



EXECUTIVE TRAINING COMPANY (INTERNATIONAL) LTD

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Module Preparation Seminar – Agenda

- **Salaries tax implications on employment income and director's fee**
- **Stamp duty exemptions and reliefs**
- **Double taxation relief and transfer pricing**



Salaries Tax implication on employment income and director's fee (Learning Pack Ch. 5)

Salaries Tax – Scope of Charge



Under **s.8(1)** of the IRO, salaries tax is imposed on a person's income arising in or derived **from Hong Kong** from the following sources:

- (a) Any office or employment of profit.
- (b) Any pension.

Office – Director's Fees

[McMillan v Guest case]

Company Director and Company Secretary

The location of an office is the place where the **central management and control** of the company is located.

Income from a Hong Kong office is chargeable to salaries tax. The fact that the person receiving the income is absent from Hong Kong during the year of assessment is irrelevant.

Hong Kong vs Non-Hong Kong Employment



In determining the situs of employment of a taxpayer, the IRD issued **DIPN No. 10 (Revised)** which specifies the following three relevant factors:

- The place where the employment contract is negotiated, concluded and enforceable;
- The residence of the employer; and
- The place where the employee's remuneration is paid.

Income arising in or derived from Hong Kong from any employment is defined in **s.8(1A)** as follows:

8(1A)(a)	Includes all income derived from services rendered in Hong Kong, including leave pay attributable to such services.
8(1A)(b)	Excludes income derived from services rendered by a person who: <ul style="list-style-type: none">• Is not employed by the Government or as master or member of the crew of a ship or as commander or member of the crew of an aircraft; and• Renders outside Hong Kong all the services in connection with his employment; and

Hong Kong vs Non-Hong Kong Employment



8(1A)(c)	Excludes income derived by a person from services rendered by him in any territory outside Hong Kong where the person is chargeable to, and has paid tax of substantially the same nature as, salaries tax in Hong Kong in respect of the income.
S8(1B)	<p>Services rendered in Hong Kong during visits not exceeding a total of 60 days in the basis period for the year of assessment.</p> <p>This so-called 60-day rule applies to visits and employment only. “Visit” does not apply to person whose family resides in HK or he has a place of abode in HK. When counting the number of days, any part of a day counts as a ‘day’.</p>

Contract of Service Vs Contract for Service



Control Test

Integration Test

Economic Reality Test

Mutuality of Obligation Test

DIPN No. 25 (Revised) provides guidance on the **application of s.9A** and the relevant factors in distinguishing a contract of service from a contract for service.

The arrangement as **disguised employer/ employee relationship** where a Service Company controlled by the person or his associate provides the services of a person previously under employer/ employee relationship.

Under such arrangement, the Service Company **receives consultancy fee** from the said employer and claims various expenses under the shelter of the Service Company.

The remuneration for the relevant individual's services is paid to a service company which is under the **control of the relevant individual**.

Pension



Pension refers to an annuity or other recurring periodic payments for consideration of past services. S.9(3) of the IRO extends the meaning of 'pension' to include payments that are voluntary or capable of being discontinued.

The IRD is of the view that the dominant factor in determining the source of a pension is the **place where the pension is managed and controlled**. With the exception of Hong Kong Government employees, only income from a Hong Kong pension that is attributable to Hong Kong services is taxable.

Income chargeable to salaries tax



s.9(1)(a) - Any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others, except:

subject to subsection (2A), any amount paid by the employer to or for the credit of a person other than the employee in **discharge of a sole and primary liability** of the employer to that other person, not being a liability for which any person was surety.

s. 9(1)(b) - The **rental value** of any place of residence provided rent-free by the employer or an associated company of the employer.

s.9(1)(d) - Any gain realised by the exercise of, or by the assignment or release of, a right to acquire shares or stock in a corporation obtained by a person as the holder of an office or an employee of that or any other corporation.

Income chargeable to salaries tax



s. 9(2A)(a) - Any benefit capable of being **converted into money** by the recipient.

s. 9(2A)(b) - Any amount paid by an employer in connection with the education of a **child** of an employee.

s.9(2A)(c) - Any amount paid by an employer in connection with a **holiday journey**.

Case : Glantre Engineering v Goodhand - Inducement payment

The lump sum payment is an inducement payment to join the employer, and is in substance a payment for future services and so chargeable to salaries tax if the employment is located in Hong Kong

Redundancy, severance or long service payments - Not taxable

These are not payments for service but are payments made to terminate the employment.

Income chargeable to salaries tax



Compensation payments :

- Damages for cancellation of a service agreement or compensation for deprivation of rights to compete. Compensation for loss of office may be argued as not taxable on the ground that it is a payment for breach of contract rather than a payment for services rendered – **Not taxable**
- Not to take up similar positions in any companies in Hong Kong for a certain period and to recruit any employees of the employer to become an employee of any other companies – **Not taxable**

Accommodation benefits



Accommodation benefits for a place of residence provided rent-free by the employer or an associated corporation of the employer Under s.9(1A)(b), a place of residence for which an employer or its associated corporation has paid or **refunded all the rent** is deemed to be provided **rent-free by the employer or associated corporation** of the employer. The **rental value** of such accommodation is chargeable to tax.

Accommodation benefits for a place of residence provided by the employer or an associated corporation of the employer at a **rent less than the rental value.**

If the employer or its associated corporation has only **paid or refunded part of the rent for a place of residence** provided by the employer or its associated corporation, the amount of rent paid which was not refunded ('rent suffered') can be deducted from the rental value. If the amount of rent suffered is greater than the rental value, the resulting amount will be zero (i.e. cannot have a negative amount).

Proper Control on the use of the money of rental payments

Share Options [DIPN38]



- The **date of grant** governs the source of gain to be taxed.
- The **date of exercise, assignment or release** of a right to option determine the timing of the taxability.
- **Exercise** after cessation of employment or after leaving HK will not extinguish the tax liability.
- There will be **no tax on the grant** of stock options.
- **Gains from unconditional stock options** granted before providing HK services are not taxable even the options are exercised when rendering services in HK.
- Gains from **conditional stock options** granted for non-HK employment will be pro-rated if partially sourced in HK.

Share Options [DIPN38]



- Notional expenses can be claimed as a deduction from the notional gain.
- **Reporting** requirements to be observed by both employer and employees.

Any gain realized by **the exercise** of, or the assignment or release of a share option, whether the shares are in the employing company or another is deemed to be income from office or employment.

Exercise Share options = MV at date of exercise X no of share options – cost of the options

Option assigned / Released – Consideration for assignment/release of option less cost of option

Termination of Employment - Taxable at the date of exercise

Share Options [DIPN38]



Departure from HK -

IRD has also introduced a **concession** (ie option) to allow taxpayer to choose to have the tax computed based upon a **notional exercise of the option** using the open market value as of the day before the submission of the person's salaries tax return for the year of assessment in which he/ she permanently departs from Hong Kong or the taxpayer can choose to tax at the date of exercise.

Share Awards [DIPN38]



Characteristics	Upfront approach	Back End approach
Vesting period	No	Yes
Time of Assessment	At the time the award is granted.	At the time when the conditions are fulfilled, e.g. when vesting period is completed.
Valuation	Market value as at granting date.	Market value as at the date when conditions are fulfilled.
Discount in valuation	Potentially - if there is sale restriction of shares after the grant (generally speaking, 5% per year).	No.
Distributions such as dividends or bonus shares	Not taxable - regarded as investment income since the employee is entitled to the shares at the time of the award.	Received during the vesting period: Taxable, since the employee is entitled to the shares only at the end of the vesting period.



Stamp duty exemptions and reliefs (Learning Pack Ch. 8)

Stamp duty exemptions and reliefs



Section

Exemptions/Relief

- 39 Instruments generally exempted
- 40 Instruments specially exempted
- 41 Exemption for Government or public officer
- 42 Relief for leases between Government/public officer and another person
- 43 Relief for leases of consular premises
- 44 Relief for gifts to exempted institutions
- 45 Relief for conveyance or transfer between associated bodies corporate
- 46 Exemption for instruments affecting immovable property made for new Government lease or exchange

Stamp duty exemptions and reliefs



Section

Exemptions/Relief

- | | |
|-----|--|
| 47A | Exemption for transfer of units of constituent funds under MPF Schemes |
| 47B | Exemption for instruments of transfer relating to indirect allotment or redemption of units under unit trust schemes |

Relief under s.45



Relief under s.45 for conveyance of **immovable property** (Head 1(1) for AVD), 1(1AA) for SSD and Head 1(1AAB) for BSD), or transfer of **Hong Kong stock** (Head 2(1) and 2(3)) between associated bodies corporate only applies when:

- (a) one of the bodies corporate is the beneficial owner of not less than **90%** of the issued share capital of the other; or
- (b) a third body corporate is the beneficial owner of not less than **90%** of the issued share capital of each of the bodies corporate.

The location where the transferor, transferee or the holding company is incorporated is **not relevant** to claiming the s.45 relief.

Application should be supported by a **statutory declaration**

Relief under s.45



It should be noted that the s.45 relief is **not available** for leases of immovable property between associated bodies corporate which are chargeable under Head 1(2).

2 years period

After the conveyance or transfer between associated bodies corporate, the transferor and transferee have to remain associated for **at least two years**. If they cease to be associated within the two-year period, the stamp duty the stamp duty exemption is revoked and duty is payable within **thirty days** of the change (s.45(4)(c) and (5A)).

Relief under s.45



If the **transferor is liquidated within two years**, s.45 relief may not be revoked in the following situations:

- a) The transferor is the holding company of the transferee and there is another holding company of the transferor which continues in existence during the two-year period; or
- b) The transferor and the transferee are under the common control of a holding company and that holding company retains not less than 90% of the shareholdings in the transferee during the two-year period.



Relief under s.45



Anti-avoidance provisions prevent the abuse of s.45 relief

- (a) any part of the **consideration** for the transfer of immovable property or Hong Kong stock was provided or received, directly or indirectly, by a person other than an associated body corporate of the transferor or transferee (s.45(4)(a))
- (b) beneficial interest in the immovable property or Hong Kong stock was previously conveyed, transferred, sold or purchased, directly or indirectly, by a **third person** (s.45(4)(b)).
- (c) the transferor and transferee were to **cease to be associated** due to a change in shareholding in the transferee within two years of the transfer (s.45(4)(c)).

If money has been obtained from a **bank** for the purpose of acquiring the property from an associated body corporate, **s.45 relief** might be denied pursuant to s.45(4)(a) as the bank is an unrelated non-associated person

Other exemptions



Under ss.47A and 47B

With effect from 1 December 2000, **four specific types** of unit transfers under MPF schemes are exempt from the requirements to pay the fixed stamp duty of \$5 per instrument of transfer: Such as :

- a) indirect allotment of units by Constituent Funds under MPF schemes to scheme members through the fund managers;
- b) redemption of units in Constituent Funds by MPF scheme members;
- c) indirect allotment of units by Approved Pooled Investment Funds to Constituent Funds under MPF schemes through the fund managers; and
Taxation
- d) redemption of units in Approved Pooled Investment Funds by Constituent Funds under MPF schemes.

Relief for alternative bond schemes under ss.47E, 47F and 47G



The Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 was enacted on 19 July 2013 to provide relief for some common types of Islamic bonds (i.e. sukuk) that are economically equivalent to conventional bonds in order to allow comparable tax treatment under the IRO and SDO.

Relief for qualified bond arrangement under s.47E

Relief for qualified investment arrangement under s.47F

Relief for special stamp duty under s.47G



Double taxation relief and transfer pricing (Learning Pack Ch. 12)

Double taxation relief and transfer pricing



Under a DTA, a Hong Kong resident who is liable to tax in respect of the same income in **both Hong Kong and the contracting territory** will be provided with a relief by way of tax credit.

The allowable **tax credit** is to be computed in accordance with s.50(3) and s.50(5) of the IRO. The amount of tax paid in the Mainland not allowed as a tax credit could be allowed as a deduction.

DIPN 45 Relief from double taxation due to transfer pricing adjustment

Economic double taxation means two enterprises residing in different states are assessed to tax on the same profit or income.

Juridical double taxation means an enterprise is charged to tax on the same profit or income in two different states, without either state providing relief for tax imposed by the other.

Economic double taxation



When the tax authority of one state makes a primary transfer pricing adjustment to the tax position of an enterprise in that state for goods or services etc it provides to an associated enterprise in the other state, the tax authority of the other state is **obliged to make a corresponding adjustment** to the tax position of the associated enterprise so as to avoid double taxation of the same profit.

Time Limit - In Hong Kong, the claim for such corresponding adjustment must be made by the taxpayer within **six years** after the end of the relevant year of assessment under s.79 of the IRO, which allows tax paid in excess to be refunded under certain conditions.

DIPN No. 45 makes it clear that the relevant assessment cannot be **re-opened** under s.70A as the retrospective price adjustment constitutes neither an error nor omission made in the taxpayer's return or statement filed with the IRD for the year concerned.

Juridical double taxation



The 'Business Profits Article' in all the DTAs that Hong Kong has signed allows the tax authority of a source state to tax an enterprise, which is a resident of the other state, and carries on business in the source state through a **permanent establishment**.

The profits that can be taxed in the source state are those **attributable to the permanent establishment only**.

Juridical double taxation would be avoided by way of the resident state either:

- exempting on its side the profits attributable to the permanent establishment in the source state; or
- granting a tax credit of the tax paid in the source state against the tax payable on its side on the same profits.

DIPN 46 - Transfer pricing guidelines – methodologies and related issues



DIPN 46 provides the basis on which the IRD will assess the **arm's length nature** of taxpayers' related party transactions, make transfer pricing/profit reallocation adjustments and determine whether a transfer pricing adjustment initiated by a party other than the IRD is correct.

DIPN 46 relies on ss.16, 17(1), 20, 61 and 61A as the basis for the Commissioner's powers on making transfer pricing adjustments.

According to DIPN 46, the arm's length principle utilises **independent transactions** as the benchmark to determine how profits and expenses should be allocated for transactions between associated enterprises.

The arm's length principle is also embodied in the Associated Enterprise and the Business Profits Articles of the OECD Model Tax Convention on Income and Capital ('MTC'), which has been adopted in the DTAs concluded by Hong Kong.

DIPN 46 - Transfer pricing guidelines

– methodologies and related issues



The practice on transfer pricing adjustments to be followed by the IRD will not differ from transfer pricing methodologies recommended by OECD Transfer Pricing Guidelines, i.e.

- (i) **traditional transaction methods** include: the comparable uncontrolled price method, the cost plus method, and the resale price method while
- (ii) **the transactional profit methods** include: the profit split method and the transactional net margin method.

Attribution of profits and expense to a permanent establishment is broadly consistent with the OECD Report of the Attribution of Profits to Permanent Establishment (2010) in regard to the adoption of the 'functionally separate entity' approach as the 'authorised OECD approach'. When attributing profits to the permanent establishment in Hong Kong, the CIR would consider the significant people functions and the key entrepreneurial risk-taking functions.

DIPN 46 - Transfer pricing guidelines – methodologies and related issues



DIPN 46 mentions that ss.16 and 17 can be used to make **transfer pricing adjustments**, even without invoking anti-avoidance provisions, i.e. ss.20, 61 and 61A. DIPN 46 also mentions that ss.20, 61, 61A will be aggressively applied where structures or transactions are created with tax evasion/avoidance as the primary motivation.

Are you familiar with these anti-avoidance provisions ?

DIPN 47 (Revised) - Exchange of information and Tax Information Exchange Agreement



DIPN 47 was **revised in January 2014** and it sets out the practice of the IRD on the processing and exchange of tax information ('Eol') upon requests received from treaty partners, following the enactment of the Inland Revenue (Amendment) Ordinance 2010 and the Inland Revenue (Disclosure of Information) Rules, Cap.112BI ('Disclosure Rules').

Hong Kong's policy on the exchange of information is restricted to **exchange upon request**, and Hong Kong will not provide any information in automatic or spontaneous exchanges.

Hong Kong will only **supply information**, including bank information, upon specific and bona fide requests received from the competent authority of a treaty partner in justifiable cases.

DIPN 47 (Revised) - Exchange of information and Tax Information Exchange Agreement



Hong Kong only **authorises** the exchange of information and the use of information exchanged in relation to the administration and enforcement of taxes covered by the respective DTAs.

The information exchanged shall not be used for purposes **other than those** for which it has been exchanged. The information pursuant to the DTA cannot be used for non-tax purposes.

Hong Kong can enter into a TIEA with other jurisdictions simply for the purpose of exchange of tax information in relation to any tax imposed by the laws of Hong Kong or that jurisdiction. In addition, persons who do not possess but have control of the information will also be obligated to supply the information upon request.

DIPN 48 - Advance Pricing Arrangement



DIPN 48, issued in March 2012, provides guidance for enterprises seeking an Advance Pricing Arrangement (APA) with the IRD. DIPN 48 explains the **APA process** and the terms and conditions of the APA process prescribed by the IRD.

The APA process gives enterprises the opportunity to reach agreement with the IRD on the **method of applying the arm's length principle** to controlled transactions so that transfer pricing issues can be more efficiently dealt with in real time as they arise, rather than retrospectively years later.

It prevents **costly and time consuming audit and litigation** of transfer pricing issues covered by the APA. Upon the expiration of the term of an APA, the enterprise may have the opportunity to renew the APA, thus prolonging the advantages.

DIPN 48 - Advance Pricing Arrangement



An APA is an arrangement that determines, in advance of **controlled transactions**, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing of those transactions over a fixed period of time.

'Controlled transactions' refer to transactions between enterprises that are **associated enterprises** with respect to each other under the Associated Enterprises Article of the relevant DTA.

The APA should fix arrangements according to the **arm's length principle** for determining the transfer pricing for the future transactions in the APA. In general, an APA will be valid for three to five years.

A **unilateral APA** is an arrangement between the IRD and the enterprise concerning the transfer pricing of controlled transactions. The APA process does not involve the agreement with a DTA partner.

DIPN 48 - Advance Pricing Arrangement



If the enterprise has agreed to and complied with the terms of an APA, the IRD will be administratively bound by the terms of the APA. The APA requires the enterprise to comply with particular requirements and depends on critical assumptions being met.

The APA process is most suitable for complex controlled transactions with high transfer pricing risk

LET's practice on past papers now !!!

Passing MD – Basic Techniques



Expectations from Students:

- Quote correctly sections (sub-sections), DIPN and cases
- Correct application of the tax rules; do not just copy
- Reasonable conclusion given – answer the question
- Count marks for each question ie 5 marks question – at least 7 minor points
- Present your answer in a logical manner
- Use assumptions
- Give tax evidence

Answer Plan for each question



Step 1 – Which kind of tax?

Profits Tax, Salaries Tax and Property Tax?
Involve Stamp Duty?

Step 2 – Is the question related to income or expense?

Step 3 – Consider the charging section or the general rule first? Then consider any DIPN & cases in support.

Answer Plan for each question



Step 4 – Apply to the question's facts

Step 5 – Discuss different applications under different assumptions

Step 6 – Suggest further evidence and give a reasonable conclusion

MD Preparation



Only got 2 and ½ months left – What shall you do?

- **Do past papers with updated answers**
- **Practice writing out:
Exam Pack (2 additional tests) + Final Mock**
- **Write as many questions out as possible**
- **Practice using your critical file**
- **Time yourself**

Final Advice



- **The time to look-up the textbook is limited during an open-book exam**
- **Students should:**
 - ❑ **have a good understanding of the topics before going into the exam**
 - ❑ **read the case and questions carefully**
 - ❑ **answer what is being asked, not what they wanted to be asked**
 - ❑ **identify the core issues of the question and allocate their time accordingly**
 - ❑ **analyse the facts of the case and apply the tax rules or principles to arrive at the conclusion**
 - ❑ **not copy large passages from the textbook**
 - ❑ **use logical thinking to understand and respond to the questions**

MD (Jun 2016) – Module Preparation Seminar – Practice Questions

Salaries tax implications on employment income and director's fee

Stamp duty exemptions and reliefs

Double taxation relief and transfer pricing

Question 1 – Mr Koo (Dec 2015 Qu 8)

Mr Koo has been employed by Ocean View Limited (“Ocean View”) for 30 years and he is currently in the position of general manager responsible for the overall control and management of the company’s business activities. Ocean View has a sole director namely Mr Cheung and he is also the sole shareholder of the company since its incorporation 30 years ago. Mr Koo and Mr Cheung have maintained a very good and close relationship both in business and personally.

It has also been noted that on the recent Chinese New Year’s eve, Mr Koo received a sum of money directly from Mr Cheung which was approximately five times his current basic annual salary. Mr Cheung emphasised to Mr Koo that it was a gift to him for Chinese New Year in pursuance of their decades of friendship, and that the money was exclusively and directly given by Mr Cheung instead of cash from Ocean View.

Mr Koo only maintained one employment contract with Ocean View, and did not enter into any other written or verbal employment contract with Mr Cheung or any other parties. Specifically, Mr Koo stated that the money received by him was beyond his expectations.

Required:

- (a) **If you were the Assessor of the Inland Revenue Department (“IRD”), how would you argue that the money received by Mr Koo should be subject to salaries tax?**
(4 marks)
- (b) **If you were Mr Koo, how would you argue that the above money should not be subject to salaries tax?**
(4 marks)
- (c) **What additional information should be obtained to further evaluate the taxability of the money received by Mr Koo?**
(3 marks)

Answer to Question 1

Answer 1(a)

Possible arguments for subject to salaries tax

Under s.9(1)(a) of the IRO, income from employment includes wages, salary, etc, derived from the employer or others. In this regard, the income of Mr Koo derived from the employment with Ocean View Limited can be paid by others, especially from Mr Cheung as he is the sole director and shareholder of the company. The payment is possibly part and parcel of the remuneration of Mr Koo attributable to his employment with Ocean View.

There is no concrete evidence substantiating the argument that the money was a gift given because of personal friendship. The assertion of Mr Cheung is self-serving and has no objective justification.

The amount received by Mr Koo is substantially in proportion to his annual salary and the date of receipt is also the eve of Chinese New Year. This pattern is in line with the payment of a performance-based bonus typically found in generic employment arrangements.

Answer 1(b)

Possible arguments for not subject to salaries tax

There was no implicit or explicit agreement entered into by Mr Koo with Ocean View nor Mr Cheung for any new employment contract or extension of existing employment covering the payment of the subject amount to Mr Koo. Substantially the amount is a spontaneous payment and has no connection to the present or any other employment of Mr Koo.

The amount was substantially higher than Mr Koo's existing annual salary. The quantum was unlikely to be in line with any performance-based bonus paid principally and directly by the employer or others, and therefore should not be regarded as part of his employment income.

The payment to Mr Koo was unexpected and was solely on a discretionary basis made by Mr Cheung personally. This is not likely to be a pattern generically found in any contractual arrangement for employment of income.

Answer 1(c)

Relevant additional information for further evaluation could be obtained from the following perspectives:-

- Details of similar payments, if any, paid to Mr Koo by Mr Cheung in prior years.
- Details of similar payments, if any, paid by Mr Cheung to other employees of Ocean View and / or other close contacts of Mr Cheung.
- Evidence justifying the long-term friendship between Mr Koo and Mr Cheung.
-
- Financial information and business performance of Ocean View for examination if there is any co-relation between the payment and the profitability of Ocean View during the relevant financial period.
- Detailed comparison of the remuneration package of Mr Koo in current and prior years in order to evaluate if the prevailing package had been revised in line with the incorporation of the subject payment.
- Examine whether Mr Koo has reached the retirement age and if the amount received by him is substantially a retirement gratuity paid by Mr Cheung.

Executive Training Company (International) Limited

Question 2 – A Limited (Dec 2014 - Case Qu 3)

A Ltd is a shipping company incorporated, controlled and managed in Hong Kong. It owns a fleet of ships, all of which are registered on the Hong Kong Shipping Register established under the Merchant Shipping (Registration) Ordinance (Cap. 415). The business of A Ltd includes the chartering and operating of ships and shipping agencies.

A Ltd is a wholly-owned subsidiary of B Ltd, a leading logistic service company in Hong Kong. On 1 April 2013, A Ltd obtained a loan of HK\$100 million from Bank C at 10% per annum (“the Loan”) to finance the acquisition of a new ship. The Loan was secured by a deposit of HK\$60 million placed by B Ltd with the US branch of Bank C at 4% per annum (“the Deposit”). In October 2013, B Ltd sold all its shares in A Ltd at a consideration of HK\$30 million to Mr. D, who did not carry on any business on his own account. Under the sale and purchase agreement, it was agreed that upon the completion of the transaction on 1 October 2013, B Ltd would cease to provide the Deposit as a security for the Loan and Mr. D would enter into a sub-participation agreement with Bank C, whereby Mr. D would advance HK\$70 million to Bank C on the condition that the repayment of principal and interest of the advance by Bank C was subject to the repayment of principal and interest of the Loan by A Ltd.

As an incentive scheme for its employees, A Ltd implemented a share option scheme under which the options can be exercised by the employees after their continuous service in A Ltd for a minimum of 2 years from the date of grant. Upon fulfillment of such condition, A Ltd would meet its obligation under the share option scheme by issuing new shares against options exercised.

The accounts of A Ltd for the year ended 31 March 2014 showed net profits of HK\$30,000,000, after crediting or debiting the following items:

	HK\$
(1) Shipping income derived from, attributable to or in respect of:	
(a) carriage of goods and passengers shipped in Hong Kong within Hong Kong waters	6,000,000
(b) carriage of goods and passengers shipped in Hong Kong to Japan	8,000,000
(c) towage operations undertaken within Hong Kong waters	4,000,000
(d) towage operations undertaken from Hong Kong to Taiwan	7,000,000
(e) charter hire where the ships navigated within Hong Kong waters	5,000,000
(f) charter hire where the ships navigated between Hong Kong and the inland waterways of Guangdong, China	12,000,000
	<u>42,000,000</u>
	HK\$
(2) Gross receipts from shipping agencies	20,000,000
(3) Interest expense payable on the Loan	10,000,000
(4) Fair value of the shares issued for share option scheme	1,000,000
(5) The overhead costs attributable to shipping agencies are agreed at 30% of the relevant agency receipts. The remaining overhead costs are attributable to shipping income.	

Executive Training Company (International) Limited

Mr. E had a Hong Kong employment with A Ltd as a ship captain. The numbers of days on which Mr. E stayed in Hong Kong in the years of assessment 2011/12, 2012/13 and 2013/14 are 30, 40 and 65 respectively. Out of the days he was present in Hong Kong, Mr. E merely attended meetings in Hong Kong for 10 days, 20 days and 30 days during the relevant three years respectively. Mr. E was granted a share option to subscribe for 100,000 shares in A Ltd at HK\$0.8 per share on 1 April 2012. He exercised the option in full after the fulfillment of the minimum service requirement on 1 May 2014, when the agreed fair value of the shares in A Ltd was HK\$1.2 per share.

Required:

- (a) **Evaluate whether Mr. E is chargeable to salaries tax for the years of assessment 2012/13 and 2013/14.**

(9 marks)

- (b) **Discuss whether and if so, in which year of assessment and how Mr. E is chargeable to salaries tax in respect of his gain from the share option.**

(Note: Computation of the chargeable share option gain, if any, is required.)

(6 marks)

Answer to Question 2

Answer 2(a)

Mr. E is a seafarer. By virtue of s.8(2)(j) of the IRO, he will be exempt from salaries tax for the years of assessment 2012/13 and 2013/14 if he was present in Hong Kong for not more than:

- (a) a total of 60 days in each of the relevant years of assessment; and
- (b) a total of 120 days falling partly within each of the two consecutive years of assessment, one of which is the relevant year of assessment.

In the year of assessment 2012/13, Mr. E was present in Hong Kong for 40 days. In the two consecutive years of assessment (i) 2011/12 and 2012/13 and (ii) 2012/13 and 2013/14, he was present in Hong Kong for (i) 70 days and (ii) 105 days respectively. Thus, Mr. E should be exempt from salaries tax for the year of assessment 2012/13 pursuant to s.8(2)(j) of the IRO.

As Mr. E was present in Hong Kong for 65 days during the year of assessment 2013/14, the exemption provided under s.8(2)(j) of the IRO is not applicable. Since he had a Hong Kong employment with A Ltd, he will be fully chargeable to salaries tax for the year of assessment 2013/14. Under s.8(2)(j), the criteria for exemption are prescribed in terms of days of presence in Hong Kong. Thus the fact that Mr. E only provided services in Hong Kong for less than 60 days in each of the relevant years is irrelevant in determining his eligibility for the exemption.

Answer 2(b)

Mr. E had a Hong Kong employment as a seafarer with A Ltd during the vesting period of 2 years (ie the years of assessment 2012/13 and 2013/14). In accordance with DIPN 38, unless he is exempt from salaries tax by virtue of s.8(2)(j) of the IRO in each of the relevant years during the vesting period, his gain from the share option will be fully chargeable to salaries tax.

As analysed in Answer 3(a), Mr. E is exempt from salaries tax for the year of assessment 2012/13, but he is chargeable to salaries tax for the year of assessment 2013/14. Thus, all his gain from the share option will be chargeable to salaries tax and no apportionment is applicable.

Mr. E exercised the share option on 1 May 2014. Pursuant to s.9(1)(d) of the IRO, his gain from the share option should be charged to salaries tax in the year of assessment 2014/15.

In accordance with s.9(4)(a) of the IRO, the taxable share option gain is computed as follows:

(HK\$1.2 - HK\$0.8) x 100,000 shares = HK\$40,000

Question 3 –E Limited (Jun 2014 - Qu 8)

Discuss the implications of profits tax, salaries tax, property tax, personal assessment and stamp duty (including special stamp duty), where applicable, in each of the following scenarios (Note: No tax computation is required.):

(a) On 1 February 2012, E Limited entered into an agreement to purchase a shop from F Limited. As a confirmor, E Limited entered into an agreement to sell the shop to G Limited at profits on 15 July 2012. By an assignment dated 15 October 2012, the shop was assigned by F Limited to G Limited. E Limited was incorporated on 1 January 2012 and was wholly financed by the contributions of its two shareholders. It became dormant after the completion of the above property transaction.

(7 marks)

(b) Mr. H and his wife, Ms. I, are retirees. The couple entered into an agreement to purchase a residential flat as joint tenants on 1 January 2012. The couple arranged a mortgage loan to finance 30% of the consideration, whilst the remainder was settled by the couple's own savings. The flat was let out after the completion of the transaction. Pursuant to a Compulsory Sale Order granted by the court under the Land (Compulsory Sale for Redevelopment) Ordinance (Cap. 545), Mr. H and Ms. I entered into an agreement to sell the flat at a profit on 1 June 2013.

(11 marks)

(c) Mr. J had a residential flat which was inherited in accordance with the will of his deceased father on 1 April 2012. He subsequently entered into an agreement to sell the flat to Mr. K on 31 December 2012. Upon assignment on 1 April 2013, Mr. K admitted his nephew, Mr. L, as a joint tenant of the flat. Mr. K and Mr. L are both salary earners. They arranged a mortgage loan to finance the acquisition of the flat and used the flat as their residence.

(7 marks)

Answer to Question 3

Answer 3(a)

Stamp duty

The assignment executed on 15 October 2012 is chargeable with stamp duty under head 1(1) in the First Schedule of the SDO.

Although the shop was sold by E Limited within 24 months after the acquisition, no special stamp duty ("SSD") will be charged as SSD is applicable to residential properties only.

Profits tax

It is likely that E Limited will be regarded as having acquired the shop as trading stock and its profits derived from the sale of the shop will be chargeable to profits tax, having regard to the following circumstances:

- (1) E Limited held the shop for a very short period of time. It sold the shop as a confirmor without taking up the assignment.
- (2) E Limited is a newly incorporated company and has become dormant since the sale of the shop. It does not appear that the shop was acquired by E Limited for investment or business purposes.
- (3) The operation of E Limited was wholly financed by shareholders' contributions. There is no evidence that the company is financially capable of holding the shop on a long-term basis.

In ascertaining the amount of assessable profits, the stamp duty for the purchase of the shop is deductible.

Answer 3(b)

Stamp duty

The agreements for sale executed on 1 January 2012 and 1 June 2013 are chargeable with stamp duty under head 1 (1 A) in the First Schedule of the SDO.

Although the residential flat was sold by Mr. H and Ms. I within 24 months after the acquisition, no SSD will be charged as the agreement for sale dated 1 June 2013 was made pursuant to a court order: s.29CA(11)(a) of the SDO.

Profits tax

In view of the following circumstances, Mr. H and Ms. I may not be regarded as having acquired the flat as trading stock and thus chargeable to profits tax in respect of the profits derived from the sale of the flat:

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- (1) Mr. H and Ms. I had used the flat for letting before the sale.
- (2) Mr. H and Ms. I should have been financially capable of holding the flat on a long-term basis. The couple could finance 70% of the consideration by their savings. The rental income from the flat should likely provide sufficient means to the couple to repay the mortgage loan.
- (3) Mr. H and Ms. I did not sell the flat voluntarily. The sale was made pursuant to the compulsory sale order granted by the court.

Property tax

Mr. H and Ms. I are chargeable to property tax in respect of the rental income from the flat.

In ascertaining the net assessable value of the flat, the stamp duty paid for the purchase of the flat is not deductible.

Personal assessment

Mr. H and Ms. I, being retirees, might not have income other than the rental income from the flat. As such, it is likely that the couple can benefit from the election for personal assessment.

By electing for personal assessment, Mr. H and Ms. I are entitled to married person's allowance. They can also be allowed for deduction of the mortgage loan interest incurred in respect of the flat, limited to the net assessable value of the flat.

Answer 3(c)

Stamp duty

The agreement for sale executed on 31 December 2012 is chargeable with stamp duty under head 1 (1 A) in the First Schedule of the SDO. Although the residential flat was sold by Mr. J within 24 months after the acquisition, no SSD will be charged as the flat was inherited by Mr. J under the will of his deceased's father: s.29CA(11)(b)(iii) of the SDO.

Provided that the above agreement for sale is duly stamped, the assignment executed on 1 April 2013 will be chargeable with stamp duty under head 1 (1) in the First Schedule of the SDO by reference to the consideration less a fraction of the stamp duty representing the proportion of the flat that is vested in Mr. K (i.e. 1/2): s.29D(4) of the SDO. Further, Mr. K will be regarded as having acquired the flat on 31 December 2012 and disposed of 1/2 share of it to Mr. Lon 1 April 2013: s.290A(8) of the SDO. SSD will be charged by reference to the relevant share under head 1 (1 AA) in the First Schedule of the SDO.

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Profits tax

It is unlikely that Mr. J will be chargeable to profits tax in respect of his sale of property as the property concerned has inherited from his father's estate.

Salaries tax

As both Mr. K and Mr. L are salary earners, they will be chargeable to salaries tax in respect of their salary income.

In ascertaining their salaries tax liabilities, Mr. K and Mr. L will each be entitled to deduct 112 share of the mortgage interest paid in respect of the flat as home loan interest, subject to the maximum limit in s.26E(2)(a)(ii) and (c) of the IRO.

Question 4 – A Ltd - (May 2010) (Amended)

In 1971, A Ltd acquired a plot of land in Yuen Long ('the Land') and erected thereon a factory for production. Due to the relocation of its manufacturing process to the Mainland, the factory in Yuen Long had been left vacant since 2014. In 2015, A Ltd resolved to put the Land in valuable use. It also planned to diversify its business mix by engaging in property investment in Hong Kong. A Ltd established a wholly-owned subsidiary in Hong Kong, B Ltd, with a view to redeveloping the Land as a residential complex. A Ltd contracted to sell the Land to B Ltd at a consideration of \$200 million plus 50% of the net profits realised by B Ltd from the redevelopment. The fair market value of the Land at that time was \$500 million. B Ltd borrowed \$150 million from Bank C to finance the initial land cost of \$200 million. The loan was secured by a fixed deposit of \$100 million in the name of A Ltd, which was placed with a branch of Bank C in the United States.

Required:

Discuss B Ltd's exposure to stamp duty in relation to its purchase of the Land from A Ltd.

Answer to Question 4

B Ltd was a wholly-owned subsidiary of A Ltd. In other words, A Ltd held 100% of the issued share capital of B Ltd. A Ltd and B Ltd were thus associated bodies corporate in terms of s.45(2). Therefore, by virtue of s.45(1), stamp duty under Head 1(1) should not be charged on the conveyance of the Land from A Ltd to B Ltd. Strictly speaking, the fact that B Ltd had arranged a loan from Bank C for the purpose of acquiring the Land might trigger the application of s.45(4)(a) to deny the exemption under s.45(1).

However, the Collector has issued a ruling (see the Law Society of Hong Kong Circular No. 1/83), stating that as long as he is satisfied that the loan was made by Bank C in the ordinary course of business, and that the bank did not have any interest in the Land other than as security, the provision of funds by the bank would not result in the exemption being lost. After the conveyance, A Ltd and B Ltd had to remain associated for at least two years. Otherwise, the stamp duty exemption would be revoked and duty would be payable under s.45(5A).

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Question 5 – VPM Ltd. (Dec 2013 Qu 8)

VPM Ltd. is a company incorporated in Hong Kong and engaged in the manufacturing and sales of textile products. In order to enlarge its production capacities, VPM Ltd. considers establishing an overseas subsidiary (Newsb) and setting up a factory in that overseas jurisdiction. Products manufactured by Newsb will be sold to VPM Ltd. for onward sales to its customers.

The management of VPM Ltd. would establish Newsb in either Country X, a country which has a Comprehensive Double Taxation Agreement (CDTA) with Hong Kong, or Country Y, a country which does not have any CDTA with Hong Kong. It is also noted that the production costs and prevailing tax rates of Country X and Country Y are substantially the same.

In view of the complexities of the tax issues involved, VPM Ltd. has approached a leading professional firm, namely DHK & Co., requesting the provision of taxation advisory services, particularly in transfer pricing matters arising from the abovesaid proposal.

Required:

- (a) Explain from a transfer pricing perspective (i) why the Inland Revenue Department (IRD) is likely to scrutinise the transactions between VPM Ltd. and its overseas subsidiaries, (ii) the principle that would be used to scrutinise the transactions, and (iii) the relevant provisions in the Inland Revenue Ordinance that may be invoked by the IRD if it decides to tackle the transactions.

(Assume VPM Ltd. has not yet chosen the country to establish Newsb.)

(8 marks)

- (b) Identify the transfer pricing methodologies available for the IRD's consideration and applicable to VPM Ltd. for the transactions with Newsb.

(3 marks)

- (c) From a transfer pricing perspective, discuss the different tax implications for VPM Ltd. with respect to the choice between establishing Newsb in Country X and Country Y.

(8 marks)

Answer to Question 5

Answer (a)

The proposed sales of products from Newsub to VPM Ltd. are controlled transactions between a Hong Kong resident enterprise (i.e. VPM Ltd.) and an associated non-resident enterprise (i.e. Newsub). In this regard, the respective basis of the pricing policy (i.e. Transfer Pricing Policy) for the abovesaid transactions will affect the Hong Kong Profits tax position and liabilities of VPM Ltd. Therefore the Inland Revenue Department (“IRD”) will diligently assess the basis of the transactions under relevant provisions in the IRO.

Endorsed by the Organisation for Economic Co-operation and Development (the OECD) Transfer Pricing Guidelines (TPG), the IRD adopts the arm’s length principle for assessing transactions with transfer pricing issues between associated enterprises. The arm’s length principle requires associated enterprises to charge the same price, royalty and other fee in relation to a controlled transaction as that which would be charged by independent enterprises in an uncontrolled transaction in comparable circumstances (Para. 36, DIPN No. 46, Dec 2009).

When transactions in this aspect are found without applying the arm’s length basis, various provisions in the IRO would be invoked by the IRD in tackling the transfer pricing issues. These provisions include:-

- (i) S.16(1) of the IRO – payments made to an associated enterprise on a basis other than arm’s length will be disallowed (Para 19, DIPN No. 46, Dec 2009)
- (ii) S.17(1)(b) and (c) of the IRO – denying a company a deduction for expenditures not connected with or arising from trade of an associated enterprise, or a capital withdrawn from the enterprise carried on in Hong Kong in order to support that of the foreign associated enterprise (Para 21 & 22, DIPN No. 46, Dec 2009)
- (iii) S.61A of the IRO – In abusive profit shifting transactions (Para 23, DIPN No. 46, Dec 2009)

(Discussion of other relevant IRO provision(s) from a transfer pricing perspective (e.g. s.20(2) & s.61 of the IRO))

VPM Ltd. therefore should formulate a transfer pricing policy in accordance with the arm’s length principle in order to avoid the possible challenge from the IRD.

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Answer (b)

The IRD seeks to apply the principle in the TPG emphasising the importance of comparability analysis under various transfer pricing methods. The methodologies include comparable uncontrolled price, resale price and cost plus methods under the category of traditional transaction methods. It also includes profit – split and the transactional net margin methods under the category of transactional profit methods. (Para 66, DIPN No. 46, Dec 2009).

All these methods are considered by the IRD to satisfy the arm's length principle, and VPM Ltd. should select the most appropriate transfer pricing method to apply to the transactions conducted with Newsub.

Answer (c)

If Newsub is established in Country Y and there is a transfer pricing adjustment made by the tax administration of Country Y to increase the taxable income of Newsub with respect to the sales transactions between VPM Ltd. and Newsub, there are no provisions under the IRO permitting the relief from double taxation by way of adjusting the quantum of assessable profits of VPM Ltd. in the absence of a CDTA (Para 9, DIPN No. 45, April 2009). Such relief in the form of revising the assessment of VPM Ltd. can only be possible in accordance with the relief provision in the Associated Enterprises Article of the CDTA and under s.79 of the IRO on the basis that the transfer pricing adjustment is made on the controlled transactions between VPM Ltd. and Newsub, which is to be established in country X (i.e. having a CDTA with Hong Kong). (Para 14, DIPN No. 45, April 2009)

If Newsub is established in Country X, it is possible for VPM Ltd., under the CDTA, to reach a bilateral Advance Pricing Arrangement (APA) with the IRD and the tax administration of Country X for the determination of an appropriate set of criteria on the transfer pricing of the transactions with Newsub over a fixed period of time (Para 6 & 10, DIPN No. 48, March 2012). However, this APA is not applicable to VPM Ltd. if Newsub is established in country Y without any CDTA concluded with Hong Kong.

On the other hand, there is a mechanism on the exchange of information to the tax administration of Country X under the CDTA. In this regard, the IRD could exchange information to Country X or other countries having a CDTA with Hong Kong in relation to the administration and enforcement of taxes covered by the respective CDTA, and the exchange is also restricted only upon request (Para 5 & 16, DIPN No. 47, June 2010). This exchange of information mechanism is not applicable to Country Y or other countries without any CDTA with Hong Kong.