SECTION A – CASE QUESTIONS

Answer 1

DIPN

Issued by the IRD, DIPN clarifies the IRD's viewpoints on particular tax provisions and/or the practice of the IRD in certain given situations. It also outlines the IRD's respective procedures in administrating relevant provisions of the IRO. Notwithstanding that DIPN has no binding force in law (BOR D54/06, para. 25), the IRD would follow, in general, what has been laid down in the DIPNs, both interpretation of tax provisions and assessing practices.

BOR Decisions

The BOR is an independent statutory body to determine tax appeals. Decisions made by the BOR are final with regard to the facts of a particular case. In addition, BOR's decisions are not binding on other BOR cases. With reference to the BOR's decisions, taxpayers can identify how the relevant provisions in the IRO are interpreted and applied in the circumstances.

Local Court Cases for tax

In the appeals to the Hong Kong Courts, the judges are required to decide the cases by expressing their opinion in respect of questions of law. If taxpayers or the IRD cannot agree on the interpretation of a provision in the IRO, both parties can use the appeal procedures laid down in the IRO to seek a ruling on a question of law from the Courts. In addition, the decisions of a higher court (e.g. Court of Final Appeal) bind all lower courts and the BOR, i.e. the doctrine of judicial precedent.

Answer 2

Under s.4 of the IRO, officers of the IRD shall preserve secrecy with regard to all matters relating to the affairs of any person coming to his knowledge, except in the performance of his duties under the IRO. However, s.49(5) of the IRO provides that where any arrangements have effect by virtue of that section, the obligation as to secrecy under s.4 of the IRO shall not prevent the disclosure to any authorised officer of the government with which the arrangements are made of such information as is required to be disclosed under the arrangements. Therefore there is no contravention by the IRD in this regard (para. 10 of DIPN No. 47, Revised January 2014).

Answer 3

As Zeus is a non-resident from a Hong Kong tax perspective, its royalty income should not be subject to profits tax under s.14(1) of the IRO notwithstanding that it is derived from Hong Kong. However, the income is deemed as a taxable trading receipt under s.15(1)(b) of the IRO as the amount was received by or accrued to Zeus from the use of a trademark in Hong Kong by Abas. Zeus is therefore chargeable to tax as a non-resident and under the name of Abas who paid these sums under the licensing agreement in accordance with s.20B(1)(a) & (2) of the IRO. Under s.21A(1) of the IRO, the assessable profits of the deemed trading receipts attributable to Zeus would be either (i) 100% of the sum derived by Zeus as an associate of Abas, unless no person carrying on business in Hong Kong has at any time wholly or partly owned the respective trademark, or (ii) 30% of the sum derived thereon in any other case. Subject to the application of s.21A(1) of the IRD, the respective profits tax liability is either HK$165,000 (HK$1,000,000 x 16.5%) or HK$49,500 (HK$1,000,000 x 30% x 16.5%). Abas is required to withhold the respective amount on behalf of Zeus for tax payment purposes under s.20B(2) of the IRO.

Answer 4

As the entertainment performance of Ms Metis Minos is exclusively conducted in Hong Kong, income received by her in connection to the singing concerts is derived in Hong Kong and should be chargeable to profits tax as a non-resident under s.20B(1)(b) of the IRO. Under s.20B(2) of the IRO, Ms Metis Minos would be chargeable to tax as a non-resident person in the name of Abas as the sum paid or credited to her is from Abas in accordance to the concert arrangement.

In ascertaining the assessable profits of Ms Minos as a non-resident with respect to the entertainment performance in Hong Kong, s.21 of the IRO does not specify any percentage of the income to be computed accordingly. In this regard, the IRD usually adopts 2/3 of the gross income as the assessable profits chargeable to profits tax (para. 14, DIPN No.17, Revised January 2005). Accordingly, the profits tax payable of Ms Minos is HK$600,000 ($6,000,000 x 2/3 x 15%). Abas is required to withhold the amount on behalf of Ms Minos for tax payment purposes under s.20B(2) of the IRO.

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Answer 5

(Either method A)

Step 1:

The amount of tax credit limit for tax paid in the PRC by Abas:

	HK$	HK$
PRC tax paid ($300,000 x 25%)		75,000
Credit limit of tax paid in the PRC Net profit from the PRC grossed up at ($300,000 - $75,000) x 1 / (1 - 16.5%)	269,461	
Less: Net profit from the PRC after deduction of tax ($300,000 - $75,000)	225,000	
Tax credit limit for tax paid in the PRC	44,461	(44,461)
Amount not allowed as tax credit (To be allowed as Deduction)		30,539

Step 2:

The Hong Kong profits tax payable for Abas with the tax credit:

	HK$
Assessable profits	5,000,000
Less: amount not allowed as tax credit	(30,539)
	4,969,461
Tax thereon @16.5%	819,961
Less: Tax credit	(44,461)
Hong Kong profits tax payable for year of assessment 2013/14 after allowance of tax credit	775,500

(Or method B)

Tax credit = taxable profits in the PRC x Tax payable in Hong Kong (before tax credit) / assessable profits

= $300,000 x ($5,000,000 x 16.5%) / $5,000,000

=$49,500

Tax credit limit is the lesser of the above or tax paid in the PRC of $75,000
Tax credit limit is therefore $49,500

Hong Kong profits tax payable for year of assessment 2013/14 after allowance of tax credit:

	HK$
Assessable profits	5,000,000
Tax thereon @16.5%	825,000
Less: Tax credit as per above	49,500
Tax payable after tax credit	775,500

Answer 6

Under the Provisional Regulations of the People's Republic of China on Value Added Tax ("VAT"), the sale of goods, provision of processing, repair and replacement services and the importation of goods in mainland China are subject to VAT. As Abas did not carry on any of the abovesaid business activities in the PRC during the year, VAT is not applicable to Abas accordingly.

Under the Provisional Regulations of the People's Republic of China on Business Tax, income derived from (i) prescribed taxable services (e.g. transportation industry, construction industry, etc.), (ii) the transfer of intangible assets or (iii) the sale of immovable properties within the territory of the PRC are subject to Business Tax. Specifically, the service provider (i.e. income recipient) would be subject to Business Tax either if the service recipient or the service provider is located in the PRC. In this regard, the inspection income derived by Abas should be subject to Business Tax as the service recipient (i.e. Poseidon) was a PRC company located in Mainland China. The amount of Business Tax is calculated at the standard rate of 5% with respect to the taxable income.

Answer 7(a)

Based on the available information, the contract of employment for Mr Panoptes Hercules was negotiated, concluded and enforceable with Zeus outside Hong Kong. In addition, his employer Zeus is a company managed and controlled in Greece (i.e. residency of the employer of Zeus is outside of Hong Kong). Further, the remuneration of Mr Hercules has also been paid outside Hong Kong during the year. Under the principles established in the Goepfert decision and as elaborated in paragraphs 7 to 25 of the DIPN No. 10 (Revised June 2007), the employment of Mr Hercules should be offshore in nature and only the income derived from services rendered in Hong Kong should be subject to salaries tax under s.8(1A)(a) of the IRO (i.e. time apportionment basis).

In accordance with the basis established in the Board of Review Decision D29/89, IRBRD vol. 4, 340 (para. 48, DIPN No. 38, Revised March 2008) that "any part of a day counts as a day", the number of days Mr Hercules visited Hong Kong for the year ended 31 March 2014 are counted as follows:-

June 2013	(1 – 15)	15 days
September 2013	(10 – 24)	15 days
December 2013	(5 – 14)	10 days
January 2014	(17 – 29)	13 days
February 2014	(17 – 18)	2 days
March 2014	(19 – 24)	6 days
Total		61 days

As Mr Hercules visited Hong Kong for more than 60 days for the year, exemption of salaries tax under s.8(1B) of the IRO is not applicable to him.

For the purpose of counting the number of days in Hong Kong in computing Mr Hercules' salaries tax liabilities under s.8(1A)(a) of the IRO, the IRD adopted the "midnight rule" as per paragraph 46 of DIPN No. 38 (Revised March 2008).

Answer 7(b)

	HK$
Salary	1,800,000
Add: Rental value (HK$1,800,000 x 4%)	72,000
	1,872,000
Assessable income attributable to services rendered in Hong Kong	
(HK$1,872,000 x $\frac{55}{365}$ (Note))	282,082
Less: Personal allowance	120,000
Net chargeable income	162,082
Salaries tax payable (at progressive rate)	
$40,000 @ 2%	800
$40,000 @ 7%	2,800
$40,000 @ 12%	4,800
$42,082 @ 17%	7,153
	15,553
Salaries tax payable (at standard rate)	
$282,082 x 15%	42,312
Tax payable, at lower one	15,553

Note:

Number of days in Hong Kong according to "midnight rule":

June 2013	14
September 2013	14
December 2013	9
January 2014	12
February 2014	1
March 2014	5
Total	55 days

* * * END OF SECTION A * * *

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SECTION B – ESSAY / SHORT QUESTIONS

Answer 8(a)

On the authority of *Lionel Simmon Properties Ltd (in liquidation) and Others v Commissioner of Inland Revenue* (1980) 53 TC 461, it is a well established tax principle that in determining whether a property is a capital asset or trading asset, the intention of the purchaser at the time of acquisition is crucial. In addition, following the decision in *All Best Wishes Limited v CIR* (3 HKTC 750), a self-serving statement put forward by a person is of limited value – it has to be tested by the objective facts of the case.

Answer 8(b)

On the facts now available, the gain on the disposal of the Property should be chargeable to profits tax for the following reasons:

(a) If it were the intention of Mr Smith to acquire the Property as his residence, he should have a thorough review on the surrounding environment beforehand. It is inconceivable that he was unaware of the hospital as it was not newly built.

(b) Mr Smith had never moved into the Property. This objective fact does not support his stated intention. (Relevant authority: *All Best Wishes Limited v CIR* (3 HKTC 750))

(c) Mr Smith sold the Property within 3 months after completing his acquisition. The quick sale is a strong indicator pointing towards the trading intention of Mr Smith. (Relevant authority: Board of Review Decision No. *D47/04* (19 IRBRD 384))

(d) Mr Smith's financial position does not support his assertion that the Property was acquired as his residence. During the time prior to his retirement, his monthly salary was HK$60,000 out of which he paid rent of HK$15,000. His disposable income was less than HK$45,000 (HK$60,000 – HK$15,000) as he had to reserve funds to meet, at least, the payment of his salaries tax. Yet he had to repay the mortgage loan by monthly instalments of HK$40,000. As to the period after his retirement, Mr Smith received no monthly pension. The sum of HK$200,000 which he received could finance his mortgage repayments at most for five instalments even if he needed not meet his living expenses. There is no evidence that he managed to finance the repayment of the mortgage loan after his retirement either.

Answer 9(a)

Mrs Chan was the owner of the property as defined in s.2 of the IRO. The licence fees were the consideration for the use of the property. Unless there was substantial evidence that Mrs Chan carried on a letting business, Mrs Chan should be chargeable to property tax.

Her property tax liability in respect of the licence fees income is computed as follows:

Year of assessment 2013/14

	HK$
Licence fee income from	
Adrian (HK$5,000 x 12 months)	60,000
Benjamin (HK$4,000 x 8 months)	32,000
Clive (HK$3,000 x 8 months)	24,000
	116,000
Less:	
Irrecoverable rent (HK$3,000 x 5 months)	15,000
Assessable value	101,000
Less:	
Rates	3,500
	97,500
20% statutory deduction	19,500
Net assessable value	78,000
Tax at	15%
Property tax payable	HK$11,700

Answer 9(b)

Although Mrs Chan entered into “licences” with Adrian, Benjamin and Clive, Mrs Chan was in effect letting or sub-letting, as the case may be, the three cubicle rooms to them. In the event that Mrs Chan was a head tenant, she was chargeable to profits tax under s.14 of the IRO as the definition of “business” in s.2 of the IRO includes the sub-letting by any other person of any premises or portion of any premises under a lease or tenancy other than from the Government.

As to the expenses, if Mrs Chan was the owner of the property, she would be allowed a deduction of irrecoverable rent (s.7C of the IRO), rates (s.5(1A)(b)(i) of the IRO) and 20% statutory allowance (s.5(1A)(b)(ii) of the IRO). In the event that Mrs Chan was the head tenant, apart from irrecoverable rent (s.16(1)(d) of the IRO) and rates (s.16(1) of the IRO), she would also be allowed deductions of the rental expense incurred on the head lease, Government rent, management fee (s.16(1) of the IRO) as well as commercial building allowance (s.33A of the IRO) on the renovation costs which she incurred. Nevertheless, no 20% statutory deduction would be allowed to Mrs Chan as that in the case of an owner.

Answer 9(c)

Stamp duty is a tax on an instrument. It is not a tax on a transaction. As long as the instruments are chargeable to stamp duty under the Stamp Duty Ordinance ("the SDO"), stamp duty has to be levied irrespective of the label given to them. With regard to a lease, if it provides the tenant an exclusive right of possession of the property, it is chargeable to stamp duty under the SDO even if it is labeled as a licence.

In the present case, no matter whether Mrs Chan is the owner or the head tenant, Licence A and Licence B are chargeable instruments under Head 1(2) specified in the First Schedule of the SDO. The stamp duty to be levied on Licence A is 0.5% on the average yearly rent whereas that of Licence B is 0.25% of the total rent payable over the term of the lease.

As to Licence B1 and Licence C, they are not chargeable to stamp duty under the SDO as no written instrument was entered into.

Answer 9(d)

The consequences of not stamping an instrument that is chargeable to stamp duty are as follows:

(a) S.15(1) of the SDO provides that, with limited exceptions, no unstamped instrument can be accepted as evidence in any proceedings other than in criminal proceedings or in civil proceedings instituted by the Collector of Stamp to recover stamp duty and / or penalty.

(b) S.15(2) of the SDO provides that all public officers and bodies corporate cannot act upon, file or register any instrument unless it is duly stamped. It follows that, for example, the Land Registrar cannot register an unstamped assignment on the sale and purchase of an immovable property, the Lands Tribunal cannot handle a case on the irrecoverable rent arising from an unstamped tenancy agreement, the share registrar of a Hong Kong company cannot register the change in shareholders upon the presentation of an unstamped contract note.

(c) S.19(3) of the SDO provides that no broker or agent can legally claim any charge for brokerage or commission for the sale or purchase of Hong Kong stock if he fails to comply with s.19 of the same ordinance, which includes causing the contract notes to be stamped (S.19(1)(b) of the SDO).

(d) S.21 of the SDO provides that an unregistered shareholder is not entitled to any dividend or interest in respect of the relevant shares.

Answer 10(a)

S.12(1)(a) of the Inland Revenue Ordinance ("the IRO") provides that in ascertaining the net assessable income of a person, there shall be deducted from the assessable income of that person all outgoings and expenses, other than expenses of a domestic or private nature and capital expenditure, wholly, exclusively and necessarily incurred in the production of the assessable income. The meaning of incurred "in the production of the assessable income" had been discussed in *Commissioner of Inland Revenue v. Humphrey* (1970) 1 HKTC 451. Expenses are not incurred "in the production of assessable income" if they are incurred only to enable the duties to be performed.

In the present case, the travelling expenses which David incurs in travelling between his home and the tennis courts are not incurred "in the production of assessable income". Rather, they are incurred for the production of assessable income. Hence, those travelling expenses are not allowable for deduction. In contrast, the travelling expenses which David incurs in travelling between various tennis courts are incurred in the production of assessable income. The latter expenses are allowable for deduction.

Answer 10(b)

The deduction criteria of s.12(1)(a) is stringent and rigid. Following the decision in *Brown v. Bullock* 40 TC1, the test is not whether the employer imposes the expenses but whether the duties do. Also, on the authority of *Hillyer v Leeke* (1976) STC 490, if an individual is wearing clothing for his own purposes of cover as well as wearing it in order to have the appearance which the job requires, it cannot be said that the expense of his clothing is wholly or exclusively incurred in the performance of duties.

In the present case, first, the invoices which Eric furnished were dated 1 March 2013. It is patently clear that the expenses were not incurred in the year of assessment 2013/14. Even if the expenses were incurred in the year of assessment 2013/14, they were not allowable for deduction either. Although Eric's employer requires him to dress properly, it does not necessarily follow that his clothing expenses are allowable for deduction. It is clear that the suits and shoes are ordinary civilian clothing which serve the dual purposes of cover and comfort as well as giving the appearance required by the job. Hence, the expenses were not wholly and exclusively incurred in the production of his assessable income.

Answer 10(c)

S.12(1)(b) of the IRO provides that in ascertaining the net assessable income of a person, there shall be deducted from the assessable income of that person depreciation allowances calculated in accordance with Part 6 in respect of capital expenditure on machinery or plant the use of which is essential to the production of assessable income. In the *Board of Review Decision No. D61/06* (2006-07) 21 IRBRD 1137, the Board held that the meaning of the word "essential" in s.12(1)(b) of the IRO is consistent with "necessarily" in s.12(1)(a).

As to the meaning of the word "necessarily", following the decision in *Ricketts v Colquhoun* 10 TC 118, expenses which were incurred due to personal choices were not deductible. Again, on the authority of *Brown v. Bullock* (1961) 40 TC 1, the test is not whether the employer imposes the expenses but whether the duties do. One therefore has to look whether the duties cannot be performed without incurring the particular expense.

On the facts now available, the new computer is not essential to the production of Felix's assessable income. The purchase of the new computer is a matter of his own choice. His employer has already provided him with a computer, albeit the model is not the latest one. Hence, the conditions set out in s.12(1)(b) are not satisfied. No deduction of depreciation allowance in relation to the new computer can be allowed.

Answer 11

S.71(2) of the IRO provides that tax shall be paid notwithstanding any objection or appeal, unless the Commissioner of Inland Revenue ("the CIR") orders that payment of tax be held over pending the result of the objection or appeal.

In the event of default of tax, s.71(5) provides that the CIR may order a sum not exceeding 5% of the amount in default to be added onto the tax and recover therewith. S.71(5A) further provides that on the expiry of six months of the date deemed to be in default, the CIR may order a sum not exceeding 10% of the total unpaid amount (i.e., tax in default together with the amount imposed under s.71(5)) be added onto the total unpaid amount and recovered therewith.

As to the recovery of tax, the CIR may recover the tax in default and the surcharge as a civil debt through the District Court pursuant to s.75 of the IRO. S.76 of the IRO further provides that the CIR may give notice in writing to third parties (including those who owe money or are about to pay money to the taxpayer) requesting them to pay such money to the collector for the purposes of settling the tax and the surcharge in default. In addition, the CIR can also turn to s.77 of the IRO to secure the payment of the tax in default by issuing a departure prevention direction.

If Mr Bill does not pay the tax in dispute before the payment due date, the outstanding tax will be in default. A surcharge of 5% or 10%, as the case may be, may be imposed on the total amount in default. Recovery action on the tax in default will also be taken against Mr Bill under ss.75, 76 and 77 of the IRO.

Answer 12(a)

As Mr Mak holds dual capacity – audit partner of A & Co and tax director of A Limited, he should ensure independence. He should make sure that the staff of A & Co and A Limited as well as himself will only take up either the audit work or the tax work of Hiccups Limited but not both. Also, he should ensure integrity and professional competence in acting as the tax advisor of Hiccups Limited.

Answer 12(b)

In view that it is probable that the closing stock of Hiccups Limited had been understated, it follows that the profits as well as its assessable profits might have been understated as well. Such being the case, Mr Mak should advise Hiccups Limited to take this into account in the tax computations for the year of assessment 2013/14. Certainly, he should also put Hiccups Limited in the best position in computing the tax liability. Also, he should advise Hiccups Limited as to the relevant penalty provisions in the event that its assessable profits were understated resulting in tax being undercharged. With regard to future years of assessment, he should advise Hiccups Limited of the importance of filing correct tax returns, inter alia, the keeping of stock records to ensure that the correct closing stock value is reflected in the company's financial statements.

* * * END OF EXAMINATION PAPER * * *