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 Sugar Ltd

To: The directors, Sugar Ltd
From: Tax adviser
Date: February 2019
Subject: Sale of assets

I refer to our earlier meeting during which we discussed the tax implications to Sugar Ltd arising from the sale of assets. Our advice on the respective issues is as follows:

(a) Tax implications arising from 'package sale'

Note (1): Taxability of profit from asset sale

We understand Sugar Ltd is presented with an offer to sell all its assets under a 'package sale'. Based on the consideration offered and the net book value of the assets, Sugar Ltd anticipates to make a profit of $11·5 million in its accounts for the year ended 31 March 2019.

In general, any profits arising from the disposal of capital assets including fixed assets and business goodwill will not be taxable (s.14). However, profits arising from the sale of revenue assets, such as inventory, will be taxable, and there can be balancing adjustments on certain assets. In this regard, the nature of each asset disposed of would need to be determined based on the tax law and prevailing practice in order to ascertain whether or not the profit arising from each asset is taxable.

As profit for individual assets is to be examined separately, it is fundamental that the total consideration of the 'package sale' is properly broken down and allocated to the individual asset item being sold, and the allocated sale proceeds need to be specified in the asset sale agreement. In the absence of individual allocation of the consideration, the Inland Revenue Department (IRD) is empowered by the law to treat each asset as having been disposed of at its fair market value as determined by the IRD, subject only to possible revision by the appellate bodies upon appeal.

The total accounting profit of $11·5 million would initially be treated as non-taxable. Subject to the assessment of individual assets' selling price, Sugar Ltd may have assessable profits chargeable to profits tax. With effect from the year of assessment 2018/19, under the two-tiered system in Schedule 8B of the Inland Revenue Ordinance (IRO), the first $2 million assessable profits of a corporation will be subject to profits tax at the rate of 8·25%, with the balance at the rate of 16·5%.

Note (2): Yuen Long office building

As the Yuen Long office has been used by Sugar Ltd for its trading operation, the office building is a capital asset and the profit arising from its disposal is capital in nature and non-taxable. For tax purposes, the office building would have qualified for commercial building allowance (CBA) since the year of acquisition. The qualifying expenditure for CBA is usually based on the cost of construction of the building, and the annual allowance at 4% would apply given that Sugar Ltd acquired the building from the property developer as first purchaser and first user. No initial allowance is claimable for commercial buildings. Assuming the sale will take place in the basis period for the year of assessment 2018/19, the company should have been allowed CBA for four years (from 2014/15 to 2017/18), or 16% of $13,000,000 (i.e. $2,080,000).

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 claimed. 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 expenditure and tax written down value of the office brought forward from 2017/18 are $13,000,000 and $10,920,000 ($13,000,000 less $2,080,000) respectively. With the estimated sale proceeds of $18,000,000 attributable to the building portion, the excess of proceeds over written down value is $7,080,000. However, the taxable balancing charge is restricted to the total CBA claimed, which is $2,080,000.

In terms of stamp duty, a transfer of immovable property is stampable under Head 1. *Ad valorem* stamp duty at Scale 1 (Part 2) rates ranging from 1·5% to 8·5% will be payable on the legal assignment of the office. The amount subject to stamp duty will be based on the amount of the consideration allocated unless it is lower than the market value. In the case of Sugar Ltd, it is likely that the estimated consideration of $25,050,000 would be accepted as the dutiable value. Stamp duty cost would become $2,129,250 ($25,050,000 x 8·5%).

Special stamp duty and buyer's stamp duty are only applicable to residential property and thus are not payable in the case of Sugar Ltd. Further, Sugar Ltd has owned the building for more than 36 months, the maximum period required for special stamp duty.

To minimise stamp duty, Sugar Ltd is considering allocating a low value to the office. Unless this is justified with good reason, the Collector of Stamp Revenue may seek to raise the stampable value to the market value of the property by invoking the 'voluntary disposition *inter vivos*' provisions (s.27 of the Stamp Duty Ordinance (SDO)) and the *Ramsay* principle. Therefore, it is advisable to adopt a market value for the stamping purpose.

Note (3): Solar water heating system

The solar water heating system installed in the office is also included in the 'package sale'. The estimated consideration for the system is $450,000. Sugar Ltd incurred a capital expenditure of $500,000 in 2014/15 and was entitled to a special tax deduction under s.16J over five years on a straight-line basis, i.e. $100,000 per year. Total tax deduction claimed prior to disposal is therefore $400,000. Upon disposal, the unallowed deduction is $100,000. Under s.16J(3)(b), the excess of sale proceeds over the unallowed deduction ($450,000 – $100,000 = $350,000) will become taxable to Sugar Ltd.

Note (4): Inventory

All inventory of medical equipment will be included in the 'package sale' and transferred at cost. Under s.15C, where the stock is sold upon cessation of business to a person who will use the stock in a business carried on in Hong Kong and who will be claiming the purchase cost as a deductible expense, the actual proceeds from the sale of the stock (even at cost) would be accepted. In any other situation, the open market value would be used for the transfer. In this case, Sugar Ltd will cease business after the sale, the buyer is carrying on business as trading in medical equipment and the inventory is expected to be deductible against the buyer's assessable profits. Thus the transfer at cost should be acceptable. No profit or loss would arise from the sale by Sugar Ltd.

Note (5): Patent

Under s.16EA, the capital cost of purchasing a registered patent can be deductible if the specified conditions are fulfilled. However, as the patent is self-developed and registered by Sugar Ltd, no deduction would have been allowed under s.16EA, but the related research and development costs should have been capitalised and deducted as research and development expenditure under s.16B. Upon the disposal, the relevant sale proceeds ($1,500,000) would be treated as a trading receipt and taxable, subject to a limit of the total amount of deduction claimed.

(b) Transfer of inventory to research and development by buyer

Assuming that the buyer transfers and capitalises some of the inventory items (medical equipment) to its research and development project which is currently carried out by a licensed R&D institution, there is a tax implication to the buyer. Under s.15BA (effective from 2018/19), if a trading stock is appropriated by the taxpayer from 'trade' to 'non-trade' purposes, then the amount which the trading stock appropriated would have realised if sold in the open market at the time of appropriation becomes taxable. Therefore, the buyer will be taxed as if these inventory items had been sold at market price, and the profit is calculated based on the excess of market price over the cost incurred. This is the case even though the buyer has not received or earned any income arising from the transfer of these inventory items.

On the other hand, upon the transfer of the items for R&D purposes, the buyer is eligible for 100% tax deduction under s.16B if stipulated conditions are met. The deduction under s.16B is also applicable to cost for plant and machinery which includes medical equipment.

[**Tutorial note:** *On passing the new law on 2 November 2018, the buyer is entitled to enhanced R&D deduction on the qualifying R&D expenditure if stipulated conditions are met. If the R&D institution confirms that the current R&D project is a qualifying R&D activity under 'Type B' as defined by the IRD, the qualifying 'Type B' R&D expenditure, including plant and machinery, is therefore eligible under s.16B for an enhanced tax deduction of 300% up to the first $2 million, and 200% for the remaining balance, with no ceiling.*]

(c) If shares in Sugar Ltd are sold instead

If the buyer chooses to acquire the entire shareholding in Sugar Ltd, this would be regarded as a 'share deal' and the shareholding transfer is between Salt Ltd (the shareholder of Sugar Ltd) and the buyer. Salt Ltd is the transferor in this deal, and any tax implication arising from the transfer of shareholding is accountable to Salt Ltd rather than Sugar Ltd. As Salt Ltd is a foreign company not carrying on business in Hong Kong, it is likely that any profit arising from the share transfer would not be taxable in Hong Kong.

However, there are stamp duty implications upon the transfer. As Sugar Ltd is incorporated in Hong Kong, so its register of members (shareholders) should be located in Hong Kong. Its shares will be Hong Kong stock as defined in s.2(1) of the SDO. Therefore the parties effecting the sale and purchase of the shares must prepare and stamp contract notes for their sale and purchase and an instrument of transfer (s.19(1) and Heads 2(1) and 2(4) respectively). Stamp duty on the contract notes under Head 2(1) is 0·2% of the amount of the stated consideration or the market value of the shares, whichever is higher. In this case, assuming the same consideration of $38 million is applied to the share transfer, the stamp duty on the contract notes under Head 2(1) will be $76,000 ($38 million x 0·2%), which is jointly and severally payable by the transferor (Salt Ltd) and the buyer. The duty under Head 2(4) on the instrument of transfer is $5.

(d) Transfer and redundancy of employees: Sugar's compliance obligations

As part of the 'package sale', some employees are transferred from Sugar Ltd to the buyer while other employees will be made redundant. From the perspective of Sugar Ltd, all employees will be treated as ceasing employment with Sugar Ltd, requiring compliance obligations to be fulfilled as follows:

(1) to submit notification to the IRD of any employee who is about to cease to be employed within one month before cessation (s.52(5));

(2) in view of the expatriate employee who may return to his home country upon cessation, Sugar Ltd is to submit notification of the 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

(3) to retain money payable to the expatriate employee who will cease employment and leave Hong Kong for one month from the date of the notice (s.52(7)). Money can be released to the employee once a letter of release is issued by the IRD.

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

End of report

2 Peter and Phoebe

(a) Tax position in respect of Peter's employment with HK Ltd

Under the Inland Revenue Ordinance (IRO), salaries tax is charged on income from an employment, office and pension arising in, or derived from Hong Kong (s.8). Income from employment includes income derived from services rendered in Hong Kong and excludes income derived from services rendered outside Hong Kong (s.8(1A)).

Following the *Goepfert* case, the source of employment income is determined by where the employment is located.

If the employment is located in Hong Kong, the employment income is fully taxable unless the employee renders ALL their services outside Hong Kong (s.8(1A)(b)), or the employee 'visits' Hong Kong for not more than 60 days in the year of assessment in issue (s.8(1B)).

If the employment is located outside Hong Kong (that is, a non-Hong Kong employment), only the income derived from services rendered in Hong Kong, including attributable leave pay, is chargeable to salaries tax. For off shore employments assessable income is usually computed based on time-in-time-out apportionment, with the overriding exception that no tax will be charged if the employee only 'visits' Hong Kong for no more than 60 days in the year of assessment.

It is critical to identify the location of employment. Based on the *Goepfert* case, the Inland Revenue Department (IRD) Departmental Interpretation and Practice Note No. 10 states that an employment is a non-Hong Kong employment where the following three factors are present:

(1) the contract of employment was negotiated, entered into, and is enforceable outside Hong Kong;
(2) the employer is resident outside Hong Kong; and
(3) the employee's remuneration is paid to him outside Hong Kong.

If all of the above factors are not outside Hong Kong, the first two factors become more important.

However, when the employer is resident in Hong Kong (the second factor), the IRD tends to accept that the employment is a Hong Kong employment. The IRD also reserves the right to look beyond these three factors where in reality the employment is a Hong Kong employment but manipulation exists.

Peter's employer, HK Ltd (HKL), would be regarded as resident in Hong Kong on the basis that it has its central management and control in Hong Kong. Therefore, Peter's employment would be regarded as a Hong Kong employment and he will be chargeable to salaries tax on all of his income from his employment with HKL.

The exemption for services rendered outside Hong Kong (under s.8(1A)(b)) is not available to Peter because he renders services in Hong Kong, and his presence in Hong Kong will be that of either a 'non-visitor' or more than 60 days. No time-apportionment is applicable to a Hong Kong employment.

(b) Relief from double taxation

In calculating assessable income for Hong Kong salaries tax purposes, if:

(1) a taxpayer is chargeable to tax in a territory outside Hong Kong in respect of income from services rendered in that territory,
(2) and the tax is of substantially the same nature as salaries tax in Hong Kong,
(3) and the overseas tax has been paid (the above three facts are collectively referred to as 'double taxation"),

the taxpayer may exclude that part of their income on which foreign tax has been paid (s.8(1A)(c)).

However, with effect from the year of assessment 2018/19, if the double taxation arises in a territory with which Hong Kong has a double taxation arrangement (DTA) and the taxpayer is entitled to tax credit relief under that DTA, the outright exemption under s.8(1A)(c) is not available (s.8(1C)). Instead, the income is subject to salaries tax and relief from double taxation has to be claimed under s.50 by crediting the foreign tax paid against the Hong Kong salaries tax payable.

Tax payable in respect of any income in the DTA territory concerned is allowed as a credit against tax payable in respect of that income in Hong Kong (s.50(1)), provided that the person entitled to the income is a Hong Kong resident person for that year (s.50(2)).

In the case of Peter, he is chargeable to tax in the Mainland in respect of his income from services rendered in the Mainland with which Hong Kong has a DTA, and he is a Hong Kong resident person. Therefore, Peter is eligible to claim foreign tax credit relief under s.50.

In computing the amount of Peter's total income, in the first instance no deduction shall be allowed in respect of the tax paid in the Mainland. The amount of tax paid in the Mainland is included in computing income subject to tax in Hong Kong. However, due to the differences in tax rates between the Mainland and Hong Kong, the tax paid in the Mainland may exceed the amount of the credit limit. In such circumstances, the excess is allowed as a deduction. Any tax paid in the Mainland which is not allowed as a credit is not available to be carried forward to subsequent years of assessment (s.50(5) and DIPN No. 44, para 136).

Moreover, Peter is required to make full use of all other available reliefs under the DTA and the laws of the Mainland to minimise the amount of foreign tax payable before claiming a tax credit (s.50AA(2)). If subsequently, the amount of the relief becomes excessive as a result of an adjustment to the Mainland tax payment, Peter must give the Commissioner written notice of the adjustment within three months after the adjustment is made (s.50AA(5)).

If the amount of the relief becomes excessive or insufficient by reason of an adjustment to the amount of the Mainland tax or tax payable in Hong Kong, an assessment, additional assessment or claim to which the adjustment gives rise may be made before (a) the end of two years from the time when all assessments, adjustments and other determinations have been made, whether in the Mainland or in Hong Kong, which are material in determining whether any, and if so what, relief is to be granted; or (b) the expiry of the time limit for making an assessment, additional assessment or claim for relief under the IRO, whichever is the later (s.50AA(6)).

A claim for a tax credit may only be made by Peter before (a) the end of six years after the end of the year of assessment; or (b) the end of six months after the date on which an assessment is made imposing liability or additional liability to tax in respect of the income on which tax in the Mainland has been assessed, whichever is the later (s.50(9)). If an assessor refuses to allow Peter's claim for a tax credit, the assessor must give him a written notice of the refusal and Peter has the same rights of objection and appeal as if the notice were a notice of assessment (s.50(9A)).

(c) Calculation of Peter's salaries tax liabilities

Salaries tax payable by Peter for the year of assessment 2018/19

	$
Salaries (90,000 x 12)	1,080,000
Less: MPF contributions	(18,000)
	1,062,000
Less: Married person's allowance	(264,000)
Net chargeable income	798,000
Tax payable at progressive rates	117,660
Effective tax rate in HK = 117,660/1,062,000	11·08%
Net income from the Mainland after tax (grossed up at the effective tax rate in HK) (810,000 – 150,000) x 100%/(100% – 11·08%))	742,240
Less: Net income from the Mainland after tax	(660,000)
Tax credit limit for tax paid in the Mainland	82,240

[**Tutorial note:** *Notional Hong Kong tax on income taxed in the Mainland is $89,748 (810,000 x 11·08%). If the tax credit limit is higher than the notional Hong Kong tax, the tax credit is restricted to $89,748.*]

	$	$
Assessable income (HK)		270,000
Assessable income (the Mainland) after deduction of tax	660,000	
Add: Tax deducted	150,000	810,000
Total HK assessable income		1,080,000
Less: Amount not allowed as a tax credit (150,000 – 82,240)		(67,760)
		1,012,240
Less: MPF contributions		(18,000)
		994,240
Less: Married person's allowance		(264,000)
Net chargeable income		730,240
Tax payable at progressive rates		106,140
Less: Tax credit allowed		(82,240)
HK salaries tax payable		23,900

(d) Options for Phoebe to take over the boutique business

In the event that Phoebe takes over the shares in the BVI company, profits earned by the boutique will belong to the BVI company. Although the company is incorporated in the BVI, it will be regarded as carrying on business in Hong Kong because its retail shop is located in Hong Kong.

Boutique business profits will be considered as sourced in Hong Kong since the boutique is located in Hong Kong. As a result, the BVI company will be assessed to profits tax in Hong Kong (at 8·25% for the first $2 million of profits and 16·5% for the remainder of profits) in respect of the profits earned by the boutique in Hong Kong. Any after-tax profits may be distributed by the company to Phoebe in the form of a dividend. Phoebe will not pay any personal tax on the dividend income.

If the boutique business incurs losses, the losses will remain in the BVI company and be carried forward to set off the future profits earned by the BVI company. In these circumstances, there will not be any tax consequences to Phoebe. Even if Phoebe elects for personal assessment, any boutique business income earned or losses incurred by the BVI company will not be eligible to be combined with Phoebe's rental income assessed to tax in Hong Kong. As the dividend income is not taxable, it also is not required to be included in the personal assessment.

In the event that Phoebe runs the business as a sole proprietor, the profits from the business will be directly attributable to Phoebe. In this case, Phoebe will be charged to profits tax in respect of the assessable profits of the business at 7·5% for the first $2 million of profits and 15% for the remainder of profits, which is 0·75% and 1·5% less than is the case where the profits are derived by the BVI company. There can be legally no dividend distribution and any after-tax profits will automatically become part of Phoebe's disposable income.

If the boutique business incurs losses, the losses will be carried forward to set off against future profits earned by the same business. However, since Phoebe also has rental income, it will be more tax effective for her to elect for personal assessment so that the losses from the boutique business will be combined with her rental income to achieve an immediate tax relief.

If she would incur any interest on loans obtained to acquire the property which gives rise to letting income, the interest payable can be offset against the net assessable value of the property. Such offset is not available if personal assessment is not elected.

3 Mr Lee

(a) Redundancy payment and compensation for restrictive covenant

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 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 in its own merits. Generally if the payment is a one off one, or one for long-term benefits, the expenditure is a capital expenditure.

In the case of redundancy payments made in accordance with the statutory requirement, it has been established in *CIR 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 obligations incurred in the running of the business prior to its cessation. More importantly, since it is statutorily required, the liability to pay will have been incurred as a cost of employing staff from the time the staff were employed, even though this liability does not crystallise until actual payment is made. As redundancy payments were attributed to the basis periods for past years of assessment when the respective employees were employed, the redundancy payments should be seen as part of the remunerations of the respective employees incurred by Sour Ltd. Provided that the remunerations PAID in the past are not capital expenditure in past years of assessment, the redundancy payment should be deductible from Sour Ltd's assessable profits for the basis period in which Sour Ltd ceased business.

In respect of the payment for the restrictive covenant to Mr Lee by Sour Ltd, its deductibility depends on whether s.16(1) is satisfied and, if so, whether s.17(1) will nevertheless disallow it. As Sour Ltd is to cease its business, the restrictive covenant aims to protect its associate companies' businesses, and is thus beneficial to the associate companies rather than Sour Ltd. In this case, the restrictive covenant payment is not relevant to Sour Ltd's profits and thus not incurred in the production of Sour Ltd's assessable profits. As s.16(1) is not satisfied, the payment would not be tax deductible to Sour Ltd. There is no issue under s.17(1) for the payment for the restrictive covenant.

(b) Taxability of compensation for restrictive covenant

From the perspective of Mr Lee, the taxability of the compensation depends on whether it is an income from employment (s.8(1)(a)) which includes a reward for services, or a compensation for deprivation of rights. If the latter, the compensation is not income from employment or provision of services and would not be taxable under salaries tax. In this case, provided that documentary evidence exists to prove that the payment is to compensate for Mr Lee's loss of rights in joining other competitors and the obligation to pay such compensation is not stated in the employment contract, the compensation is not taxable.

(c) Consultancy proposal

Based on the discussion between Mr Lee and his supervisor, it is likely that the company established by Mr Lee will be regarded by the Inland Revenue Department (IRD) as a Type I service company and the provisions of s.9A will be applied to determine whether the new appointment constitutes a contract for services (i.e. an independent contractor), or a contract of service (i.e. an employment). If s.9A applies, the arrangement will be 'looked through', such that the relationship between Sour Ltd and Mr Lee will continue to be treated as an employer–employee relationship. Any payment made to the service company will be deemed as employment income received by Mr Lee who will provide the services to Sour Ltd in return for the income. Accordingly, salaries tax will be imposed on Mr Lee based on the total amount of the service fee receivable by the service company (instead of the salary which might be payable by the service company to Mr Lee). As the service company is being 'looked through', it will be exempt from profits tax in respect of the fee received, and correspondingly, no expense deduction will be allowed to the service company.

For s.9A to successfully apply, the following conditions must be satisfied:

(i) There is an agreement – in this case, the service contract between Sour Ltd and the service company will be the relevant agreement.

(ii) There is a 'relevant person' – in this case, Sour Ltd will be the relevant person who carries on business in Hong Kong and who will enter into a service contract with the service company.

(iii) There is a 'relevant individual' – in this case, Mr Lee will be the relevant individual who will provide the services to the relevant person (Sour Ltd) pursuant to the service contract.

(iv) The remuneration for the relevant individual's service is paid to a service company which is under the control of the relevant individual – in this case, the remuneration for the services will be paid to the service company, which will be wholly owned and controlled by Mr Lee.

If the above conditions are satisfied, *prima facie* the arrangement will be regarded as a 'disguised employment' between Mr Lee and Sour Ltd. However, s.9A can have no application to deem such an employer–employee relationship if ALL of the following criteria in relation to the appointment terms are satisfied:

(1) The remuneration for the service should not include any of the employment-like fringe benefits stipulated in s.9A(3)(a), one of which is annual leave. In this case, Mr Lee will continue to be entitled to most of the staff benefits including annual leave and annual performance bonus. This criteria is not satisfied.

(2) The relevant individual (Mr Lee) also carries out similar services for persons other than the relevant person (Sour Ltd). In this case, Mr Lee is the individual designated to provide the services to Sour Ltd. However, if Mr Lee or his service company will also provide similar services to other parties, this factor will be satisfied.

(3) The performance of any services by the relevant individual (Mr Lee) is not subject to any control or supervision commonly exercised by an employer. No information on this point is given in the question.

(4) The remuneration is not paid or credited periodically or calculated on a basis commonly used in employment contracts. The service fee will be payable to Mr Lee on a quarterly basis, which does not appear to be a common basis for employment remuneration.

(5) The relevant person (Sour Ltd) does not have the right to terminate the services of the relevant individual (Mr Lee) as if in the capacity of an employer. Again, there is no information on this point.

(6) The relevant individual (Mr Lee) is not held out to the public to be an officer or employee of the relevant person (Sour Ltd). In this case, Mr Lee will continue to use his existing business card, indicating that he will continue to represent himself as an employee of Sour Ltd even after the proposed consultancy arrangement.

It is for Mr Lee to prove the above conditions apply to his case. Given that not all of the above criteria are satisfied, it is likely that the disguised employer–employee relationship between Sour Ltd and Mr Lee will remain.

However, there is still an 'escape clause' under s.9A(4) allowing a genuine service company to escape from the deeming provision. If the CIR is satisfied that in substance Mr Lee is not holding an office or employment, the escape clause will apply. For this purpose, the common criteria (integration test, control test, and economic reality test) leading to the distinction between

a contract of service (i.e. an employment) and a contract for services (i.e. an independent contractor) will be examined. If Mr Lee could prove this with sufficient evidence, Mr Lee might genuinely be accepted as an independent consultant. Otherwise, a disguised employer–employee relationship will be deemed by s.9A, and Mr Lee will continue to be treated as an employee of Sour Ltd and subject to salaries tax.

4 (a) (i) Proposal 1: Intercompany loan to China Ltd

Under this proposal, AB Ltd has to pay interest on the loan from MegaBank and receives interest income from China Ltd on the intercompany loan.

Taxability of interest income on the shareholder loan

Any person carrying on a trade, profession or business in Hong Kong is chargeable to profits tax in respect of the profits derived from such trade, profession or business arising in or derived from Hong Kong (s.14(1)). In the case of interest income, s.15(1)(f) also provides that interest income earned by a corporation carrying on a business in Hong Kong is deemed as a taxable trading receipt if the interest is derived from Hong Kong. In determining the source of interest income, there are two possible approaches, viz:

One approach is that one should look at what the taxpayer has done to earn the interest income, taking a broad approach looking at all the lending activities carried out by the taxpayer. This is the approach taken by the Privy Council in deciding the case of *Orion Carribbean* v *CIR* in 1997.

The other approach takes into consideration the place where the loan is first made available to the borrower; and if the place is in Hong Kong, its source is in Hong Kong thereby rendering the interest chargeable to profits tax. Otherwise the source is outside Hong Kong and not chargeable to profits tax. This is based on an old case as well as a dictum by the Privy Council in the *Hang Seng Bank* v *CIR* case.

The current practice is to apply the 'provision of credit' test (as stated in Departmental Interpretation and Practice Note No. 13), except for interest forming part of a trading transaction, involving a mortgage asset, or from a money-lending transaction. Under the 'provision of credit' test, the loan interest is regarded as sourced in Hong Kong if the loan is first made available to the borrower in Hong Kong.

In the case of AB Ltd extending the intercompany loan to China Ltd, the source of loan interest income receivable by AB Ltd depends on the place where the loan is first made available to China Ltd. The case given does not specify how the loan is remitted. If the loan money is remitted to the People's Republic of China (PRC) bank account of China Ltd, the place of credit is in the PRC and the source of interest income is offshore Hong Kong. Despite the absence of specific information given, it is reasonable to assume that the loan money is remitted to the PRC for use by China Ltd to acquire the PRC property. In the circumstances, AB Ltd is not taxable on the interest income receivable from China Ltd on the shareholder loan.

Deductibility of interest expense on MegaBank loan

Under s.16(1), any expense or outgoing incurred in the production of assessable profit is deductible, unless specifically provided. In the case of loan interest, s.16(1)(a) also provides that the money borrowed is required to be used for the purpose of producing assessable profits. In addition to the general rule, for a deduction to be allowed, at least one of the conditions under s.16(2) must be satisfied.

To satisfy the general rule, whether an interest is incurred 'for the purpose of producing assessable profits' is usually dependent upon how the loan proceeds are applied. In this proposal, the loan proceeds are to be used to finance the intercompany loan extended to China Ltd. If the intercompany loan is interest-bearing and the interest receivable by AB Ltd is assessable to tax in Hong Kong, s.16(1) and s.16(1)(a) would be satisfied. Based on the case given and the analysis of the interest income above, it is likely that the interest on the shareholder loan is not taxable in Hong Kong. As a result, the general deductibility rule under s.16(1) and s.16(1)(a) are not satisfied. The interest incurred by AB Ltd on the MegaBank loan is not deductible.

(ii) Proposal 1 (modified): Equity injection into China Ltd

Assuming that the MegaBank loan is injected as further equity share capital into China Ltd, AB Ltd will not receive interest income from China Ltd. Instead, the return to AB Ltd would be dividend income which is exempt from tax in Hong Kong on the basis that the dividend is offshore sourced. As a result, the proceeds from MegaBank loan cannot be regarded as used for the production of assessable profits, hence the general tax deductibility rule under s.16(1) and s.16(1)(a) is not satisfied.

(iii) Proposal 2: Acquisition of residential property as the sales director's living accommodation

Under this proposal, AB Ltd incurs interest on the MegaBank loan and uses the loan to buy Hong Kong residential property used as accommodation for its sales director.

As explained above, the general deductibility rule requires the loan proceeds to be used for the production of assessable profits. In the case where the proceeds are used to acquire a capital asset, one would look at whether the capital asset is being put into use in a way which contributes to the course of business in the production of assessable profits. In this case, the proceeds are used to acquire a residential property which is put into use as a staff benefit which, together with other staff costs, contributes to the operation of the business for the production of assessable profits. As a result, s.16(1) and s.16(1)(a) are satisfied.

The law continues to require that any one of the conditions under s.16(2) must be satisfied for interest to be tax deductible. Under s.16(2)(d), the payment of interest to a bank in Hong Kong is already eligible, subject to the restriction under s.16(2A) and s.16(2B). Under s.16(2A), the deduction of interest is restricted if the loan is secured by any deposit or loan which derives non-assessable income in Hong Kong. Under s.16(2B), the deduction of interest is restricted if there is any arrangement in place whereby any interest payment is ultimately flowed back to the borrower or its connected person.

In the case of AB Ltd, it is assumed for this part that no security is put in place for the MegaBank loan. Therefore, s.16(2A) would not apply. There is also no information to indicate that there is any arrangement for interest flow back. Section 16(2B) also does not apply. In conclusion, AB Ltd is able to deduct the interest expense incurred under proposal 2.

(b) MegaBank loan is secured by RMB deposit and used for proposal 2

Based on the analysis under (a)(iii) above, s.16(1) and s.16(1)(a) are satisfied on the basis that the loan proceeds are used to acquire a property used as a staff benefit for the production of assessable profits. Section 16(2)(d) is also satisfied as the interest is payable to a bank in Hong Kong.

However, the restriction under s.16(2A) may be applicable if the loan is secured by a RMB deposit placed by Mr Chen with MegaBank (PRC). As a shareholder of HK Ltd, Mr Chen is an associated person for the purpose of applying s.16(2A). The PRC branch and HK branch of MegaBank are also regarded as associated persons for this purpose. Although interest is earned on the deposit, Mr Chen would not be assessed to Hong Kong tax on the bank interest unless he is carrying on a money-lending business. In Hong Kong, interest income is only taxable under profits tax if it is sourced in Hong Kong earned by a trade, profession or business carried out in Hong Kong.

On the basis that the deposit interest income is not taxable in Hong Kong, the tax deduction for AB Ltd on the interest paid to MegaBank is to be restricted, such that the total interest expense will be reduced by the HK$ equivalent of non-taxable interest income earned on the RMB deposit by Mr Chen.

(c) Shareholder loan from Mr Chen to AB Ltd and used for proposal 2

Based on the analysis under (a)(iii) above, s.16(1) and s.16(1)(a) are satisfied on the basis that the loan proceeds are used to acquire a property used as a staff benefit for the production of assessable profits. However, in this case, interest is incurred on the loan from Mr Chen who is not a financial institution. Therefore, s.16(2)(d) would not apply. Under s.16(2)(c), tax deduction is eligible when the interest is payable to a non-corporation and the interest in the hands of the lender is taxable in Hong Kong. In this case, interest is payable by AB Ltd to Mr Chen. However, as an individual not carrying on a money-lending business in Hong Kong, Mr Chen will not be assessed on the loan interest income receivable. As a result, s.16(2)(c) would not apply to allow the tax deduction for AB Ltd on the interest incurred. Section 16(2)(e) would also not be applicable as the loan would be used to acquire the property which is not trading inventory or plant and machinery of the company, and the lender is an associate of the company.

			Available	*Maximum*
1	(a)	**Profit from 'package sale'**		
		Capital profits v revenue profits	1·0	
		Each asset to be examined	0·5	
		Need to allocate prices to different assets sold	0·5	
		Otherwise, the IRD will do this	0·5	
		Total accounting profit non-taxable	0·5	
		First $2m at 8·25%; balance at 16·5%	1·0	
		Individual asset items		
		Yuen Long office		
		Capital profit not taxable	0·5	
		Qualifies for CBA based on construction cost of building	1·0	
		Annual allowance at 4%, no initial allowance	1·0	
		Balancing charge/allowance arises on disposal	0·5	
		Balancing charge $2,080,000 limited to total allowance claimed	1·0	
		Stamp duty under Head 1, at Scale 1 (Part 2), 1·5% to 8·5%	1·0	
		Based on consideration allocated or market value if higher	0·5	
		Estimated $2,380,000 ($28m x 8·5%)	1·0	
		Special stamp duty and buyer's stamp duty not applicable	1·0	
		Risk of 'voluntary disposition'	0·5	
		Solar water heating system		
		Capital expenditure but tax deduction over five years	0·5	
		Unallowed deduction upon disposal $100,000	0·5	
		Taxable upon disposal $350,000 ($450,000 – $100,000)	1·0	
		Inventory		
		If sold upon cessation, buyer carries on business in HK, claims deduction	1·0	
		Transfer at cost acceptable under s.15C	0·5	
		Otherwise, open market value used	0·5	
		Applicable in this case, no profit or loss to Sugar Ltd	1·0	
		Patent		
		Capital cost 100% deductible under s.16EA	0·5	
		But not applicable due to self-developed patent	0·5	
		R&D deductible under s.16B	0·5	
		Disposal proceeds taxable if deduction claimed before	0·5	
		Subject to deduction claimed	0·5	
			19·5	18
	(b)	**Change of inventory by buyer**		
		S.15BA applies if inventory changes from 'trade' to 'non-trade'	1·0	
		Taxable as if sold at market price	0·5	
		Excess of market price at time of inventory transferred over cost	0·5	
		Tax deduction on R&D expenditure	1·0	
				3
	(c)	**If shares are sold instead**		
		Transfer between Salt Ltd and buyer, tax implication on Salt Ltd	0·5	
		Salt Ltd is not carrying on business in HK, not taxable on profits if any	1·0	
		Stamp duty applies to transfer of Hong Kong stock	0·5	
		Sugar Ltd is HK company	0·5	
		Prepare and stamp contracts notes and instrument of transfer	1·0	
		Stamp duty payable on contract note is $56,000	1·0	
		Stamp duty payable on instrument of transfer is $5	1·0	
		Jointly and severally payable by seller and buyer	1·0	
			6·5	6

	Available	Maximum
(d) Transfer and redundancy of employees		
Compliance obligation for cessation of employment	0·5	
Notification of cessation within one month before cessation	1·0	
Notification of leaving HK within one month before departure	1·0	
Retain money for leaving HK employee for one month from notice	1·0	
Letter of release from IRD after all HK tax is settled	0·5	4
Presentation:		
Appropriate format and presentation	2·0	
Logical development	1·0	
Effectiveness of communication	1·0	4
		35

		Available	Maximum
2	Peter and Phoebe		
(a)	**Position in respect of Peter's employment with HK Ltd**		
	Scope of charge under s.8/s.8(1A)	0·5	
	HK employment income potentially fully taxable	0·5	
	Unless all services rendered outside HK	0·5	
	Or visits not more than 60 days	0·5	
	Offshore employment taxes only income from services in HK	0·5	
	No tax if visits HK for not more than 60 days	0·5	
	Source of employment under the *Goepfert* rule (three criteria)	1·0	
	Employer (HK Ltd) is resident in HK, with reason	0·5	
	Employment is HK-sourced	0·5	
	Taxed on 100% basis	0·5	
	No time apportionment applies, with reason	0·5	
		6·0	5
(b)	**Relief from double taxation**		
	Exclusion of income on which foreign tax has been paid (s.8(1)(A)(c))	1·0	
	S.8(1A)(c) exemption not applicable if double taxation arises in a DTA territory	0·5	
	Instead, foreign tax credited against HK salaries tax payable under s.50	0·5	
	Provided the person is a HK resident	0·5	
	Peter has to claim the foreign tax credit relief	1·0	
	No exclusion of income on which tax had been paid in the Mainland	0·5	
	No deduction for tax paid in the Mainland	0·5	
	Excess of Mainland tax paid over the credit limit allowed as a deduction	1·0	
	But cannot be carried forward to subsequent years	0·5	
	Peter is required to make full use of other available reliefs to minimise Mainland tax payable before claiming a tax credit	0·5	
	And notify the IRD of any adjustment to Mainland tax payments which may result in tax credit granted being excessive	0·5	
	Time limit for assessment/additional assessment/claim under s.50AA(6)	0·5	
	Time limit for a claim for a tax credit	0·5	
	Right of objection and appeal to an assessor's refusal to allow relief	0·5	
		8·5	7
(c)	**Calculation of Peter's salaries tax liability**		
	Calculation of effective tax rate in HK	1·5	
	Calculation of credit limit for tax paid in the Mainland	1·5	
	Calculation of net chargeable income	3·0	
	Calculation of HK salaries tax payable for 2018/19	2·0	8
(d)	**Options for Phoebe to take over the boutique business**		
	BVI company is managed and controlled in HK, thus carrying on business in HK	0·5	
	Boutique profit is sourced in HK and subject to profits tax	0·5	
	After-tax profits distributed to Phoebe as dividend, not taxable	0·5	
	Losses by BVI company carried forward	0·5	
	BVI company's profit/loss not eligible to be combined under PA	0·5	
	Dividend income not taxable, so not combined under PA	0·5	
	If taken over directly, Phoebe is assessable to profits tax	0·5	
	Lower tax rate (7·5% and 15% v 8·25% and 16·5%)	0·5	
	Business profit/loss can be combined with other income under PA	0·5	
	More tax effective to elect for PA if boutique business is held directly	0·5	
	Mortgage loan interest also deductible under PA	0·5	
		5·5	5
			25

3 Mr Lee

		Available	Maximum
(a)	**Redundancy payment and compensation for restrictive covenant**		
	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	
	Compensation for restrictive covenant – s1.6(1) deduction rule?	0·5	
	Beneficial to Sour Ltd's associates, not Sour Ltd	1·0	
	S.16(1) is not satisfied, not deductible	1·0	8
(b)	**Taxability of compensation for restrictive covenant**		
	Income from employment or compensation for deprivation of rights	1·0	
	Not taxable if deprivation of rights	0·5	
	Compensation for loss of right to join competitors	0·5	
	If not in contract, not taxable	0·5	
		2·5	2
(c)	**Consultancy proposal**		
	Type I service company	0·5	
	Contract for services v contract of service	0·5	
	Employer–employee relationship	0·5	
	Deemed as employment income	0·5	
	Service company 'looked through'	0·5	
	Salaries tax payable on total service fee	0·5	
	An agreement	0·5	
	A relevant person (Sour Ltd)	0·5	
	A relevant individual (Mr Lee)	0·5	
	Remuneration paid to a service company	0·5	
	Service company under the relevant individual's control	0·5	
	Deemed as disguised employer–employee relationship	0·5	
	Six criteria for s.9A not to be applied	3·0	
	Escape clause: Commissioner's discretion	1·0	
	Integration test, control test, economic reality test	1·5	
		11·5	10
			20

				Available	Maximum
4	(a)	(i)	**Proposal 1: Intercompany loan to China Ltd**		
			S.14(1) – scope of profits tax charge	0·5	
			S.15(1)(f) – deemed taxable trading receipt	0·5	
			Provision of credit test	1·0	
			Except for trading, mortgage loan or money-lending business	1·0	
			If remitted to PRC, offshore sourced	1·0	
			Not taxable to AB Ltd	0·5	
			S.16(1) – general deductibility rule	0·5	
			S.16(1)(a) – use of loan money for producing assessable profits	0·5	
			S.16(2) – any condition met	0·5	
			Interest on shareholder loan not taxable, thus general rule not met	0·5	
			Interest on Loan-1 not deductible	0·5	7
		(ii)	**Proposal 1 (modified): Equity injection into China Ltd**		
			No interest income is earned on equity injection	0·5	
			Dividend income not taxable in HK, offshore	0·5	
			Loan-1 not used for producing assessable profits	0·5	
			Interest on Loan-1 not deductible	0·5	2
		(iii)	**Proposal 2: Acquisition of property as staff accommodation**		
			Whether asset acquired is used to produce assessable profits	0·5	
			Staff accommodation is staff benefit for production assessable profits	0·5	
			S.16(1) and s.16(1)(a) met	1·0	
			S.16(2)(d) is met	0·5	
			Restrictions under s.16(2A) and s.16(2B)	1·0	
			No security, s.16(2A) does not apply	0·5	
			Presumably s.16(2B) does not apply	0·5	
			Interest on Loan-1 is deductible	0·5	5
	(b)		**Loan-1 is secured by RMB deposit and proposal 2**		
			Restriction under s.16(2A) applies	0·5	
			Mr Chen and AB Ltd are associated	0·5	
			PRC and HK branches of Megabank are associated	0·5	
			Interest on RMB deposit not taxable	0·5	
			Tax deduction is reduced by non-taxable interest on RMB deposit	1·0	3
	(c)		**Shareholder loan from Mr Chen to AB Ltd and used for proposal 2**		
			S.16(1) and s.16(1)(a) satisfied	0·5	
			S.16(2)(d) does not apply as lender is not financial institution	0·5	
			S.16(2)(c) applies if interest is paid to non-corporation and taxable	1·0	
			Mr Chen is not assessable to tax on interest income	0·5	
			S.16(2)(e) does not apply as not trading stock or plant and machinery	0·5	
			Interest on shareholder loan is not tax deductible to AB Ltd	0·5	
				3·5	3
					20