Answers

Cases are given in the answers for educational purposes. Unless specifically requested, candidates are not required to quote specific case names to obtain the marks. Only the general principles involved are required.

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1 Report to the directors of Holland Ltd

To: The directors, Holland Ltd
From: Tax adviser
Date: 9 December 2018
Subject: Hong Kong tax implications of HK Ltd's operations and proposed initiatives

I refer to my earlier meeting with you during which we discussed the tax position of HK Ltd (HK-Co), in particular, the chargeability in Hong Kong of the said company's profits earned from the services provided in Hong Kong and mainland China (Mainland). We have also addressed the proposal to dispose of the shareholdings in HK-Co by Holland Ltd (Holland). Our advice on the respective issues is as follows:

(i) Chargeability of HK-Co's profits earned from the clinics in Hong Kong and Mainland

Under the Hong Kong tax regime, for a person's profits to be chargeable to profits tax, three cumulative conditions have to be satisfied. These conditions are: (1) a business is carried on in Hong Kong; (2) the profits are derived from that business; and (3) the profits arise in or are derived from Hong Kong (s.14(1)). In HK-Co's case, conditions (1) and (2) are both satisfied and condition (3) is therefore critical. Unfortunately, there is no statutory definition for the term 'arise in or derived from'. One has to look to case law for the interpretation.

The Hong Kong tax regime operates on a 'territorial' concept. To determine the source of profits, the broad guiding principle is that one looks to see what the taxpayer has done to earn the profits and where this has been done: the *Hang Seng Bank* case and *HK-TVB International* case. The Inland Revenue Department (IRD) has set out what the IRD regards as the general principles in Departmental Interpretation and Practice Note (DIPN) No. 21 (paragraphs 6 to 17) which literally confirms the principles stated by the courts in the aforesaid *Hang Seng Bank case*, *HK-TVB International* case, and other subsequent cases, e.g. the *Kwong Mile* case and the *ING Baring* case. In general, it is the direct profit-generating activity which determines the source of profit. Any antecedent and incidental activities, such as pre-service preparation and post-service follow-up, are not relevant to the determination of the source, despite the fact that these activities might be significant from a commercial perspective. Depending on the nature of the profit, different source tests apply to determine the source of profits, making reference to the relevant direct profit-generating activity. In the event that certain profit-generating activities are conducted offshore by agents, the agency principle (*International Wood Products* case, *ING Baring* case, *Li* & *Fung* case) recognises that the agents' activities conducted overseas are to be attributable to the taxpayer in Hong Kong as if the Hong Kong taxpayer itself conducted the activities overseas. Indeed, the Court of Final Appeal in the *ING Baring* case expanded the agency principle by taking into consideration activities carried out by a third party for the benefit of the taxpayer when determining the source of profits in that case.

In the case of HK-Co, the nature of profits derived from the provision of healthcare services are service profits. Based on DIPN 21 and the 'operation test', i.e. 'where do the operations take place from which the profits in substance arose', the source of profits from the provision of service is determined by the place where the services were rendered to earn the service fees. The place of incorporation and the principle place of business of HK-Co being in Hong Kong are not relevant. The origins of customers receiving the services, be they from Hong Kong or overseas, are also irrelevant. If the services were conducted in Hong Kong, the source of the related service profits is in Hong Kong and thus taxable. If the services were conducted outside Hong Kong, the source of the related service profits is offshore and non-taxable in Hong Kong.

In the event that services were rendered outside Hong Kong by outsourcing agents overseas, based on *ING Baring*, the activities giving rise to the relevant gross income earned by HK-Co are still the provision of healthcare services in discharge of its obligations to the overseas customers. In the absence of the services provided by the agents, HK-Co would not have been able to earn the service income, thus the agents' acts overseas have the closest proximity to the earning of income by HK-Co. Since all these obligations are discharged by agents on behalf of HK-Co in a place offshore Hong Kong, the acts of these agents should be attributable to HK-Co such that HK-Co is deemed as having conducted the related services to the overseas customers overseas. Profits received for such services would be offshore-sourced and non-taxable in Hong Kong. The agency fee payable to overseas agents for these offshore services would become non-deductible as they are not incurred in the production of taxable profits.

Supporting work provided by HK-Co to the overseas agents, including training and consultation, and liaison with customers are antecedent and incidental activities (*ING Baring* and *Li* & *Fung*), which should be ignored for the purposes of determining the source of profits, although they are important parts of the business model.

For services rendered in Hong Kong, related profits are sourced in Hong Kong and taxable in Hong Kong. Related expenses are deductible. If necessary, certain expenses may be apportioned based on the extent of contribution to onshore and offshore income.

(ii) Tax deductibility of the loan interest

It was given that Holland has extended an interest-bearing loan to HK-Co to finance HK-Co's acquisition of healthcare equipment in 2016. Interest was accrued on the loan as payable and claimed as tax deductible for HK-Co's profits tax in all years since 2016/17.

Under s.16(1) of the IRO, an expense would be allowed to the extent that it is incurred in the production of profits chargeable to profits tax. It is also specifically provided under s.16(1)(a) that interest (together with other expenditures relating to those borrowings) is deductible provided that any condition under s.16(2), as well as the requirements under s.16(2A) and s.16(2B), are satisfied.

In the case of HK-Co, the loan money from Holland was used to acquire healthcare equipment to be used in the Hong Kong clinics in the production of profits assessable to profits tax in Hong Kong. This satisfies s.16(1)(a). However, s.16(2)(c) requires that, for the interest to be deductible, the interest income in the hands of the lender (Holland) must be subject to Hong Kong tax. We understand from the meeting that Holland has not been carrying on business in Hong Kong and the loan monies were not put into the possession of HK-Co. As such, Holland is not chargeable to profits tax in Hong Kong in respect of the loan interest. Therefore, the loan interest expense would not be eligible for a tax deduction under s.16(2)(c). Another possible condition under s.16(2) is s.16(2)(e) which allows a deduction for interest incurred on a loan used to acquire trading stock or plant and machinery for the production of assessable profits, provided that the lender is not associated with the borrower. Despite the fact that the loan is used by HK-Co for financing plant and machinery, no interest deduction would be allowed under s.16(2)(e) for the reason that the lender, Holland, is associated with HK-Co. Accordingly, s.16(2A) and s.16(2C) are not applicable.

As other conditions under s.16(2) are not relevant in this case, no tax deduction is allowed for the interest expense on the loan from Holland to HK-Co.

(iii) Prior years' tax filing position

For tax filing purposes, it was given that HK-Co has included all its service profits as taxable and claimed tax deductions for the loan interest expense in the tax returns since 2016/17. Based on the above advice, provided that sufficient evidence is available, service profits earned from clinic services rendered outside Hong Kong have a high chance of being excluded from HK-Co's taxable profits. On the other hand, interest incurred on the loan from Holland would not be allowed for tax deduction despite the fact that the equipment is used in Hong Kong. It appears that the tax returns for the prior years were incorrectly prepared in these aspects. Although no queries have been raised by the IRD, it is advisable that HK-Co takes the initiative to rectify the error. Under s.70A, if it is proved to the satisfaction of the IRD that an assessment is excessive by reason of an error or omission in a tax return or statement submitted by the taxpayer, the taxpayer has the right to apply for the error or omission to be corrected. The application must be made within six years after the end of the relevant year of assessment or within six months after the service of the notice of assessment, whichever is the later. In the case of HK-Co, an application should be made under s.70A to exclude the relevant offshore income from Hong Kong assessable profits, while at the same time removing the tax deduction claim of the loan interest. Sufficient supporting evidence is required to substantiate the claim.

(iv) Eligibility of the tax loss for carry forward in HK-Co after the shareholding change

In general, tax losses incurred by a company carrying on business in Hong Kong will continue to be carried forward under the name of the company to set off against the company's future assessable profits indefinitely. This principle holds true regardless of any change in the shareholding in the company, except where the shareholding change is regarded as a tax avoidance transaction under s.61B.

By virtue of s.61B, the ability to carry forward tax losses may be denied by the Commissioner of Inland Revenue if he is satisfied that:

(1) the change in the shareholding of the company has resulted, directly or indirectly, in profits having arisen in or been accrued to the company; and

(2) the sole or dominant purpose of the change in shareholding was to utilise the tax losses sustained in the company in order to obtain a tax benefit or to avoid a tax liability of the company or any other person.

For condition (1) to apply, the IRD must have evidence that the change in shareholding is the cause of the receipt of profits by the loss company, and due to the change in shareholding, profits are being transferred to the loss making company. For condition (2) to apply, the motive to utilise the tax losses must outweigh all other non-tax motives in justifying the change in shareholding. In this context, provided that a change in shareholding is initiated as a result of a commercial reason such as a group restructuring, and the change is not driven by the sole or dominant purpose of obtaining a tax benefit by utilising the tax losses, the IRD is unlikely to invoke s.61B to disallow the carry forward of the tax losses.

In the case of Holland, the chance of challenge under s.61B is high because, from an objective perspective, the consideration for the shareholding significantly recognises the tax benefit from the accumulated tax losses in HK-Co. If Holland is to issue a warranty letter, it is advisable that the calculation basis for the consideration be reviewed by removing the tax loss benefits. It is also crucial for Holland to prove that there is a commercial motive to sell the shareholding in HK-Co and the tax benefit to Buyer from the company's tax losses is not the sole or dominant reason for the sale. Otherwise, it is highly likely that HK-Co's tax losses for the prior years would be denied after the change in shareholding, and no balance would be left to offset against the company's future profits earned subsequent to the change in shareholding. Supporting documentary proof would be required to counteract any possible action under s.61B by the IRD.

(v) Stamp duty implications of the transfer of shares in HK-Co

The shares in a Hong Kong company with a share register kept in Hong Kong are Hong Kong stock as defined in s.2(1) of the Stamp Duty Ordinance (SDO). Therefore the parties effecting the sale and purchase of the shares 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 stated consideration or market value whichever is the higher; and duty under Head 2(4) on the transfer is $5. The place of executing the sale and purchase agreement is irrelevant, except that the contract note for offshore transactions must be stamped not later than 30 days after execution.

Stamp duty should be paid on the total consideration of $12 million (assuming it is market value) plus the $5 million shareholder's loan assigned (s.24(1)). The fact that a separate assignment deed is executed for the loan assignment is not relevant to the amount of 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 will affect the calculation of the stamp duty payable. If the parties prepare separate documents without proper and full disclosure with an intent to defraud the Government, they would commit an offence.

Total duty on the contract notes under Head 2(1) is $34,000 ($17 million x 0·2%); and duty for the instrument of transfer is $5. It is the usual practice but not a matter of law for each of the vendor and purchaser to pay one-half of the duty but the Stamp Office can recover any outstanding stamp duty from both parties irrespective of any agreement between them on the liability of paying stamp duty.

We trust that the above addresses all the significant Hong Kong profits tax implications relating to the issues raised. Should there be any questions, please let us know.

End of report

2 Ms Carnation

Taxability of the termination payments

Under s.8, salaries tax is imposed on any income arising in or derived from Hong Kong from an office, employment or pension. Termination payments made by an employer to an employee are assessable to salaries tax if they constitute income arising from the employment, including income from services rendered in the past, or to be rendered in the future. In *Walter Alfred Heinz Fuchs* v *CIR* (2011), the Court of Final Appeal ruled that income chargeable under s.8(1) is not confined to income earned in the course of employment but embraces payments 'made in return for acting as or being an employee', or 'as a reward for past services, or as an inducement to enter into employment and provide future services'.

Tax treatments of payment items agreed in the compromise deal:

(i) Payment in-lieu-of notice – Ms Carnation agreed to receive a sum equivalent to three months' salary as a result of an early termination by the company. It was provided in her employment contract that a three-month notice needs to be served before termination, or by payment in-lieu. Upon receiving the payment, Ms Carnation is not required to provide any services during the forthcoming three months and is requested to leave immediately. Despite the fact that no services are rendered during the three-month period, the obligation to pay is pre-arranged as part of the terms of employment and thus is regarded as a deferred remuneration (*Henry* v *Foster*). This is further elaborated in the *Fuchs* case that the rights to receive the payment is enforceable at law if it is provided for under the employment contract, and thus is an income from an employment and assessable.

(ii) Payment in-lieu-of annual leave – 'Income' is further defined under s.9 to include leave pay and gratuities. Payment made for accrued annual leave days brought forward is income from employment and therefore taxable.

(iii) Payment from the Occupational Retirement Scheme Ordinance (ORSO) retirement scheme – The sum withdrawn from the ORSO fund upon termination of service, to the extent it represents previous contributions from the employee and the subsequent return of fund investments, is not taxable. The portion of the sum withdrawn upon termination representing the employer's contribution is also not taxable provided that it does not exceed the 'proportionate benefit' as calculated under the following formula:

Accrued benefit x (number of completed months of service)/120 months

Accrued benefit in the case of termination is defined as the maximum amount which the person would have been entitled to receive had they retired at the termination date.

In Ms Carnation's case, as her employment with the Company is more than 10 years (i.e. 120 months), the exempt portion of the proportionate benefit would be equivalent to the accrued benefit. Therefore, as long as the sum withdrawn is less than the accrued benefit amount, the total sum withdrawn would be non-taxable.

(iv) Payment to compensate loss of office – Compensation for loss of office may be argued as not taxable on the grounds that it is a payment for breach of contract rather than a payment for services rendered. For this basis to be valid, the 'breach' must be a real and identifiable breach, and not a pre-arranged term under the employment contract or represent a payment for past services or a substitute for a reward-type of payment such as a bonus. However, case-law indicates that the Inland Revenue Department (IRD) is entitled to look beyond the description and ascertain whether it is merely window-dressing to disguise the true arrangements which have been agreed. Therefore, the payment would not be non-taxable simply because it was described or named so. In the case of Ms Carnation, it is given that the resignation of Ms Carnation is driven by the loss of trust between the Company and herself rather than by the extinction of Ms Carnation's position. The loss of trust has led to the initiation by the Company to terminate the employment, and most importantly, the Company is empowered to do so by serving sufficient notice or make payment in-lieu-of notice. As the Company has already agreed to make the payment in-lieu-of notice, Ms Carnation does not suffer any loss for which compensation should be sought. It is therefore unclear whether the compensation was effectively a kind of 'golden handshake payment' which is generally considered as income from employment and taxable. Unless there is sufficient evidence to prove otherwise, it is likely that the payment would be regarded as income from employment and taxable.

(v) Compensation for withdrawal from legal claim – The payment is made in exchange for Ms Carnation agreeing to withdraw from making a legal claim against the Company. This payment is a consideration for deprivation of rights rather than a reward for past services or from employment, and thus would not be taxable provided that sufficient evidence exists. However, there have been cases in recent years illustrating that the IRD is now taking a stance that, if a compensation type of payment has been pre-arranged as part of the terms of employment, it is in reality deferred remuneration from employment. Therefore, the compensation could be treated as taxable if it has been provided in the employment contract.

(vi) Payment for share option buy-back – Ms Carnation is required to release her unexercised share option back to the Company at a certain percentage of the exercise price. Under s.9(1)(d), any gain realised on the exercise, release or assignment of an option to acquire shares which was obtained by an individual as the holder of an office or employee would be taxable as income from that office or employment. In the case of a release or assignment, the taxable gain is the consideration received less the cost paid for the option. In the case of Ms Carnation, despite the fact that she is not releasing the option back to the Company 'voluntarily', the payment receivable in surrendering the share option back to the Company is effectively consideration for the release. It is a taxable gain after deducting any associated cost for the option.

(vii) Staff accommodation extended – Ms Carnation was granted one-month's extension to reside in the Company's accommodation at no cost. In general, when an employee is provided with accommodation benefit, a taxable rental value is calculated based on a fixed % (4%/8%/10%) of the assessable income from employment for the period during which a place of residence was provided, as reduced by any share option benefit, sums from retirement scheme, deductible expenses and depreciation allowance, and termination payments. In the case of Ms Carnation, rental value should be assessed based on her relevant assessable income from employment for the period when accommodation is provided. In respect of the additional one-month stay during which no income is payable by the Company, there is technically no impact on the taxable rental value to be assessed, since the amount of assessable income remains the same irrespective of the length of stay in the accommodation.

(viii) Payment for restrictive covenant – Compensation for agreeing to enter into a covenant restricting an employee from joining a competitor for a certain period is a payment for deprivation of rights. Similar to the payment for withdrawal of a legal claim, the payment is not made for employment or services, and thus would normally not be taxable. However, it is critical that such a payment is not part of the terms of the employment contract, and the amount of payment is reasonable and substantiated.

Ms Carnation also requested that all the payments are made to her after the cessation of her employment, with a view that these payments could be argued as not associated with the employment and thus not taxable. However, this idea is not valid. Under s.11D(b)(ii), any payments made to taxpayers after they have ceased to derive income are deemed to have accrued on the last day of employment. This is to prevent any post-cessation payments from escaping tax assessment. As a result, all the payments would have to be included in Ms Carnation's tax return for the year of assessment in which her employment terminated and will be assessed to salaries tax for the same year.

3 Turnip Ltd

(a) Leasing of property – If Turnip Ltd (Turnip) acquires the office in Central and leases it for rental income, Turnip, as the 'owner' of the Hong Kong property, will be subject to property tax at the standard rate on the net assessable value of the property under s.5(1) of the Inland Revenue Ordinance. 'Net assessable value' as defined under s.5B includes any consideration payable in money or money's worth in respect of the right to use the land and/or buildings, as reduced by rates and a statutory allowance of 20% of the assessable value of the property after the deduction of any rates paid by Turnip. The applicable tax rate is 15% on net assessable value. However, there will be no deduction of other actual expenses incurred in respect of the property including the loan interest, service fees payable to the property agent or other expenses incurred in connection with acquiring and renovating the property, and provision of the necessary furniture. No depreciation allowance is granted under property tax.

On the other hand, according to s.2, 'business' is defined to include the letting or sub-letting of property by a corporation. Therefore, Turnip through letting the property is also considered as carrying on a business in Hong Kong under s.14. Any assessable profits derived from Hong Kong, including rental income, will then be assessed to profits tax.

While rental income is assessable to profits tax, all relevant expenses and outgoings which are incurred in the production of the assessable rental income would be tax deductible under s.16. The applicable tax rate is 16·5% on net assessable profits.

In the case of Turnip, tax deductions would generally apply to the following:

(i) service fees payable to the property agent – to the extent the fee payment is revenue in nature, reasonable and substantiated, and is incurred in producing the rental income which is taxable, the fee is deductible under s.16(1).

(ii) loan interest – as the loan will be obtained from a bank and is secured by the property (not by any deposit), the condition in s.16(2)(d) should be satisfied, and the restrictions in ss.16(2A), (2B) and (2C) should not apply. Tax deduction should be allowed.

(iii) Capital expenditure on the property and furniture – The expenses incurred on acquiring the property as well as its renovation are capital in nature and non-deductible under s.17(1)(c). However, Turnip will be entitled to industrial or commercial building allowance on the qualifying cost of construction of the building (excluding land value) including leasehold improvement. Tax depreciation allowance for plant and machinery will also be allowed for the cost of the furniture.

In a situation where total deductible expenditure exceeds total income, the excess can be carried forward as a loss to subsequent years and is eligible for deduction against any future taxable income.

By law, Turnip will be subject to double taxation under both property tax and profits tax. This excessive tax burden is eliminated by the application of s.5(2)(a). Under this section, any corporation which is assessed to profits tax in respect of rental income can apply for an exemption from property tax in relation to the same rental income. If exemption is granted, Turnip will not be required to file a property tax return nor be subject to property tax on the rental income, but instead will only be required to report the rental income for profits tax purposes. Alternatively, if no such exemption is allowed or no application is made, Turnip will continue to report and pay both taxes but is still eligible to apply s.25 to offset its property tax paid against the profits tax chargeable under its profits tax computation. Any balance of profits tax is payable or any excess of property tax paid over profits tax will be refunded.

(b) **Depreciation allowance** – Turnip, which holds the relevant interest of the building, can claim industrial building allowance (IBA) if the usage of the property can qualify as an industrial building as defined in s.40(1); or commercial building allowance (CBA) if the property is other than an industrial building or structure. In Turnip's case, the property is an office building which does not fall within the qualifying uses for industrial building, and thus it is a commercial building for depreciation allowance purposes. Unlike an industrial building, no initial allowance is granted for a commercial building, but an annual allowance of 4% would have been granted for each year of assessment in which Turnip has had a relevant interest in the building which is used for producing assessable rental income at the end of the basis period for the year of assessment. However, only the portion of capital expenditure attributable to the building construction cost qualifies for the annual allowance, which is 25% of the consideration based on the vendor's information. Given a cost of $80,000,000, the annual allowance claimable is: $800,000 ($80,000,000 x 25% x 4%) per annum.

The cost of furniture and other plant and machinery is eligible for plant and machinery depreciation allowance. Initial allowance at 60% is deducted in the year the capital expenditure is incurred and annual allowance at 10%, 20% or 30% (based on the nature of asset items) is granted on a reducing balance basis.

(c) **Disposal of building** – If Turnip disposes of the office building after five years, Turnip will calculate the balancing adjustment arising from the disposal of its commercial building. Assuming that a total of five years' commercial building allowance would have been claimed prior to the year the building is sold, the balance of qualifying cost for annual allowance brought forward would be regarded as the 'residue of expenditure before sale', and this would be compared with the sale proceeds attributable to the building portion. If the residue before sale exceeds the sale proceeds, a balancing allowance would be granted and available for deduction against any assessable profits of Turnip in the year of disposal. On the other hand, if sale proceeds exceed the residue balance, a balancing charge would arise (but limited to the total building allowance claimed). The balancing charge would be added to any assessable profits of Turnip in the year of disposal. Based on an estimated 50% appreciation of property price, the disposal proceeds will be $120m. Assuming (as for the purchase price) 25% of the proceeds are allocated to the building portion, an estimated calculation of the balancing adjustment is as follows:

Calculation of balancing adjustment

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Qualifying cost for commercial building allowance ($80m x 25%)	20,000,000
Annual allowance (4% for 5 years)	(4,000,000)
Residue of expenditure before sale	16,000,000
Less: Sale proceeds (assumed 25% of sale proceeds, $120m x 25%)	(30,000,000)
Excess of proceeds over residue	14,000,000
Balancing charge, limited to commercial building allowance allowed	4,000,000

With regard to plant and machinery depreciation allowance, sale proceeds will be deducted from the balance of the relevant pool. If Turnip will have ceased business upon asset disposal, no further annual allowance will be granted. Any balance in the pools will become deductible balancing allowance(s) or taxable balancing charge(s), depending on the difference between the sale proceeds and the tax written down balances.

4 (a) Won Ltd

(i) Application of profits tax in the case of a non-resident company

Under s.14(1) of the Inland Revenue Ordinance (IRO), profits tax is imposed on any person who 'carries on a trade, profession or business in Hong Kong and derives profits from that trade, profession or business arising in or derived from Hong Kong'. Amongst the conditions to be satisfied, the first and fundamental one is that the person chargeable to profits tax must carry on a trade, profession or business in Hong Kong. In this respect, the place of incorporation is irrelevant.

A company incorporated outside Hong Kong may still be regarded as carrying on business in Hong Kong if it carries on activities amounting to a business for the purpose of s.14. If a non-resident company is a company incorporated for the making of profits and 'puts its assets into gainful use in Hong Kong', the company carries on a business in Hong Kong (the *Bartica* case). The IRO confirms this point by defining profits arising in or derived from Hong Kong to include all profits from business transacted in Hong Kong, whether directly or through an agent (s.2). The IRO in its definition of the term 'agent' expands the common law concept of agent to a wider scope.

Tutorial note: *Placing time deposits with banks in Hong Kong and purchasing and selling shares in Hong Kong also constitute business for the purpose of s.14.*

In the event that a non-resident company is regarded as carrying on business in Hong Kong and so is chargeable to tax under s.14(1), its assessable profits will be ascertained and determined by reference to Inland Revenue Rule (IRR) No. 5. Under that rule, where a person has a 'permanent establishment' in Hong Kong, but whose head office is situated elsewhere, the assessable profits of that person will be determined according to IRR No. 5(2). For this purpose, a 'permanent establishment' is defined 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 has a stock of merchandise from which he regularly fills orders on his principal's behalf.' In determining the assessable profits, reference may be made to the accounts kept by the Hong Kong establishment, or based on the same proportion of the total worldwide profits as the Hong Kong turnover bears to the total worldwide turnover. In the case of either method, tax adjustments are required to be made based on the IRO. In the event that these methods are considered as impracticable or inequitable, the assessor may compute the assessable profits based on a fair percentage of the Hong Kong turnover.

(ii) Tax implications for Won Ltd (Won)

Won has entered into a consignment agreement with HK Ltd (HKL) in Hong Kong, which enables Won to earn income from sales made to customers in Hong Kong. Won is thereby carrying on business in Hong Kong with the help of HKL as an 'agent holding a stock of merchandise from which it regularly fills orders on behalf of its principal'. As a result, all profits arising from the sales made in Hong Kong via HKL would be profits derived by Won from Hong Kong.

The ascertainment of Won's profits tax liability is, in general, consistent with that applicable to other local companies. However, the IRO provides that an agent who sells goods in Hong Kong on behalf of a non-resident principal is required to submit a quarterly return showing the related gross sales proceeds and at the same time remitting a sum equal to 1% of the gross proceeds as the final profits tax liability (s.20A(3)). Under the current prevailing practice, the 1% basis is reduced to 0·5% as agreed by the Commissioner. This requirement justifies the clause providing that in remitting the sales proceeds to Won, HKL would be entitled to deduct from the remittance a sum equivalent to 1% of the gross sales proceeds, or any other amount which is sufficient to cover the Hong Kong profits tax applicable. In practice, 0·5% of the gross proceeds is usually regarded as the final tax liability but Won is also allowed to choose to be assessed at 16·5% on net chargeable profits based on the actual figures as evidenced by financial statements. However, unless the actual financial result gives a lower tax amount or a loss, the deemed basis of 0·5% will be more favourable and is recommended.

As the IRD is empowered to collect tax due by a non-resident through its Hong Kong agent (s.20A(1)), the tax law requires the agent to retain out of any assets of the non-resident a sufficient amount to meet the related tax liability (s.20A(2)). Therefore, as the agent (HKL) is obliged under the IRO to withhold the related tax from Won's sale proceeds before remitting the balance back to Won, any claim by Won against HKL's withholding act is statutorily protected.

(b) Incorporating a subsidiary in Hong Kong

Won will expand into the Hong Kong market by incorporating a subsidiary in Hong Kong (HK subsidiary). By setting up a subsidiary, the Hong Kong operations would be carried on by that HK subsidiary as a separate legal entity from Won. Goods will be bought by the HK subsidiary from Won and the sales effected in Hong Kong will be recorded as sales income of the HK subsidiary. The profits earned from the buying and selling of the goods would be accounted for by the HK subsidiary. As the HK subsidiary would be selling goods in Hong Kong, this would lead to the satisfaction of the first condition under the scope of profits tax charge, i.e. carrying on a business in Hong Kong. While it is possible that the HK subsidiary may arrange to have all of its activities for purchasing carried out offshore, its sales will be done in Hong Kong. Such trading profits will be regarded as arising in or derived from Hong Kong, leading to the satisfaction of the second condition under the scope of profits tax charge. As a result, the HK subsidiary will be charged to profits tax in Hong Kong in respect of the profits earned from its Hong Kong operation.

As regards the sale of goods by Won to the HK subsidiary, provided that the HK subsidiary is dealing with Won on a principal-to-principal basis rather than as an agent (or a permanent establishment of Won), Won will be carrying on business 'with' (as opposed to 'in') Hong Kong, and any profits arising from the sale to the HK subsidiary will not be chargeable to

Hong Kong tax. In the future when the HK subsidiary makes profits and distributes dividends to Won, the dividends will not be chargeable to tax under the IRO.

The above tax position assumes that the pricing between Won and the HK subsidiary is benchmarked with the market price. If, however, the pricing strategy for selling goods to the HK subsidiary deviates from the arm's length principle, other tax implications may arise. Pricing on sales between associated entities is generally referred to as transfer pricing. Won and the HK subsidiary are associated on the basis that Won 'participates directly or indirectly in the management, control or capital of the HK subsidiary'. In determining the price for the supply of goods, the arm's length principle must be observed, the Departmental Interpretation and Practice Notes (DIPN) No. 46 contains the related transfer pricing rules. Under the arm's length principle, transactions of independent enterprises should be used as a benchmark to determine the transfer price including the allocation of profit and expenses between the associated entities. Therefore, the price charged by Won for the goods supplied to the HK subsidiary should be comparable to that which would have been charged by Won if the supply was made to an independent buyer in Hong Kong. If it is found that the sales price of the goods supplied to the HK subsidiary is above fair market price so that the Hong Kong tax deduction claimed by the HK subsidiary on the cost of goods sold is excessive, the IRD may seek to adjust the deduction to bring any shortfall of assessable profits into assessment. Alternatively, the IRD may deem that Won is carrying on business in Hong Kong in such a manner that the HK subsidiary makes a profit which is less than the ordinary level, and seek to tax Won on the related profits arising from the sales in Hong Kong (s.20). Having said that, given that the enterprise income tax rate in China is usually higher than the Hong Kong tax rate, it would be unusual for Won to overstate the sale price of the goods sold to the HK subsidiary.

On the other hand, understating the sales price to the HK subsidiary may give rise to a transfer pricing issue from the China tax perspective, leading to a potential challenge by the China tax authority. If a transfer pricing adjustment is made by the China tax authority, and a corresponding adjustment is not made for Hong Kong profits tax assessment purposes, a double tax problem may arise at the group level.

5 Smart Ltd

(a) (i) Deduction of remuneration by Smart Ltd (Smart)

The remuneration paid by Smart to Joseph as its employee would be tax deductible against Smart's assessable profits under s.16(1), provided that the remuneration is incurred in the production of Smart's profits assessable to profits tax under s.14. This refers to the situation where Joseph's services are rendered for the benefit of Smart in respect of Smart's profits derived from Hong Kong. Without the assignment, it would be reasonable to assume that Joseph's services are all rendered in Hong Kong and for the production of Smart's profits in Hong Kong; however, this will not necessarily be the case during Joseph's five-month assignment.

Section 16(1) only allows deductions for expenses 'to the extent' that they are incurred in the production of assessable profits. Where expenses are partly incurred for purposes in the production of assessable profits and the rest are for other purposes, only the first portion of the expenses is allowed. In carrying out the assignment in Singapore, Joseph's services may be regarded as rendered for the benefit of the subsidiary, given that Joseph's assignment is to monitor and oversee the implementation of the new financial reporting system in the subsidiary. In these circumstances, it is possible that the Inland Revenue Department (IRD) would challenge that at least part of Joseph's remuneration attributable to his services in Singapore is not incurred in the production of Smart's profits and, thus, not tax deductible. If this portion of the remuneration is borne by Smart, i.e. there is no recharge to the subsidiary, Smart may suffer a tax disallowance of the total portion of the related remuneration. If, however, a recharge to the subsidiary is made, then the disallowed portion will be reduced accordingly by the amount recharged or recovered.

It may be argued that Joseph's services rendered in Singapore is for the benefit of Smart in Hong Kong, on the basis that the new system is a reporting system which enables the subsidiary to provide a better report of its financials to its parent company in Hong Kong. But, unless it can be proved that Joseph's services in Singapore will help Smart in its production of assessable profits under the Inland Revenue Ordinance (IRO), Joseph's remuneration and related expenses will be disallowed in computing the assessable profits of Smart for the year.

(ii) Tax assessment for 2017/18

In order to accelerate the collection of tax revenue, the IRD adopts an 'assess-first-audit-later' system so that assessments are raised based on tax returns filed, and cases are selected for post assessment scrutiny and audit. Under the IRO, the IRD is empowered to raise any assessment within six years after the end of the year of assessment for which the profits assessed by the assessment are chargeable to tax (s.60(1)) in the absence of fraud or willful evasion. In the case of fraud or willful 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. Based on the six-year time limit, the latest date for issuing an additional assessment, if applicable, for the 2017/18 assessment year will be 31 March 2024.

In the case of Smart, the IRD's enquiry into the claim for a tax deduction in respect of Joseph's remuneration for the five-month period of service rendered in Singapore is to ascertain whether the deduction is or is not justified. If not justified, Smart would be regarded as under-assessed, and an additional assessment will be issued to recover the tax under-charged.

(iii) Options available to Smart

In the event that an additional assessment is issued, and Smart disagrees with the assessment, a valid objection can be lodged against the assessment under s.64(1). An objection will only be valid if all of the following conditions are satisfied:

(1) The objection is lodged in writing addressed to the Commissioner.

(2) The objection states precisely the grounds for the objection.

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

Subject to sufficient evidence, Smart may also ask for a holdover of the tax in dispute, until the objection is settled.

By lodging the objection, Smart's rights are protected so that it can continue the dispute with the IRD until the objection is finally settled.

(b) Joseph's liability to salaries tax

Based on the facts given, Joseph's employment with Smart should be a Hong Kong employment. This is because it likely satisfies all three conditions laid down in the *Goepfert's* principles, i.e. (1) the employer is carrying on business in Hong Kong, hence resident in Hong Kong; (2) the employment contract, though not explicit, is likely negotiated and concluded in Hong Kong; and (3) the employee's remuneration was paid in Hong Kong. Moreover, Joseph does not appear to be a visitor to Hong Kong but is a resident in Hong Kong. In the circumstances, all of his employment income would be liable to Hong Kong salaries tax unless s.8(1A)(c) applies. Under s.8(1A)(c), a portion of Joseph's remuneration would be exempt from Hong Kong salaries tax if (i) it was derived by Joseph from services rendered in Singapore; (ii) it is chargeable to Singapore personal income tax which is substantially of the same nature as Hong Kong salaries tax; and (iii) the Commissioner is satisfied that Joseph has, by deduction or otherwise, paid the tax in Singapore. Provided that all the conditions are satisfied, Joseph may rely on this section to exclude the five-month period's remuneration from the total assessable income for Hong Kong salaries tax purposes. Although for s.8(1A)(c) to apply, Singapore personal income tax must be paid in Singapore, it does not matter who actually pays this tax. Thus, it is irrelevant as to whether Smart pays the tax directly to the Singapore tax authorities or reimburses Joseph for the Singapore tax paid by him.

In respect of the travel and hotel accommodation costs paid by Smart, the issue of whether they constitute taxable income to Joseph depends on various factors. In general, if an employer makes payments to a third party which discharges the liability of the employee, the payments would be taxable income to the employee. However, there is case law saying that when an employee is on business trips, all reasonable expenses paid by him for the employer's business and then reimbursed by the employer are not assessable income to the employee. Therefore, the travel and hotel accommodation costs paid by Smart would likely not constitute taxable income to Joseph.

			Available	Maximum
1	**(i)**	**Taxability of service income**		
		Section 14 scope of charge	0·5	
		Whether taxable depends on the source of income	0·5	
		No statutory definition on source, look to case law	0·5	
		Broad guiding principle	1	
		Operation test	0·5	
		Income-generating activity	0·5	
		Antecedent/incidental activities not relevant	1	
		Activities of agents abroad taken into account	0·5	
		Nature of HK-Co's income is service income	0·5	
		Source determined by the place of service	0·5	
		Place of incorporation and principal business not relevant	0·5	
		Origins of customers not relevant	0·5	
		If service provided in HK, onshore and taxable	0·5	
		If service provided overseas, offshore and non-taxable	0·5	
		Agency principle applies	0·5	
		Agency fee for overseas activities not deductible	0·5	
		Supporting work in HK not relevant	0·5	
		Expenses for onshore taxable income are deductible	0·5	
		Apportionment of expenses if necessary	0·5	
			10·5	10
	(ii)	**Tax deductibility of loan interest**		
		Section 16(1) – general deductibility rule	0·5	
		Section 16(1)(a) – loan used to produce assessable profits, met	0·5	
		Section 16(2)(c) requires lender to be taxed on interest	0·5	
		Section 16(2)(c) is not met as lender is not chargeable on interest income	0·5	
		Section 16(2)(e) for financing trading stock and plant and machinery	0·5	
		Section 16(2)(e) is not met as lender is associate	1·0	
		Section 16(2A) and s.16(2B) need not be considered	1·0	
		Conclusion: loan interest not deductible	0·5	5
	(iii)	**Prior years' tax filing positions**		
		Offshore income likely non-taxable if sufficient evidence	0·5	
		Loan interest non-deductible	0·5	
		Prior years' tax returns incorrect	0·5	
		Need to revise under s.70A	0·5	
		Tax return to be revised due to error or omission	1·0	
		Within six years or six months from assessment	1·0	4
	(iv)	**Eligibility of loss in HK-Co after shareholding change**		
		Losses continue to be carried forward indefinitely by company	0·5	
		Regardless of change in shareholding except tax avoidance	0·5	
		Section 61B risk – tax loss offset may be denied	1·0	
		Change in shareholding leading to profits arising in company	0·5	
		Direct or indirect result	0·5	
		Sole or dominant purpose	0·5	
		To obtain a tax benefit by utilising tax losses	0·5	
		Evidence of causal relationship between change in shareholding and transfer/occurrence of profits	0·5	
		Intention of Holland to sell HK-Co	0·5	
		Basis of consideration removes tax loss benefit	1·0	
		Commercial reason to sell shareholding	0·5	
		Supporting documentation	0·5	7

		Available	Maximum
(v)	**Stamp duty on sale of HK-Co**		
	Sale and purchase of HK stock with definition	0·5	
	Stampable documents	1·0	
	Duty rate 0·2% plus $5	1·0	
	Place of execution irrelevant	0·5	
	30 days after execution	0·5	
	Consideration includes shareholder's loan ($12m + $5m)	1·0	
	Stamp duty payable $34,000	0·5	
	Jointly and severally liable by seller and buyer	0·5	
		5·5	5

	Available	Maximum
Presentation:		
Appropriate format and presentation	1·0	
Logical development	1·0	
Effectiveness of communication	2·0	4
		35

		Available	Maximum
2	**Tax position of Ms Carnation**		
	Income arising in or derived from office, employment or pension	0·5	
	Taxable if income from employment or services	0·5	
	Services include past or future	1·0	2
	Payment in lieu of notice		
	Implications of the *Fuchs* case	1·5	
	Income from employment, taxable	0·5	2
	Payment in lieu of leave		
	Income includes leave pay	0·5	
	Income from employment, taxable	0·5	1
	Payment from ORSO retirement scheme		
	Employee's contributions and investment return, non-taxable	1·0	
	Employer's contributions not exceeding the proportionate benefit	1·0	
	Formula for calculating the proportionate benefit	0·5	
	Definition of accrued benefit	0·5	
	More than 10 years, exempt	1·0	4
	Payment to compensate for loss of office		
	For breach of contract	1·0	
	Not pre-arranged in employment contract	0·5	
	Not for past services or a substitute for a reward-type of payment	1·0	
	Not window-dressing, IRD to look beyond description	1·0	
	No extinction of position	0·5	
	Company is entitled to terminate, payment in lieu of notice	1·0	
	Not clear of the true nature, risk of challenge	0·5	
	If income from employment, taxable	0·5	6
	Payment for withdrawal from legal claim		
	For deprivation of rights, not reward for services	1·0	
	Not pre-arranged in contract	0·5	
	Not taxable unless income from employment	0·5	2
	Payment for share option buy-back		
	Gain on exercise, release or assignment is taxable	0·5	
	Consideration less option cost	1·0	
	Release back to company, taxable	0·5	2
	Staff accommodation extended		
	Rental value	1·0	
	Same rental value regardless of length of accommodation	1·0	
	No tax impact, not taxable	0·5	
		2·5	2
	Payment for restrictive covenant		
	Deprivation of rights, not for employment or services	1·0	
	Not part of employment contract, not taxable	1·0	
	Reasonable and substantiated	0·5	
	Payments deemed to fall on the last day of employment	1·0	
	Regardless of date of payments	0·5	4
			25

			Available	Maximum
3	**(a)**	**Leasing of property**		
		Rental income subject to property tax as owner	0·5	
		Definition of NAV and standard rate 15%	1·0	
		Actual expenses not deductible, no depreciation allowance	1·0	
		Definition of 'business'	0·5	
		Rental income subject to profits tax	0·5	
		Expenses deductible if in the production of rental income	0·5	
		At corporation rate of 16·5%	0·5	
		Agency fee deductible if revenue, reasonable, substantiated	0·5	
		Loan interest deductible under s.16(2)(d)	1·0	
		Capital expenditure not deductible	0·5	
		Industrial or commercial building allowance	0·5	
		Plant and machinery depreciation allowance	0·5	
		Tax loss carried forward	0·5	
		Double taxation under both property tax and profits tax	1·0	
		Exempt from property tax under s.5(2)(a)	0·5	
		Or property tax set off against profits tax under s.25	0·5	10
	(b)	**Depreciation allowance**		
		Industrial v commercial building	1·0	
		Office building is a commercial building	0·5	
		No initial allowance for CBA	0·5	
		Annual allowance of 4% for unused building	0·5	
		Only 1/3 of price is building portion for CBA	0·5	
		Assumed qualifying cost $20,000,000, annual allowance $800,000	1·0	
		Plant and machinery depreciation for furniture	0·5	
		60% initial allowance, 10%/20%/30% annual allowance	0·5	5
	(c)	**Disposal of building**		
		Residue exceeding proceeds, balancing allowance deductible	0·5	
		Proceeds exceeding residue, balancing charge taxable	0·5	
		Balancing charge limited to allowance claimed	0·5	
		Calculation of estimated balancing adjustment for CBA	2·0	
		Plant and machinery pools with proceeds deducted	0·5	
		Deductible balancing allowance or taxable balancing charge	0·5	
		Cessation of business	0·5	5
				20

				Available	Maximum
4	**(a)**	**(i)**	Carrying on a trade, profession or business in HK: s.14(1)	0·5	
			Place of incorporation is irrelevant	0·5	
			Putting assets into gainful use in HK	0·5	
			Whether directly or through an agent	0·5	
			Assessable profits determined referring to IRR5	0·5	
			Foreign companies through a PE in HK	0·5	
			IRR5 defines PE to include branch, management or place of business, and agent with general authority or stock of merchandise	1·0	
			Based on accounts kept by the PE	0·5	
			Worldwide profits x ratio of HK turnover to worldwide turnover	0·5	
			Fair percentage of HK turnover	0·5	
				5·5	5
		(ii)	HKL keeps inventory of stock in HK and fills orders	0·5	
			Won is deemed as carrying on business in HK via HKL as an agent	1·0	
			Profits from the sales are taxable in HK	0·5	
			HKL to submit a quarterly return to the IRD	0·5	
			HKL to remit 1% (0·5% in practice) of the sales proceeds	0·5	
			1% (or 0·5%) is deemed as the final tax payable	0·5	
			Sino can elect to report true profits and be taxed at 16·5%	1·0	
			HKL is empowered to withhold tax from proceeds	0·5	
			Claim against HKL is protected	1·0	
				6·0	5
	(b)		Subsidiary is a separate legal entity	0·5	
			Subsidiary records sales income	0·5	
			Subsidiary carries on business in HK	0·5	
			Subsidiary's purchases and sales are in HK, thus profit is sourced in HK	0·5	
			Profits of subsidiary taxable in HK	0·5	
			Won not taxable in HK as it carries on business 'with' HK	0·5	
			Subsidiary is not a PE in HK	0·5	
			Dividend from subsidiary not taxable in HK	0·5	
			Transfer pricing issue	0·5	
			Won and HK subsidiary are associated, with reason	1·0	
			Arm's length principle	0·5	
			Benchmarked with independent transactions	1·0	
			If price is overstated, HK tax deduction is over-claimed	0·5	
			The IRD may adjust the deduction	0·5	
			Or deem Sino to carry on business in HK (s.20)	1·0	
			Unusual as China tax rate is usually higher	0·5	
			Understating the price may lead to a transfer pricing issue in China	0·5	
			Double tax problem may arise at group level	0·5	
				10·5	10
					20

				Available	Maximum
5	**(a)**	**(i)**	**Deductibility of remuneration**		
			Deductible if incurred in the production of profit (s.16(1))	0·5	
			Whether Joseph's services rendered in Singapore are for the benefit of Smart	1·0	
			Apportionment to the extent of any benefit rendered to the subsidiary	1·0	
			If no recharge to the subsidiary, fully disallowed	1·0	
			If recharge to the subsidiary, disallowance is reduced	0·5	
			Arguable that it is for the benefit of Smart	0·5	
			Conclusion	0·5	5
		(ii)	**Tax assessment for 2014/15**		
			Explain the 'assess-first-audit-later' system	1·0	
			Power to raise assessment within six years	1·0	
			If fraud or willful evasion, extend to ten years	0·5	
			Due date for the 2017/18 additional assessment	0·5	
			Purpose of the IRD's enquiry	1·0	4
		(iii)	Right to lodge an objection under s.64(1)	0·5	
			Conditions for a valid objection	1·5	
			Holdover of tax in dispute	1·0	3
	(b)	**Liability to salaries tax**			
		Salary:			
			HK employment – conditions (x 3)	1·5	
			Not a visitor	0·5	
			Fully taxable unless exempt under s.8(1A)(c)	1·0	
			Conditions under s.8(1A)(c)	1·5	
			Five-month period's remuneration excluded if conditions are satisfied	0·5	
			Singapore personal income tax must be paid	1·0	
			But who pays is irrelevant	0·5	
		Travel and hotel accommodation costs:			
			Taxable if a discharge of the employee's liability	1·0	
			Reimbursement of reasonable expenses paid by employee for employer's business while on business trip not taxable	1·0	
		Conclusion		0·5	
				9·0	8
					20