations, you can deduct the donations upon election of personal assessment, but this will be limited to 35% of your assessable income net of the loan interest. In the case of your wife, the excess amount of \$5,000 (\$47,000 – \$120,000 x 35%) can be transferred to you and claimed as a deduction against your assessable income.

Since you and your former wife are both eligible to claim child allowance in respect of your daughter and each of you was solely responsible for the maintenance of your daughter for eight months and four months respectively, apportionment of the child allowance based on time is likely to be made by the IRD.

However, you are not entitled to claim dependent parent allowance in respect of your father as he was not ordinary resident in Hong Kong during the year: *D116/99*. Elderly residential care expenses cannot be claimed, as the nursing home in Shenzhen is unlikely to be an approved nursing home in Hong Kong.

## Your tax positions

Based on the personal assessment calculation (see appendix), you and your wife have a net chargeable income of \$1,355,717 for the year of assessment 2008/09. Accordingly, you should pay tax at progressive rates rather than at the standard rate on \$1,605,050. The tax liability will be split between the two of you based on the proportion of your share of the reduced total income.

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

## Appendix

### Computation of net chargeable income

	Mr Chan \$	Mrs Chan \$	
Net assessable value of property	176,000	–	
Net assessable income	1,461,050	120,000	
Loan interest	(60,000)	–	
Donations	(50,000)	(42,000)	
Reduced total income	<u>1,527,050</u>	<u>78,000</u>	1,605,050
Married person's allowance			(216,000)
Child allowance (50,000 x 8/12)			(33,333)
Net chargeable income			<u>1,355,717</u>

- 3 (a) Setting up a branch in Hong Kong will not involve any capital duty or stamp duty and is less formal. Zeta should take into account the following considerations in deciding whether to set up a branch in Hong Kong:
- (1) A branch, not being a separate legal entity, has no limited liability and Zeta will have to bear the risk of taking up the liabilities of the branch should there be a failure in its business in Hong Kong.
  - (2) It will be difficult to apply transfer pricing arrangements with a branch although a reasonable share of the head office administrative expenses may be allowed by the IRD.

(3) No tax deferral can be obtained by Zeta if its Hong Kong branch makes a profit but delays the repatriation of the profit to Zeta.

- (b) For there to be a charge to profits tax, s.14 of the IRO requires various cumulative conditions to be satisfied, that is (1) a business is carried on in Hong Kong, (2) there are profits from that business, and (3) those profits arise in or are derived from Hong Kong. Therefore, if a company carries on a business in Hong Kong, only Hong Kong sourced profits are taxable. Profits derived from overseas are not taxable.

A company is regarded as carrying on a business in Hong Kong whenever there is a permanent establishment in Hong Kong. Inland Revenue Rule (IRR) 5(1) defines 'permanent establishment' to mean a branch, management, or other place of business but does not include an agency unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of his principal; or the agent has a stock of merchandise from which he regularly fills orders on behalf of his principal.

Zeta would be regarded as carrying on a business in Hong Kong through its branch, i.e. a permanent establishment, here. The issue is therefore, whether the profits earned from the branch operations are derived from Hong Kong, i.e. having a Hong Kong source. In deciding this issue, the broad guiding principle is to ascertain what the taxpayer has done to earn the profits and where he has done it: the *Hang Seng Bank* and *HK-TVB International* cases.

For trading profits as in the present case, the IRD considers that the location of the profits is determined by the place where the contracts of purchase and sales are effected. However, this does not only mean the place where contracts are legally executed but includes the actual steps leading to the existence of the contracts, such as negotiation, conclusion and execution; and a better approach is to consider the totality of facts: see *Magna Industrial Company Ltd v CIR*. In the present case, it is pertinent to consider the following operations of the branch in Hong Kong; and the places where they are carried out:

- (1) Overseas sales promotions are made by the branch's sales team outside Hong Kong.
- (2) Negotiation and finalisation of the terms of sales orders are made by the branch's sales team outside Hong Kong.
- (3) Orders are confirmed and processed in Hong Kong.
- (4) Letters of credit are handled in Hong Kong.
- (5) Purchases of products are made in Hong Kong.
- (6) Shipments of goods are handled in Hong Kong. It should be added that shipment through Hong Kong is relevant but the mere fact that goods do not pass through Hong Kong would not make the profits offshore.

It is submitted that, on the whole, relevant operations are predominantly carried out in Hong Kong and so Zeta's profits would be chargeable to profits tax.

It should also be mentioned that the IRD's stance is that, for trading profits, if either the contract of sale or contract of purchase is effected in Hong Kong, the profits are fully taxable and no apportionment would be accepted. In the present case, all the branch's purchases are likely to be effected in Hong Kong. It is therefore unlikely that the IRD would agree to apportion the company's profits between onshore and offshore profits even though some of the branch's operations are conducted outside Hong Kong.

- (c) Under IRR 5, the assessable profits of the branch would be ascertained as follows:

- (1) If branch accounts are kept which show the true profits arising in Hong Kong, assessable profits will be computed by reference to the branch accounts.
- (2) Where (1) above is not applicable, the assessable profits will be computed as a percentage of the worldwide profits, which are to be adjusted for tax purposes as if the whole of those profits are chargeable to profits tax. The percentage is the ratio of Hong Kong turnover to the worldwide turnover.
- (3) Where, because of impracticality or inequity, neither of the methods in (1) and (2) above can be adopted, the Assessor may compute the assessable profits by taking a fair percentage of the Hong Kong turnover. The Assessor's decision is subject to the taxpayer's rights of objection and appeal.

- 4 (a) Under the Hong Kong Inland Revenue Ordinance (IRO), the Hong Kong salaries tax position of Li Ping in respect of the services he rendered in Hong Kong depends on various factors including, fundamentally, the location of Li Ping's employment. Based on the facts given, Li Ping is and will continue to be employed by ChinaNet Ltd, which is a company incorporated in the PRC. Since Li Ping himself is also a PRC citizen, it is reasonable to assume that the employment contract has been concluded in the PRC. Li Ping is also receiving his remuneration in the PRC. As a result, based on DIPN No.10 and *Goepfert's* principle, Li Ping's employment is obviously a non-Hong Kong employment.

Based on s.8(1A)(a) of the IRO, in the case of a non-Hong Kong employment, only remuneration for services rendered in Hong Kong, including leave pay attributable to such services, is taxable in Hong Kong. However, based on s.8(1A)(b) and s.8(1B), exemption is available if Li Ping qualifies as a 'visitor' in Hong Kong and stays in Hong Kong for not more than 60 days. To qualify as a 'visitor', the most common criteria is that he must not have any form of permanent base or normal place of residence in Hong Kong. As Li Ping was only on short-term assignment during each trip to Hong Kong and he only stayed in a hotel, the facts seem to support that Li Ping was a 'visitor' during his stay in Hong Kong. In calculating the number of days of 'visits' in Hong Kong, the Board of Review case *D29/89* held that both the day of arrival and the day of departure are included.

In Li Ping's case, for the year of assessment 2007/08, he was present in Hong Kong for 60 days:

10 May 2007 to 31 May 2007	22
1 September 2007 to 20 September 2007	20
1 December 2007 to 18 December 2007	18
Total	<u>60 days</u>

As Li Ping's visits in Hong Kong for the year of assessment 2007/08 are for not more than 60 days, he is not subject to Hong Kong salaries tax for that year under s.8(1A)(b) and s.8(1B) of the IRO.

For the year of assessment 2008/09, he was present in Hong Kong for 172 days:

1 April 2008 to 21 April 2008	21
1 May 2008 to 30 July 2008	91
8 August 2008 to 31 August 2008	24
15 January 2009 to 19 February 2009	36
Total	<u>172 days</u>

As Li Ping's total number of days of visits in Hong Kong for the year of assessment 2008/09 is more than 60 days, he would not be eligible for the exemption under the IRO. Taxable income would be based on simple time apportionment making reference to the number of days he spent in Hong Kong as a ratio to the total number of days in the year of assessment. If Li Ping has taken any leave days during the year, a portion of the leave days should also be calculated and added to the time apportionment formula. For time apportionment purposes, only one of the day of arrival and day of departure is counted. Therefore, in the year of assessment 2008/09, Li Ping may be subject to Hong Kong salaries tax based on the ratio of 168/365.

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

The first condition is that the aggregate number of days that Li Ping stayed in Hong Kong in any 12-month period did not exceed 183 days. In counting the days, the rule of 'days of presence minus one' applies, i.e. only one of the day of arrival or departure is counted. According to the schedule, Li Ping did not stay in Hong Kong for 183 days or more during any 12-month period. He should, therefore, be considered as having fulfilled this condition.

It should be noted that the 12-month period under the DTA does not refer to any specific period starting on 1 January or 1 April. The condition applies to any period of 12 months either starting or ending in any year of assessment. Therefore, the counting of days should be done for each 12-month period, e.g. 10 May 2007 to 9 May 2008 (90 days) or 1 September 2007 to 31 August 2008 (174 days). (See DIPN No. 10, paragraphs.110-2.)

The second condition is that Li Ping's remuneration is paid by an employer who is not a resident of Hong Kong. As it is given that Li Ping's remuneration would continue to be paid by ChinaNet Ltd in the PRC, assuming that ChinaNet Ltd is not a tax resident in Hong Kong, this condition is also fulfilled. The fact that the hotel bill was settled by the Hong Kong company is not relevant in this context.

The third condition is that the payment of Li Ping's remuneration is not to be borne by any permanent establishment which the employer, ChinaNet Ltd, has in Hong Kong. This condition is considered fulfilled as ChinaNet Ltd did not have the intention to recharge Li Ping's salary to the Hong Kong company.

Based on the above arguments, it is likely that Li Ping is eligible for exemption under the DTA, although he stayed in Hong Kong for more than 60 days. In the event that the DTA offers a tax treatment which is more beneficial than that under the domestic IRO, the DTA would prevail.

- 5 There are two general anti-avoidance provisions under the IRO, ss.61 and 61A. Under s.61, the Assessor is empowered to disregard a transaction and assess the taxpayer accordingly, if:

- (a) there is a transaction, being the whole transaction rather than the part of it;
- (b) the transaction is artificial or fictitious, generally referred to as a transaction that is not commercially realistic; and
- (c) the transaction has the effect of reducing the tax payable.

In the case of Aggressive Co Ltd (the Company), 'transactions' would refer to the cancellation of the November invoices and the re-issuance of the January invoices under idea (a); and the preparation of a salary voucher to the individual project consultant under idea (b). These transactions would be artificial or fictitious unless there is commercial reason to cancel the November invoices and replace them with the January invoices; and unless the individual consultant has actually performed the consultancy services to the Company.

The last condition for s.61 to apply is that the transaction must have the effect of reducing the tax payable. This would be applicable to idea (b) where the expense voucher would have the effect of increasing the Company's deductible expenses and reducing the Company's tax payable for the year. However, it may not be applicable to idea (a) on the basis that the tax liability of

the Company has not been 'reduced', but only 'postponed' from 2008/09 to 2009/10. As a result, s.61 may not apply to 'disregard' the transaction under idea (a).

In 1986, the second general anti-avoidance provision, s.61A, was introduced. For s.61A to apply, the conditions to be fulfilled are:

- (1) there must be a transaction which includes a transaction, operation or scheme whether or not they are enforceable by legal proceedings; and this covers single, multiple or composite transactions;
- (2) the taxpayer must obtain a tax benefit which is defined to include (i) the avoidance of tax liability, (ii) the postponement of tax liability by shifting the tax to a later year, or (iii) the reduction in the amount of tax by altering the assessable profit/income to a lower level; and
- (3) having regard to the seven specific matters, the transaction must be entered into or carried out for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit.

In the case of the Company, conditions (1) and (2) are satisfied. As for (3), the seven specified matters as defined under DIPN No. 15 (revised) are:

- (i) The manner in which the transaction was entered into or carried out

In this case, the fact that the November invoices have already been issued but subsequently cancelled before the year end and replaced by January invoices would be sufficient to support that the transaction was intended to be removed from the accounting year 2008, unless there is a justified commercial reason to explain. The preparation of an expense voucher under idea (b) right before the year end but covering the salary for the whole year is another example of a pre-year end transaction aimed at altering the Company's profits for 2008.

- (ii) The form and substance of the transaction

The legal form of the transaction under idea (a) would be the invoices and credit notes. This legality would be compared to the substance of the transaction, i.e. what is the reason for the cancellation of the November invoices and re-issuance of the January invoices. For idea (b), the expense voucher is not sufficient unless a letter of engagement is in place. Moreover, the substance of idea (b), i.e. whether and what services have actually been performed would be examined.

- (iii) The result that would have been achieved by the transaction without s.61A

If s.61A was not applicable, the relevant fee income from the November invoices would become taxable income for the year ending 31 December 2009 instead of 31 December 2008, and the tax liability is postponed. This is a timing effect. Moreover, the Company's profits tax payable for 2008/09 would be reduced to the extent the individual consultant's salary is allowed as a tax deduction.

- (iv) Any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result, from the transaction

If both ideas are implemented, the changes in the Company's financial position would include the deferral of tax payment in respect of the November invoice values and the reduction of its tax liability in respect of the consultant's deductible salary.

- (v) Any change in the financial position of any person who has, or has had, any connection with the relevant person

Under idea (a), the change in financial position of the Company's customers would be the deferral of fee payments and the corresponding tax deductions in their own tax returns. This is again a timing effect. Under idea (b), whether there is any change in the financial position of the individual project consultant (the financial controller's mother) would depend on the income position of that individual. If the named individual does not earn any income during the year and the amount of salary does not exceed the statutory personal allowance, she may not be subject to any tax and thus her financial position is not changed before and after the transaction.

- (vi) Whether the transaction has created rights and obligations that would not normally be created between persons dealing with each other at arm's length under a similar transaction

The cancellation and re-issuance of the November invoices do not seem to have altered the rights and obligations of the Company or its customers other than the fact that this would not normally happen in an arm's length situation. As for idea (b), unnecessary rights and obligations have been created to the financial controller's mother unless she is *de facto* competent to perform the services (albeit being a housewife) and has actually performed such services.

- (vii) The participation in the transaction of a corporation resident or carrying on business outside Hong Kong

This matter is not relevant in the Company's case.

Based on DIPN No. 15 (revised), each of the above matters would be considered and weighed in order to draw a conclusion as to whether the transaction was entered into for the sole or dominant purpose of obtaining a tax benefit. Each matter does not necessarily carry equal weighting and each case has to be considered on its own merit. Based on the above analysis, it is likely that the transactions conducted under both ideas (a) and (b) would be considered as carried out for the sole or dominant purpose of obtaining a tax benefit.

The consequences to the Company would be an assessment to be made by the Commissioner on the basis that either the transaction did not take place; or that an arm's length value is substituted. As a result, for idea (a), it might be possible that the January invoices would be disregarded and the original November invoices would be recognised as part of the 2008 assessable profits of the Company. The tax assessment for 2008/09 would be issued accordingly. As for idea (b), it is likely that the salary voucher would be ignored and no deduction would be allowed to the Company.

		<i>Marks</i>	
<b>1</b>	<b>(a) Acquisition of Co-2</b>		
	<b>(i)</b> Sale and purchase of HK stock		
	Stampable documents	1	
	s.45 exemption not available	0.5	
	Assignment of shareholder's loan	1	
	Stamp duty payable	<u>0.5</u>	3
	<b>(ii)</b> Tax compliance risks		
	Undertaking that all tax related records and information are disclosed	1.5	
	Specific reference to PRC position	0.5	
	Ineffectiveness of seller's guarantee	2	
	Final and conclusive assessments under s.70	1	
	Ineffectiveness of seller's undertaking to handle tax disputes	1.5	
	Indemnity from seller	<u>1.5</u>	8
	<b>(b) Business restructuring</b>		
	<b>(i)</b> Use of computer services		
	Tax deduction for computer used by Co-2 at no charge	1.5	
	Basis of recharge	<u>1.5</u>	3
	<b>(ii)</b> Building transferred to Co-2 at nominal value		
	Voluntary disposition <i>inter vivos</i>	2	
	s.45 exemption not available	1	
	Balancing allowance to Co-1	1.5	
	Annual allowance to Co-2	<u>1.5</u>	6
	<b>(iii)</b> Transfer of employees to Co-2		
	Report cessation of employment	1	
	Report departure from HK	1	
	Withhold payment to leaving employee	1	
	Report commencement of employment	<u>1</u>	4
	<b>(iv)</b> Tax deductibility of interest expense		
	Option A – bank loan guaranteed by Mr Mi	3	
	– Co-2's interest repaid by Co-1	1	
	Option B – bank loan borrowed by Co-1 and lent to Co-2	2	
	Option C – repayment from Mr Mi to Co-1 lent on to Co-2	1	
	– interest on personal loan incurred by Mr Mi	1	
	Option D – bank loan borrowed by Co-1 to pay dividend	2.5	
	– no implications for Co-2	<u>0.5</u>	<u>11</u>
			35
	Appropriate format and presentation	1	
	Effectiveness of communication	<u>1</u>	
			<u>2</u>
	<b>Total</b>		<b><u>37</u></b>

		<b>Marks</b>
<b>2</b>	Employment with REIL:	
	Location of employment	
	Test in <i>Goepfert's</i> case	1
	Determining the source	1
	Tax position if claim for 2 separate contracts is accepted	1
	Commissioner's position	2
	No exemption under s.8(1A)(b)	1.5
	Exemption under s.8(1A)(c)	1
	Tax credit under Article 21 of the DTA	<u>1</u>
		8.5
	Other matters	
	Rental income not taxable under salaries tax	1
	Taxability of rental value	0.5
	No deduction of home loan interest	0.5
	Taxability of medical insurance	0.5
	Taxability of expenses paid with corporate credit card	0.5
	Taxability of bonus points	1
	Taxability of share option	2
	Taxability of holiday journey	0.5
	Calculation of assessable income	<u>1</u>
		7.5
	Employment with Apple Ltd	0.5
	Acquisition and lease of property	
	Stamp duty payable on purchase of property	1
	Stamp duty payable on lease	<u>1</u>
		2
	Property income – NAV and loan interest	1.5
	Personal assessment	0.5
	Other available deductions:	
	MPF contributions	0.5
	Charitable donations	1.5
	Child allowance	1.5
	Dependent parent allowance	<u>1</u>
		4.5
	Tax position:	
	Tax position under personal assessment	1
	Calculation of net chargeable income	<u>1</u>
		2
		<u>27</u>
	Appropriate format and presentation	1
	Effectiveness of communication	<u>1</u>
		2
	<b>Total</b>	<b><u>29</u></b>
<b>3</b>	(a) No capital duty or stamp duty	1
	No limited liability	1
	Transfer pricing arrangements	1
	No tax deferral	<u>1</u>
		4
	(b) The three conditions in s.14(1)	1
	Definition of permanent establishment	1.5
	Carrying on business through a PE	1
	Source of trading profits – contract effected test	1.5
	Consideration of branch's operations	3
	Conclusion re chargeability to profits tax	1
	IRD's practice	<u>1</u>
		10
	(c) The three methods under IRR 5(1) (1 mark each)	<u>3</u>
	<b>Total</b>	<b><u>17</u></b>

		<i>Marks</i>
<b>4</b>	<b>(a)</b> Non-HK employment	2
	Taxability under s.8(1A)(a)	0.5
	Exemption under s.8(1A)(b)	1.5
	Exempted for 2007/08	1
	No exemption for 2008/09	1
	Basis for time-apportionment	<u>2</u>
		8
	<b>(b)</b> Exemption under the DTA	1
	1st condition – not exceeding 183 days	2
	Counting of 12-month	2
	2nd condition – employer not resident of HK	1.5
	3rd condition – remuneration not borne by PE in HK	1.5
	Conclusion	<u>1</u>
		9
	<b>Total</b>	<u><b>17</b></u>
<b>5</b>	Transaction disregarded under s.61	
	Meaning of transaction	1.5
	Artificial or fictitious	1.5
	Has the effect of reducing tax payable	1.5
	Three conditions in s.61A	1.5
	Seven specified matters in s.61A (1 mark each)	7
	Conclusion – s.61A applicable	2
	Consequences	
	January invoices disregarded	1
	No deduction for salary	1
	<b>Total</b>	<u><b>17</b></u>