
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 Greenery Fresh Food Ltd

To: The directors, Greenery
From: Tax adviser
Date: June 2021
Subject: Taxation implications of recent measures

I refer to our earlier meeting during which we discussed the measures taken by Greenery Fresh Food Ltd (Greenery) in the year 2020 to ease the financial burden and cash flow. The following is an analysis of the Hong Kong tax implications of the issues raised by the directors.

(a) Staff redundancy

The general rule for the deductibility of outgoings and expenses requires that they must be incurred during the basis period for the year of assessment in the production of profits chargeable to profits tax (s.16(1)), and must not be capital in nature (s.17(1)(c)). However, the Inland Revenue Ordinance (IRO) does not define what is a capital expense, and the rules generated from common law would have to be observed.

There is no statutory definition for capital expenditure or what is capital in nature. From case law, each case has to be determined on its own merits. Generally, if the payment is a one-off, or one for long-term benefits, the expenditure is capital expenditure.

In the case of redundancy payments made in accordance with statutory requirement, it has been established in *CIR v Cosmotron Manufacturing Company Limited* that, despite the payment being made at the time of cessation of a business, the payments represented a discharge of statutory liability arising from obligations assumed in the running of the business prior to its cessation. More importantly, since it is statutorily required, the obligation to pay will have been assumed as a cost of employing staff from the time the staff is employed, even though this obligation does not become a liability due until the statutory conditions for the liability to pay crystallises. Provided that the functions of the relevant staff members are not capital in nature in past years of assessment, the redundancy payment should be deductible from Greenery's assessable profits for the basis period in which the payments are incurred. If the redundant staff members' functions have been capital in nature in the past, the amount of redundant payment should be apportioned on a reasonable basis so that the part attributable to the staff members' functions of capital in nature should be disallowed (s.17(1)).

(b) Consolidation of operation

(i) Commercial/industrial building allowance for the two-storey factory block

Greenery owns and uses the two-storey factory block for its own operation. Provided that the building is used in the production of its assessable profits, it is eligible for either industrial building allowance (IBA) or commercial building allowance (CBA), depending on the usage of the building (or part thereof).

Based on the information given, there are three types of usage for the factory block after consolidation: (i) leased out as warehouse (ground floor), (ii) Greenery's own manufacturing operation (two-thirds of first floor), and (iii) Greenery's office (one-third of first floor).

Under s.40(1), industrial building or structure means, amongst other things, any building or structure used for the purposes of a trade which 'consists of the manufacture of goods or materials or the subjection of goods or materials to any process'. In addition, the term also includes any building or structure used for the purposes of a trade which 'consists in the storage of goods or materials (i) which are to be used in the manufacture of other goods or materials; (ii) which are to be subjected in the course of a trade to any process; or (iii) on their arrival into Hong Kong'. However, to qualify for the usage as storage, the trade itself must be one of storage. Based on the Departmental Interpretation and Practice Note No. 2, if the building is used to store the goods or materials which are to be 'sold by the storer or are for use or consumption within the trade of the storer', this is not a qualifying trade and thus not qualifying for IBA. On the other hand, by virtue of the term 'industrial building or structure', the use of a building or part of a building as 'office' is excluded. That said, a 10% *de minimis* rule exists whereby the whole building would still be treated as qualifying if the capital expenditure on the non-qualifying part (e.g. office) does not exceed one-tenth of the total capital expenditure of the building or structure.

Based on the above principles, the eligibility of the factory block to IBA is analysed as follows:

- First floor: Two-thirds of the first floor of the building will continue to be used for Greenery’s manufacturing operation. As Greenery has been claiming IBA in the past based on this usage in the same building, it is expected that this qualifying trade would continue to be accepted by the Inland Revenue Department (IRD) after consolidation, except that the qualifying cost for this qualifying trade may now be reduced to one floor, and part of the first floor (one-third) will be occupied as ‘office’ which is excluded from the term of ‘industrial building or structure’. If the *de minimis* rule is to be relied on, the qualifying cost attributable to the non-qualifying office area should not exceed 10% of the total qualifying expenditure of the first floor. If this is satisfied, the portion of qualifying cost attributable to the entire first floor would still be eligible for IBA. However, if a detailed calculation of the expenditure is not available, the percentage of floor area for the office to total floor area (intended 33.3%) might be used as an estimate, in which case the 10% rule would be exceeded. In this case, the total qualifying cost needs to be apportioned based on the office area, and that part of the expenditure attributable to the office area will only qualify for CBA, rather than IBA. To avoid disallowance, it is advisable to restrict the total floor area for use as office to not more than 10% of the total area of the first floor.
- Ground floor: For the ground floor which is used by the tenant as a warehouse, the usage is not a qualifying trade for IBA purposes as storage is not the trade of the tenant, but only incidental to the retail trade. As a result, this part of the qualifying cost as attributable to the ground floor will no longer be eligible for IBA. However, CBA can start to be claimed as the related lease income from the ground floor is assessable to profits tax and thus the building is used in the production of profits chargeable to profits tax. The fact that the floor is leased out does not affect the eligibility of Greenery to claim IBA or CBA, based on the qualifying expenditure incurred by Greenery.

(ii) Costs spent for refurbishment

As part of the consolidation exercise, Greenery spent \$500,000 to refurbish the first floor of the factory block in order to accommodate the office move-in. Whether the expenditure can be allowed as tax deduction depends on the nature of the expenditure being capital or revenue. In general, the common test is to ascertain whether the expenditure results in ‘improving’ or ‘repairing’ the building or structure. Costs with the effect to ‘repair’ or ‘restore to usable condition’ are generally revenue expenditure which is fully deductible under s16(1). Otherwise, costs seeking to ‘improve’ the building or structure would be considered as capital in nature and disallowed for tax deduction under s.17(1)(c), subject to specific provision below.

Capital expenditure on ‘refurbishment’ for a building or structure is deductible in equal portions over five years of assessment under s.16F, i.e. 20% each year. However, there are exceptions to this provision. Insofar as this case is concerned, these exceptions include expenditure incurred to enable a building to be used for a purpose different from that for which it was used immediately before the capital expenditure was incurred.

In the case of Greenery, the total expenditure of \$500,000 was incurred to refurbish the area to accommodate the office move-in. As such, s.16F does not apply to allow 20% of the capital expenditure each year. Instead, CBA of 4% each year is allowable.

(iii) Disposal of office building

After the consolidation, Greenery intends to dispose of the office building which has been listed for sale before the year end at an anticipated price of \$10,000,000. A book profit of \$2,500,000 is anticipated. Under s.14, if profits arise from a trade, profession or business carried on in Hong Kong and the profits so derived are sourced in Hong Kong, profits tax is chargeable, unless the profits arise from the sale of a capital asset. Whether profits from the sale of properties can be regarded as capital gain and thus excluded from assessable profits depends on whether the sale constitutes a ‘trade’ or not. This issue has remained contentious, in particular to Greenery due to the short duration of ownership before the office disposal.

The IRO does not contain provisions for determining whether profits from the sale of properties are capital gains. The courts in the past usually examined the case by reference to the so-called ‘badges of trade’, which include:

- (1) Subject matter of the transaction – the subject matter in this case is commercial property in Hong Kong. Property may be used for personal enjoyment (e.g. for self-occupation), for long-term income-generating purposes (e.g. for leasing), or for short-term speculation (e.g. for trading). It is generally considered that a property which does not yield an income or personal enjoyment to its owner is more likely to be held for trading purposes. In this case, Greenery has been occupying the property for its own use as office, albeit for a relatively short time. A trading intention is not obvious preliminarily.
- (2) The length of ownership – the shorter the period of ownership, the more likely that the transaction is trading. In this case, the building was acquired only two years ago. Such a period of ownership would normally be too short to argue for capital investment, unless evidence exists to prove otherwise.
- (3) The frequency or number of similar transactions – the higher the frequency, the more likely that the transaction is trading. This piece of information is currently unknown and would need to be determined.
- (4) Supplementary work done – if additional work has been performed to enable the building to be sold at a better profit, a trading intention would be implied. Again, this is currently unknown and would need to be determined.
- (5) Circumstances leading to the sale – in terms of timing, Greenery could argue that the decision to sell the building was driven by its financial burden. If financial statements and other proof are available, the non-trade intention may sustain.

- (6) Motive – any motive behind the acquisition and leading to the quick disposal is of relevance to determine whether a profit-making motive exists.

In addition to the above six badges, the IRD would normally look at other factors such as the funding of the acquisition cost and the utilisation of the sale proceeds. This information is not provided.

In the case of Greenery, the property was bought with the intention of using it for the purpose of its own operation, and CBA has been claimed since then. Hence, in principle, the property is arguably intended to be a capital asset to Greenery. However, the short ownership may be at risk of challenge by the IRD which would choose to treat the asset as acquired for trading and treats the profits from sale of the properties chargeable to profits tax. As the burden of proof falls on Greenery, it is advisable for it to prepare for all the documentation to prove that the trading intention does not exist.

As far as the tax adjustment to the CBA is concerned, where the relevant interest in a commercial building is sold, a balancing charge or a balancing allowance is to be calculated by deducting the sale proceeds from the residue of expenditure. If the sale proceeds exceed the residual value, the excess is a balancing charge. Balancing charge is taxable but restricted to the total of the allowances allowed. If the sale proceeds are less than the residual value, the shortfall is a balancing allowance. Balancing allowance is deductible. Based on the information given, the qualifying cost and tax written down value of the office brought forward from 2019/20 are \$2,000,000 and \$1,840,000 respectively. With the estimated sale proceeds of \$10,000,000, the portion attributable to the building (30%) is \$3,000,000. There would be an excess of proceeds over written down value of \$1,160,000 (\$3,000,000 – \$1,840,000). However, the chargeable balancing charge is restricted to the total CBA claimed, which is \$160,000 (\$2,000,000 x 4% x 2).

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

End of report

2 James Liu and Jade Lau

(a) Whether James is liable to profits tax or salaries tax

James Liu should be advised of the following points:

If his various amounts of income in the question arose from employment, office or pension, the income amounts are chargeable to salaries tax (s.8(1) of the Inland Revenue Ordinance (IRO)). From the facts, there is no indication that his income amounts arise from an office from BSL or pension. One has to examine if the amounts of income are derived from an employment.

If his various amounts of income in the question arise from a trade, profession or business, the income is chargeable to profits tax (s.14(1)). The term of business includes trade (*Lee Yee Shing's* case). Hence once his activities constitute a business, there is no need to find whether he carries on a trade for profits tax purpose. From the facts, he displays on his business card that he is an account executive of Boom Securities Ltd (BSL). There is no indication that James is carrying on a profession. One has to examine if his activities constitute a business which includes the case where he is self-employed.

Tutorial note: *It should be noted that in cases like this, a given amount of income can only be derived from an employment or business but not both.*

The question of whether James is regarded as an employee (having a contract of service) or self-employed (having a contract for services) is a question of fact. Based on various case laws, a number of factors would be considered, and each case should be determined on its own merits. Factors to be considered include whether James provides his own equipment, whether he hires his own helpers, what degree of financial risk he runs, what degree of responsibility he has and whether he has an opportunity to benefit from sound management: *Ready Mixed Concrete* case (the economic reality test).

The question is not sufficiently clear for these factors to be fully assessed and more information is required. The service agreement should be obtained as this will indicate the nature and scope of his services and other terms including the payment mechanism and any indemnity or liability clause would also be important to illustrate the intention of both parties at the time of entering into the agreement. *Prima facie*, the fact that James has obtained a business registration certificate is evidence that he has the intention to carry out activities as an independent contractor and he should be subject to profits tax rather than salaries tax: *D77/90*. However, this may not be conclusive to prove that his relationship with BSL is one of an independent nature. James also has no fixed working hours. As flexible working hours are not uncommon in Hong Kong's workplaces, this factor may or may not add weight depending on whether it is specifically mentioned in the agreement, what kind of mode of operation BSL has, and what is being required of the other employees of BSL.

However, the facts indicate that he represents himself to customers of BSL as part of the overall organisation of BSL, his business card bears the name of BSL and his position assigned by BSL, he is offered a work partition and is paid a monthly sum irrespective of performance and, most importantly, he is entitled to various employment-type benefits including medical benefit and paid annual leave: *D24/93*. Therefore, the evidence appears to point to the conclusion that he is an employee of BSL because he is part and parcel of the organisation: *Market Investigation* case (the 'integration test').

Should it be the genuine intention of James and BSL for James to work as an independent contractor for BSL, he is advised to produce sufficient information to illustrate that the provision of these benefits is a common practice within the industry, and similar benefits would also be available to him if he were to be engaged by a different securities company. He should also produce information to convince the Commissioner that the provision of benefits is in the interests of both parties, e.g.

the business card bearing the position and name of BSL, which would enhance his identity and his convenience for work. This is particularly the case when he is not allowed to serve other competitors without prior consent from BSL, and thus it is reasonable to assume that part of the reason why BSL provides the related benefits to James is to enhance the relationship with him.

James and Jade's tax positions for the year of assessment 2020/21

James' income and expenses

On the basis that James is more likely regarded as an employee of BSL, the retainer fee and commission he received are chargeable to salaries tax. However, the payment of \$150,000 received from the newspaper is not income from his employment and is not taxable: *Hochstrasser v Mayes*.

The legal fees of \$50,000 reimbursed by BSL, being a reimbursement of James' private expenditure, is taxable: *Humprey's* case, unless it can be said to be a purely gratuitous payment, without expectation, made for special reasons, which cannot be classified as a reward for services: *Glynn's* case.

The payment of legal fees of \$100,000 is not deductible to James as it was not incurred in the production of his assessable income: s.12(1)(a).

The mandatory contribution made by James to the Mandatory Provident Fund Scheme qualifies for a concessionary deduction (s.26G(3)) of \$18,000 (the maximum amount). The remaining payment of \$6,000 is a non-deductible private expense.

Jade's director's fee from Unique Boutique Ltd (UBL)

Income from an office is chargeable to salaries tax if it is derived from a source in Hong Kong (s.8(1)). The office of directorship has a *situs* in Hong Kong if the central management and control is exercised in Hong Kong. A company exercises its central management and control in Hong Kong if its board of directors meeting(s) was (were) held in Hong Kong and its resolutions are not subject to approval by any other body outside Hong Kong (*De Beers Consolidated Mines Ltd's* case).

Tutorial note: *The Board of Review had in some of its decisions also regarded the taxpayers in decided cases as having their central management and control in Hong Kong where the taxpayer companies had substantial operations management below the level of directors in Hong Kong. The Inland Revenue Department in practice follows suit.*

The question does not contain sufficient information to decide if UBL exercised its central management and control in Hong Kong. Hence, one cannot conclusively say the *situs* of Jade's directorship in UBL is in Hong Kong. But given that UBL was wholly owned by Jade, Jade is resident in Hong Kong and UBL carries on its business in Hong Kong, it would be difficult for Jade to prove UBL did not exercise its central management and control in Hong Kong. The following comments are made on the basis that UBL exercised its central management and control in Hong Kong which leads to the position that Jade's directorship in UBL is located in Hong Kong.

As the director of a company centrally managed and controlled in Hong Kong, the director's fee of \$60,000 is chargeable to salaries tax. Since this amount is below the basic allowance of \$132,000, it is to the couple's advantage to elect joint assessment under salaries tax. Under joint assessment, income from both James' employment and Jade's office would be aggregated into one assessment. They would be entitled to a married person's allowance of \$264,000 and tax savings could be achieved.

(b) Tax compliance obligations in respect of Unique Boutique Ltd

As a company carrying on business in Hong Kong and as an employer, UBL has to comply with the following compliance obligations:

Since UBL has derived profits chargeable to tax in Hong Kong, under s.51(2) it has to notify the Inland Revenue Department (IRD) within four months after the end of the basis period for the relevant year of assessment in which the chargeable profits were derived, unless it has been required to file the tax return for the year of assessment aforesaid by the IRD.

If the first accounts are closed on 31 March 2020, the first relevant year of assessment would be 2019/20. The basis period for this year of assessment is 1 March 2020 to 31 March 2020. The due date for notifying chargeability would have been 31 July 2020, i.e. four months from 31 March 2020. It is obvious that this deadline has been missed without giving proper notification. Failure to notify chargeability to tax may result in a penalty to UBL.

If the first accounts are closed on 28 February 2021, the first relevant year of assessment would be 2020/21. The basis period for this year of assessment is 1 March 2020 to 28 February 2021. Four months from the end of the basis period would be 30 June 2021. Therefore, UBL will have to notify the IRD of its chargeability to tax on or before 30 June 2021, unless a tax return for 2020/21 has been issued to it before that date.

If issued with an annual tax return by the IRD, UBL is obliged under s.51(1) to complete and submit the return within the period stipulated, together with its audited accounts. Normally, one month is allowed for filing purposes but, in practice, an extension may be given upon application depending on the situation.

If UBL has employed any staff and incurred salary expenses, it is obliged under ss.52(2) and 52(4) to complete and submit notifications of commencement of employment within three months of commencement, as well as an annual employer's return in respect of each member of staff, giving details of the staff involved and the remuneration paid under the cover of a header employer's return of BIR 56A. It is also required to submit notification of any employee who is about to cease to be employed within one month before cessation (s.52(5)); notification of any employee who is about to leave Hong Kong for more than one

month, other than for a business purpose, one month before the employee's departure (s.52(6)); and to retain money payable to any employee who will cease employment and leave Hong Kong for one month from the date of the notice (s.52(7)).

Under s.51C, UBL has to maintain proper business records to enable its profits or loss to be assessed for a period of not less than seven years after completion of each transaction.

3 Miss Wong and Mr Hui

(a) Tax position of Miss Wong

If rental income is receivable from properties located in Hong Kong, Hong Kong property tax is payable under s.5(1). Under this section, property tax is levied on any owner of land or buildings or land and buildings situated in Hong Kong, at the standard rate (15%) on the net assessable value of the property. '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 or/and buildings, including service charges and management fees; as reduced by two types of deductions:

- (1) Government rates paid by the owner if it has been so agreed between the owner and the tenant; and
- (2) A one-off statutory allowance of 20% of assessable value after deducting rates if applicable. This statutory allowance is deemed to cover all related expenses incurred by the owner on the property. Therefore, all other actual expenses incurred by Miss Wong, such as government rent, cleaning, watchman's wages, renovation, repairs and mortgage interests, will not be deductible for property tax purposes.

The rental deposit of \$64,000 which is repayable to the tenant under certain circumstances is not regarded as income to the owner until such time as the deposit is used to settle any outstanding rental payment. Thus, it is not assessable for the year.

Initial premium of \$32,000 is taxable consideration for the right of use of the property. It is spread over the term of the lease, subject to a maximum of three years from the start of the lease.

Under s.7C, outstanding rent proved to the satisfaction of the assessor to have become irrecoverable in a year of assessment is deducted from the assessable value of the property. It is for Miss Wong to prove that the rent outstanding has become irrecoverable. There is no information on whether the rent is irrecoverable to Miss Wong, and whether Miss Wong has taken any action to recover the rent outstanding. On the basis that the tenant is still leasing the property and contactable, from a tax perspective, the debt has not yet been proved as bad and irrecoverable. In such circumstance, no bad debt deduction will likely be allowed for the year 2020/21.

Therefore, Miss Wong's property tax liability for the year of assessment 2020/21 is \$182,544.

Property tax computation for the year of assessment 2020/21

	\$
Rental (1,362,000 + 60,000)	1,422,000
Premium (32,000 x 9/36)	8,000
Service charges	72,000
Management fees	96,000
Assessable value	1,598,000
Less: Rates	(76,800)
	1,521,200
Less: 20% statutory deduction	(304,240)
Net assessable value	1,216,960
Tax at 15%	182,544

(b) Ways of reducing Miss Wong's tax liability

Miss Wong might incorporate a service company, wholly owned by her, to pick up the provision of furniture, repairs, cleaning and watchman of the house, in return for the service charges and management fees. The lease terms should be revised such that the service charges and management fees are payable by the tenants directly to the service company. Although the service company would be subject to profits tax, it would be entitled to the normal revenue deductions such as cleaning, watchman's wages, renovation and repairs to offset the income it receives. The total amount of profits tax and property tax payable will likely be less than the scenario as it presently is.

The mortgage loan interest is not deductible under property tax. The only way in which she can obtain relief for the interest is by applying for personal assessment if:

- (1) She is aged 18 or above; and
- (2) She is a permanent or temporary resident of Hong Kong.

Under personal assessment, all assessable income from various sources will be aggregated, including rental income from the property. It is specifically provided that when property income is included, related mortgage interest can be deducted against the property income under personal assessment. The deduction is limited to the 'net assessable value' of the property, i.e.

80% of the total rental received. However, there is no restriction on deductibility to the effect that the recipient must be liable to profits tax on the interest income; all that is required is to prove to the satisfaction of the Commissioner that the amount is payable.

- (c) (i) 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), and it is liable to *ad valorem* duty (AVD) at either Scale 1 (Part 1 or Part 2) or Scale 2 rates. Where the property is a residential property (RPPT) and the purchaser or transferee (or all purchasers or transferees) is a Hong Kong permanent resident (HKPR) who buys the RPPT on his/her own behalf (i.e. the person is both the legal and beneficial owner) and does not own any other RPPT in Hong Kong at the time of acquisition, lower rates under Scale 2 ranging from \$100 (for a value not exceeding \$2 million) to 4·25% (for a value exceeding \$20 million) applies. 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.

In the case of Mr Hui, if he acquires the property in joint names with his wife, lower rates under Scale 2 will apply as he is a HKPR and his wife, though not a HKPR, is his close relative and each of them did not own any other RPPT in Hong Kong at the time of acquisition. Therefore, the stamp duty payable will be \$2·55 million (4·25% on \$60 million). 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 parties to the transaction, the buyer and the seller, are jointly and severally liable to pay the stamp duty, but in market practice, the purchaser is normally the person to pay.

In addition, special stamp duty (SSD) will be payable if the RPPT is sold by the seller within 36 months of acquisition. The applicable rates of SSD depend on the holding period, the longer the holding period the lower the rate of duty. SSD is jointly and severally payable by both the purchaser (Mr Hui) and the seller (Miss Wong). In Mr Hui's case, it is unclear when the property was acquired by Miss Wong. He is therefore advised to obtain more information from Miss Wong, in order to ascertain whether the property will fall within the SSD regime. If so, he may seek to negotiate and agree with Miss Wong as to which party will pay and bear the duty, and to have this specified in the agreement.

Buyer's stamp duty (BSD) will not apply in Mr Hui's case because he is a HKPR and his wife, though not a HKPR, is his close relative and each of them is acting on his/her own behalf.

- (ii) If the property is acquired in the name of a company, the AFS will be liable to Part 1 of Scale 1 AVD at a flat rate of 15% and the stamp duty payable will be \$9 million (15% on \$60 million). 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 SSD implication will be the same as discussed in (c)(i) above. However, BSD applies to companies which acquire a RPPT, regardless of whether they are controlled by a HKPR or have any shareholders or directors who are HKPRs, and is charged at the flat rate of 15% on the higher of the stated consideration or market value of the RPPT. Therefore, in this case, BSD of \$9 million (\$60 million at 15%) will be payable. The company, as transferee, will be liable to pay the BSD, on top of the AVD and SSD, if applicable.

- (d) Mr Hui is mistaken in the belief that Option 2 would result in no Hong Kong tax being payable.

As explained in (a) above, the rental income is received from properties located in Hong Kong and property tax is chargeable notwithstanding the decision making, the place of incorporation or the residence of the company are in the UK (or otherwise outside Hong Kong).

Further, a company letting a real property in Hong Kong is deemed to carry on business in Hong Kong under s.2. The property being located in Hong Kong renders the rental income to be derived from Hong Kong. Hence the company will be chargeable to profits tax under s.14. Decision making, place of incorporation and residence of the company are irrelevant in this regard.

Tutorial note: *The property tax paid by the company will be offset against the profits tax payable by the company under s.25. The company may apply for exemption from property tax under s.5(2).*

4 Mr Chan

Under the Hong Kong schedular tax system, income from different sources are taxed separately under salaries tax, property tax or profits tax. Accordingly, rules for tax deduction for expenditure including loan interest expense are legislated under the respective types of tax. In the given case, C-HK is subject to profits tax while Mr Chan is subject to salaries tax and property tax. Therefore, the loan interest incurred by C-HK for loans 1 to 4 should be assessed from profits tax perspectives, and loan interest incurred by Mr Chan for loans 5 and 6 should be assessed from the perspectives of salaries tax and property tax, where appropriate.

Loan 1 under profits tax

Under profits tax, the issue of the eligibility to tax deduction for loan interest expense depends on whether the conditions under s.16(1), s.16(1)(a) and s.16(2) are satisfied. Under the general deductibility rule of s.16(1), an expense is allowed, to the extent that it is incurred in the production of profits chargeable to profits tax. In the case of loan interest expense, it is also specifically provided under s.16(1)(a) that the loan money is required to be used for the production of assessable profits. This means that the usage of loan money for profit-producing purpose is the first criterion. Satisfying this, a loan interest expense would be further assessed by virtue of s.16(2) whereby at least one of the conditions under s.16(2)(a) to s.16(2)(g) must be satisfied. In the event that s.16(2)(d), (c) or (e) is satisfied, the interest expense deduction may be subject to restriction under s.16(2A) or s.16(2B). Under s.16(2A), a deductible interest expense would be restricted or reduced if the related loan is secured by any deposit or loan which

derives interest income not taxable in Hong Kong (the so-called 'secured loan test'). If this happens, the interest expense will be reduced by the non-taxable interest income earned on the secured deposit or loan, and only the remaining balance, if any, would be deductible. Under s.16(2B), similar restriction applies if the related loan is transacted under an arrangement whereby the interest payment is ultimately paid back to the borrower or its connected person, unless, among others, such interest flowed back is taxable in Hong Kong (the so-called 'interest flow-back test').

Loan 1 is obtained from a bank in Hong Kong for use in C-HK's own operation. As all income earned by C-HK is returned and taxed under profits tax, the criteria under s.16(1) and s.16(1)(a) are satisfied. Interest expense payable to a bank is eligible for deduction under s.16(2)(d) but subject to the restriction under s.16(2A) or s.16(2B). Based on the information given, the bank loan is secured by Mr Chan's personal deposit placed with the same bank. Presumably interest income is earned on the deposit by Mr Chan. Unless Mr Chan is deemed as carrying on business in Hong Kong, the interest income on deposit would very likely be not subject to any tax in Hong Kong. As a result, the restriction under s.16(2A) applies such that the deductible amount of loan interest payable by C-HK would need to be reduced by the non-taxable interest income receivable by Mr Chan on the bank deposit. The excess, if any, would be deductible to C-HK.

Loan 2 under profits tax

The loan is obtained from a bank in Hong Kong to buy an office in Hong Kong for use by C-HK. In ascertaining whether interest is incurred 'for the purpose of producing assessable profits', it is usually dependent upon how the loan proceeds are applied, and in the case where the proceeds are used to acquire an asset, whether or not the asset is used to 'produce assessable profits'. The fact that the loan money was applied to acquire a capital asset does not render the loan interest to be capital expense unless the capital asset so acquired is not immediately used for producing assessable profits. In the case of C-HK, the bank loan is obtained to acquire the office which is used for its operation. As all income from the operation is assessable to tax in Hong Kong, the bank loan is considered as applied for the production of assessable profits, hence satisfying s.16(1)(a) and s.16(1). In addition, s.16(2)(d) is also satisfied as the interest is payable to a bank. Therefore, the loan interest is in principle deductible, subject to the restriction under s.16(2A) or s.16(2B).

One has to examine whether the restriction under s.16(2A) or s.16(2B) is applicable. It is given that this loan is secured by Mr Chan's personal guarantee. This means that all of Mr Chan's assets are pledged to the bank, including, if any, his deposit with any bank. There is in strict principle the possibility that the restriction rule under the secured loan test applies. In practice, the Inland Revenue Department does not take such a strict construction of s.16(2A) and s.16(2B) and usually does not view the personal guarantee as a deposit or loan as referred to in s.16(2A). In other words, the restrictions are not applicable. Hence the loan interest expense is totally deductible.

Loan 3 under profits tax

This loan is obtained from a bank in Hong Kong to buy an apartment for use by Mr Chan whilst on business. As explained in the analysis of loan 2 above, where the loan is used to acquire a capital asset, the use of the capital asset would determine whether the loan is considered as profit-producing. The apartment in this case is used by Mr Chan in the capacity of C-HK's shareholder (note that Mr Chan is neither a director nor an employee). Expenditure for the benefit of the shareholder is not considered as in the production of C-HK's assessable profits, as a result of which s.16(1)(a) and s.16(1) are not satisfied. No tax deduction is allowed for the interest payable on loan 3.

Loan 4 under profits tax

This loan is obtained from an overseas associate, C-OS, to buy C-HK's portfolio of listed shares held as inventory. As all income earned by C-HK is returned and assessable under profits tax, the criteria under s.16(1) and s.16(1)(a) are satisfied. Interest is payable to C-OS which is a non-financial institution. The conditions under s.16(2)(c) or s.16(2)(e) would be assessed. Under s.16(2)(c), deduction would be allowed if the interest in the hands of the lender is subject to tax in Hong Kong. In this case, the interest is receivable by C-OS, which is not carrying on business in Hong Kong, and thus the interest is not subject to tax in Hong Kong in the hands of C-OS. Therefore, s.16(2)(c) is not satisfied. As regards s.16(2)(e), deduction is allowed if the loan money is being used to purchase plant and machinery or trading stock, and the lender is not an associate of the borrower. As C-OS is an associate of C-HK, by the fact that both are wholly owned by Mr Chan, s.16(2)(e) is also not satisfied. Other conditions under s.16(2) are not relevant in this case. In conclusion, no tax deduction is allowed for the interest payable on loan 4.

Loan 5 under salaries tax

Loan 5 is obtained by Mr Chan from a bank in Hong Kong to buy an apartment for his own use to live in with his parents. Information shows that Mr Chan is subject to salaries tax on his employment income. The eligibility to interest tax deduction is therefore assessed under salaries tax provisions. Pursuant to s.12, any expense/outgoing may be deductible if the expense/outgoing is incurred 'wholly, exclusively and necessarily in the production of assessable income', and the expense is not of the nature of domestic, private or capital. Given that the bank loan is used to acquire a property for personal use, the related loan interest would be domestic and private, and thus not deductible under s.12. However, under the concessionary deduction of 'home loan interest' under s.26E(1), a maximum deduction of \$100,000 per annum for up to 20 years (not necessarily consecutive) is allowed, if conditions are satisfied. Amongst all the pre-requisite is that the property must be used by the taxpayer as their principal place of residence in Hong Kong. The loan must be mortgaged or secured over the property or any property in Hong Kong and the lender is one of the prescribed organisations including a bank.

According to the question, the property is used as Mr Chan's principal residence with his parents and he should be eligible for home loan interest deduction against his assessable income for salaries tax purposes up to \$100,000 for each year of assessment.

Loan 6 under property tax and personal assessment

Loan 6 is obtained by Mr Chan from a bank in Hong Kong to buy a warehouse which is leased for rental. The information shows that Mr Chan is subject to property tax on his rental income. The eligibility to a tax deduction in respect of the interest expense is therefore assessed under property tax provisions. Under s.5(1), property tax is levied on any owner of land or buildings in Hong Kong on the 'net assessable value' which is calculated from the property's assessable value reduced by two types of deductions: government rates paid by the owner if agreed between the owner and the tenant, and a statutory allowance equivalent to 20% of the assessable value after government rates. No other deduction is allowed under the property tax regime. In the case of Mr Chan, the loan interest is in principle not deductible pursuant to the property tax regime.

However, the tax legislation provides for a tax deduction for loan interest payment relating to leased property provided that the taxpayer elects for personal assessment and the rental income is being assessed under personal assessment. To be eligible for personal assessment election, the taxpayer (or his/her spouse) must be either a permanent or temporary resident in Hong Kong. In the case of Mr Chan, as he is a permanent resident in Hong Kong, he is eligible to elect personal assessment. In doing so, the net assessable value of his warehouse will be aggregated with his employment income, and the bank loan interest for financing the leased warehouse is deductible up to the net assessable value included in the calculation. The concessionary deduction of home loan interest (as explained in the loan 5 analysis above) will still be deductible under personal assessment. In conclusion, the interest on loan 6 will be tax deductible, but only under personal assessment.

	<i>Available</i>	<i>Maximum</i>
1 (a) Redundancy payment		
S.16(1) general rule for deductibility	0.5	
S.17(1)(c) capital expense disallowed	0.5	
No statutory definition for capital expenditure	0.5	
If one-off or for long-term benefits, it is capital expenditure	1.0	
Statutory redundancy is a discharge of statutory obligation incurred in running a business	1.0	
Liability started to accrue since employment	0.5	
Liability crystallised upon payment	0.5	
Seen as part of staff remunerations	0.5	
If staff remunerations are deductible, redundancy payment is deductible	0.5	
	<u>5.5</u>	5
(b) Consolidation of operation		
(i) Two-storey building		
Building used in the production of assessable profits	0.5	
Qualifying trade includes manufacturing	1.0	
Or used for storage, but must be a trade of storage	1.0	
Office is excluded	0.5	
10% <i>de minimus</i> rule	1.0	
First floor – IBA if office is less than 10%	1.0	
If exceeds 10%, apportioned cost under CBA	1.0	
Ground floor – not qualifying trade as tenant is not of storage trade	1.0	
CBA is claimed	1.0	
Leasing out does not affect eligibility to IBA/CBA	0.5	
	<u>8.5</u>	8
(ii) Refurbishment		
Depends on capital or revenue nature	0.5	
Improving or repairing	0.5	
Revenue expenditure fully deductible	1.0	
Capital expenditure disallowed subject to special provision	0.5	
Refurbishment under s.16F over five years	1.0	
Exceptions include building used for different purpose	1.0	
CBA can be claimed	0.5	
Purpose changed from manufacturing to office, disallowed	1.0	
	<u>6</u>	6
(iii) Disposal of office building		
Book profit on sale of capital asset not taxable	1.0	
If constitutes a 'trade', profit is taxable	0.5	
Six badges of trade and explain	6.0	
Other factors looked at by IRD	1.0	
Building used as own office	0.5	
Short holding of building at risk of challenge by IRD as trade and taxable	1.0	
Burden of proof on Greenery	0.5	
CBA balancing adjustment, taxable balancing charge or deductible allowance	1.0	
Calculation of balancing charge, limited to total allowance claimed	2.0	
	<u>13.5</u>	12
Presentation:		
Appropriate format and presentation	2.0	
Logical development	1.0	
Effectiveness of communication	1.0	
	<u>4</u>	4
		<u>35</u>

	<i>Available</i>	<i>Maximum</i>
2 James Liu and Jade Lau		
(a) Whether James is liable to profits tax or salaries tax		
If income from employment, office or pension, chargeable to salaries tax	0.5	
No indication that income arose from office or pension	0.5	
If income from trade, profession or business, chargeable to profits tax	0.5	
No indication that James was carrying on a profession, have to examine if his activities constitute a business which includes self-employed	0.5	
An employee having a contract of service	0.5	
Self-employed having a contract for service	0.5	
Various factors/reference to case law principles	1.0	
Economic reality test	1.0	
Service agreement terms	1.5	
Business registration helpful but not conclusive	0.5	
Flexible working hours	0.5	
Business card and position	0.5	
Workplace	0.5	
Paid a monthly sum irrespective of performance	0.5	
Medical benefit and paid annual leave	0.5	
Integration test	1.0	
Common industry practice	1.0	
Benefit to both parties/exclusively for company	1.0	
Tax position of James and Jade		
James: taxability of income		
Retainer fee and commission	0.5	
Payment from newspaper	1.0	
Legal fee reimbursed by BSL	1.0	
James: deductibility of expense		
Legal fee incurred	1.0	
MPF contribution	0.5	
Jade's director's fee		
Income from office chargeable to salaries tax if derived from HK	0.5	
Source of office of directorship: where central management and control is exercised, i.e. where board of directors' meetings are held	0.5	
Difficult for Jade to prove UBL did not exercise its central management and control in HK	0.5	
Director's fee chargeable to salaries tax	0.5	
Effect of joint assessment	1.0	
	<u>19.5</u>	17
(b) Tax compliance obligations:		
Under s.51(2)	1.0	
Accounts closed on 31 March 2020	2.0	
Accounts closed on 28 February 2021	2.0	
Under s.51(1)	1.0	
Under s.52(2)	0.5	
Under s.52(4)	0.5	
Under s.52(5)	0.5	
Under s.52(6)	0.5	
Under s.52(7)	0.5	
Under s.51C	0.5	
	<u>9</u>	<u>8</u>
		<u>25</u>

	<i>Available</i>	<i>Maximum</i>
3 Miss Wong & Mr Hui		
(a) Tax position of Miss Wong		
Rental income subject to property tax under s.5(1)	0.5	
On owner at standard rate on net assessable value (NAV)	0.5	
Definition of NAV	0.5	
Actual expenses not deductible	0.5	
Rental deposit not taxable	0.5	
Premium spread over a maximum of three years	0.5	
No deduction for outstanding rental	0.5	
Calculation of property tax liability	2.0	
	<hr/> 5.5	5
(b) Ways of reducing Miss Wong's tax liability		
Incorporate a service company wholly owned by her	0.5	
The company will pick up the costs		
In return for service charges and management fees	0.5	
Payable by tenants directly to the company	0.5	
Subject to profits tax but entitled to normal revenue deductions	0.5	
Interest deductible under personal assessment	1.0	
But interest limited to NAV	0.5	
No restriction of deductibility even if recipient not taxable on interest	0.5	
	<hr/> 4	3
(c) (i) Stamp duty implications if property is acquired in joint names		
Conveyance on sale subject to stamp duty	0.5	
Agreement for sale liable to <i>ad valorem</i> duty	0.5	
Application of Scale 1 and Scale 2 rates	0.5	
Dutiable value based on higher of transaction price and market value	0.5	
Scale 2 applies	0.5	
AVD payable is \$2.55m	1.0	
Formal assignment liable to a fixed duty of \$100	0.5	
Both parties liable	0.5	
SSD payable if property sold by seller within 36 months	0.5	
Seller and buyer jointly and severally liable	0.5	
Check with seller whether SSD is payable	0.5	
Agree with seller who will bear the SSD	0.5	
BSD not applicable	0.5	
(ii) Stamp duty implications if property is acquired in name of a company		
Scale 1 applies	0.5	
AVD payable is \$9m	0.5	
Formal assignment liable to a fixed duty of \$100	0.5	
SSD implication same as discussed above	0.5	
BSD payable is \$9m	1.0	
	<hr/> 10	9
(d) Effectiveness of Option Two		
Rental income from properties located in Hong Kong subject to property tax	1.0	
Company letting a property in Hong Kong deemed to carry on business in Hong Kong	0.5	
Property being located in Hong Kong renders rental income to be derived from Hong Kong	0.5	
Chargeable to profits tax	0.5	
Decision making, place of incorporation and residence irrelevant	0.5	
Conclusion: does not achieve a non-Hong Kong tax position	0.5	
	<hr/> 3.5	3
		<hr/> 20

	<i>Available</i>	<i>Maximum</i>
4 Mr Chan: Tax deductibility of loan interest		
Loan 1: Profits tax: s.16(1) – general deductibility rule	0.5	
S.16(1)(a) – loan money used to produce assessable profits	0.5	
At least one of conditions under s.16(2) satisfied	0.5	
Restriction under s.16(2A) or s.16(2B), explain	2.0	
Used for operation, s.16(1)(a) met	0.5	
S.16(2)(d) met	0.5	
S.16(2A) met, loan secured and interest not taxable	1.0	
Conclusion: deduction reduced by non-taxable interest, balance deductible	<u>0.5</u>	6
Loan 2: s.16(1)(a) met, despite for buying capital asset	0.5	
S.16(2)(d) met	0.5	
S.16(2A) and s.16(2B) not met, no restriction	0.5	
Conclusion: fully deductible	<u>0.5</u>	2
Loan 3: s.16(1) and (1)(a) not met	1.0	
For benefit of shareholder is not in the production of company's assessable profits	0.5	
Conclusion: not deductible	<u>0.5</u>	2
Loan 4: s.16(1) and (1)(a) met	0.5	
S.16(2)(c) not met as C-OS is not taxable in HK	1.0	
S.16(2)(e) not met as lender is an associate	1.0	
Conclusion: not deductible	<u>0.5</u>	3
Loan 5: salaries tax deduction not met due to domestic and private nature	1.0	
Home loan interest concessionary deduction, explain	2.0	
Conclusion: home loan interest deductible	<u>0.5</u>	
	<u>3.5</u>	3
Loan 6: property tax deduction not met under s.5(1)	1.0	
Eligible to elect personal assessment	1.0	
Interest deduction under personal assessment up to net assessable value	2.0	
Conclusion: deductible only under personal assessment	<u>0.5</u>	
	<u>4.5</u>	4
		<u>20</u>