SECTION A – CASE QUESTIONS

Answer 1(a)

Salaries tax is imposed under s.8(1)(a) of the Inland Revenue Ordinance ("IRO") on a person's income arising in or derived from Hong Kong from any office or employment of profit, or under s.8(1A)(a) on income derived from services rendered in Hong Kong including leave pay attributable to such services. S.8(1)(a) of the IRO is the basic charge of salaries tax for Hong Kong employment whilst s.8(1A)(a) of the IRO is the extended charge covering income derived from services rendered in Hong Kong from a non-Hong Kong employment.

In determining the situs of employment, the Inland Revenue Department ('IRD") issued the Departmental Interpretation & Practice Notes No. 10 Revised June 2007 ("DIPN 10 June 2007") elaborating that the major factors are (a) contract of employment, (b) residence of the employer, and (c) place of payment of remuneration. In this regard, the salaries tax exposures of Mr. Smart could be analysed as follows:

(a) Contract of employment
This refers to the place where the employment contract is negotiated, concluded and enforceable. Based on the information provided, Mr. Smart entered into his employment contract with Rhonda CA in Canada and has not been seconded to Rhonda HK with any new employment contract. This indicates that the employment contract of Mr. Smart was negotiated, concluded and enforceable outside Hong Kong.

(b) The residence of the employer
This refers to the place of central management and control of the employer. As Mr. Smart has been at all relevant times employed by Rhonda CA and it is a company managed and controlled in Canada, this indicates that the residency of the employer for Mr. Smart was also outside Hong Kong.

(c) The place where the employee's remuneration is paid
The remuneration of Mr. Smart has been paid in Canada both before and after Mr. Smart rendered his services in Hong Kong. There has been no change of the payment arrangement.

Based on the abovesaid analysis, the employment of Mr. Smart with Rhonda CA should be offshore source in nature, and accordingly only the income derived from services rendered in Hong Kong including leave pay attributable to such services should be subject to salaries tax under s.8(1A)(a) of the IRO, subject to s.8(1B) of the IRO.

The income earned by Mr. Smart during the year ended 31 March 2010 should be exempt from the charge of salaries tax as he visited Hong Kong in that year for less than 60 days (s.8(1B) of the IRO). For the two years ended 31 March 2011 and 31 March 2012, Mr. Smart visited Hong Kong for more than 60 days each year and accordingly his income earned during those two years should be assessable to salaries tax by apportioning the total income usually on a time-in time-out basis.

This is apportioning Mr. Smart's remuneration including leave pay in a year based on the total number of days he spent in Hong Kong in that year over the total number of days of the year (DIPN 10 June 2007 paragraphs 25 & 29).

Answer 1(b)

Mr. Smart is entitled to claim the whole amount of married person's allowance in the relevant years under s.29 of the IRO, as he is married and his spouse did not have any assessable income. There is no residency requirement for his spouse for the purposes of claiming married person's allowance. Likewise, Mr. Smart is also entitled to claim the whole amount of child allowance for his son, as the conditions stipulated in s.31(1) of the IRO were satisfied based on the information provided, and there is also no residency requirement for his child for Mr. Smart to claim child allowance. However, Mr. Smart could not claim dependent parent allowance under s.30 of the IRO as, during the three-year period, his mother was not ordinarily resident in Hong Kong under s.30(1)(b)(i) of the IRO.

Answer 2

Under s.80(2)(e) of the IRO, Mr. Smart could be liable on conviction by court to a fine at level 3 ($10,000) and a further fine of treble the amount of tax that has been undercharged with respect to his failure to inform his chargeability to salaries tax under s.51(2) of the IRO without reasonable excuse. Alternatively under s.80(5) of the IRO, the Commissioner of Inland Revenue ("CIR") may compound any offence under s.80(2) of the IRO in this case.

If it appears that Mr. Smart had willfully intended to evade tax by giving false answers to any questions or requests for information asked or made leading to the failure of informing chargeability to salaries tax, he could be prosecuted in court under s.82(1)(e) of the IRO. The penalty would be a fine at level 3 ($10,000), a further fine of three times the amount of tax undercharged and imprisonment for six months under summary conviction, or a penalty at level 5 ($50,000), a further fine of three times the amount of tax undercharged and imprisonment for three years on indictment.

If no prosecution under s.80(2) or 82(1) of the IRO has been instituted to him, the CIR could impose a penalty under s.82A(1)(e) of the IRO on Mr. Smart by way of an additional tax of an amount not exceeding treble the amount of tax which has been or would have been undercharged in consequence of the failure to comply with s.51(2) of the IRO.

Answer 3(a)

Under s.14(1) of the IRO, profits tax shall be charged on every person carrying on a trade, profession or business in Hong Kong. In order to evaluate whether the acquisition and proposed disposal of the shares of ASG Corp. by Rhonda HK constituted a trade, analysis could be made in line with the so-called six badges of trade as follows:-

i. Subject matter of the realisation

Listed shares could be held for short-term trading purposes or for long-term investment purposes, as the shares in themselves were neutral in nature. However, it appears that Rhonda HK constantly conducted share trading business and treated those shares as trading stocks. In this regard, this would be unfavourable for Rhonda HK to argue that it held the ASG Corp. shares for long-term investment purposes.

ii. Motive

The motive of holding ASG Corp. shares by Rhonda HK was implicit and could not be verified by any direct evidence. However, the classification of the shares as long-term fixed assets in its financial statements and other evidence could provide a positive indication to substantiate the long-term investment intention.

iii. Length of ownership

Rhonda HK has held the ASG Corp. shares for only about more than a year. The ownership period was relatively short and could likely be challenged by the IRD as an indication of trade.

iv. Frequency of similar transactions

Rhonda HK has been proactively involved in the trading of listed shares as its business. These frequent transactions on similar items would also likely be considered by the IRD as an indication of trade with respect to the shares of ASG Corp.

v. Supplementary work done

There could not be any form of supplementary work done for listed shares available to Rhonda HK for enhancing their market value. In this connection, this badge of trade is irrelevant to the analysis.

vi. Circumstances responsible for the realisation

It appears that the proposed disposal of ASG Corp. shares was to capture the gain from the appreciation in the share value. This reason would likely be challenged by the IRD as synonymous with trading of shares for profit purposes, and thereby constituted an indication of trade.

The above analysis reveals that the proposed disposal of ASG Corp. shares by Rhonda HK could likely be challenged by the IRD as a trading transaction and thereby the IRD would seek to assess profits tax on the gain derived from the disposal.

Answer 3(b)

Additional information / documents for further evaluation could be obtained under the following categories:-

Subject matter of the realisation

- Feasibility study or investment plan for holding the shares of ASG Corp. as long-term investment, if any
- Information differentiating ASG Corp. shares from other listed shares to be held for long-term investment intention, if any

Motive

- Memorandum & Articles of Association of Rhonda HK indicating the business strategy of holding assets
- Circumstances leading to the acquisition of ASG Corp. shares
- Board minutes of Rhonda HK for the acquisition of the ASG Corp. shares

Length of Ownership
- Information of circulation velocity of other shares held for trading purposes

Frequency of trading transactions on ASG Corp. shares
- Information on whether Rhonda HK had previous trading transactions of ASG Corp. shares for short-term profit purposes

Circumstances leading to disposal
- Information on whether Rhonda HK would acquire other listed shares for long-term investment purposes after the disposal
- The plan on the application of sales proceeds derived from the disposal

Financing
- Information on the funding of the acquisition of ASG Corp. shares, whether it was from short-term funds or long-term funds from equity or loans

Others
- Any other relevant information / documents facilitating the evaluation

Answer 4(a)

Under s.88A of the IRO, Rhonda HK can apply for an advance ruling from the IRD on the contemplated regional timber distribution business in order to ascertain the tax exposures of the gain derived from the abovesaid distribution business.

Rhonda HK should submit all relevant information to the IRD about the proposed regional timber distribution business (information as per paragraphs 19 & 20 and Appendix I of Departmental Interpretation and Practice Note No. 31 Revised November 2011("DIPN 31 November 2011") issued by the IRD). On the basis that there is no decline or refusal to make a ruling by the IRD under s.2 & s.3 of Part I of Schedule 10 of the IRO, a ruling will be made by the CIR on how the relevant provision of the IRO could apply to the proposed distribution business described in the application, and the CIR shall apply the provision in accordance with the ruling provided that Rhonda HK implements the distribution business in the way stated in the ruling.

Answer 4(b)

The ruling is applicable to Rhonda HK only for the period stated by the IRD. In addition, s.7 of Part 1 of Schedule 10 of the IRO states that a ruling shall not apply in relation to an arrangement if (i) the arrangement is materially different from that identified in the ruling (ii) there was a material omission or misrepresentation in the ruling application, and (iii) any assumption of the CIR on a future event or other matters stated in the ruling is incorrect (paragraph 46 of DIPN 31 November 2011).

Under s.13 of Part 1 of Schedule 10 of the IRO, the CIR may at anytime withdraw a ruling by notifying the respective applicant in writing with the reasons therefor. The ruling may also be affected if the relevant provision of the IRO applicable to the ruling is repealed or amended during the ruling applicable period (s.16 of Part 1 of Schedule 10 of the IRO). In addition, the ruling may also be affected if the interpretation of law, on which a ruling is based, is changed by the IRD as a result of a court decision (paragraph 52 of DIPN 31 November 2011).

Answer 5

From an ethical perspective, Robert Tang & Co should firstly issue a tax engagement letter to Rhonda HK specifying clearly the scope of the tax services regarding the advance ruling application in order to avoid any misunderstanding of either party. In the course of providing the tax services, Robert Tang & Co. should put forward the best position in favour of Rhonda HK under the IRO, provided that it does not in any way impair the standard of integrity and objectivity under s. 430 "Ethics in Tax Practice" in the Code of Ethics for Professional Accountants (Revised June 2010) issued by Hong Kong Institute of Certified Public Accountants.

Robert Tang & Co. should also ensure that relevant information requested by the IRD for the ruling is included in the application. In addition, Robert Tang & Co. must not associate itself with any information or communication to the IRD for which there is a reason to believe that the information or statements are obscure, false, misleading, incomplete, etc. Robert Tang & Co. should also elaborate clearly to Rhonda HK about the applicability and limitations of the advance ruling to be applied for.

* * * END OF SECTION A * * *

SECTION B – ESSAY / SHORT QUESTIONS

Answer 6(a)

Whilst B Limited did not carry on any business in Hong Kong, it received the Licence Fee from A Limited in respect of the Trademark used for selling toys in Hong Kong. By virtue of s.15(1)(b) of the IRO, the Licence Fee is deemed to arise in or be derived from Hong Kong from a trade, profession or business carried on by B Limited in Hong Kong.

As it appears that the Trademark had not been previously owned by any person carrying on a trade, profession or business in Hong Kong, the assessable profits deemed to be derived from Hong Kong in respect of the Licence Fee should be computed as 30% of the Licence Fee pursuant to s.21A(1)(b)(ii) of the IRO.

Since B Limited is a non-resident, A Limited is chargeable to profits tax on behalf of B Limited in respect of the Licence Fee (s.20B(2) of the IRO).

Answer 6(b)

If the directors of B Limited held all the board meetings in Hong Kong, it is likely that B Limited will be regarded as carrying on a business in Hong Kong: see *De Beers Consolidated Mines Ltd v Howe* (1906) 5 TC 198.

Moreover, as B Limited negotiated and concluded the agreement for the grant of the Licence in Hong Kong, the Licence Fee will also be regarded as having a source in Hong Kong: see *Commissioner of Inland Revenue v HK-TVB International Limited* 3 HKTC 468 and *Lam Soon Trademark Limited v Commissioner of Inland Revenue 6* HKTC 768.

In the circumstances, B Limited will be chargeable to profits tax in respect of the Licence Fee under s.14 instead of s.15(1)(b) of the IRO.

Answer 6(c)

B Limited should be chargeable to business tax in respect of its sale of the Trademark to C Limited because C Limited, being the recipient of the Trademark, is in the Mainland.

The above liability to business tax arises on the date on which B Limited transferred the Trademark to C Limited, i.e. 1 December 2011.

Since the consideration for the Trademark (RMB 20 million) is apparently below its market value (RMB 100 million), by virtue of Article 7 of the PRBT, the Mainland Tax Authority may adopt the market value as the taxable turnover and the applicable tax rate is 5%.

Therefore, the business tax payable = RMB 100 million x 5% = RMB 5 million.

Answer 6(d)

S.16EA of the IRO allows the deduction of expenditures incurred in the purchase of intellectual property even though they are capital in nature and should have been disallowed by virtue of s.17(1)(c) of the IRO.

However, A Limited is not entitled to any deduction under s.16EA of the IRO because the relevant purchase cost is prohibited from deduction by virtue of s.16EC(1) and (2) of the IRO, having regard to the following circumstances:

(1) The Trademark had been used by A Limited under the Licence of which the expiry date falls after 16 December 2011. Further, the Licence was terminated before its expiry and the Trademark was purchased by A Limited at a consideration below market value with an option for licensor, C Limited, to purchase back the Trademark after 5 years. In such circumstances, it is likely that the CIR will consider that the consideration for the purchase of the Trademark is not reasonable.

(2) The Trademark was purchased by A Limited from its subsidiary, C Limited.

Answer 7(a)

Under s.24(1) of the IRO, a person, who carries on a club or similar institution and receives not less than half of its gross receipts from its members on revenue account, will be deemed not to carry on a business.

For the year of assessment 2011/12, the Club's position is as follows:

	$
Receipts from members	
Entrance fees	250,000
Subscriptions	600,000
Hire charges for sports facilities	120,000
	970,000
Receipts from non-members	
The Rent	300,000
The Fee	40,000
Hire charges for sports facilities ($200,000 - $120,000)	80,000
	420,000
% of members' receipts [$970,000 / ($970,000 + $420,000)]	69.78%

As the Club received not less than half of its gross receipts from its members on revenue account for the year of assessment 2011/12, it is deemed not to carry on a business and is not chargeable to profits tax for that year.

Answer 7(b)

The Club is the registered owner of Building D. For the year of assessment 2011/12, the Club received the Rent and the Fee in consideration for the right of use of the ground floor and the roof of the building respectively. Subject to the exemption provided under s.5(2)(a) of the IRO, the Club is chargeable to property tax for the year of assessment 2011/12 in respect of the Rent and the Fee pursuant to s.5(1) and s.5B(2) of the IRO.

Although the Club is a corporation, it is deemed not to be carrying on a business for the year of assessment 2011/12 by virtue of s.24(1) of the IRO. As such, the Rent and the Fee are not chargeable to profits tax. It follows that the exemption provided under s.5(2)(a) does not apply to the Club.

Answer 7(c)

The Lease is chargeable with stamp duty under head 1(2)(b) of the First Schedule of the Stamp Duty Ordinance ("SDO"). The Club and E Limited should present it for stamping within 30 days after the execution of the Lease.

For the Agreement, it does not give F Limited the right to exclusive possession. The rights of F Limited under the Agreement are also restricted. As such, the Agreement is more akin to a licence which is not chargeable with stamp duty.

F Limited is considering to register the Agreement in the Land Registry. However, s.15(2) of the SDO provides, among others, that no instrument chargeable with stamp duty shall be registered by any public officer unless such instrument is duly stamped. In order to avoid any doubt on the stamp duty chargeability of the Agreement which may prevent its registration in the Land Registry, it is advisable that F Limited should submit the Agreement for adjudication under s.13(1) of the SDO.

Answer 8(a)

		$
Salary ($40,000 x 12)		480,000
Share option gain [($2 - $1.5) x 10,000]		5,000
Value of residence [Note (2)]		23,200
Assessable Income		508,200
Less:	Mandatory contributions to MPF scheme [Note (3)]	12,000
	Approved charitable donations [Note (4)]	177,870
		318,330
Less:	Married person's allowance	216,000
Net Chargeable Income		102,330

Note:

(1) The MPF Benefits attributable to Marcus' contributions are clearly not taxable.

As Marcus left Hong Kong and emigrated to Canada after his resignation, the MPF Benefits attributable to the mandatory contributions by G Limited are exempted from salaries tax by virtue of s.8(2)(cb) of the IRO.

(2) Value of residence for the period from 1 April 2011 to 31 January 2012:
$480,000 x 10/12 x 10% - ($12,000 - $10,000) x 10 = $20,000

Value of residence for the period from 1 February 2012 to 31 March 2012:
$480,000 x 2/12 x 4% = $3,200

Total value of residence = $20,000 + $3,200 = $23,200

(3) Under the MPF scheme, Marcus is required to make a mandatory contribution at 5% of his income, subject to an income ceiling of $20,000 per month (for the year of assessment 2011/12). By virtue of s.26G and Schedule 3B of the IRO, such mandatory contributions (i.e. $20,000 x 5% x 12 = $12,000) are allowable for deduction.

(4) Under s.26C(2)(a)(ii) and (2A) of the IRO, the allowable amount of approved charitable donations is restricted to 35% of Assessable Income (i.e. $508,200 x 35% = $177,870).

Answer 8(b)

If the MPF Benefits also include an amount of $20,000 attributable to the voluntary contributions made by G Limited, such amount will only be exempted from salaries tax to the extent of the proportionate benefit (s.8(2)(cc)(ii) and (4) of the IRO), which is computed as $20,000 x 12 months / 120 months = $2,000 (s.8(5) of the IRO). The balance (i.e. $20,000 - $2,000 = $18,000) will be included as part of Assessable Income (s.9(1)(ae) of the IRO).

* * * END OF EXAMINATION PAPER * * *