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 Flower Group Ltd

To: The directors, Flower Group Ltd
From: Tax adviser
Date: June 2020
Subject: Setting up subsidiary in Hong Kong

I refer to our earlier meeting during which we discussed the proposed set-up of a wholly-owned subsidiary in Hong Kong. Following is the analysis of certain issues of the Hong Kong tax implications to Flower Group Ltd (Flower) arising from the proposal.

(a) (i) Permanent establishment

Under s.14(1) of the Inland Revenue Ordinance (IRO), Hong Kong profits tax is imposed on any person who 'carries on a trade, profession or business in Hong Kong and derives profits that are arising in or derived from Hong Kong'. Amongst the aforesaid conditions for charging the tax, 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. Companies incorporated in foreign jurisdictions may still be regarded as carrying on business in Hong Kong if business activities are carried on in Hong Kong whether or not through a permanent establishment ('PE') in Hong Kong.

Given that Flower and HK-Sub are residents in Singapore and Hong Kong respectively, and there is no double tax agreement signed between Singapore and Hong Kong, reference should be made to s.50AAC(5) and Schedule 17G of the IRO in ascertaining whether Flower has a PE in Hong Kong by virtue of the establishment of HK-Sub. Based on s.50AAC(5), a PE is, broadly speaking, regarded as existing in Hong Kong if a foreign entity maintains a fixed place of business in Hong Kong through which its business is wholly or partly carried on, or a person acts in Hong Kong on behalf of the foreign entity and the person habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts routinely without major modification. For 'fixed place of business', it includes but is not limited to place of management, branch, office, factory, workshop and a mine/oil or gas well/quarry/other place of extraction of natural resources. It also includes a building site or construction or installation project which extends beyond 12 months.

In any circumstances, the fact that the foreign entity controls or is controlled by another entity in Hong Kong, such as a holding company and a subsidiary, does not of itself constitute either entity being a PE of the other.

(ii) Flower is setting up a subsidiary in Hong Kong (HK-Sub), and goods will be purchased by HK-Sub from the Hong Kong supplier and sold to Flower at a margin by HK-Sub. HK-Sub is therefore doing business with Flower as a separate legal entity on a principal-to-principal basis. Provided that HK-Sub is not acting on behalf of Flower or habitually concludes contracts or plays the principal role leading to the conclusion of contracts routinely on behalf of Flower, HK-Sub is not regarded as a PE of Flower in Hong Kong.

Accordingly, Flower is not regarded as carrying on business 'in' Hong Kong, but 'with' Hong Kong only. Any profits earned from the buying of the goods from HK suppliers and selling of the goods to Flower will be accounted for by HK-Sub and subject to profits tax in Hong Kong by HK-Sub if the profits are sourced in Hong Kong.

(b) Transfer pricing risk to HK-Sub

(i) A transfer price is the price charged in a transaction between two associated persons (Departmental Interpretation and Practice Note No. (DIPN) 59). The arm's length principle refers to the basis under which the profits which would have arisen from the transaction between associated persons should be determined making reference to the profits from similar transactions between independent persons (DIPN 59).

(ii) Based on the recently enacted transfer pricing rules under s.50AAF, if the following circumstances occur, a transfer pricing risk arises and the Inland Revenue Department (IRD) may take action to re-compute the profit or loss of the 'advantaged person' based on the arm's length value for the transaction:

(1) There is an actual provision between two 'affected persons';

(2) Participation conditions as defined in s.50AAG apply to the 'affected persons', i.e. the 'affected persons' are associated in terms of management, control or capital;

(3) The pricing for the provision between the 'affected persons' is not at arm's length;

(4) The actual provision confers a potential advantage in relation to HK tax on an 'affected person', the so-called 'advantaged person'. Based on s.50AAJ, a potential advantage exists if, in general, profit is understated or loss is overclaimed.

(iii) In the case of HK-Sub, if it sells goods to Flower (which is its wholly owned parent), circumstances (1) and (2) above are satisfied. If the sale is priced at 10% above market price, the pricing would be regarded as not at arm's length, meeting circumstance (3) above. However, the pricing would cause HK-Sub to generate income which is higher than ordinary, indicating that there is no potential HK tax advantage for HK-Sub. As a result, circumstance (4) above is not met.

It is not likely that the pricing will be challenged by the Hong Kong IRD under transfer pricing rule.

(c) Transfer pricing methodologies

Based on OECD guidelines, there are five methodologies which may help ascertain the arm's length price in an associated transaction. The methodologies are:

(1) comparable uncontrolled price (CUP) – making reference to the price used for a transaction with an independent party. There are internal CUP and external CUP. For internal CUP, the price between the independent party and either party involved in the associated transaction is used as reference. For external CUP, the price between two independent parties without any involvement by the associated parties would be used as reference.

(2) cost-plus – making reference to the mark-up % above cost based on the industry practice.

(3) resale – making reference to the commonly accepted profit margin included in the sale price.

(4) profit-split – making reference to the aggregated profit earned by all associated entities within the same group and allocating the profit into respective associated entities based on the contributions (functions, assets, risks) made by each associated entity.

(5) transactional net margin (TNM) – making reference to the financial ratio (such as profit-asset ratio) common to the relevant industry and applying the ratio to the associated entities.

(d) Funding options

The following two funding options are discussed and analysed:

(i) Option 1: Interest-bearing loan from Flower to HK-Sub

When Flower injects funding into HK-Sub in the form of an interest bearing loan, an interest expense will be incurred by HK-Sub and interest income will be earned by Flower.

Whether Flower would be taxable in Hong Kong in respect of the loan interest income earned depends first on whether Flower is considered as carrying on business in Hong Kong and if so, whether the interest is derived from a source in Hong Kong (s.14(1) and s.15(1)(f)).

For a non-resident like Flower, it is carrying on business in Hong Kong if Flower 'puts its assets into gainful use in Hong Kong' by transferring the funds to be lent to HK-Sub via any location in Hong Kong, e.g. a bank account in Hong Kong owned by it or its agent (the *Bartica* case) or carries on business activities through an agent or a 'permanent establishment' in Hong Kong.

Otherwise Flower will not be carrying on business in Hong Kong and the loan interest income would not be taxable in Hong Kong.

If Flower is carrying on business in Hong Kong, its loan interest income would be taxable only if it is sourced in Hong Kong. Source of interest income is usually determined by the place where the loan credit is first made available to the borrower (the so-called 'provision of credit' test).

If the source is in Hong Kong, the loan interest income would be taxable provided that Flower is deemed as carrying on business in Hong Kong.

From the perspectives of HK-Sub, the Hong Kong tax deductibility of the interest expense incurred on the loan will depend on:

(1) whether the loan interest is incurred in the production of assessable profits (s.16(1)), by having the loan money used for the production of assessable profits (s.16(1)(a);

(2) whether the borrowing, being a loan from a person other than a financial institution, generates interest income which is chargeable to profits tax in Hong Kong in the hands of that person (s.16(2)(c)); or the loan is used to finance acquisition of trading stock or plant and machinery and the lender is not an associate of the borrower (s.16(2)(e)); and

(3) if all of the above are satisfied, whether the deduction amount will be restricted under the 'secured loan test' (s.16(2A)) or 'interest flow back test' (s.16(2B)).

In the case of HK-Sub, provided that the loan money is to be applied in funding HK-Sub's operation which generates income subject to tax in Hong Kong, the first condition under s.16(1) and (1)(a) is satisfied. As regards the second condition under s.16(2)(c)), it would only be fulfilled if Flower is taxable in Hong Kong on the interest income received.

If Flower does not carry on business in Hong Kong, the interest income in its hand would not be taxable in Hong Kong. As a result, the same interest payable by HK-Sub would not satisfy s.16(2)(c) and thus not be deductible.

The alternative condition for an interest deduction under s.16(2)(e) will also not be satisfied, because Flower (the lender) is the shareholder of HK-Sub and thus will be considered as an 'associate', even though the loan may be used by HK-Sub to acquire plant or machinery or trading stock. As a result, it is likely that HK-Sub will not be allowed a tax deduction on the loan interest paid to Flower.

(ii) Option 2: Interest-bearing loan from HK bank to HK-Sub, secured by deposit from Flower with the same bank

Under this option, Flower would place a deposit with the bank in Hong Kong to secure a loan extended from the bank to HK-Sub. Bank interest income will be earned by Flower and bank loan interest expense is incurred by HK-Sub.

The taxability of bank interest income earned by Flower is the same as option 1, i.e. Flower is only possibly subject to Hong Kong tax on the interest income if and only if Flower is carrying on business in Hong Kong and the interest arises from Hong Kong (s.14(1) and s.15(1)(f)).

By placing a time deposit in Hong Kong, Flower is putting its asset into gainful use in Hong Kong and should possibly be regarded as carrying on business in Hong Kong (the *Baritca* case). The interest income from the time deposit therefore falls under s.14(1) and is assessable. It is necessary to see if the tax payable on such interest income could be exempt from profits tax by virtue of the Exemption from Profits Tax (Interest Income) Order (the Order) granted under s.87 of the IRO.

According to s.2(2) of that Order, the exemption is not allowable in respect of interest where the condition for the application of s.16(1)(a) of the IRO is satisfied under s.16(2)(c), (d) or (e) of the IRO and s.16(2A) of the IRO does not apply. Section 16(2A), as further explained below, does apply in this case. In such scenario, the interest income on the deposit is chargeable and taxable.

[**Tutorial note:** *If Flower places the deposit with a bank outside Hong Kong, the interest income from that deposit is not chargeable to tax because the provision of credit is not in Hong Kong, and there is no question of whether the Order should apply or not.*]

From the perspective of HK-Sub, the deductibility of interest expense is subject to various conditions including the general deduction rules under s.16(1) and s.16(1)(a), s.16(2)(d) and the restrictions under s.16(2A) and s.16(2B). Assuming that the bank loan money is used by HK-Sub to finance its profit-generating business in Hong Kong, both s.16(1) and s.16(1)(a) are satisfied. While the loan is borrowed from a bank in Hong Kong, the interest payable would be eligible for deduction under s.16(2)(d).

The bank loan is secured on a deposit placed by Flower and it is necessary to see if the deduction is restricted by s.16(2A). Under the restriction rule of s.16(2A), the extent of interest deduction to HK-Sub would be reduced, in practice, by the amount of non-taxable interest income received by Flower on the deposit used as security.

If the deductible bank interest expense to HK-Sub exceeds the non-taxable interest income to Flower, the excess would still be allowed as a tax deduction to HK-Sub. However, if the non-taxable interest income exceeds the deductible interest expense, no interest deduction is allowed to HK-Sub.

In this case, Flower places the deposit with a bank in Hong Kong, as aforesaid, interest income from the deposit is not exempted from profits tax by virtue of the Order. Hence, s.16(2A) does not apply to reduce the deduction of interest expense allowable to HK-Sub. As a matter of reality, this is a commercially sound arrangement only if the interest income exceeds or equals the interest expense, both computed on after-tax bases and HK-Sub has sufficient assessable profits to absorb the interest expenses for the years during which this arrangement exists. Please check the interest rates for the deposit and the loan available and the profitability of HK-Sub during which this arrangement exists.

We trust the above has addressed all the related tax concerns. Should there be any questions, please let us know.

End of Report

2 Simon and Annie

(a) Section 8(1) imposes salaries tax on income arising in or derived from Hong Kong from any office or employment of profit. If the location or source of a person's office or employment is in Hong Kong, any income arising from that office or employment is chargeable to salaries tax except those specifically exempted. If the source of a taxpayer's income from employment is outside Hong Kong, they are chargeable to salaries tax only on income derived by them from services rendered in Hong Kong (s.8(1A)(a)).

Section 8(1A)(b) provides an exemption for employment where all services are rendered outside Hong Kong. For this purpose, services rendered in Hong Kong only during visits of not more than 60 days are ignored (s.8(1B)). However, this 60-day rule only applies to an employee who is a 'visitor' during their stay in Hong Kong, and does not apply to a person who is employed by the Government or as master or member of the crew of a ship or as commander or member of the crew of an aircraft. Instead, income derived from services rendered by a seaman or aircrew will be exempt from tax if they are present in Hong Kong for not more than:

(i) a total of 60 days in the basis period for that year of assessment; and

(ii) a total of 120 days falling partly within each of the basis periods for any two consecutive years of assessment, one of which is that year of assessment (s.8(2)(j)).

Simon's employment with Panda Ltd (Panda) and directorship with Moose Corp (Moose)

The situs of Simon's employment has to be examined to determine if his employment with Panda is a Hong Kong employment or non-Hong Kong employment. Based on the *Goepfert's* case, an employment is a non-Hong Kong employment if all of the following conditions are satisfied:

(1) Hong Kong is not the place where the contract of employment was negotiated, entered into and enforceable;

Although the contract was emailed to Canada but not signed by Simon, the original contract was subsequently signed by both parties in Hong Kong when Simon arrived there. The contract was entered into in Hong Kong and enforceable in Hong Kong. Hence this condition is not satisfied.

(2) Hong Kong is not the place of residence of the employer;

Simon has an employment with Panda and he also holds an office with Moose, in Canada. Whether Panda is a resident of Hong Kong is first determined by where its central management and control is exercised and this is *prima facie* determined by where its board of directors' meeting(s) is (are) held in the year of assessment. It could also be determined by finding where its substantial business is carried on. In this case, there is no indication that Panda has any activities outside Hong Kong. Hence Panda is apparently resident in Hong Kong and this condition is apparently not satisfied.

(3) Hong Kong is not the place where the employee's remuneration is paid.

On the facts, Simon's monthly salary was paid partly in Canada and partly in Hong Kong. In principle, this condition is only partly satisfied. The Inland Revenue Department (IRD) in practice does not see this point as critical (Departmental Interpretation and Practice Note No. (DIPN) 10), and would likely regard the location at which the larger portion of the salary is received as the source. In this case, it is Hong Kong.

On the basis of the above analysis, Simon's employment with Panda should be a Hong Kong employment. All of his employment income should be chargeable to salaries tax under s.8(1)(a), unless relieved by other provisions in the Inland Revenue Ordinance.

Simon's directorship of Moose is an office, so the situs of this income is determined by the place where the office legally exists. In *McMillan* v *Guest* (24 TC 190), it was held that the office of a director is located at the place where the control and management of the corporation is exercised. Assuming the directors' meetings of Moose were held in Canada, the central management and control of Moose was not in Hong Kong. The director's fee payable by Moose to Simon is not sourced in Hong Kong and is thereby not chargeable to salaries tax under s.8(1)(a). This is true regardless of whether or not Simon went back to Canada for the directors' meetings.

Annie's employments with the Hong Kong Government and Dragon Airways

Annie's employments with the Hong Kong Government and Dragon Airways were both Hong Kong employments chargeable to salaries tax for reasons mentioned above, unless she qualified for the exemption available to aircrew under s.8(2)(j).

(b) Simon's tax claims

Simon claimed that during the year of assessment 2017/18, he should not be chargeable to salaries tax since he did not work in Hong Kong for more than 60 days in that year. As the employment is located in Hong Kong, the employment income is fully taxable unless Simon renders all his services outside Hong Kong (s.8(1A)(b)). For this purpose, services rendered in Hong Kong during visits not exceeding 60 days are ignored (s.8(1B)). Although Simon stayed in Hong Kong for only 45 days (15 February to 31 March 2018), the stay was the beginning of a long period of residence in Hong Kong and is neither short nor temporary. His presence therefore does not come within the ordinary meaning of the word 'visit' and s.8(1B) does not apply to ignore his services during the 45 days. Hence his claim for exemption under s.8(1A)(b)(ii) fails.

For the years of assessment 2018/19 and 2019/20, his claim that his income attributable to services rendered in China and Singapore should be exempt from tax would fail because his employment is a Hong Kong-sourced employment and the 'day-in-day-out' apportionment of income is not applicable.

The 60-day rule will not apply to Simon because he is not likely to be regarded by the IRD as a visitor, given that his work base and family base are in Hong Kong. Even if the IRD is convinced that he is a visitor only, he will still be subject to tax in Hong Kong on the whole of his employment income on the basis that he stayed and worked in Hong Kong for more than 60 days in each of the two years 2018/19 and 2019/20.

In respect of the income attributable to services rendered in the Mainland on which China tax had been paid for the year of assessment 2018/19, since the double taxation arises in the Mainland with which Hong Kong has a double tax arrangement (DTA) and Simon can claim tax credit relief under the DTA, the outright exemption under s.8(1A)(c) is no longer available (s.8(1C)). Instead, Simon has to claim the relief from double taxation under s.50 by crediting the China tax paid against the Hong Kong salaries tax payable. The amount of tax credit available has to be calculated according to s.50. As confirmed by examples in DIPN 44 (revised), the amount of China tax to be eligible for credit against Hong Kong tax is not necessarily the same amount as the China tax paid. The tax credit amount needs to be recalculated taking into account the different tax rates applicable in China and Hong Kong.

In respect of the income derived from services rendered in Singapore for the year of assessment 2019/20, as he has paid tax in Singapore which is a non-DTA territory, he qualifies for the exemption under s.8(1A)(c), which excludes income from services rendered outside Hong Kong if the taxpayer is chargeable to tax in a non-DTA territory in which services are rendered, and tax of substantially the same nature as salaries tax in Hong Kong has been paid in respect of the income attributable to the services rendered in that territory.

As regards the deduction of China tax and Singapore tax, the taxes paid would not be deductible under s.12(1)(a) as they were not incurred to earn the assessable income. As regards the Canadian tax, since the directors' fees would not be brought into charge under Hong Kong salaries tax, the Canadian tax relating to this directors' fee would not be deductible either.

(c) Annie's claims

Annie's claim that she was liable to Hong Kong salaries tax only to the extent of income derived from services rendered in Hong Kong would fail because her employments are Hong Kong-sourced employments and the 'day-in-day-out' apportionment of income is not applicable. However, as a flight attendant, Annie may be exempt from tax if she satisfies the conditions in s.8(2)(j).

Annie's salaries tax positions for the years of assessment concerned are therefore as follows:

Year of assessment	No. of days present in HK	
2018/19	45	(fully exempt)
2019/20	70	(fully liable)
	115	

The presence during 1 April 2018 to 31 August 2018 is not to be taken into account for the purpose of s.8(2)(j) because during this period she did not derive her income as a flight attendant.

For the period from 1 May 2018 to 31 August 2018, she derived income from the Hong Kong government. Since this is a Hong Kong employment, the total of her income will be taxable under s.8(1)(a).

3 P Ltd, A Ltd and B Ltd

(a) Profit from the sale of shares in B Ltd

Where profits arise from a trade, profession or business carried on in Hong Kong and the profits so derived are derived from Hong Kong, profits tax will be charged, unless the profits arise from the sale of capital assets (s.14). Whether the $5 million profit from the sale of the B Ltd shares by A Ltd can be regarded as capital in nature and thus excluded from tax will depend on whether or not the sale is considered as constituting a 'trade' or an 'adventure in the nature of trade'. This issue is contentious and subject to the merits of each case. The courts in decided cases usually, and so does the Inland Revenue Department, examine the case at issue by reference to the so-called 'badges of trade', as follows:

(1) Subject matter of the transaction – Shares may be held for long-term income-generating purposes, or for short-term speculation. A Ltd's principal line of business is trading in properties while B Ltd has carried on a business of trading in listed securities. Apparently holding the shares in B Ltd is a separate line of business for A Ltd. In consequence, A Ltd's past record of trading in properties has little relevancy here.

(2) Length of the ownership period – The shorter the period of ownership, the more likely that the transaction is trading. A Ltd was the founding shareholder of B Ltd and has held the shares for 20 years.

(3) Frequency of similar transactions – The higher the frequency, the more likely that the transaction is trading. Information is not provided as to whether A Ltd has undertaken any previous transactions in shares.

(4) Supplementary work done – If additional work has been performed to enable the asset to be sold at a better profit, a trading intention would be implied. Primarily, no supplementary work has been done on the shares before they are sold.

(5) Circumstances leading to the sale – Whether due to an increase in share price or other non-profit making reason. The sale of the shares in B Ltd has been triggered by a commercial reason, i.e. the restructuring of the group.

(6) Motive – Any motive to make a profit from a resale would constitute a 'trading' purpose.

The transaction in issue is either a trading one (acquisition and disposal of trading stock) or a non-trading one (acquisition and disposal of non-trading stock, i.e. a capital asset). An asset is either a trading asset or a capital asset but not both to its owner at any particular point of time.

Judging from the facts of this case, it can be reasonably inferred that the shares in B Ltd are not trading stock to A Ltd having regard to the 20-year ownership period, there is no track records of its acquisition and disposal of shares and more importantly, the disposal was a result of group restructuring in consequence of which the shares go back to P Ltd, the ultimate shareholder. Hence, the relevant shares in B Ltd would not likely be considered as the trading stock of A Ltd and so, the profit which will be derived from the sale of the shares would likely be accepted as profit from sale of capital assets and are thereby not chargeable to profits tax.

(b) Profits tax treatment of trading stock of A Ltd upon liquidation

Upon liquidation, the properties held as trading stock by A Ltd at the date of cessation need to be valued for the purpose of computing the profits of A Ltd according to s.15C.

Property X will be sold to a director for valuable consideration and the director will deduct the cost in computing his profits chargeable to tax. Therefore Property X will be valued at the amount realised on the sale or the value of the consideration given for the transfer, i.e. $17 million. Given that the selling price is $1 million less than the fair market value known to A Ltd, there is some chance that an assistant commissioner of the Inland Revenue Department may see that the pricing renders the sale falling within the scope of s.61A. Section 61A is an anti-avoidance provision which empowers the assistant commissioner to make an assessment counter-acting any tax benefits which might otherwise arise, in this case assessing the profit as if the sale had been made at $18 million. That the shortfall in the selling price will be mirrored by an increase in profit by the director, the ultimate shareholder who is an individual, upon sale is relevant but not a conclusive defence. There was a deferment in A Ltd's tax liability unless the director immediately resold the property in issue. A Ltd might argue that selling to a director is easier than selling in the open market and there could be savings in brokerage which is usually 1% on the selling price. The reduction in tax liability to A Ltd is relatively small. In the end, it is up to the assistant commissioner and on appeal the appellate body to decide if the sale pricing is a tax avoidance attempt.

Property Y will be distributed to the shareholder, P Ltd. Property Y should be valued at the amount which would have been realised if the property had been sold in the open market at the date of cessation, i.e. $16 million.

(c) Stamp duty implications

B Ltd is a company incorporated in Hong Kong, hence its register of members should be kept in Hong Kong and the shares in B Ltd are Hong Kong stock for the purposes of the Stamp Duty Ordinance (s.2(1)). The transfer of the shares in B Ltd is therefore, *prima facie*, subject to stamp duty on the sale and purchase contract notes at 0·2% of the dutiable value and on the instrument of transfer at $5 (s.19(1); Heads 2(1) and 2(4) respectively). The dutiable value will be $100 million. If the market value of the shares is higher than $100 million, then stamp duty will be levied on the higher market value.

A transfer of stock within a corporate group where the transferor and transferee are associated corporations may be exempt from stamp duty (s.45). Two corporations are associated if one is the beneficial owner of not less than 90% of the other, or a third corporation is the beneficial owner of not less than 90% of each of the transferor and transferee. The fact that the parent, P Ltd, is incorporated outside Hong Kong does not mean that the exemption does not apply. In this case, A Ltd is 100% held by P Ltd. Therefore, A Ltd and P Ltd are associated, and stamp duty exemption may be available. Adjudication by the Collector is required (s.45(3)).

However, the exemption under s.45 will not be available if, as part of the arrangement, the transferor and transferee will cease to be associated by reason of a change in the percentage of the issued share capital of the transferee held by the transferor or a third corporation. Even if such an arrangement is not in existence at the time of the transfer, if the transferor and transferee cease to be associated within two years for the same reason, the stamp duty exemption previously granted will be 'clawed back' and stamp duty becomes payable.

As a result of A Ltd's liquidation, P Ltd will no longer hold any shares in A Ltd and thus, strictly speaking, A Ltd and P Ltd will no longer be associated. However, a disqualification of the s.45 exemption is made by reference to a change in shareholding by the transferee, i.e. P Ltd. Thus, any change in the shareholding of the transferor, i.e. A Ltd, should not affect the s.45 exemption.

Therefore, on an application under s.45, the restructuring should not give rise to any stamp duty liability and the subsequent liquidation of A Ltd should not impact this stamp duty exemption.

Upon liquidation, the liquidator will sell Property X, a residential property (RPPT), to a director. 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), which is chargeable to *ad valorem* duty (AVD). With effect from 5 November 2016, Scale 1 AVD rates are divided into Part 1 and Part 2. Part 1 of Scale 1 applies to instruments of RPPT and Part 2 of Scale 1 applies to instruments of non-RPPT and certain instruments of RPPT executed on or after 23 February 2013 but before 5 November 2016. Since the director acquires the RPPT, Part 1 rate (15%) will apply.

The dutiable value is usually based on the transaction price or consideration, unless the consideration is below the market price, in which case the property market value would be used for stamping purposes. Since Property X is transferred at a price below the market price, because of the inadequacy of the consideration, the transfer is regarded as a voluntary disposition *inter vivos* (s.27(4)). As such, stamp duty is chargeable on the market value of the property transferred (s.27(1)). Therefore, the stamp duty payable will be 15% on $18 million, i.e. $2·7 million. Where the AFS is stamped, the subsequent formal assignment or conveyance executed in conformity with the stamped AFS will be chargeable to a fixed duty of $100.

In addition, special stamp duty (SSD) will be imposed, because the transaction relates to a RPPT which was acquired by A Ltd after 27 October 2012 and disposed of within 36 months (s.29CA and s.29DA). The SSD payable will be $1·8 million ($18 million at 10%).

Finally, Property Y will be distributed *in specie* to its only shareholder, P Ltd. Because it lacks any valuable consideration, such a distribution would normally be deemed to be a voluntary disposition *inter vivos* (s.27(4)) and the instrument of transfer effecting such a transaction would have been chargeable to stamp duty (Head 2(3)). However, a distribution *in specie* of A Ltd's asset to its shareholder in the course of liquidation will not involve any change of beneficial interest in the property transferred (see *Wigan Coal* & *Iron Co Ltd* v *IRC* [1945] *1 All ER 392*). As such, the instrument of transfer will be exempt from a charge to stamp duty (s.27(5)).

4 Star (HK) Ltd ('Star')

(a) Galaxy – Trademark acquired

Galaxy is an intellectual property acquired by Star for use in the manufacturing of a new product for sale. Galaxy is a capital asset to Star. Under the Inland Revenue Ordinance, capital expenditure is by general principle (s.17) not tax deductible. However, by virtue of s.16EA, capital expenditure incurred on the acquisition of a trademark is tax deductible subject to the conditions below. The tax deduction is granted over five successive years on a straight-line basis, starting from the year of acquisition. To qualify for the deduction, the following conditions must be fulfilled:

(1) The trademark must have been registered (s.16EA(11)). Moreover, documentary evidence must be submitted to substantiate that a change of ownership has been applied.

(2) The acquisition must be an outright purchase of both the legal and economic ownership (or proprietary interest) in the trademark. No deduction is allowed if the payment is only for acquiring the right to use the trademark for a specified period (s.16EA(13) and s.16EC(8)).

(3) The trademark must have been used in the production of profits chargeable to tax in Hong Kong in each of the basis periods of the years of assessment in which the deduction is claimed. If the trademark is not put into use during any intermittent year after acquisition, or the trademark is only partly put into use to produce Hong Kong chargeable profits, apportionment is required.

(4) The trademark must not have been acquired wholly or partly from an 'associate', irrespective of whether or not the price is at arm's length. Under s.16EC(8), an 'associate' includes an associated corporation, any person in control, any partner (and his/her relatives) of a person who is in control, any director or principal officer (and his/her relatives) or its associates.

In Star's case, provided that all the above conditions have been satisfied, the cost of acquiring trademark Galaxy will qualify for a tax deduction under s.16EA, at 20% each year, for five years.

Nebula – Licensed design and royalties

Nebula is a design which is intellectual property to be licensed from a Korean company. A royalty is payable by Star at 2% of quarterly sales of products bearing the design.

An expense or outgoing is deductible to the extent it is incurred in the production of assessable profits under s.16(1), and the expense must not be capital in nature (s.17(1)(c)). As Star's sale income of products bearing the design Nebula is assessable to profits tax in Hong Kong, therefore the royalty paid for licensing the design would be tax deductible (s.16(1)).

The royalty income receivable by the Korean licensor is deemed as assessable in Hong Kong under s.15(1)(b) or s.15(1)(ba), The scenario states that the Korean licensor does not carry on business in Hong Kong, so s.14 does not apply to the Korean licensor.

Section 15(1)(b) would apply if the trademark is used in Hong Kong, and s.15(1)(ba) would apply if the trademark is used outside Hong Kong but the royalty payment is claimed by Star as a tax deduction from Star's assessable profits. Given that the royalty is deemed taxable in Hong Kong, Star, being the payor of the royalty, would be obliged under s.20B to withhold the relevant tax amount from the money due to the Korean licensor, to file the tax return reporting the amount of royalty paid and tax withheld, and pay the tax amount to the IRD upon receiving the relevant notice of assessment on behalf of the Korean licensor.

(b) Noah – R&D

Noah is an intellectual property (IP) created and developed by Star itself through the engagement of an R&D institution. The costs incurred in self-developing the IP are not deductible under s.16E or s.16EA as the IP was not 'acquired' by the taxpayer. However, provided that the costs incurred are qualifying R&D expenditure under s.16B, and the related income earned from the application of the IP is taxable in Hong Kong, the related R&D costs would be eligible for tax deduction as a 'Type B expenditure' which, subject to further conditions, qualifies for the enhanced tax deduction at 300% for the first $2 million and 200% for the balance.

To qualify for the enhanced tax deduction, the R&D activity must be related to the taxpayer's trade, profession or business or the class of trade, profession or business to which the taxpayer belongs. The related R&D expenditure must be qualifying Type B expenditure as defined in Schedule 45 of the Inland Revenue Ordinance and must be wholly undertaken and carried on in Hong Kong.

Capital expenditure incurred on plant and machinery used in R&D activities is also deductible in full under s.16B, despite that expenditure being capital in nature.

In the case of Star, provided that the R&D activity and its related expenditure fulfils the above conditions, Star is able to claim the tax deduction based on 300% for the first $2 million and 200% for the remaining balance of $800,000 ($2,800,000 – $2,000,000). The expenditure spent on plant and machinery for use in the R&D activity is also eligible for the deduction.

[**Tutorial note:** *The cost of land and buildings used in R&D activities does not qualify for an outright deduction but the qualifying expenditure is eligible for industrial building allowances or commercial building allowances, as applicable.*]

				Available	Maximum
1	**(a)**	**(i)**	**Permanent establishment**		
			S.14 scope of profits tax charge	1·0	
			Fixed place of business through which business is carried on	0·5	
			Place of incorp not relevant	0·5	
			Non-res cos. can carry on business in HK without having a PE	0·5	
			Define PE; fixed place of business	0·5	
			Or, person acts in HK on behalf of foreign entity	0·5	
			Habitually concludes contracts or plays principal role	0·5	
			Includes place of management, branch, office, factory	0·5	
			Holding company and subsidiary not PE	0·5	
				5·0	4
		(ii)	**Carrying on business in HK**		
			HK-Sub is separate legal entity	0·5	
			Principal-to-principal basis	0·5	
			Not acting on behalf of Flower: own contracts	0·5	
			HK-Sub not PE	0·5	
			Flower not carrying on business in HK	1·0	
			Trading profits by HK-Sub	0·5	
				3·5	3
	(b)	Transfer pricing risk to HK-Sub			
		(i)	**Definitions**		
			Definition of transfer pricing	1·0	
			Definition of arm's length principle	1·0	2
		(ii)	**Circumstances for transfer pricing risk** (4 factors)		4
		(iii)	**Analysis of pricing between HK-Sub and Flower**		
			All risk factors are met except 'potential advantage'		
			HK-Sub has higher income, no potential advantage		
			Therefore, no transfer pricing risk to HK-Sub		
			Not likely challenged to IRD		3
	(c)	Transfer pricing methodologies			
		CUP		2·0	
		Cost-plus		0·5	
		Resale		0·5	
		Profit-split		1·0	
		TNM		1·0	5
	(d)	Funding options			
		(i)	**Option 1: interest bearing loan**		
			Flower is taxable if carrying on business in HK	0·5	
			And loan interest is sourced in HK	0·5	
			Puts its assets into gainful use in HK	0·5	
			PE in HK	0·5	
			Not taxable if not carrying on business in HK	0·5	
			Place where loan credit is first made available to borrower	0·5	
			Provision of credit test	0·5	
			HK-Sub deductible if in the production of assessable profits	1·0	
			If loan interest income is taxable by Flower	0·5	
			Or if loan is for trading stock or plant/machinery but not associate	0·5	
			If not restricted by secured loan test or interest flow-back test	0·5	
			If Flower is not taxable, HK-Sub not deductible	1·0	
			S.16(2)(e) not applicable as Flower is associate	0·5	
				7·5	7

		Available	Maximum
(ii)	**Option 2: bank loan with security**		
	Is Flower carrying on business in HK	0·5	
	If Flower is taxable, 1998 exemption order not applicable due to security	0·5	
	HK-Sub deductible if in the production of assessable profits	0·5	
	Bank loan interest is deductible under s.16(2)(d)	0·5	
	Restricted by non-taxable interest earned by Flower	0·5	
	Excess of interest expense over interest income is deductible	0·5	
	Otherwise, no deduction	0·5	
		3·5	3

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

2 Simon and Annie

		Available	Maximum
(a)	Scope of charge – basic and extended	2·0	
	The 60-day rule (exemption under ss.8(1A)(b) and (1B))	1·0	
	Not applicable to government employees, seamen and aircrew	0·5	
	Exemption to seamen and aircrew under s.8(2)(j)	1·0	
	Simon's employment with Panda and directorship with Moose		
	Source of income from employment		
	Three factors in *Goepfert* case	2·0	
	Conclusion: HK employment, fully taxable	1·0	
	Source of income from office – foreign office	2·0	
	Annie's employments with HK Government and Dragon Airways		
	HK employments fully chargeable to salaries tax	1·0	
	Unless qualifies for the exemption under s.8(2)(j)	0·5	
		11	9
(b)	**Simon's tax claims**		
	1st claim		
	Exemption under s.8(1A)(b) and s.8(1B)	1·0	
	Start of long period of stay – not visit and no exemption for 2017/18	2·0	
	2nd claim		
	HK employment, no time apportionment and fully taxable	1·0	
	Income attributable to services rendered in China and Singapore not exempt	1·0	
	Not 'visit', stays > 60 days	1·0	
	S.8(1A)(c) exemption not applicable to income from services rendered in China, a DTA territory	1·0	
	Claim the tax credit relief under s.50	1·0	
	Tax credit amount recalculated taking into account the different tax rates	1·0	
	S.8(1A)(c) applies to exclude income from services rendered in Singapore	2·0	
	China tax and Singapore tax paid not an allowable deduction	1·0	
	Directors' fee not chargeable and Canadian tax paid not deductible	1·0	
		13	12
(b)	**Annie tax claims (3rd claim)**		
	Government employee, fully taxable	1·0	
	HK employment with Dragon Airways, no time apportionment	1·0	
	S.8(2)(j) exemption		
	2018/19 fully exempt	1·0	
	2019/20 fully taxable	1·0	4
			25

		Available	Maximum
3	**P Ltd, A Ltd and B Ltd**		
(a)	Profit on the sale of capital assets not taxable	0·5	
	Trade or adventure in the nature of trade	0·5	
	Consideration of badges of trade	5·0	
	Conclusion: no trading intention, not taxable	1·0	
		7·0	6
(b)	On cessation, trading stock valued for computing profits	0·5	
	Property X sold to a director who will deduct the cost in computing his chargeable profits – valued at consideration given for the transfer	1·0	
	Application of s.61A	1·0	
	Property Y distributed to shareholder – valued at market value	1·5	
		4·0	3
(c)	**Stamp duty**		
	Shares of HK company are HK stock	0·5	
	Rates of duty payable: 0·2% and $5	0·5	
	Dutiable value is $100m	0·5	
	Stamp duty on market value if higher	0·5	
	Section 45 exemption for associated corporations	0·5	
	90% holding required	0·5	
	A Ltd and B Ltd are associated	0·5	
	P Ltd being incorporated overseas not relevant	0·5	
	Adjudication required	0·5	
	Exemption not available if ceased to be associated within two years	0·5	
	Effect of the liquidation of A Ltd on s.45 exemption	1·0	
	Conclusion	1·0	
	Sale of Property X to a director		
	AFS liable to AVD at Part 1 of Scale 1	1·0	
	Transfer below market value regarded as a voluntary disposition *inter vivos*, chargeable on market value	1·0	
	Stamp duty payable at 15% on $18m, i.e. $2·7m	0·5	
	Fixed duty of $100 on formal assignment	0·5	
	SSD payable at 10% on $18m, i.e. $1·8m	1·0	
	Distribution of Property Y *in specie* deemed a voluntary disposition	1·0	
	But no change of beneficial interest, hence not chargeable	1·0	
		13	11
			20

		Available	Maximum
4	**Star (HK) Ltd (Star) – IP costs**		
(a)	**Galaxy trademark**		
	Capital expenditure not tax deductible by general rule	0·5	
	Specific deduction under s.16EA	0·5	
	Deduction over five years, straight-line	1·0	
	Trademark must be registered	1·0	
	Outright purchase of both legal and economic ownership	1·0	
	Used in producing HK assessable profits	1·0	
	Apportionment is available	0·5	
	Not acquired from an associate, including definition	1·0	
	Star should get an annual deduction of 20% for five years	0·5	
	Nebula design		
	Royalty deductible if in the production of assessable profits	0·5	
	And not capital in nature	0·5	
	Star's sales bearing Nebula design is taxable, then royalty deductible	1·0	
	Licensor deemed taxable even if not carrying on business in HK	1·0	
	If trademark is used in HK (s.15(1)(b))	1·0	
	Or if tax deduction is claimed in HK (s.15(1)(ba))	1·0	
	Star has withholding obligation (s.20B)	1·0	
	File tax return and pay tax on licensor's behalf	1·0	14
(b)	**Noah**		
	IP cost not deductible under s.16E or s.16EA, not acquired	0·5	
	Qualifying R&D expenditure fully deductible under s.16B	1·0	
	Provided related income is taxable	1·0	
	Type B expenditure 300% on first $2m, then 200% on balance	1·0	
	Related to trade/business	1·0	
	Wholly undertaken in HK	0·5	
	Cost of plant and machinery qualifies despite capital nature	0·5	
	Star can claim 300% on first $2m and 200% on $800,000	1·0	
		6·5	6
			20