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.

The suggested answers are in the nature of general comments only. They are not offered as advice on any particular matter and should not be taken as such. No reader should rely on the suggested answers as the basis for any decision. The examiners expressly disclaim all liability to any person in respect of any direct, indirect, incidental, consequential or any other damages relating to the use of the suggested answers.

1 Report to the directors of Vendor Co

To: The directors, Vendor Co
From: Tax adviser
Date: June 2019
Subject: Tax due diligence report on Yellow (HK) Ltd

I refer to our earlier meeting during which we discussed the tax position of Yellow (HK) Ltd (Yellow), in particular, the issues arising from the tax due diligence exercise. Our advice on the respective issues is as follows:

(i) Yellow's estimated profits tax computation

(1) Refurbishment adjustment of $48,000 – The total refurbishment cost is $60,000, comprising $40,000 for the company director's residence and $20,000 for Yellow's office. Under s.16F, the refurbishment cost for a building or structure, other than a domestic building or structure, is deductible over five years of assessment. Therefore, only the amount spent on Yellow's office ($20,000) is allowable for deduction over five years. The other amount spent on the director's residence would be capital expenditure which is disallowed for deduction but can qualify for commercial building allowance at 4% per annum. This will be reflected in item (2) depreciation allowance below. In conclusion, subject to the commercial building allowance to be computed separately, the correct adjustment should be $56,000 ($40,000 + $20,000 x (1 – 20%)).

(2) Depreciation allowance of $41,000 – The new addition of a computer at $50,000 qualifies as a prescribed fixed asset which is eligible for 100% outright deduction and thus is not eligible for tax depreciation allowance. Moreover, commercial building allowance at 4% on the refurbishment cost of $40,000 on the director's residence should be computed. The correct tax depreciation allowance should be $6,600 (20% pool: $2,000; 30% pool: $3,000; CBA: $1,600).

(3) Disallowed donation adjustment of $8,000 – The approved charitable donation of $12,000 paid in cash to Community Chest is deductible but the donation of $8,000 in bottled water is not deductible because it was not made in the form of money, which is the definition of approved charitable donations in s.2, although Hong Kong Red Cross is an approved charitable institution. However, the deduction is also restricted to 35% of Yellow's assessable profits before such a donation. Therefore, the total donation of $20,000 should be added back to the profits first, and the allowable deduction should be subsequently adjusted to arrive at the assessable profits, subject to the maximum limit of 35% of assessable profits before the allowable donation. No deduction will be granted if a loss is incurred.

(**Note to marker:** *If a candidate makes the valid suggestion to re-package and present with evidence the donation of the bottled water as an advertising and marketing expense which could possibly be deducted under s.16(1), a mark may be awarded.*)

(4) Interest income adjustment of $5,000 – The total interest income of $5,000 comprises $4,000 on staff loans and $1,000 on overdue accounts receivable from overseas customers. Interest income is taxable if it arises in or is derived from Hong Kong (based on the place where the credit/loan is provided). This applies to the amount of $4,000 which will be taxable if the loan is provided to the staff in Hong Kong. In the case of interest arising from a trading transaction, such as overdue accounts receivable, the nature of the interest follows that of the accounts receivable. If Yellow carried out all of its sales in Hong Kong, which appears to be the case as it is a retailer carrying on business in Hong Kong and there is no mention of any business outside Hong Kong, all of its sales should be chargeable to profits tax and, therefore, the interest would still be taxable. As a result, all the interest income should be taxable and no adjustment is required.

(5) General allowance for doubtful debts written back of $7,000 (not adjusted) – Under s.16(1) of the Inland Revenue Ordinance (IRO), an expense is allowed to the extent that it is incurred in the production of profits chargeable to profits tax. The word 'incurred' denotes that deduction is only allowed in relation to expenses for which the liability or commitment to pay has been crystallised. Under s.16(1)(d), insofar as Yellow as a retailer is concerned, only doubtful debts arising from trading receipts and estimated to the satisfaction of the assessor to have become irrecoverable are allowable. The section further requires that if any amount previously allowed under the section is recovered in the basis period for any subsequent year of assessment, the recovered amount should be included as the assessable profits of Yellow for the subsequent year of assessment. The general allowance for doubtful debts was calculated and accrued for contingent irrecoverability, and thus was not deductible at the time when it was charged to the accounts. If this is the case, the write-back of the same allowance in the current year should not be taxable. Further action is required to trace back prior years' assessments to confirm whether the general allowance had been allowed as a tax deduction previously. If a deduction has previously been allowed, the write-back in the current year should then be taxable.

(6) Interest expense on bank loan of $3,500 (not adjusted) – The deductibility of interest expense is subject to various conditions including the general deduction rules under s.16(1) and s.16(1)(a) which require the associated loan to be used for the production of assessable profits. Assuming that this is satisfied, the interest expense payable on a bank loan should be eligible for deduction under s.16(2)(d) but subject to restriction under s.16(2A) and s.16(2B). Based on the information given, the loan is secured on a company director's real estate. Section 16(2A) should not apply. Assuming that there is no arrangement in place to flow back the interest expense to Yellow (or its associates), s.16(2B) should not apply either and the interest expense should be deductible. It is correct that the item requires no adjustment in the tax computation. Further action is required to confirm that the loan has been used for the production of Yellow's assessable profits.

(7) Royalty paid to an unrelated Japanese licensor of $30,000 (not adjusted) – Similarly, the general deduction rule under s.16(1) has to be satisfied for the royalty expense to be deductible, i.e. the licence should be used by Yellow to produce assessable profits. Further action is required to confirm the usage of the licensing property. If this is the case, it is correct that the item requires no adjustment in the tax computation. However, on top of the deductibility, Yellow is obligated under s.21A to withhold the relevant Hong Kong tax amount from the payment before remittance. This tax amount represents the Hong Kong profits tax payable by the Japanese licensor under either s.15(1)(b), on the basis that the licensing property has been used in Hong Kong, or s.15(1)(ba) on the basis that Hong Kong tax deduction has been claimed on the royalty payment by Yellow. The amount of tax to be withheld should be $1,485 ($30,000 x 30% x 16·5%) if the Japanese licensor is a corporation, or $1,350 ($30,000 x 30% x 15%) if the Japanese licensor is an unincorporated body. Upon withholding the tax, Yellow is also required to file the tax return with the Inland Revenue Department (IRD) on behalf of the Japanese licensor and pay the tax on its behalf accordingly. Further action is required to ascertain and confirm that Yellow has complied with these reporting obligations.

(ii) Waiver of inter-company balance due to shareholder

It was found during the statement of financial position review that Yellow has an amount owing to Vendor representing an accumulated unsettled balance of purchases in previous years. As all the sales were returned as assessable profits for Hong Kong tax purposes, it is reasonable to assume that all purchases, including those from Vendor despite being unsettled, would have been claimed as a deduction against Yellow's sales income. If Vendor is to waive the claim against this balance, the waiver would trigger a credit entry in Yellow's income statement, which should be included in the profits before taxation. This effectively is a discharge of Yellow's obligation to pay a trade debt. Section 15(2) specifically provides for bringing the waived amount into assessable profits to the extent that the amount has previously been allowed as a deduction in computing the assessable profits. If the trade debt has been deducted in earlier years, the subsequent discharge would become assessable in the year in which the discharge occurs.

(iii) Redundancy payment

The general rule for the deductibility of expenses under s.16(1) is that the expense and outgoings must be incurred during the basis period for the year of assessment in the production of profits chargeable to profits tax. Section 17(1)(c) also applies to disallow an expense which is capital in nature. However, the IRO does not define a capital expense, and thus the rules generated from common law would have to be observed.

In the case of redundancy payments made in accordance with the statutory requirement, it was established in *CIR* v *Cosmotron Manufacturing Company Limited* (1996) that, despite the payment being made at the time of cessation of a business, the payments represented a discharge of statutory obligations incurred in the running of the business prior to its cessation. More importantly, since it is statutorily required, the liability for redundancy pay will have been incurred at the time the staff were employed, even though this liability does not crystallise until actual payment is made. On this reasoning, the redundancy payment made under the statutory requirement will be tax deductible for Yellow.

(iv) Change of accounting date

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

The general principles to be followed in ascertaining the basis period for the year of change and the year preceding the year of change are:

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

(b) to make sure that, in the case of a new business (commenced on or after 1 April 1974), none of the profits arising during the life of the business fall out of the profits tax net; and in the case of an old business (commenced before 1 April 1974), the period left out of the assessment is not one of high profit;

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

(d) to ensure fairness to both the IRD and the taxpayers.

Based on the above principles, Yellow's year of change is 2019/20 as the accounts are not made up to the corresponding day (31 March) in the year of assessment. As there are different rules for old and new businesses, the determination of the basis period for the year of change will depend on the date of commencement of Yellow's business. In this case, Yellow was incorporated on 1 January 2010 and thus the business must be a new business (commenced on or after 1 April 1974). The basis periods for the relevant years of assessment are:

Year of assessment 2019/20 – This is the year of change. As Yellow is a new business and there is a compelling reason for the change of accounting date (to conform with the new parent group's financial reporting period), the CIR is normally prepared to limit the basis period to a period of less than 12 months by concession. Therefore, the basis period for 2019/20 is likely to be the nine months from 1 April 2019 to 31 December 2019. In the event that there is no compelling reason to change the accounting date, or if Yellow was an old business, the CIR would not apply the concession but choose to follow a period of 12 months for the year of change, i.e. from 1 January 2019 to 31 December 2019. In this case, there would be double assessment of the profits arising from 1 January 2019 to 31 March 2019.

Year of assessment 2018/19 – This is the year preceding the year of change of accounting date. As Yellow is a new business and a nine-month basis period is adopted for the year of change 2019/20, then it is likely that the basis period for 2018/19 would remain unchanged, i.e. 1 April 2018 to 31 March 2019, because no profits have fallen out of assessment.

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 Amy

(a) For an objection to be valid under s.64(1), it must:

(i) be in writing and addressed to the Commissioner;

(ii) state precisely the grounds for the objection;

(iii) be received by the Commissioner within one month after the date of the notice of assessment; and

(iv) be accompanied by a proper tax return, including a nil return, if the assessment was an estimated assessment under s.59(3) of the Inland Revenue Ordinance.

In this case, requirement (iii) may pose a problem because the one-month period has already expired. *Prima facie* the objection cannot be made. However, s.64(1) proviso (a) requires the Commissioner to accept the objection after the one-month period if he is satisfied that the taxpayer is prevented from making the objection within such period due to absence from Hong Kong or other reasonable cause. On this basis, it is advisable that Amy should lodge the objection as soon as possible and state the period of absence from Hong Kong with evidence.

(b) An illustrated example of a notice of objection:

[Date]
The Commissioner of Inland Revenue
[Address]

Dear Sir,

Notice of objection for salaries tax assessment for 2017/18 under charge no. xxxx

I refer to the above notice of assessment to salaries tax dated 1 April 2019. I hereby write to object to the assessment on the following grounds:

The course fee of $60,000 was refunded to me by AB CPA & Co (the Firm) before I joined the Firm, therefore it was not income from my employment. However, if the course fee is deemed to be taxable employment income, I should be allowed a deduction of the course fee of $60,000 which is incurred to produce the income from my employment.

I understand this notice of objection will reach you after 1 May 2019, i.e. the date which is one month after the date of issuance of the aforesaid notice of objection. I was prevented from lodging this notice of objection by 1 May 2019 because:

(1) I have been absent from Hong Kong since xx March 2019 on a two-month trip to Europe; and
(2) I was not aware of such notice of assessment until I returned to Hong Kong at the end of May.

To prove my absence from Hong Kong during the aforesaid period, I also attach copies of my passport for your information. In view of the above, I request that this late objection be accepted in accordance with s.64(1) proviso (a) of the Inland Revenue Ordinance.

I would be grateful if you would accept my objection, revise the assessment and the amount of tax payable before the tax payment is due. In the meantime, I would like to request the tax demanded is held over unconditionally pending the settlement of the objection.

Should there be any questions, please let me know.

Yours truly,
[signed]

(**Tutorial note:** *The above format is for illustration. Any other format serving the same purpose will be accepted.*)

(c) The course fee refunded by AB CPA & Co (ABCo) is assessable to salaries tax if it constitutes income arising from the employment. Income from any office or employment includes any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance (s.9(1)(a)). In *Walter Alfred Heinz Fuchs* v *CIR* (2011), the Court of Final Appeal ruled that contractual payments made pursuant to the terms of the employment contract are income from employment and should be chargeable to salaries tax. It was also held 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'.

In *David Hardy Glynn* v *CIR* (1989), it was held that a perquisite not only meant the payment of money, it also included money which could be obtained from property which was capable of being converted into money and money which was paid in discharge of a debt of the employee. In this case, Amy was personally liable to pay the course fee. The refund of the course fee by ABCo represented a discharge of Amy's liability and amounted to a perquisite specifically included as income from employment under s.9(1)(a). Although the course fee was refunded to Amy before she joined ABCo, it was a contractual payment made pursuant to the terms of the employment contract to induce Amy to enter into employment with ABCo. Following the *Fuchs* case, the payment should be regarded as income chargeable to salaries tax.

The assessable income of a person in any year of assessment shall be the aggregate amount of income accruing to them from all sources in that year of assessment (s.11B), and income accrues to a person when they become entitled to claim payment thereof (s.11D(b)). In this case, the course fee was refunded to Amy by ABCo in January 2017 but Amy only took up the employment with ABCo on 1 July 2017. When ABCo refunded to Amy the course fee, it was not yet an income from employment. The sum only became an income from employment on 1 July 2017 when Amy took up the employment. Therefore, the course fee accrued to Amy as income from employment on 1 July 2017 and should be regarded as her assessable income for the year of assessment 2017/18.

(d) The rules governing the deductions of outgoings and expenses are contained in s.12(1)(a) which allows as deductions 'all outgoings and expenses, other than expenses of a domestic or private nature, and capital expenditure, wholly, exclusively and necessarily incurred in the production of the assessable income'. This means that to be deductible, the expenditure must satisfy each of the following tests in addition to not being expenditure of a domestic or private nature or expenditure of a capital nature:

(1) it must have been 'incurred',
(2) 'wholly, exclusively' and
(3) 'necessarily'
(4) in the production of the income.

The 'incurred' test means that the expenditure must either be paid or have given rise to an established liability or a definite commitment arising in the year in which the deduction is claimed. If payment has not been made, it is allowed only if an actual and known liability or obligation of ascertainable amount existed on the last day of that year.

The 'wholly and exclusively' test means that the entire amount must have been expended for the sole purpose of producing the income. In practice, however, expenditure incurred for more than one purpose may be apportioned and the part attributable to the employment will be allowed, provided the other tests are satisfied, e.g. depreciation allowance and petrol cost.

The 'necessarily' test means that the expenditure must be essential to the conduct of the employment, i.e. vital to the employment to the extent that it would not be possible for the taxpayer to perform the duties and to produce the income from the employment without incurring that expenditure.

'In the production of income' is considered to be the same as the meaning of the phrase 'in the performance of duties'. Expenditure is not incurred in the production of income if it is only incurred to enable the duties to be performed, e.g. travelling to and from the place of employment: *CIR* v *Humphrey* (1970).

As the course fee was Amy's private expense, it was not incurred in the performance of her duties and not deductible under s.12(1)(a). However, Amy is entitled to claim deduction of self-education expenses for the course fee paid in the year of assessment for prescribed courses of education attended at approved institutions not exceeding the prescribed amount (s.12(1)(e)). The course is offered by a university and is an approved course under s.12(6). As the course fee of $60,000 was paid on 3 January 2017, Amy is entitled to claim deduction of the whole of the self-education expenses in the year of assessment 2016/17. However, it appears that Amy may not be able to benefit from the deduction as she was studying during the year of assessment 2016/17 and did not have any assessable income.

3 (a) Tax implications arising from Property A

Profits tax and property tax implications

Property A was let during the period from June 2018 to December 2018 under a formal lease, and then from December 2018 to April 2019 without a lease agreement. Lease income was earned for both periods, and thus would all be subject to property tax in Hong Kong on the basis that consideration is earned and receivable for the right of use of land/buildings in Hong Kong. This is true regardless of whether a lease agreement is put in place or not. The net assessable value is determined by the sum of rent, lump sum premiums, management fees paid to the owner, and owner's expenditure borne by the tenant, reduced by rates paid by the owner and 20% of the balance thereof. The statutory tax rate for property tax is 15%.

Edmond financed 90% of the acquisition cost of Property A by a loan from the property developer. The interest cost incurred on the borrowing is not deductible from the net assessable value under property tax. If Edmond elects for personal assessment, the interest cost would be deductible against the net assessable value in computing his total assessable income. However, interest on borrowing to acquire Property A can only be deducted against the property income arising from that property. If there is any excess of interest over the income from Property A, the excess cannot be offset against other income, if any, nor can it be carried forward to offset against future taxable income from Property A.

Apparently, Edmond sold Property A at a profit in May 2019 and therefore the question of whether or not the profit should be assessable under profits tax arises. In the event that the acquisition and disposal of the property constitutes a 'trade' or 'an adventure in the nature of trade', any gain derived from the disposal would be taxable as trading profit. If, however, it is deemed to be a capital profit arising from the disposal of an investment, it is not subject to tax in Hong Kong. It is often difficult to ascertain whether an isolated transaction constitutes a 'trade' or 'an adventure in the nature of trade'. The principles which would generally apply are the so-called 'badges of trade', i.e. the original intention of acquisition, the funding arrangement, frequency of similar transactions, any supplementary work done on the property, length of holding period and the circumstances leading to the disposal. Generally, if the property has been let for rental income since acquisition, it would likely be accepted as an investment property unless other factors prove otherwise. However, in the case of Property A, the property was initially listed at the property agency for sale immediately after the acquisition. This shows that the property was acquired with an intention or a view to resale. It will be a very strong fact for concluding that Edmond acquired the property in an adventure in the nature of trade. In addition, the fact that the property was only held for approximately 14 months and had been let on a short-term basis would not be convincing enough to prove that the intention of holding the property was for long-term investment purposes. Coupled with the fact that 90% of the acquisition cost was financed by loan borrowing, it is very likely that the profit would be regarded as trading profit and chargeable to profits tax.

Stamp duty implications

Conveyances on the sale or transfer of immovable property in Hong Kong are subject to stamp duty under Head 1 of the Stamp Duty Ordinance (SDO). The chargeable document is the agreement for sale and purchase (AFS). As Property A was a residential property (RPPT) acquired by Edmond, a Hong Kong permanent resident (HKPR) who bought the RPPT on his own behalf (i.e. he is both the legal and beneficial owner) and owned no other RPPT in Hong Kong at the time of purchase, the AFS would be subject to *ad valorem* duty (AVD) at Scale 2 rates. The amount of AVD payable is $150,000 ($5m x 3%). Where the AFS is stamped, the subsequent formal assignment or conveyance executed in conformity with the stamped AFS will be liable to a fixed duty of $100. The law stipulates that both parties to the transaction are jointly and severally liable to pay the stamp duty, but in practice, the purchaser is normally the person to pay.

However, buyer's stamp duty (BSD) is not chargeable because although the property is a RPPT, Edmond is a HKPR acquiring the RPPT on his own behalf.

Stamp duty payable on the first one-year lease is 0·25% of the yearly rent (Head 1(2)(b)(iii)). Therefore, the stamp duty payable on the lease will be $450 ($15,000 x 12 x 0·25%). A fixed duty of $5 is payable on any duplicate or counterpart (Head 4). For the second lease, as no lease was signed, no stamp duty is payable.

Upon sale of Property A, a RPPT acquired in April 2018 and resold within 24 months (in May 2019), special stamp duty (SSD) at 10% of $7m, i.e. $700,000, will be payable. SSD is jointly and severally payable by both the purchaser and the seller (Edmond).

(b) Tax implications arising from Property B

Salaries tax and profits tax implications

Following acquisition, Property B was occupied by Edmond during the period from May 2018 to April 2019. During that period, interest was paid on a loan obtained from Edmond's employer to acquire the property. As Property B was used by Edmond as his place of residence at some point during the assessment year, the interest deduction will be allowed as 'home loan interest' under salaries tax, subject to a maximum of $100,000 for the whole year. This amount will be reduced on a reasonable basis as determined by the IRD, since the property was not used by Edmond as his place of residence for the whole year. The general practice is to adopt time apportionment, based on the period of eligible residency.

The low-interest loan provided by the employer to Edmond is not a chargeable benefit under salaries tax where the cost involved in providing the benefit is the sole liability of the employer. This is based on the understanding that the benefit received by Edmond (i.e. paying less than market rates) is not of itself convertible into cash.

Apparently, Edmond also earned a profit from the disposal of Property B in May 2019 after moving out of it in April 2019. As for Property A, the question of whether the profit is chargeable to profits tax arises. As well as the general principles of 'badges of trade', it is also relevant to consider whether the intention of Edmond has changed at any time during the year. Following acquisition, Property B was occupied by Edmond until April 2019. This fact may prove that Property B was acquired for self-use and thus should not be deemed trading in nature. However, Edmond moved out of the property after only a short period of occupancy (one year). The question does not provide information as to the reason for moving out. Unless there is sufficient reason to justify vacating the property, Edmond may be regarded as having changed his intention from investment to profit-making, particularly in view of the fact that renovation to add value to the property was carried out after Edmond moved out. If the change of intention is proved, the market value of Property B at the time of the change of intention, i.e. the time of Edmond vacating the property, would need to be ascertained. This value would be deemed as the cost base for Property B (s.15BA) and any excess of the disposal price over this cost base after deducting allowable expenses (e.g. stamp duties and cost of renovation) would be taxable under profits tax at 15%.

Stamp duty implications

As Property B was a RPPT acquired by Edmond who already owned a RPPT in Hong Kong at the time of purchase, the AFS would be subject to AVD at Scale 1 (Part 1) rates. The amount of AVD payable is $1,050,000 ($7m x 15%). Where the AFS is stamped, the subsequent formal assignment or conveyance executed in conformity with the stamped AFS will be liable to a fixed duty of $100.

However, BSD is not chargeable because although the property is a RPPT, Edmond is a HKPR acquiring the RPPT on his own behalf.

Upon sale of Property B, a RPPT acquired in April 2018 and resold within 24 months (in May 2019), SSD at 10% of $9m, i.e. $900,000, will be payable.

4 Skybird (HK) Ltd

(a) Chargeability to profits tax

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'. In determining whether a business is carried on in Hong Kong, the place of incorporation is irrelevant. For Skybird (HK) Ltd (Skybird), the business is considered as carried on in Hong Kong if any part of the company's profit earning activities are carried out in Hong Kong (*Bartica* case). When a business is determined to be carried on in Hong Kong, the profits from that business would be taxable in Hong Kong if the profits are 'sourced' in Hong Kong. In determining 'source', the broad guiding principle in the *Hang Seng Bank* case which is adopted in Departmental Interpretation and Practice Notes (DIPN) No. 21 requires that one should look to see what the taxpayer has done to earn the profit, and where he has done it. Therefore, different source tests would apply depending on the nature of the profits.

The business of Skybird is aircraft leasing. Pursuant to the newly enacted ss.14G-N and the DIPN 54, qualifying aircraft leasing business is taxable in Hong Kong and eligible for tax concession at a preferential tax rate. Skybird is a qualifying aircraft lessor if it satisfies all of the following conditions:

(i) the company is a standalone corporation with its ordinary course of business as aircraft leasing;

(ii) the company is not an aircraft operator;

(iii) the company owns the aircraft for leasing under 'dry' lease;

(iv) the central management and control (CMC) of the corporation is exercised in Hong Kong (the CMC requirement);

(v) the activities which produce its qualifying profits in that year are carried out in Hong Kong by the corporation; or arranged by the corporation to be carried out in Hong Kong (the 'substantial activity' requirement);

(vi) the leasing activities are not carried out by a permanent establishment outside Hong Kong (the attribution to Hong Kong requirement).

In general, the place of directors' meetings where central decisions are made would be accepted as the place of CMC.

In ascertaining the source of aircraft leasing income, the 'substantial activity requirement' mentioned above requires that the core income generating activities need to be carried out in Hong Kong, including raising funds, agreeing funding terms, identifying and acquiring aircraft, soliciting lessees, setting terms of leases, monitoring and revising lease agreements, managing risks and maintaining documentation (DIPN 54). This is consistent with the 'operation test'. Moreover, s.15(1)(n) is newly enacted to deem such aircraft leasing income as chargeable to profits tax even if the aircraft are used outside Hong Kong.

Basis of assessment

Under s.14H(1), a qualifying aircraft lessor is entitled to a preferential tax rate at one-half of the corporate profits tax rate (i.e. 8·25%), and the preferential rate is applied to the qualifying profits which are equal to 20% of gross lease payments less deductible expenditure. Qualifying profits would include incidental income such as interest income, exchange gains or hedging gains. Effectively, Skybird would be charged at 1·65% (8·25% x 20%) of its net assessable profits (ignoring depreciation on aircraft).

It is worth noting that the concession is only applicable if Skybird makes a written election which is irrevocable.

(b) Tax depreciation allowance

Capital expenditure incurred on the acquisition of fixed assets would normally not be allowed as an expense for tax purposes, but would qualify for a depreciation allowance if it represents plant and machinery, industrial building or commercial building. Under Rule 2 of the Inland Revenue Rules, aircraft qualify for 30% annual allowance calculated based on the reducing value. Initial allowance of 60% can be claimed in the year of acquisition based on capital expenditure incurred.

However, under s.39E and DIPN15, where the plant and machinery is a ship or aircraft which is leased out for income, no initial or annual allowance would be granted to the lessor if: (i) the lessee is not an operator of a Hong Kong ship or aircraft; or (ii) the whole or a predominant part of its cost of acquisition or construction was financed directly or indirectly by a non-recourse debt. In the case of Skybird, the aircraft was leased to a China aircraft operator (presumably not qualifying as a Hong Kong aircraft operator) and thus tax depreciation allowance would be denied. Moreover, if Skybird elects to be taxed under the concessionary regime at half of the corporation tax rate, s.14H(7) also applies to deny the tax depreciation allowance on the aircraft under lease.

(c) Expense deductibility

The general rule for the deductibility of expenses requires that the expense and outgoing must be incurred during the basis period for the year of assessment in the production of profits chargeable to profits tax (s.16(1)). An expense which is capital in nature is generally disallowed (s.17(1)(c)) unless specifically provided.

In the case of Skybird, the service fee payable to Sky Management, the lease manager, would be eligible for deduction on the basis that the income arising from the aircraft leasing is taxable and the fee is incurred in the production of the taxable aircraft leasing income. The total relevant expense would be deducted against the gross rental income from leasing, before the 20% concessionary adjustment for tax base applies to arrive at the net qualifying profits.

In respect of the China withholding tax, the prevailing practice for tax deduction requires that the overseas tax is calculated based on the gross amount of income instead of net profit, and the related income is chargeable to tax in Hong Kong. In this case, the withholding tax is 5% based on the gross rental income derived from the China lessee, and the rental income is included in the tax base subject to Hong Kong profits tax. As a result, the China withholding tax is eligible for tax deduction under s.16(1).

				Available	*Maximum*
1	**(i)**	**Company's estimated profits tax computation**			
		(1)	**Refurbishment**		
			S.16F – over five years	0·5	
			Other than domestic building or structure	0·5	
			Director's residence not deductible, qualify for commercial building allowance (CBA)	0·5	
			Correct adjustment: $56,000	0·5	
		(2)	**Depreciation allowance**		
			Computer does not qualify, prescribed fixed asset	0·5	
			100% deduction	0·5	
			CBA includes refurbishment on director's residence	0·5	
			Correct adjustment: $6,600	0·5	
		(3)	**Disallowed donation**		
			Non-cash donation is not deductible	0·5	
			Subject to 35% limitation	0·5	
			Add back total donation first, then check 35% limit	0·5	
			No deduction if loss	0·5	
		(4)	**Interest income**		
			Provision of credit test	0·5	
			Taxable if sourced in Hong Kong	0·5	
			Interest from trading transaction follows same nature	0·5	
			If sales is taxable, interest is taxable	0·5	
			No adjustment is required	0·5	
		(5)	**General allowance for doubtful debts**		
			General deduction rule s.16(1)	0·5	
			'Incurred' when liability crystallised	0·5	
			If general allowance is not deductible, write-back is not taxable	0·5	
			Further action required to check prior years' records	0·5	
		(6)	**Interest expense**		
			General deduction rule s.16(1) and s.16(1)(a)	0·5	
			S.16(2)(d) interest paid to bank is eligible for deduction	0·5	
			Subject to restriction under s.16(2A) and s.16(2B)	0·5	
			Personal guarantee, restriction does not apply	0·5	
			No adjustment is correct	0·5	
		(7)	**Royalty**		
			General deduction rule s.16(1) used for producing assessable profits	0·5	
			No adjustment is correct	0·5	
			Obligation to withhold tax from remittance s.21A	0·5	
			Japan licensor is taxable s.15(1)(b)	0·5	
			Or taxable under s.15(1)(ba)	0·5	
			Calculation of tax withheld	1·0	
			File tax return and pay tax on behalf of licensor	0·5	
			Further action required to check compliance	0·5	
				17·5	16
	(ii)	**Waiver of inter-company balance**			
		Balance arose from prior years' purchase cost used for sales		0·5	
		As sales were taxable, all purchases had been deducted before		0·5	
		If waived, a credit to income statement in profits before tax		0·5	
		A discharge of obligation to pay trade debt		0·5	
		S.15(2) waived amount is taxable if deducted before		1.0	3
	(iii)	**Redundancy payment and additional bonus**			
		General deduction rule s.16(1)		0·5	
		Capital expense disallowed s.17(1)(c)		0·5	
		Statutory redundancy is discharge of statutory obligation incurred in running the business		0·5	
		Liability started to accrue when employment began		0·5	
		Liability crystallised upon payment		0·5	
		Redundancy payment deductible		0·5	3

		Available	Maximum
(iv)	**Change of accounting date**		
	Definition of change of accounting date	1·0	
	Principles:		
	Adopt the new accounting date as soon as possible	0·5	
	New business: no profits falling out	0·5	
	Old business: profit left out is not high	0·5	
	Amend the preceding year	0·5	
	Ensure fairness	0·5	
	1 April 1974 to define new and old business	0·5	
	Year of change is 2019/20	1·0	
	2019/20: New business	0·5	
	Conformity of group's practice is compelling reason	0·5	
	Less than 12 months' basis period is acceptable	0·5	
	Nine-month basis period 1 April 2019 to 31 December 2019	0·5	
	If no compelling reason, 12-month basis period 1 January 2019 to 31 December 2019	0·5	
	Double assessment for profits 1 January 2019 to 31 March 2019	0·5	
	2018/19: Year preceding the year of change	0·5	
	New business, no change in basis period as no profits fall out	0·5	
	Basis period 1 April 2018 to 31 March 2019	0·5	
		9·5	9
Presentation:			
Appropriate format and presentation		2·0	
Logical development		1·0	
Effectiveness of communication		1·0	4
			35

		Available	Maximum
2	Amy		
(a)	Four conditions for a valid objection	2·0	
	One-month period for lodging an objection has expired	0·5	
	Absence from Hong Kong a reasonable excuse	0·5	
	Amy should lodge the objection as soon as possible	0·5	
		3·5	3
(b)	**Notice of objection**		
	Subject	0·5	
	Date of assessment	0·5	
	Course fee not income from employment	1·0	
	Or deductible as incurred to produce income from employment	1·0	
	Late objection grounds	1·0	
	Reply before tax due date	0·5	
	Request unconditional holdover	1·0	
		5·5	5
(c)	**Taxability of the course fee refunded by ABCo**		
	Taxable if constitutes income from employment	0·5	
	Income included in s.9(1)(a)	0·5	
	Contractual payments were income from employment	0·5	
	Also include reward for past services, or inducement to enter into employment and provide future services	1·0	
	Discharge of employee's liability taxable as perquisite	0·5	
	Payment represented a discharge of Amy's liability by ABCo	1·0	
	And a contractual payment as an inducement, so taxable	1·0	
	Aggregate amount of income accruing from all sources	0·5	
	Income accrues when entitled to claim payment thereof	0·5	
	Course fee refunded in 2016/17	0·5	
	But Amy took up employment in 2017/18	0·5	
	Therefore, course fee accrued to Amy in 2017/18	1·0	8
(d)	**Deductibility of the course fee paid by ABCo**		
	Rules governing the deductions of outgoings and expenses in s.12(1)(a)	0·5	
	Meaning of 'incurred'	1·0	
	Meaning of 'wholly, exclusively'	1·0	
	Meaning of 'necessarily'	1·0	
	Meaning of 'in the production of the income'	1·0	
	Course fee private expenses not deductible	0·5	
	But deductible as self-education expenses	1·0	
	The course is a prescribed course of education	0·5	
	Is an approved institution	0·5	
	Paid in January 2017, deductible in 2016/17	1·0	
	Likely that no assessable income to deduct	1·0	9
			25

3 Edmond

	Available	Maximum
(a) Tax implications arising from Property A		
Profits tax and property tax implications		
Lease income subject to property tax	0·5	
Regardless of whether there is a lease contract	0·5	
Property tax at 15% on net assessable value	0·5	
Interest on bank borrowing not deductible under property tax	0·5	
Deductible against lease income under personal assessment	0·5	
Excess not deductible, nor carried forward	0·5	
Profit on sale taxable if a 'trade' or 'an adventure in the nature of trade'	0·5	
Otherwise, capital profit not taxable	0·5	
Apply the six badges of trade	1·0	
If let since acquisition, likely an investment property	0·5	
However, let on a short-term basis	0·5	
Second lease not proved in written contract	0·5	
Listed at the property agency for sale immediately after purchase	0·5	
90% of acquisition cost funded by borrowing	0·5	
Very likely regarded as trading profit chargeable to profits tax	1·0	
Stamp duty implications		
Agreement for sale and purchase subject to stamp duty	0·5	
Why *ad valorem* duty (AVD) at Scale 2 rates apply	0·5	
AVD payable = $150,000	0·5	
Fixed duty of $100 on assignment	0·5	
Buyer and seller jointly and severally liable	0·5	
In market practice, paid by purchaser	0·5	
Why buyer's stamp duty (BSD) not chargeable	0·5	
Stamp duty on first lease = $450	0·5	
Fixed duty of $5 on any duplicate or counterpart	0·5	
No duty on second lease (no written lease)	0·5	
Special stamp duty (SSD) payable = $700,000	0·5	
Jointly and severally by purchaser and seller	0·5	
	14·5	12
(b) Tax implications arising from Property B		
Salaries tax and profits tax implications		
If property used exclusively as place as residence	0·5	
Loan interest deductible as home loan interest	0·5	
Based on period of eligible residency	0·5	
Low-interest loan sole liability of employer not taxable	0·5	
Benefit not convertible into cash	0·5	
Whether profit on sale subject to profits tax	0·5	
Self-use not trading in nature	0·5	
Moved out after short period of occupancy	0·5	
Renovation to add value to property	0·5	
Unless sufficient reason to justify a genuine move-out	0·5	
Otherwise change of intention from investment to profit-making	0·5	
Market value at time of change deemed as cost base (s.15BA)	1·0	
Excess of disposal price over cost base taxable at 15%	0·5	
Stamp duty implications		
Agreement for sale and purchase subject to stamp duty	0·5	
Why AVD at Scale 1 (Part 1) rates apply	1·0	
AVD payable = $1,050,000	0·5	
Fixed duty of $100 on assignment	0·5	
Why BSD not chargeable	0·5	
SSD payable = $900,000	0·5	
	10·5	8
		20

			Available	Maximum
4	**(a)**	**Chargeability to profits tax**		
		Profits tax scope of charge: s.14(1)	0·5	
		Place of incorporation is irrelevant	0·5	
		Business carried on in Hong Kong (HK) if centrally managed/controlled in HK	0·5	
		Directors' meetings	0·5	
		Profits are sourced in HK	0·5	
		Broad guiding principle	1·0	
		Qualifying aircraft leasing eligible for tax concession	1·0	
		Standalone business of aircraft leasing	0·5	
		Not an aircraft operator	0·5	
		Owner of aircraft	0·5	
		Dry lease	0·5	
		Central management and control (CMC) in HK	0·5	
		Substantial activity in HK	0·5	
		No permanent establishment outside HK	0·5	
		Leasing income deemed taxable despite use outside HK (s.15(1)(n))	1·0	
		Basis of assessment		
		One-half of corporate tax rate, i.e. 8·25%	1·0	
		20% of gross lease payments less deductible expenses	1·0	
		Incidental income included	0·5	
		Written election and irrevocable	0·5	12
	(b)	**Tax depreciation allowance**		
		Capital expenditure not allowed as deduction	0·5	
		30% annual allowance and 60% initial allowance	1·0	
		Reducing balance	0·5	
		Denied if lessee is not HK aircraft operator (s.39E)	1·0	
		Or if financed by non-recourse debt	1·0	
		No depreciation for Skybird if non-HK operator or concession regime	1·0	5
	(c)	**Expense deductibility**		
		General deduction rule (s.16(1))	0·5	
		Non-capital nature	0·5	
		Service fee deductible	0·5	
		Before 20% tax base	0·5	
		Withholding tax deductible if gross-based and income taxable	1·0	3
				20