

Qualification Programme

Module D: Taxation



FOURTH EDITION



Hong Kong Institute of
Certified Public Accountants
香港會計師公會



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Qualification Programme

Module D

Taxation

Flashcards

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Welcome to the HKICPA Flashcards for Module D Taxation.

- They concentrate on the key topics you need for your exam preparation.
- They include **diagrams** to assist your memory.
- They follow the overall **structure** of HKICPA Learning Packs, but these Flashcards are not just a summarised book. Each card has been separately designed for clear presentation. Topics are self contained and can be grasped visually.
- The Flashcards are **just the right size** for pockets, briefcases and bags.

Run through the **Flashcards** as often as you can during your final revision period. The day before the exam, try to go through the **Flashcards** again! You will then be well on your way to passing your exams.

Good luck!

Overall structure of Module D

Part A Hong Kong Taxation and Administration

Part B
Profits Tax

Part C
Salaries Tax, Personal
Assessment, Property Tax

Part D
Stamp
Duty

Part E
Tax Planning & Tax
Investigation

Part F
Tax Compliance, tax
advisory and double
taxation arrangement



Part G Overview of China Tax System

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Notes

1: The tax system in Hong Kong

Topic List

Principles of taxation

The Basic Law

Types of taxation

Double taxation arrangements

The Hong Kong tax system largely retains the form it had before 1997 and the Basic Law ensures that Hong Kong remains independent of the tax system of the Mainland of China. The Hong Kong tax authority continues to raise revenues effectively through a narrow range of taxes, notably profits tax, salaries tax, property taxes and stamp duty. The administration of Hong Kong taxation is relatively simple, improving the efficiency of the tax collection.

Territorial basis

Only income **arising in or derived from sources in Hong Kong** is subject to tax.

Stamp Duty Ordinance

Estate Duty Ordinance

Capital gains

Capital gains are outside the scope of charge for tax in HK

Double taxation relief

One country  Two systems

The **Basic Law** outlines the tax relationship between HK and the PRC

Articles

5	HK social and economic systems unchanged
8	HK law before 1997 maintained
73	HK has power to make taxation policies
106	HK uses its own revenues to its own purpose
108	HK practices an independent tax system
151	HK may use “Hong Kong, China”
153	PRC will decide application of international agreements into HK law

Persons chargeable to tax

“**Person**” includes corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons

Taxation rates

Type	Classification	2008/09 onwards
Property	Standard rate of net assessable	15%
Salaries tax	Lower of – Standard rate – Progressive rates	15% From 2-17%
Profits	Corporation Unincorporated business	16.5% Standard (15%)

Progressive tax rates

Rates – 2007/08 and onwards

First \$40,000	2%
Next \$40,000	7%
Next \$40,000	12%
Balance	17%

Trade, profession and business losses

Tax losses can be carried on indefinitely to offset against future assessable profits on the same trade, profession or business.

Applies to individuals, corporations, partnerships and trustees.

Special administrative region

HK taxation separate from mainland taxation.

HK not covered by the PRC double tax treaties.

Double taxation agreements

Significant differences between HK tax system and PRC tax system.

Section 49 of the IRO means HK can enter into double taxation arrangements.

Hong Kong is expanding its tax treaty network.

As of 1 June 2013, Hong Kong has signed 29 double taxation agreements.

Notes

2: Administration procedures under the Inland Revenue Ordinance

Topic List

Overview

Returns and records

Assessments

Objection and holdover procedures

The tax appeal channel

Error or omission claim

Offences and penalties

Advance rulings system

Payment of taxes

Application to the Commissioner for a notice under Section 88B

It is important to have an understanding of the various rights and obligations of taxpayers and employers under the Inland Revenue Ordinance and the related penalties for non-compliance. Tax advisors should be familiar with the appeal procedures and the possible use of advance ruling.

Tax returns

Under Section 51(1) of the IRO, an assessor may give notice to any person in writing, requesting that person, within a reasonable time stated in the notice (normally one month), to furnish a return that may be specified by the Board of Inland Revenue for:

- Property tax, salaries tax or profits tax (i.e. separate tax returns); or
- Property tax, salaries tax and profits tax (i.e. a composite tax return).

Taxpayer's returns

Tax returns filed 1 month from issue date

Returns now filed via e-tax for **individual, property, business** and **payment**

Employer's return

Remuneration returns for all employees

Form BIR56A

Issued on 1 April with 1 month for filing

Time limit

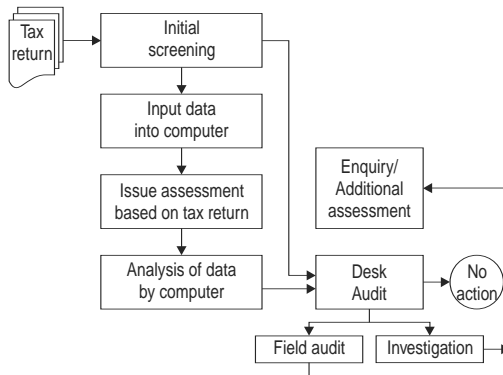
Time limit for raising an assessment is:

- a) Within the year of assessment
- b) Within 6 years after year of assessment
- c) Within 10 years after the assessment if the non-assessment was due to fraud/evasion

Assessments raised

Section	Estimated assessment can be raised:
59(1)	After expiry of time limit
59(1) proviso	At any time
59(2)(a)	In accordance with a return accepted by an assessor
59(2)(b)	Established assessment
59(3)	In the absence of a return
59(4)	If the accounts have not been kept in a satisfactory form.

Audit trilogy



Objection

Taxpayers can lodge an **objection** to a tax assessment.

The notice of objection must be:

- In writing
- State precisely the grounds for objection
- Be received by the Commissioner < 1 month after notice of assessment

There is **no deadline** placed on the IRD to review and decide on the objection

Holdover of tax

The taxation under dispute in an objection can be **held over** (not paid) until the dispute is resolved

Conditional Holdover	Unconditional Holdover
Usually granted in cases considered by the Commissioner to be of little merit.	Usually granted in cases where the tax in dispute is likely to be discharged.
Holdover is granted on condition that the taxpayer purchased a Tax Reserve Certificate or provided a banker's undertaking.	No tax is payable until a notice is issued by the Commissioner.
If the tax is subsequently discharged, the Tax Reserve Certificate will be redeemed with interest to the taxpayer.	If the tax is subsequently payable, the taxpayer has to pay interest on the tax payable at a rate specified by the Chief Justice.

Holdover of provisional tax

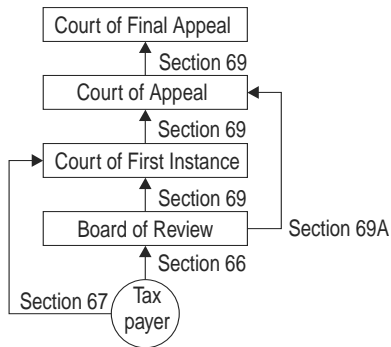
A taxpayer may apply in writing for a partial or complete holdover of provisional tax in circumstances.

Property Tax	Salaries Tax	Profits Tax
N/A	Entitlement to further allowances under Part V of the IRO.	N/A
Assessable value of the property for the year is likely to be less than 90% of the provisional amount assessed.	Net chargeable income for the year is likely to be less than 90% of the provisional amount assessed.	Assessable profit for the year is likely to be less than 90% of the provisional amount assessed.
N/A	A loss brought forward has been omitted or is incorrect.	A loss brought forward has been omitted or is incorrect.
Cessation of income from property.	Cessation of income chargeable to salaries tax.	Cessation of trade, profession or business.
Election for personal assessment has been made which is likely to reduce the tax liability.	N/A	Election for personal assessment has been made which is likely to reduce the tax liability.
An objection has been lodged against the final assessment upon which the provisional assessment is based.	An objection has been lodged against the final assessment upon which the provisional assessment is based.	An objection has been lodged against the final assessment upon which the provisional assessment is based.

Tax appeal channel

Section	Hearing Body	Time Limit
66	Board of Review	<1 month after objection
67	Court of First Instance	<21 days from the date of notice of appeal to the Board of Review
69	Court of First Instance	<1 month after the decision of Board of Review <14 days after receiving case
69A	Court of Appeal	<1 month after the decision of Board of Review <14 days after receiving case
69	Court of Appeal	Within a period according to the High Court Ordinance and the Rules of the High Court
69	Court of Final Appeal	Orders and Rules governing appeals to the Court of Final Appeal

Tax appeal process



An assessment which is closed can be reopened with an error or omission claim under Section 70A of the IRO

Section 70A

A correction can be made if the assessment:

- Is excessive due to an error or omission
- An application is made within the later of six years after the end of the year of assessment, or within six months after the date of the Notice of Assessment

Section 70A

A correction will not be made if the assessment was issued in accordance with the conditions at the time.

Refusal to correct

If an assessor refuses to correct an assessment the taxpayer can lodge an objection.

Offence

An offence is committed by:

- Non-compliance without a reasonable excuse
- Wilful wrongdoing

Penalties

Non-compliance offences not affecting tax charged

- Comply within stated time
- Fine
- Pay up to 300% of tax undercharged

Fines range from Level 1 (\$2,000) to Level 6 (\$100,000)

Reasonable excuse

A **reasonable person** is not a perfect person, but an average person using the reasonable skill and care in handling tax affairs.

The following reasons for committing an offence are **not** reasonable excuses:

- Ignorance of law
- Limited education/illiteracy
- Language difficulty
- Domestic pressure
- Incompetent staff

Advance rulings

To establish the position of an anticipated transaction/arrangement, taxpayers can apply for an **advance ruling** from IRD.

Section 88A of IRO outlines advance ruling provisions.

IRD has selected some rulings for publication found at <http://www.ird.gov.hk/eng/ppr/arc.htm>

Process

Apply for form IR1297



Pay fee outlined in Schedule 10 of IRO
(Fees for anti-avoidance pay HK\$100,000 on submission)



Complete all sections of IR1297



Post IR1297 with supporting documents and fees



Commissioner assesses whether ruling will be made – NO – no ruling issued
YES – Issues ruling

Rulings are generally valid for no more than 2 years of assessments

Methods of payment

Payment

- Cash in person or post
- Cheque in person or post
- Tax Reserve Certificates (TRC)
- Auto tax Payment Service
- Electronic TRC schemes
- Internet
- Telephone banking

Tax Reserve Certificates

Two types

- Ordinary TRCs (electronic only)
- Conditional Standover Order (paper form only)

Ordinary TRCs

- Purchased in denominations of HK\$300 or above in multiples of HK\$50
- Only earn interest when redeemed to pay TRC's account holders tax
- Interest rate follows the market. Current rate 4 Jan 2010 is 0.0433% p.a.
- TRC will earn interest for a maximum period of 36 months

Process

Application made under s. 88B through Form IR 1263

Payment of fee

Commissioner will then issue notice of **no objection to deregister a private company**

Deregistration occurs

Conditions

The deregistration will occur if:

- the company has never commenced operation, or has already ceased business
- the company will not start / resume business in the future
- the company has disposed of all trading stock, landed property and securities
- the company has no outstanding tax liabilities
- the company has no outstanding obligations under the IRO
- there are no unanswered enquiries from the IRD
- there are no unsettled objections or appeals in respect of assessments already raised

Notes

3: Hong Kong profits tax

Topic List

The scope of profits tax charge

Badges of trade

Source of profits

Miscellaneous income and exemptions

Stock valuation

Capital and revenue items

General and specific deductions

Depreciation allowances

Profits tax computation

Partnerships: allocation of profit

Loss relief

Special classes of business

Profits tax is one of the most important taxes in Hong Kong. The general charging provision is s.14 of the IRO. There are also deemed trading receipts under s.15. It is important for tax advisors to be able to identify the related profits tax issues and their tax treatments. They should also be able to ascertain the tax liability of their clients, taking into account the deductibility of various items of expenditure.

Scope of charge

Profits tax is charged when the following conditions are satisfied:

- the person must carry on a trade, profession or business in HK;
- the profits to be charged must be from such trade, profession or business carried on by the person in HK; and
- the profits must be profits arising in or derived from HK.

Definitions

The term 'agent', in relation to a non-resident person or a partnership in which any person is a non-resident person, includes:

- the agent, attorney, factor, receiver, or manager in HK of such person or partnership; and
- any person in HK through whom such person or partnership is in receipt of any profits or income arising in or derived from HK.

The term 'profits' is not defined. The ordinary meaning of profits refers to net profits, being the balance derived from deducting expenditures from receipts.

Profits tax rate for corporations (16.5%) is slightly higher than the standard rate (15%) because there is no tax on dividends.

Trade

'Trade' includes every trade and manufacture, and every adventure and concern in the nature of trade. This definition is wide and it covers isolated transactions.

Badges of Trade	Implications
<ul style="list-style-type: none"> Subject matter of the realisation 	An asset may be purchased for personal enjoyment, production of income or trading. If neither personal enjoyment nor income could be obtained from the asset, the asset is likely to be acquired for trading purposes.
<ul style="list-style-type: none"> Motive 	The intention to make a profit is relevant but not decisive in determining whether or not an activity constitutes trading. In the absence of direct evidence, it is often necessary to infer the seller's intention from the surrounding circumstances.
<ul style="list-style-type: none"> Length of ownership 	Short period of ownership is likely to exist in trading transactions. However, there are many exceptions.
<ul style="list-style-type: none"> Frequency of similar transactions 	If there are a number of similar transactions, it is likely that a trade is being carried on.
<ul style="list-style-type: none"> Supplementary work done 	If there is work done to enhance the value of the asset to make it more marketable, it is likely that a trade is being carried on.
<ul style="list-style-type: none"> Circumstances responsible for the realisation 	Assets realised in a sudden emergency may show that there is no plan to carry on a trade in respect of the subject matter.

In *Quitsubdue*, the court considered the properties were acquired by the taxpayer as its fixed assets and that the shareholders' intentions for their own shares should not be equated with the taxpayer's intention for the properties.

Scope of profits
tax charge

**Badges of
trade**

Source of
profits

Miscellaneous income
and exemptions

Stock
valuation

Capital and
revenue items

The badges of trade are not exhaustive. It is important to consider the relevant facts and merits of each case.

Other factors	Implications
Method and reason of acquisition	If the asset is not acquired through purchase, it is more likely that a trade is not carried on.
Trading interest in the same field	If the person is engaged in the same field and shows expertise or specialised knowledge of the commodity, it is more likely that he is trading in the asset.
Method of financing the acquisition	If the asset is acquired with short-term finance, it is likely that the asset is acquired with the purpose of quick disposal for profit; particularly in property transactions.
Utilisation of sale proceeds	The way the sale proceeds were put into use may indicate the purpose for sale and thus the intention of the person carrying on such a business.
Classification of asset in the accounts	If the asset is shown as a current asset or trading stock in the accounts of a business, it is very likely that the asset is acquired for trading purposes.

Business

'Business' includes agricultural undertaking, poultry and pig rearing and the **letting or sub-letting by any corporation** to any person of any premises or portion thereof and the **sub-letting by any other person** of any premises or portion of any premises held by him under a lease or tenancy other than from the Government.

Income from	Corporations	Persons Other than a Corporation
Letting of premises	Profits tax Property tax (the corporations can claim s.5(2)(a) exemption or s.25 relief)	Property tax Profits tax, if the person is actually carrying on a business of letting. In that case, the person can claim to set off the property tax paid against the profits tax liability under s.25.
Sub-letting of premises	Profits tax	Profits tax

Profession

'**Profession**' is not defined. It usually involves the exercise of intellectual skill or manual skill controlled by intellectual knowledge.

In practice, most professions also **fall within the meaning of business**.

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Source of profits

Two sources of income or profits:

- rendering services or performing activities – **active income**
- holding of property – **passive income**

Active income:

- trading profits
- profits from purchase and sale of listed securities
- profits from purchase and sale of unlisted securities
- manufacturing profits
- commission income or service fees

Passive income:

- interest income
- rental income from immovable property
- rental income from movable property
- royalties or licence fees from intangible assets

The broad guiding principle

The Privy Council in *Hang Seng Bank* provided the 'broad guiding principle' for the determination of source: 'one looks to see what the taxpayer has done to earn the profit in question'.

Operations test

The 'operations test' was further elaborated by the Privy Council in *HK-TVBI*: One looks to see what the taxpayer has done to earn the profit in question and where he has done it.

Relevant operations do not comprise the whole of the taxpayer's activities carried out in the course of its business, but only those that produce the profits in question.

“The focus is therefore on establishing the geographical location of the taxpayer’s profit-producing transactions . . . as distinct from activities antecedent or incidental to those transactions. Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer’s business, but they do not provide the legal test for ascertaining the geographical source of profits for the purpose of s.14.” (ING Baring)

In ***Kwong Mile Services***, the court emphasised the need to grasp the reality of each case, focusing on **effective causes** without being distracted by **antecedent or incidental matters**.

Traditional tests for source of profits

Five tests for determining the source of profits:

- operations test (for commission income, service fees and active interest income.)
- contract effected test (for trading profit and profit from sale of unlisted securities)
- provision of credit test (for passive interest income)
- situs (or location) test (for rental income and profit from sale of real property and listed securities)
- activities test (for manufacturing profit)

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Source of trading profits

Trading profits are earned by buying goods or commodities and selling them for a higher price. The making of the purchase and sale contracts and the performance of them are part of the source of the trading profits.

Test used:

- contract effected test
- relevant operations that produce the trading profits

The IRD's view: Trading profits are either fully taxable or fully exempt. The question of apportionment does not arise.

DIPN 21 Example

Company A, incorporated in HK, is a re-invoicing centre of a group of companies with a holding company incorporated in the US. It manages in HK all foreign currency exposures from intra-company trade, guarantees the exchange rates for future orders and manages intra-affiliate cash flows, including lead and lags of payments. Manufacturing affiliates in the PRC sell goods to Company A, which in turns resells to the distribution affiliates in North America and Europe. Company A resells at cost plus a mark-up for its services. The mark-up covers the cost of the re-invoicing centre and a reasonable return on the services provided.

The profits accruing to Company A are service income derived from HK. The mark-up earned by Company A, which acts as a re-invoicing centre, is chargeable to profits tax.

Tax cases on source of trading profits:

Taxpayer	Subject Matter	Reference
<i>Sinolink Overseas Co Ltd</i>	Trading profits	(1985) 2 HKTC 127
<i>Exxon Chemical International Supply S.A.</i>	Trading profits	(1989) 1 HKRC 90-019
<i>Bank of India</i>	Trading profits	(1990) 1 HKRC 90-929
<i>Hang Seng Bank Ltd</i>	Trading profits	(1990) 1 HKRC 90-044
<i>Euro Tech (Far East) Ltd</i>	Trading profits	(1995) 1 HKRC 90-074
<i>Magna Industrial Co Ltd</i>	Trading profits	(1997) 1 HKRC 90-082
<i>Conesco Trading Co Ltd</i>	Trading profits	(2004) HKRC 90-132

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Source of manufacturing profits

Manufacturing profits are earned by converting raw materials to merchantable products, and the source is where the manufacturing activities are carried out.

Test used:

Activities test

IRD's practice:

- goods manufactured in HK: profits 100% taxable
- goods manufactured partly in HK and partly outside HK: apportionment of profits is possible

DIPN 21 Example

- (1) Company B manufactures goods in HK and sells them to overseas customers. The fact that Company B has sales staff based overseas does not give a part of the profit an overseas source. The whole of the profits are liable to profits tax.
- (2) Company C manufactures in the Mainland and sells the finished goods through a retailing branch in HK. The retailing branch has sales staff and a fixed place of business, and has registered for business in HK.

Company C is both a manufacturer and a retailer. Profits are derived from the manufacturing operations in the Mainland and the retailing operations in HK. Profits are apportioned, and the part attributable to the HK retailing branch are chargeable to profits tax.

Contract processing vs Import processing

Arrangement	Tax treatment
<p>Contract processing</p> <ul style="list-style-type: none"> ■ HK company supplies raw materials, machinery, technical and managerial know-how ■ Mainland processing enterprise provides factory premises, utilities and labour ■ HK company pays a subcontracting charge, and takes title to the raw materials and finished goods 	<ul style="list-style-type: none"> ■ HK company heavily involved in the processing arrangement in the Mainland ■ Appointment of profits on a 50-50 basis, or any rational basis only ■ If the HK company has restricted involvement in the processing arrangement, profits fully chargeable
<p>Import processing</p> <ul style="list-style-type: none"> ■ HK company sells raw materials to FIE and buys back the finished goods from the FIE ■ Legal title to the raw materials and the finished goods passes to/from the FIE ■ HK company trades in raw materials and finished goods ■ The FIE manufactures the finished goods 	<ul style="list-style-type: none"> ■ Profits accrued to the HK company from trading transactions carried but in HK and cannot be attributed to the manufacturing operations of the FIE ■ Trading profits fully chargeable

Tax cases on source of manufacturing profits

<i>Taxpayer</i>	<i>Subject Matter</i>	<i>Reference</i>
Datatronic Ltd	Manufacturing profits	HCIA 3&4/2007, CACV 275/2008
CG Lighting Ltd	Manufacturing profits	HCIA 8/2009, CACV 119/2010

The above cases are relevant only for import processing cases.

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Source of commission income/service fees

Commissions or service fees, being a reward for services rendered, generally arise in the place where the relevant services are performed. If the services are performed both in HK and overseas, an apportionment of the services fees may be made if there is an appropriate basis.

Test used:

Operations test

DIPN 21 Example

A HK company holds the Far East Area sales or purchase responsibility for a product or group of products sold into the area or sourced in the area by principals who are associated concerns. The HK company and the associates are members of a group under the control of a common parent organisation. The HK company is appointed agent for the area, and is remunerated by a commission on all sales and/or purchases in this area. The HK company may either:

- a) actively solicit orders ex-HK, on behalf of its principals by sending employee representatives overseas or by employing sub-agents overseas (profits derived from offshore services); or
- b) factually do nothing whatsoever, either itself or through sub-agents (no services are required).

Therefore, profits are fully exempt.

In the case of an investment advisor whose organisation and operations are located only in HK, rebates, commissions and discounts received by the advisor from brokers located in HK or elsewhere in respect of the securities transactions executed on behalf of the advisor's clients are **fully chargeable to tax**.

Tax cases on source of commissions/service fees/rebates:

Taxpayer	Subject Matter	Reference
<i>Karsten Larssen & Co (HK) Ltd</i>	Agency commission	(1951) 1 HKTC 11
<i>The HK & Whampoa Dock Co Ltd</i>	Salvage income	(1960) 1 HKTC 85
<i>International Wood Products Ltd</i>	Agency commission	(1971) 1 HKTC 551
<i>Wardley Investment Services (HK) Ltd</i>	Rebates	(1993) 1 HKRC 90-068
<i>Indosuez W I Carr Securities Ltd</i>	Agency commission	(2002) HKRC 90-117 (2005) HKRC 90-157 (2007) HKRC 90-191
<i>Macquarie Securities Ltd (formerly known as ING Baring Securities (HK) Ltd)</i>	Brokerage commission and marketing income	(2005) [CACV 202/2005] (2007) [FACV 19/2006]
<i>Kim Eng Securities (HK) Ltd</i>	Brokerage commission, consulting fees and interest income	(2007) [FACV 11/2006]
<i>Li & Fung (Trading) Ltd</i>	Agency commission	(2010) [HCIA 1/2010]

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Source of interest income

For persons other than a financial institution the locality of their interest income will be determined on the basis set out in DIPN 13.

Test used:

Provision of credit test: the place where the sum of money is first made available to the borrower. It is not difficult for a HK resident to derive offshore interest income without leaving HK.

Tax cases on source of interest income:

Taxpayer	Subject Matter	Reference
<i>Orion Caribbean Ltd</i>	Loan interests	(1997) 1 HKRC 90-089

In *Orion Caribbean*, the taxpayer was carrying on a business of money lending. The Privy Council was of the view that the provision of credit test was not applicable as the taxpayer's activities were different from that of a person lending its own funds. The taxpayer borrowed funds from its HK parent, and acted as a channel between the parent and the overseas borrowers. Having regard to the services of the parent in HK, the taxpayer's interest income was sourced in HK.

As such, for money lenders, the operation test would be used instead of the provision of credit test to determine the source of active interest income.

Source of rental income from immovable property

DIPN 21 says the location of the immovable property is the source of the rental income.

Source of rental income from movable property

Movable property includes ships and aircrafts, and other movable properties.

Test used:

Situs test

DIPN 15 Example

Rental income from movable property will generally be regarded as non-taxable in cases where the recipient is not allowed to claim depreciation allowance in respect of the property by virtue of s.39E.

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Source of royalties or licence fees from intangible asset

DIPN 21 says the locality of royalties other than those deemed chargeable under ss.15(1)(a), (b) or (ba) would be the place of acquisition and granting of the licence or right of use.

DIPN 49 says:

- IPR created or developed by the licensor – royalty income generally regarded as HK sourced as it is generated by the taxpayer using his wits and labour to create or develop the IPR in HK
- IPR purchased by the licensor – royalty income generally regarded as non-HK sourced if the IPR is licensed for use outside HK
- IPR not owned by the licensor – source of royalty income would be the place of acquisition and granting of the license

Tax cases on source of royalties/licence fees:

Taxpayer	Subject Matter	Reference
<i>HK-TVB International Ltd</i>	Sublicensing fees	(1992) 1 HKRC 90-064
<i>Lam Soon Trademark Ltd</i>	Licensing fees	(2005) HKRC 90-171

Source of cross-border land transportation income

DIPN 21 says the locality of the cross-border land transportation income will normally be the place of uplift of the passenger or goods. Where the contract of carriage does not distinguish between outward and inward transportation, apportionment will not be permitted.

Source of underwriting income

The source of underwriting income is not covered by DIPN 21, except for para. 54 which relates to underwriting income for FIs.

Tax case on source of underwriting income:

Taxpayer	Subject Matter	Reference
<i>Kwong Mile Services Ltd</i>	Underwriting income	(2004) HKRC 90-135

This case is also referred to when applying the broad guiding principle in determining the source of other types of income/profits.

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Chargeability of e-commerce transactions

Contracts that are concluded in the cyberspace and signed digitally have the same effects as those concluded and signed in the normal way. The provisions of the IRO will be applied to electronic commerce on the same basis as those applied to conventional forms of business.

The IRD's views:

- A server does not constitute a PE unless there is a physical place and personnel involved at the place where the server is located.
- The absence of a PE does not mean that no business is carried on in HK.
- It is generally the location of the physical business operations, rather than the location of the server alone, that determines the locality of the profits.
- Apart from the nature of the contracts concluded via the Internet, the IRD will look at the location of the following processes:
 - where goods are stored and delivered
 - where services are provided
 - where payments are made and received
 - where purchases and sales are made
 - where bank accounts are maintained
 - where business back-up services are provided

DIPN 39 Example on Trading Business

A company carries on business of selling books in HK, and operates a server (at its disposal) located outside HK. Its customers obtain details of books and price lists, place orders and make payment through the server. However, all other business operations of the company (including procurement, storage and physical delivery of books) are performed in HK. In this case, the profits made by the company from selling books through the server are sourced in HK, and chargeable to HK profits tax.

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Sums chargeable to profits tax

Section	Sums Specifically Chargeable to Profits Tax
15(1)(a)	Sums received by or accrued to a person from the exhibition or use in HK of any films, tapes, sound recording or any advertising materials connected with any such properties.
15(1)(b)	Sums received by or accrued to a person for the use of or right to use in HK any patent, design, trade mark, copyright material, secret process or formula or other similar property, or for imparting knowledge in connection with the use in HK of any such properties.
15(1)(ba)	Sums received by or accrued to a person for the use of or right to use outside HK any intellectual properties listed in s.15(1)(b), or for imparting knowledge in connection with the use outside HK of any such properties, which are deductible in ascertaining the assessable profits of a person under profits tax.
15(1)(c)	Sums received by or accrued to a person by way of grants, subsidies or other financial assistance in connection with a trade, profession or business carried on in HK, other than sums in connection with capital expenditure.
15(1)(d)	Hire or rental received for the use of or right to use movable property in HK.
15(1)(f)	Interest derived from HK received by or accrued to a corporation carrying on a trade, profession or business in HK.
15(1)(g)	Interest derived from HK received by or accrued to person other than a corporation carrying on a trade, profession or business in HK, and the interest is in respect of funds of the trade, profession or business.

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15(1)(h)	Refund of contributions to a ROPS or to a MPFS, to the extent the amount has been allowed as a tax deduction.
15(1)(i)	Interest received by a FI through or from the carrying on of its business in HK, notwithstanding that the source of interest income is outside HK.
15(1)(j)	Profits arising in or derived from HK from the disposal of, or on the redemption on maturity or presentment of, certificates of deposit or bills of exchange received by or accrued to a corporation carrying on a trade, profession or business in HK.
15(1)(k)	Similar profits from certificates of deposit or bills of exchange received by or accrued to a person other than a corporation carrying on a trade, profession or business in HK, and the profit is in respect of funds of the trade, profession or business.
15(1)(l)	Similar profits from certificates of deposit or bills of exchange received by or accrued to a FI through or from the carrying of its business in HK, notwithstanding that the source of profit is outside HK.
15(1)(m) & 15A	Consideration for the transfer of the right to receive income which is subject to profits tax.
15(2)	Debts allowed but subsequently released.
16(1)(d)(ii)	Recovery of bad debts previously allowed under s16(1)(d)(i).
16B(3)	Proceeds from sale of machinery or plant used for R&D previously allowed as a deduction. The taxable amount is limited to the amount of the deduction.

Section	Sums Specifically Chargeable to Profits Tax
16E(3)	Proceeds from sale of patent rights previously allowed as a deduction. The taxable amount is limited to the amount of the deduction.
16EB(2)	Proceeds from sale of specified intellectual property rights or rights to know-how previously allowed as a deduction that exceeds the unallowed amount (if any). The taxable amount is limited to the amount of the deduction.
16G(3)	Proceeds from sale of a prescribed fixed asset previously allowed as a deduction. The taxable amount is limited to the amount of the deduction.
16J(2) & (2A)	Proceeds from sale of an environmental protection machinery or environment-friendly vehicle previously allowed as a deduction. The taxable amount is limited to the amount of the deduction.
16J(3)	Proceeds from sale of an environmental protection installation previously allowed as a deduction. The taxable amount is limited to the amount of the deduction.
18F(1)	Balancing charge on disposal of machinery and plant.

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Concessionary trading receipts chargeable to tax at half of the profits tax rate

Section	Concessionary Trading Receipts
14A(1)(a)	Sums received by or accrued to a person as interest paid or payable on a medium term or short term debt instrument.
14A(1)(b)	Sums received by or accrued to a person as any gain or profit on the sale or other disposal or on the redemption on maturity or presentment of a medium term or short term debt instrument.
14B	Assessable profits of a corporation derived from the business of reinsurance of offshore risks as a professional reinsurer within the meaning of s.23A(2).

Sums exempt from profits tax

Section	Sums Specifically Exempt from Profits Tax
14	Profits not arising in or derived from HK, and profits from the sale of capital assets (subject to other provisions of the IRO).
15E	Profits from stock borrowing and lending transactions and repurchase transactions.
20AC to 20AE	Assessable profits of offshore funds from dealing in transactions specified in Schedule 16 carried out through or arranged by a specified person.
26(a)	Dividends from corporations chargeable to profits tax.
26(b)	Profits already charged to profits tax in the name of another person.
26A(1)(a)	Interest on Tax Reserve Certificates.
26A(1)(b)	Interest on bonds issued under the Loans Ordinance or the Loans (Government Bonds) Ordinance.
26A(1)(c)	Any profit on the sale or other disposal or on the redemption on maturity or presentation of a bond issued under the Loans Ordinance or the Loans (Government Bonds) Ordinance.
26A(1)(d)	Interest on an Exchange Fund debt instrument.
26A(1)(e)	Any profit on the sale or other disposal or on the redemption on maturity or presentation of an Exchange Fund debt instrument.
26A(1)(f)	Interest on a HK dollar denominated multilateral agency debt instrument.

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26A(1)(g)	Any profit on the sale or other disposal or on the redemption on maturity or presentation of a HK dollar denominated multilateral agency debt instrument.
26A(1)(h)	Interest paid or payable on a long term debt instrument.
26A(1)(i)	Any gain or profit on the sale or other disposal or on the redemption on maturity or presentation of long term debt instrument.
26A(1A)(a)	Any sums received or accrued in respect of a specified investment scheme by or to the person as a person chargeable to profits tax in respect of a mutual fund, unit trust or similar investment scheme: <ul style="list-style-type: none">i) that is authorised as a collective investment scheme under s.104 of the SFO; orii) where the Commissioner is satisfied that the mutual fund, unit trust or investment scheme is a bona fide widely held investment scheme which complies with the requirements of a supervisory authority within an acceptable regulatory regime.
87	Interest on any deposit placed in HK with an authorised institution, regardless of the currency in which the deposit is denominated, received by or accrued to a corporation or a person other than FIs, after deduction of all allowable outgoings and expenses incurred in producing such interest. This exemption does not apply to deposits used to secure or guarantee money borrowed from a FI, and the interest expense is allowable under s.16(1)(a) and ss.16(2)(c), (d) or (e) and s.16(2A) does not apply.
87	Sums received by or accrued as interest or profits arising from Renminbi Sovereign Bonds as from the year of assessment 2009/10.

Stock valuation methods

Guidance is given in **DIPN 1**.

Not all stock valuation methods are accepted for tax purposes.

Stock Valuation Method	Acceptability for Tax Purposes
Adjusted selling price	Acceptable
Average cost	Acceptable
Base stock cost	Not acceptable
First in first out (FIFO)	Acceptable
Last in first out (LIFO)	Not acceptable
Latest purchase price	Not acceptable
Lower of cost and market	Acceptable
Replacement cost	Not acceptable
Standard cost	Acceptable
Unit cost (specific identification)	Acceptable

Stock taken for own use

The *Sharkey v. Wernher* principle establishes the fact that **one can trade with oneself**. In this case, the taxpayer took valuable horses from her stud farm business for her hobby of horse racing. It was held that the market value of the horses should be brought into the farm business's profits, not the cost.

Doubt has been raised on this principle by the following cases:

- Board of Review has refused to implement the *Sharkey v. Wernher* principle: *D41/91, D47/91, D75/96*
- ***CIR v Quitsubdue Ltd* [(1999) 1 HKRC 90-099]**
- ***CIR v Nice Cheer Investment Limited* [(2012) CACV 135/2011]**

Stock valuation on cessation of trade

Situation	Stock Valuation
Stock is sold or transferred for valuable consideration and the purchaser will deduct the cost in computing his profit chargeable to tax	At amount realised or consideration given for the transfer.
Other cases	At open market value on date of cessation.

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Change of intention of holding an asset

Situation	IRD's Assessing Practice	Tax Implications
Capital asset => Trading stock	Business is deemed to have sold a capital asset at its market value and purchased a trading stock at its market value.	Difference between the cost and market value is a capital gain/loss.
Trading stock => Capital asset	Business is deemed to have sold a trading stock at its market value and purchased a capital asset at its market value.	Notional profit/loss is taxable/deductible in the year of change of intention.

Capital receipts and revenue receipts

Revenue or trading receipts include:

- receipts from disposal of trading stock or services in the course of business; and
- receipts arising incidentally to the business.

Capital receipts are those relating to the structure of the business.

Compensation

As a general principle in common law, a compensation payment usually takes the character of the item which it replaces.

- Compensation received in lieu of trading receipts is taxable as trading income.
- Compensation for loss or damage to the profit making structure of the business is capital in nature.
- Compensation received in relation to the sterilisation of business assets, closure of business or entering into a restrictive covenant is capital in nature.

Property Transactions

To determine whether a property was acquired by a person as an **investment** or a **trading stock** and whether the gains on disposal of the property are revenue or capital in nature, reference is often made to the '**badges of trade**'.

General test

Receipts are capital in nature if connected with fixed capital (fixed assets) of the business but revenue in nature if connected with circulating capital (current assets) of the business.

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Capital expenditure and revenue expenditure

Fixed capital versus circulating capital

Fixed Capital	Circulating Capital
Fixed capital refers to what a company retains, in the shape of assets upon which the subscribed capital has been expended and which either themselves produce income, independent of any further action by the company; or are made use of to produce income or to gain profits.	Circulating capital refers to what a company intends to be used by being temporarily parted with and circulated in the business, in the form of money, goods or other assets, and which, or the proceeds of which, are intended to return to the company with an increment, and are intended to be used again and again, and to always return with some accretion.

Capital expenditure vs. revenue expenditure

The following is a general comparison of capital expenditures and revenue expenditures:

Capital Expenditures	Revenue Expenditures
▪ Once and for all	▪ Often recur
▪ Usually of large amount	▪ Usually of small amount
▪ Provide an enduring benefit to the business	▪ Provide short-term benefits or temporary influence to the business
▪ Influence the profit yielding structure of the business	▪ No or limited effect on the profit yielding structure of the business
▪ May be fixed within the business in the form of an asset	▪ May circulate within or depart from the business
▪ Shown in the statement of financial position as assets	▪ Charged to the income statement as expenses

Allowable deductions

Company pays profits tax on its **assessable profit** which is computed by **deducting allowable expenditures** among other items.

Section 16 provides for a deduction of all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by a person in the production of profits chargeable to tax for any period.

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Deductible items under s.16(1)(a) to (h)

Section	Allowable deductions
16(1)(a)	Subject to the conditions in ss.16(2) and (2A) to (2G), interest payable on money borrowed for the purpose of producing chargeable profits, and sums payable by way of legal fees, procuracy fees, stamp duties and other expenses in connection with such borrowing.
16(1)(b)	Rent in respect of premises occupied for the purpose of producing chargeable profits.
16(1)(c)	Foreign tax paid in respect of interest income and gains or profits from sale or redemption of certificates of deposit or bills of exchange chargeable under ss.15(1)(f), (g), (i), (j), (k) or (l).
16(1)(d)	Bad and doubtful debts proved to the satisfaction of the Assessor to have become bad, provided that the debt has been included as a trading receipt or has been lent in the ordinary course of a money-lending business.
16(1)(e)	Expenditure on repairs to assets employed in the production of chargeable profits. The deductible amount is reduced by sums recoverable under insurance contracts.
16(1)(f)	Expenditure on the replacement of implement, utensil or article employed in the production of chargeable profits, provided that no depreciation allowances have been claimed.
16(1)(g)	Expenditure expended for the registration of a trade mark, design or patent used in the production of chargeable profits.
16(1)(ga)	The payments and expenditures specified in ss.16AA, 16B, 16C, 16E, 16F, 16G and 16I as provided therein.
16(1)(h)	Such other deduction as may be prescribed by any rule made under the IRO.

Any one of the six conditions for deductible interest

Borrowing	Applicable to	Section
By special classes of business	Borrowing by FIs	16(2)(a)
	Borrowing by public utility companies	16(2)(b)
From non-FIs	Lender of money is subject to tax on the interest	16(2)(c)
From FIs	Borrowing from local or overseas FIs	16(2)(d)
For special purposes	Borrowing for the purchase of machinery or plant or trading stock, other than from associates	16(2)(e)
By special methods	Borrowing by the issue of listed debentures or marketable instruments	16(2)(f)

Secured-loan test in s.16(2A)

If the borrowing is secured by a deposit or a loan, whether wholly or in part, directly or indirectly, made by the borrower or its associate with or to:

- the lender or its associate;
- a FI or its associate; or
- an overseas FI or its associate, and

any interest payable on the deposit or loan is not chargeable to profits tax, the amount of deductible interest will be reduced.

Interest flow-back test in ss.16(2B) and (2C)

If arrangements are in place whereby any of the interest on the money borrowed is payable, whether directly or through any interposed person, to the borrower or a connected person (other than the lender); and the borrower or the person is not an excepted person, the amount of deductible interest will be reduced.

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Items which are specifically deductible

Section	Expenditure	Allowable Deductions	Treatment of Refund/Sale Proceeds
16A	Special payment under a RORS or contributions other than regular contributions to a MPFS	20% per year of assessment from the year of assessment in which the expenditure was incurred.	Refund of contributions to a RORS or voluntary contributions to a MPFS, to the extent that the sums were previously allowed as deductions, is taxable.
16AA	Mandatory contributions to a MPFS in self-employment cases	Mandatory contributions to a MPFS made by a self-employed person (a sole-proprietor or a partner) which are not otherwise allowable and not exceeding \$15,000 (subject to apportionment if a deduction is only allowed for part of the expenditure).	N/A
16B	Expenditure on R&D	General expenditure/ expenditure on machinery or plant fully deductible (subject to apportionment if the expenditure is incurred outside HK and the trade, profession or business is carried on partly outside HK) in the year of assessment in which the expenditure was incurred.	Sale proceeds of rights in, or arising out of, the R&D, to the extent that they are not otherwise chargeable to profits tax and do not exceed the amount of the deduction previously allowed, are taxable.

		Expenditure on buildings or structures qualifies for industrial building allowance.	Sale proceeds of buildings or structures are not taxable, but are deducted from the reducing value to compute the balancing adjustment.
16C	Payments for technical education	Fully deductible in the year of assessment in which it was incurred.	N/A
16D	Approved charitable donations	Allowable if the aggregate is not less than \$100 and not exceeding 35% of the assessable profits.	N/A
16E	Purchase of patent rights, rights to know-how	If not purchased from an associate, fully deductible (subject to apportionment for non-business use) in the year of assessment in which the expenditure was incurred.	Sale proceeds (subject to apportionment for non-business use) of patent rights, rights to know-how, etc., to the extent that they are not otherwise chargeable to profits tax and do not exceed the amount of the deduction previously allowed, are taxable.
16EA-EC	Purchase of specified IPRs (copyright, registered trade mark/ design)	If not purchased from an associate, 20% per year of assessment (subject to apportionment for non-business use) from the year of assessment in which it was incurred.	Sale proceeds (subject to apportionment for non-business use) of specified IPRs, to the extent that they are not otherwise chargeable to profits tax and do not exceed the amount of the deduction previously allowed, are taxable.

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Section	Expenditure	Allowable Deductions	Treatment of Refund/Sale Proceeds
16F	Expenditure on building refurbishment	20% per year of assessment from the year of assessment in which it was incurred.	N/A
16G	Capital expenditure on the provision of a PFA	Fully deductible (subject to apportionment for non-business use) in the year of assessment in which the expenditure was incurred.	Sale proceeds of the PFA, to the extent that they are not otherwise chargeable to profits tax and do not exceed the amount of the deduction previously allowed, are taxable.
16H-K	Capital expenditure on EPM and EFV	Fully deductible (subject to apportionment for non-business use) in the year of assessment in which the expenditure was incurred.	Sale proceeds of the EPM and EFV, to the extent that they are not otherwise chargeable to profits tax and do not exceed the amount of the deduction previously allowed, are taxable.
16H-K	Capital expenditure on EPI	20% per year of assessment from the year of assessment in which it was incurred.	Sale proceeds of the EPI, to the extent that they are not otherwise chargeable to profits tax and do not exceed the amount of the deduction previously allowed, are taxable.

Deductions not allowable under s.17

Section	Non-allowable deductions
17(1)(a)	Domestic or private expenses, including the cost of travelling between residence and place of business.
17(1)(b)	Expenses not expended for the purpose of producing chargeable profits.
17(1)(c)	Expenditure of a capital nature or any loss or withdrawal of capital.
17(1)(d)	Cost of improvements.
17(1)(e)	Sums recoverable under an insurance or contract of indemnity.
17(1)(f)	Rent and expenses for premises not used for producing chargeable profits.
17(1)(g)	Any tax payable under the IRO, except salaries tax paid on behalf of employees.
17(1)(h)	Ordinary annual contributions or ordinary annual premiums made to a RORS or regular contributions made to a MPFS, which exceed 15% of the total emoluments of each employee's remuneration.
17(1)(i)	Any provision made for the payment in respect of a RORS or a MPFS in s.17(1)(h) which exceeds 15% of the total emoluments of each employee's remuneration.
17(1)(j)	Any provision made in respect of initial and special contributions to a RORS.
17(1)(k)	Any contribution made to a RORS or a MPFS, where a provision for payment of the sum has been made in a prior year of assessment and a deduction has been allowed for the provision.
17(1)(l)	Contributions made to the funds of, or payments made for the purposes of the operation of, an ORS other than a RORS.
17(2)	Salaries or other remuneration of, or interest on capital or loans provided by, the sole-proprietor, partners and/or their spouses; or contributions made to a MPFS in respect of the sole-proprietor's or partner's spouses.

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Section	Expenditure	Treatment of expense	Treatment of Refund
17(1)(j)	Provision for initial and special contributions to RORS	Not deductible	N/A
16A 15(1)(h)	Initial and special contributions to RORS and contributions other than regular contributions to MPFS	Deductible over 5 years in equal annual instalments, commencing from the year the contributions are made	Refund of contributions, to the extent that the sums were previously deductible, is taxable
16(1) and 17(1)(i) 15(1)(h)	Provision for ordinary contributions to RORS and regular contributions to MPFS	Deductible, but limited to 15% of each employee's remuneration	Refund of contributions, to the extent that the sums were previously deductible, is taxable
16(1) and 17(1)(h) 15(1)(h)	Ordinary contributions to RORS and regular contributions to MPFS	Deductible, but limited to 15% of each employee's remuneration	Refund of contributions, to the extent that the sums were previously deductible, is taxable
17(1)(k)	Contributions to RORS and MPFS where a provision has previously been allowed as a deduction	Not deductible	N/A
16AA	Mandatory contributions to MPFS made by a self-employed person	Deductible, if not otherwise allowable and not exceeding \$15,000	N/A

Summary of general tax treatment for common expenses

Expenses	General Tax Treatment
Bad debts in respect of <ul style="list-style-type: none">Trade debtsMoney lost in a money lending businessAdvance/loan	<ul style="list-style-type: none">AllowableAllowableNot allowable
Embezzlement <ul style="list-style-type: none">By directorBy employee	<ul style="list-style-type: none">Not allowableAllowable
Exchange loss <ul style="list-style-type: none">On trade debtsOn bank balances/loans	<ul style="list-style-type: none">AllowableNot allowable

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Expenses	General Tax Treatment
Ex gratia payment or compensation for loss of office <ul style="list-style-type: none">For past servicesFor removing an unwanted employeeFor prevention of future competition	<ul style="list-style-type: none">AllowableAllowableNot allowable
Insurance <ul style="list-style-type: none">On fixed assetsOn goods or employees	<ul style="list-style-type: none">AllowableAllowable
Initial set-up cost or special payment to an ORS <ul style="list-style-type: none">Recognised scheme (RORS)Unrecognised scheme	<ul style="list-style-type: none">Allowable by 5 instalments (20% per annum) in 5 years of assessment pursuant to s.16ANot allowable
Contributions other than regular contributions to a MPFS	<ul style="list-style-type: none">Allowable by 5 instalments (20% per annum) in 5 years of assessment pursuant to s.16A

<p>Ordinary contributions to an ORS</p> <ul style="list-style-type: none"> ■ Recognised scheme (RORS) ■ Unrecognised scheme 	<ul style="list-style-type: none"> ■ Allowable if not exceeding 15% of the total remuneration of each employee ■ Not allowable after 15 October 1995
<p>Regular contributions to a MPFS</p>	<ul style="list-style-type: none"> ■ Allowable if not exceeding 15% of the total remuneration of each employee
<p>Legal and professional fees</p> <ul style="list-style-type: none"> ■ For acquisition of capital assets ■ For amendment to Memorandum and Articles of Association ■ For arrangement of mortgage loan ■ For collection of trade debts ■ For company formation 	<ul style="list-style-type: none"> ■ Not allowable ■ Not allowable ■ Allowable if the property is occupied or used for production of assessable profits ■ Allowable ■ Not allowable

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Expenses	General Tax Treatment
<ul style="list-style-type: none">■ For criminal proceeding■ For increase of corporate capital■ For new tenancy■ For protection of business asset■ For renewal of existing tenancy■ For tax appeals	<ul style="list-style-type: none">■ Not allowable■ Not allowable■ Not allowable■ Not allowable■ Allowable■ Not allowable
<p>Penalty</p> <ul style="list-style-type: none">■ For breach of the law (e.g. parking fines, late filing of tax return)■ For late settlement of debts■ For late delivery of goods	<ul style="list-style-type: none">■ Not allowable■ Allowable■ Allowable
<p>Pre-commencement expenses (salaries, rent, etc.)</p>	<ul style="list-style-type: none">■ Allowable in the first basis period by the IRD's concession

<p>Redundancy/severance payments</p> <ul style="list-style-type: none"> ■ For closing down a line of unprofitable business ■ On cessation of business, in accordance with the Employment Ordinance 	<ul style="list-style-type: none"> ■ Allowable ■ Allowable, in accordance with the <i>Cosmotron Manufacturing Company Ltd</i> case
<p>Removal expenses</p> <ul style="list-style-type: none"> ■ For trading stock ■ For machinery or plant ■ On compulsory removal ■ On voluntary removal 	<ul style="list-style-type: none"> ■ Allowable ■ Not allowable (but rank for depreciation allowances) ■ Allowable ■ Not allowable
<p>Repairs</p> <ul style="list-style-type: none"> ■ To make a newly acquired asset usable ■ To replace the entire asset ■ To restore the asset to a usable stage 	<ul style="list-style-type: none"> ■ Not allowable ■ Not allowable ■ Allowable

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Tax cases on deductions under profits tax:

Taxpayer	Subject Matter	Reference
<i>Hang Seng Bank Ltd</i>	Exchange differences	(1972) 1 HKTC 583
<i>Swire Pacific Ltd</i>	Payment to end a strike	(1979) HKTC 1145
<i>Li & Fung Ltd</i>	Exchange differences	(1980) HKTC 1193
<i>Lo and Lo</i>	Provision for long service payment	(1984) 2 HKTC 34
<i>Banque National De Paris Hong Kong Branch</i>	Interest to head office	(1985) 2 HKTC 139
<i>County Shipping Co Ltd</i>	Interest expenses	(1990) 1 HKRC 90-034
<i>Overseas Textiles Ltd</i>	Compensation payments	(1990) 1 HKRC 90-042
<i>Asia Securities International Ltd</i>	Bad debts	(1991) 1 HKRC 90-052
<i>AP Fahy</i>	Medical expenses	(1992) 1 HKRC 90-062

<i>Chinachem Finance Co. Ltd</i>	Exchange differences	(1992) 1 HKRC 90-066
<i>Wharf Properties Ltd</i>	Interest expenses	(1997) 1 HKRC 90-085
<i>General Garment Manufactory (Hong Kong) Ltd</i>	Exchange differences	(1997) 1 HKRC 90-090
<i>Cosmotron Manufacturing Company Ltd</i>	Severance pay	(1997) 1 HKRC 90-091
<i>National Mutual Centre (HK) Ltd</i>	Interest expenses	(1998) 1 HKRC 90-094
<i>Secan Ltd/Ranon Ltd</i>	Interest incurred during the period of property development	(2001) 1 HKRC 90-107
<i>So Kai Tong, Stanley trading as Stanley So & Co</i>	Office facilities charges, equipment rental and entertainment expenses	(2004) HKRC 90-131
<i>Zeta Estates Ltd</i>	Interest attributable to payment of dividend	FACV 15/2006

General and
specific deductions

Depreciation
allowances

Profits tax
computation

Partnerships:
allocation of profit

Loss
relief

Special classes of
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Taxpayer	Subject Matter	Reference
<i>Chu Fung Chee</i>	Costs of disciplinary proceedings	HCIA 10/2005
<i>Tai Hing Cotton Mill (Development) Ltd</i>	Expenses paid to a related company	[CACV 343/2005] (2007) FACV 2/2007
<i>HIT Finance Ltd</i> <i>HK International Terminals Ltd</i>	Interest expenses	HKIA 14 & 15/2005 (2007) FACV 8 and 16/2007
<i>Shui On Credit Company Ltd</i>	Deferred expenditures	(2008) HCIA 2/2007 (2008) CACV 85/2008 (2009) FACV 1/2009
<i>Canton Industries Ltd</i>	Acquisition cost of permanent quota	(2008) HCIA 6/2007
<i>Braitrim Industries (Far East) Ltd</i>	Acquisition cost of moulds	(2012) CACV 45/2012

Depreciation allowances

Allowable for capital expenses incurred on:

- 1 industrial buildings or structures;
- 2 commercial buildings or structures
- 3 machinery or plant

Depreciation allowances on fixed assets

Allowance	Industrial Building	Commercial Building	Machinery or Plant
Initial allowance	20%	N/A	60%
Annual allowance	4% on cost or computed based on the residue of expenditure	4% on cost or computed based on the residue of expenditure	10%, 20% or 30% on reducing balance
Balancing adjustments	Balancing charge or balancing allowance	Balancing charge or balancing allowance	Balancing charge or balancing allowance

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Preparing a profit tax computation

Areas of consideration

1 Tax Rules

To check changes in the tax rules (e.g. locality of trading profits)

To check changes in tax rates, allowable deductions, etc.

To check new provisions, new definitions (e.g. s.16 EA)

To check changes in DIPNs (eg. DIPN 21) and IRRs

2 Tax Records

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graph TD; A[2 Tax Records] --> B[To review prior year assessments, profits tax returns, profits tax computations, enquiries from the IRD, outstanding objections, etc.]; B --> C[3 Operations Review]; C --> D[To identify changes in the operation of the business during the year which may affect the tax computation (e.g. if there is a merger, it is likely that part of the legal and professional fees is of a capital nature and not deductible).];
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3 Operations Review

To identify changes in the operation of the business during the year which may affect the tax computation (e.g. if there is a merger, it is likely that part of the legal and professional fees is of a capital nature and not deductible).

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Statement of Financial Position

To identify whether there are any interest-bearing funds obtained to finance both income generating assets and non-income generating assets (e.g. if there are interest-free loans to associated companies, part of the interest expenses may be disallowed)

To identify whether there is any transfer of trading stock to fixed assets or vice versa (the principle in *Sharkey v. Wernher* may not apply)

To identify whether there is a large investment portfolio (a portion of the management, clerical and general expenses may need to be disallowed for a large investment portfolio pursuant to IRR 2C)

To identify any additions to fixed assets (e.g. patent rights) which are specifically deductible (e.g. s.16E)

To identify any disposal of fixed assets for which the sale proceeds of the assets are specifically taxable (e.g. sale proceeds of patent rights)

To ensure that the total additions to fixed assets can be reconciled with additions in the depreciation allowances computation

5 Statement of Cash Flows

To reconcile the sale proceeds of fixed assets with the deductions in the depreciation allowances computation and the items shown in the profits tax computation which are specifically taxable (e.g. sale proceeds of patent rights)

To reconcile the movement in the hire-purchase creditors with the initial allowance on assets acquired under hire purchase in the depreciation allowances computation

6 Statement of Comprehensive Income

To identify any offshore profits which should be excluded in preparing the profits tax computation together with the related expenses which should be added back in the tax computation

To identify any non-taxable income or profits (e.g. dividends, capital gains)

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Post-cessation receipts and payments

- Post-cessation receipts are deemed to be profits for the year of assessment in which the cessation occurs; and are taxable in that year if such sums are taxable if received before cessation: s.15D(1).
- Post-cessation payments are deemed to be expenditure for the year of assessment in which the cessation occurs; and are deductible in that year if such payments are deductible if paid before cessation: s15D(2).
- 'Cessation' is to be distinguished from 'temporary suspension' of trade.

Pre-commencement expenditure

- Not incurred in the production of assessable profits.
- By concession, the IRD allows pre-commencement expenditure of a revenue nature, which would be allowed if incurred after commencement, in the first accounting period.
- Capital expenditure on acquisition of fixed assets subject to depreciation allowance is treated as incurred on the date of commencement: s.40(2).
- Date of commencement is the date upon which the taxpayer's intentions begin to translate into an activity which can be characterised as trading, normally the date when the income is first derived or when 'profit-seeking' acts start.

Basis period is the period which is used as a basis for the computation of assessable income or profit.

For property tax and salaries tax purposes, the basis period is from 1 April to 31 March of the following year

For profits tax purposes:

- For accounts made up to 31 March, basis period is the same as the fiscal year
- For accounts made up to a date other than 31 March, basis period is the accounting year ended with the year of assessment
- There are special provisions for the commencement of business, cessation of business and a business which changes its accounting date

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Partnership vs. Joint Ventures

Partnership – The relation that subsists between persons carrying on business in common with a view of profit.

- A partnership is a taxable entity for tax purposes.
- Tax imposed on the share of profits of a corporate partner is 16.5%.
- Standard rate applies to the balance of profits.

Joint venture – The parties involved share, in agreed proportions, the benefits, risks and obligations in the venture in order to achieve mutual goals.

- A joint venture which is not a partnership is not a taxable entity.
- The profits or losses shared from a joint venture are combined with the operating result of the individual joint venturer and taxed in its own name.

Partnership vs. Joint Ventures

Partnership	Joint Venture
Each partner is regarded as an agent of the partnership and his acts will bind the partnership.	The acts of a joint venturer will not bind the joint venture.
All partners (other than a limited partner) are jointly and severally liable.	Each joint venturer is liable for its own stake.
Usually for long term purposes.	Usually for short term purposes.
May have a large number of partners.	Usually consists of a small number of venturers.
Have a whole set of books of account.	May not have separate books of account.
Assessments issued in name of the partnership.	Separate assessments on individual venturers.

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Special provisions relating to a partnership business

Section	Provisions and Implications
16(1)(b)	Rent paid by a partnership to any partners or partners' spouses is allowed, but restricted to the assessable value of the relevant property.
16AA	Mandatory contributions under the MPFS (not exceeding \$15,000) in respect of a partner are deemed to be an expense wholly and exclusively incurred in the production of assessable profits and deductible.
17(2)	No deduction is allowed for salaries or other remuneration to any partner or partners' spouses, and interest on capital and/or loan from any partner or their spouses or subject to s.16AA, contribution made to a MPFS in respect of any partner or partners' spouses.
22B	There are restrictions on the share of loss of a limited partner of a partnership which may be set off against the assessable profit of that limited partner.

Computing tax for partnerships

- Assessable profits computed in one sum
- Charged in one partnership name
- Only difference between the tax computation of a sole trader/company and that of a partnership is an allocation of profit and loss among the partners may be required.

Example of partnership profits tax computation

H and S are partners of HS & Co. Each contributed \$200,000 to the partnership. H manages the operations of the business while S takes a passive role. H takes \$200,000 per annum as salary from the partnership business. The partnership suffered a loss of \$100,000 (after deduction of H's salary and interest on capital at 5% per annum) which is shared by H and S equally.

HS & CO

PROFITS TAX COMPUTATION

	\$	\$
Loss per accounts		(100,000)
Add back:		
Interest on capital		
H	10,000	
S	10,000	
H's salary	<u>200,000</u>	
		<u>220,000</u>
Assessable profits		<u>120,000</u>

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Loss relief

A loss is computed in a similar manner and for a similar basis period as profit. A loss should be converted to HK dollar each year and carried forward in HK dollar.

General rule

- Loss is carried forward and is available for set off against future profits.
- No time limit on the loss, carry forward for set off purposes.
- Loss cannot be allowed for more than once.
- No provision for group loss relief.

Loss relief for an individual

- Loss is carried forward and set off against future profits of the same trade carried on by the same individual, unless PA is elected and the loss is transferred to and dealt with under PA.
- Loss lapses upon cessation of business if no PA is elected.

Loss relief for a partnership

- Loss is individually related to the partners and are not partnership losses.
- An individual's share of partnership loss is carried forward and set off against his/her share of future profits of the partnership, unless PA is elected and the loss is transferred to and dealt with under PA.
- Loss lapses when the individual ceases to be a partner if no PA is elected.

Loss relief for a corporate partner

- Loss incurred in respect of a corporation's own trading may be set off against its share of the partnership profits for that year of assessment. The balance of any loss is carried forward to set off against the future profits of its own trade, and then against its share of the partnership's future profits
- Share of partnership loss may be set off against any other profits of the corporation for that year of assessment. The balance of any loss is carried forward to set off against the future profits of its share of the partnership's future profits, and then against the future profits of its own trade.

Loss relief for a trust

- Loss is carried forward and set off against future profits of that trust.
- Loss of one trust is not available for set off against profits of another trust administered by the same trustee, or against profits of the trustee himself in his personal capacity.

General and specific deductions

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Specific provisions

There are special provisions for each class of business:

Section	Special Classes of Business
15(1)(i) and (l)	FIs
23	Life insurance companies
23A	Non-life insurance companies
23AA	Mutual insurance companies
23B	Ship owners carrying on business in Hong Kong
23C	Resident aircraft owners
23D	Non-resident aircraft owners
24(1)	Clubs etc.
24(2)	Trade associations etc.

Financial Institutions

Profits tax computation is the same as that for individuals but the provision of the credit test is not applicable.

Tax cases on FIs:

Taxpayer	Subject Matter	Reference
<i>Hang Seng Bank Ltd</i>	Exchange differences	(1972) 1 HKTC 583
<i>Banque National De Paris Hong Kong Branch</i>	Interest to head office	(1985) 2 HKTC 139
<i>Bank of India</i>	Profit from discounting bills of exchange	(1990) 1 HKRC 90-029
<i>Hang Seng Bank Ltd</i>	Profit on sale of certificates of deposit	(1990) 1 HKRC 90-044

Life insurance companies

Two tests for establishing assessable profits:

- Method 1 (five percent method) produces a notional profit
- Method 2 (adjusted surplus method) involves actuarial valuation and is only applicable on election by the taxpayer

There are no decided tax cases.

Non-life insurance companies

Profits tax computation follows the financial accounts subject to apportionment between onshore and offshore business, plus standard statutory adjustments.

Tax cases on non-life insurance companies:

Taxpayer	Subject Matter	Reference
<i>Sincere Insurance and Investment Co Ltd</i>	Profit on disposal of properties	(1973) 1 HKTC 602
<i>Carlingford Life and General Assurance Co Ltd and Carlingford Insurance Co Ltd</i>	Offshore interest	(1989) 1 HKRC 90-025

Mutual insurance companies

Deemed to carry on an insurance business and profits tax computation prepared in the same manner.

Ship owners

Formula for computing the assessable profit of a ship owner is the same as that for resident and non-resident ship owners:

$$\text{Assessable profits} = \text{Total shipping profits} * \frac{\text{Relevant sums}}{\text{Total shipping income}}$$

Tax case on non-resident ship owners:

Taxpayer	Subject Matter	Reference
<i>Zim Israel Navigation Co Ltd</i>	Grants from Government	(1972) 1 HKTC 573

Hong Kong Aircraft Owners

An aircraft owner is deemed to be carrying on a business of chartering or operating if:

- the business is normally controlled or managed in Hong Kong; or
- the owner is a company incorporated in Hong Kong.

Profits tax computation is as follows:

$$\text{Assessable profits} = \text{Total aircraft profits} * \frac{\text{Relevant sums}}{\text{Total aircraft income}}$$

Non-resident aircraft owners

Non-residents aircraft owners (who land at any airport in HK) are deemed to be carrying on a business and therefore liable for profits tax. Profits tax computation is as follows:

$$\text{Assessable profits} = \text{Total aircraft profits} * \frac{\text{Relevant sums}}{\text{Total aircraft income}}$$

Decide tax case

Taxpayer	Subject Matter	Reference
Malaysian Airline System Berhad	Losses carried forward for tax purposes	(1994) 1 HKRC 90-070

Clubs and trade associations

Clubs must meet the test to determine whether the receipts of the club are business receipts and therefore chargeable to profits tax.

There is no definition of **club and trade association**.

Tax cases on clubs and trade associations:

Taxpayer	Subject Matter	Reference
<i>Far East Exchange Ltd</i>	Entrance fees	(1979) 1 HKTC 1036
<i>Kowloon Stock Exchange</i>	Club or trade association, subscription and founders' contributions and entrance fees	(1984) 2 HKTC 99

Notes

4: Non-resident persons

Topic List

Tax implications of residence and non-residence

Provisions concerning non-resident persons

Avoidance of double taxation

The concept of residency in Hong Kong is of little importance except where there is an election for personal assessment. There are special provisions for non-resident persons, particularly for recovery purposes.

Provisions relating to non-resident persons include the assessment of a non-resident person's liability, deemed trading receipts of non-resident persons, withholding obligations on HK agents and resident persons, goods on consignment, resident persons not treated as agents, business with closely connected resident persons, and exemptions for offshore funds.

Concept of residency

Concept of residency is of little importance **except for personal assessment election, business with non-resident persons and exemptions for non-resident persons.**

Definitions

'Non-resident' is a person with no permanent business presence in HK.

'Permanent establishment' means a branch, management or other place of business. It does not generally include an agent unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of his principal or has a stock of merchandise from which he regularly fills orders on his behalf.

Non-resident person's liability

A non-resident maybe liable to;

- Property tax,
- Salaries tax, or
- Profits tax

If;

He has income arising in or derived from HK falling within the scope of these taxes.

Same tax rates apply to resident persons and non-resident persons

Provisions concerning non-resident persons

Section	Scope
15(1)(a), (b), (ba) and (d)	Deemed trading receipts
20	Business with closely connected resident persons
20A	Assessments on Hong Kong agents and non-resident persons and goods on consignment
20AA	Stockbrokers and approved investment advisors not to be treated as agents of non-resident persons
20B	Withholding obligations on resident persons paying or crediting certain payments to non-resident persons
20AB, AC, AD and AE	Exemption for offshore funds
21	Assessable profits computed on a fair percentage of turnover
21A	Assessable profits from deemed trading receipts under s.15(1)(a), s.15(1)(b) or s.15(1)(ba)
70AB	Revision of assessment due to exemption for offshore funds
79(3)	Tax overpaid by non-resident persons

Sections 20A & 20B: Assessing non-resident's liability

Three methods of assessing liability:

1. Direct assessment on the non-resident person;
2. Assessment in the name of the non-resident's HK agent; and
3. Assessment in the name of any person who has paid or credited a non-resident person entitled to receive royalties or license fees from HK, or who is an entertainer or sportsman and has performed in HK.

IRR 5

Profits of the HK branch of a person whose head office is situated elsewhere will be ascertained as follows:

- (a) Branch accounts are kept which show the true profits arising in HK, those accounts will be adopted and adjusted in accordance with the rules of profits tax.
- (b) Branch accounts do not show the true profits of accounts are not kept

$$\text{Assessable profit} = \text{Adjusted worldwide profits} \times \frac{\text{Hong Kong turnover}}{\text{Worldwide turnover}}$$

- (c) Failing either (a) or (b), the assessor may compute the assessable on a fair percentage of the HK turnover

IRR 3

Profits of the HK branch of a bank whose head office is situated elsewhere will be ascertained as follows:

- (a) Branch accounts are kept which show the true profits arising in HK, those accounts will be adopted and adjusted in accordance with the rules of profits tax;
- (b) Branch accounts do not show the true profits arising in HK or accounts are not kept

$$\text{Assessable profit} = \text{Adjusted worldwide profits} \times \frac{\text{Hong Kong assets}}{\text{Worldwide turnover}}$$

- (c) Failing either (a) or (b), the assessor may estimate the assessable profits of the branch.

Section 15(1): Deemed trading receipts

A non-resident person not carrying on a trade, profession, or business may still be chargeable to profits tax on the following income:

1. Sums from the exhibition or use in HK of film/tape, sound recording and connected advertising material.
2. Sums for the use **in HK** of a patent, design, trade mark, copyright etc.
3. Sums for the use **outside HK** of a patent, design, trade mark, copyright etc. which are deductible in ascertaining the assessable profits of a person under profits tax.
4. Sums by way of hire, rental or charges for the use of moveable property in HK.

Section 20: Business with closely connected residents

A person is closely connected with another where **each person is assessed as identical** or the controlling interest of each is **owned by the same person(s)**.

Where a non-resident person carries on business with a closely connected resident person and the business is so arranged that it produces to the resident person either nil or less than ordinary profits, the business conducted by the non-resident person will be deemed to be carried on in HK and chargeable to tax in the name of the resident person as his agent.

Section 20A: Goods on consignment

Agents selling goods in HK on behalf of a non-resident person must:

- Produce quarterly returns showing sales proceeds;
- Pay 1% of the sale proceeds to the Commissioner; and
- Retain an amount sufficient to meet tax liability of the principal.

Section 20AA: Stockbrokers and approved investment advisers

Where the conditions are met, approved stockbrokers and investment advisers are not treated as agents of non-resident persons and are therefore not liable to profits tax in respect of securities trading and investment profits derived by the non-resident persons for whom they act.

Sections 20 AB, AC, AD and AE: Exemption for offshore funds

Section 20AC: Exemption provisions

A non-resident person who only carries on a business in HK is exempt from profits tax in respect of:

- Profits from dealing in 'specified transactions' carried out through or arranged by a 'specified person'.
- Profits from transactions incidental to the carrying out of the specified transactions if receipts from incidental transactions do not exceed 5% of the total receipts from specified and incidental transactions.

Schedule 16 lists specified transactions in:

- Securities;
- Futures contracts;
- Foreign exchange contracts;
- Making of a deposit (excl. margin lending).
- Foreign currencies; and
- Exchange traded commodities.

A 'specified person' is a corporation licensed, or an authorised FI registered, under the SFO.

Section 20AE: Deeming provisions

A HK resident who:

- a) Alone or jointly with his associate, holds directly or indirectly a beneficial interest of $\geq 30\%$ in a tax-exempt offshore fund, or
- b) Holds any % in a tax-exempt offshore fund if the offshore fund is his associates

is deemed to have derived assessable profits in respect of the trading profits earned by the offshore fund.

Formula

Formula used to ascertain the amount of deemed assessable profits imposed on a HK resident:

$$A = (B * C)/D$$

Where:

- A means the exempt profits of the offshore fund for a particular day in a year of assessment.
- B means the extent of the resident person's beneficial interest in the offshore fund on the particular day.
- C means the exempt profits of the offshore fund for the accounting period in which the particular day falls.
- D means the total no. of days in the accounting period of the offshore fund in which the particular day falls.

Section 20B: Withholding obligation on resident person

Withholding obligation on the resident person who pays or credits a non-resident:

- Sums chargeable under s.15(1) (a), (b) or (ba);
- Sums derived from a performance in HK by a non-resident entertainer or sportsman.

Tax withheld is:

- Standard rate or corporate profits tax rate on 30% or 100% of the sum taxable under s.15(1)(a), (b) or (ba).
- For non-resident entertainer/sportsman, standard rate or corporate profits tax rate on 2/3 of the sum.

Section 21A: Assessable profits from deemed trading receipts

Assessable profits for deemed trading receipts are:

- Payment made by an associate and IP was previously owned by a person carrying on HK business – 100%
- All other cases – 30%

Section 79(3): Tax overpaid by non-residents

Resident or non-resident can claim a repayment of tax overpaid.

HK double taxation arrangements

- 29 agreements on airline income
- 6 agreements on shipping income
- 2 agreements on combined airline and shipping income
- 29 comprehensive double taxation agreements

Guidance

DIPN 45 clarifies the IRD's position on double taxation resulting from transfer pricing adjustment made by overseas jurisdictions.

DIPN 46 clarifies the IRD's position on transfer pricing adjustments.

DIPN 47 clarifies Exchange of Information under comprehensive double taxation arrangements.

DIPN 48 clarifies Advanced Pricing Arrangement for transfer pricing purposes.

5: Hong Kong salaries tax

Topic List

Introduction

Office, employment and pension

Income chargeable for salaries tax

Benefits specifically excluded from tax

Allowable deductions

Personal allowances

Computation of salaries tax

Tax efficient strategies under salaries tax

Taxation from employment is an issue that affects many Hong Kong taxpayers. Individuals may be dealing with the distinction between employment and self-employment and employed individuals will need to know how to prepare a full computation of employment income, including benefits and deductions.

Sources

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

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

DIPN 10 (Revised) provides guidance on the charge for salaries tax

DIPN 44 (Revised) provides guidance on salaries tax and double taxation

Types of income subject to salaries tax

Section	
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
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.

Office

In *Great Western Railway Co v. Bater* [(1922) 8 TC 231], **office** is 'a subsisting, permanent, substantive position, which has an existence independent from the person who fills it and which goes on and is filled in succession by successive holders'.

Location: where the central management and control of the corporation is exercised.

Salaries tax: income from an office is subject to salaries tax

Employment

A relationship of employer and employee must exist. *Fall v Hitchen* [(1972) 49 TC 433] distinguishes a 'contract of service' (i.e. an employer-employee relationship) from a 'contract for service' (i.e. a principal-independent contractor relationship).

Other factors to meet employment test:

Control	Degree of control (e.g. restrictions imposed on the working for others; strict compliance with rules and regulations; stipulated office hours) exercised by the party demanding the services.
Integration	Identity of the person providing the services. Whether they have a position in the organisation demanding the services or is held out to the public as an officer of that organisation. If the person providing the services is part and parcel of the organisation, there is evidence of an employer-employee relationship.
Economic reality	The financial risk undertaken by the person providing the services. Whether required to risk their own capital; whether the risk is a general entrepreneurial risk or a risk arising only if they do not undertake their duties with due care and precision.

Employment

DIPN 25 – contract of service vs. contract for service

DIPN 33 – tax position of insurance agents

DIPN 10 – establishes employment status

- 1) Place of contract
- 2) Residence of employer
- 3) Where remuneration is paid

Income from non-HK employment

Visits to Hong Kong	Income from Hong Kong Employment	Income from Non-Hong Kong Employment
≤ 60 days	Exempt	Exempt
> 60 days	100% chargeable but subject to exemption under s.8(1A)(c)	Time-in-time-out basis or s.8(1A)(c)

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.

Dominant factor in determining status of pension = where it is managed and controlled

Only income from HK pension attributable to HK services is traceable

Under s. 9 of the IRO, income from any office or employment is summarised below.

Section	
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.
9(1)(aa)	So much of an amount (other than a pension) as is attributable to the employer's contributions to a fund, scheme or society other than a recognised occupational retirement scheme or MPF scheme.
9(1)(ab)	So much of an amount (other than a pension) received by an employee under a recognised occupational retirement scheme: otherwise than because of termination of service, death, incapacity or retirement of the employee as is attributable to the employer's contributions under the scheme in respect of the employee; or by reason of termination of service as represents such part of the employer's contributions under the scheme in respect of the employee that exceeds the proportionate benefit calculated in accordance with Section 8(5).
9(1)(ac)	Any payment received by an employee pursuant to a judgement given under Section 57(3)(b) of ORSO that is attributable to his employer's contributions to the occupational retirement scheme in respect of which the judgement was given.

Section	
9(1)(ad)	A sum equal to so much of the accrued benefit that an employee has received, or is taken to have received from a MPF scheme (otherwise than on retirement, death, incapacity or termination of service) as is attributable to contributions paid to the scheme by the employee's employer.
9(1)(ae)	A sum equal to so much of the accrued benefit that an employee has received, or is taken to have received, from a mandatory provident fund scheme as is attributable to voluntary contributions paid to the scheme by the employee's employer that exceeds the proportionate benefit calculated in accordance with Section 8(5).
9(1)(b)	The rental value of any place of residence provided rent-free by the employer or an associated corporation.
9(1)(c)	Where a place of residence is provided by an employer or an associated corporation at a rent less than the rental value, the excess of the rental value over such rent.
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 in or an employee of that or any other corporation.

s.9(2A) specifically states that the following items are assessable income from any office or employment:

Section	
9(2A)(a)	Any benefit capable of being converted into money by the recipient.
9(2A)(b)	Any amount paid by an employer in connection with the education of a child of an employee.
9(2A)(c)	Any amount paid by an employer in connection with a holiday journey.

Emoluments chargeable to salaries tax

s.9 is an inclusive definition (i.e. non-exhaustive).

s.9(1)(a) covers the general emoluments that are chargeable to salaries tax.

For an item to be taxable, the basic principle is that it must arise directly from an office or employment.

The following are examples of taxable and non-taxable items:

Taxable Items [Ref.]	Non-taxable Items [Ref.]
Tips to a taxi driver [Calvert v. Wainwright (27 TC 475)]	Compensation for loss suffered on disposal of a house on relocation [Hochstrasser v. Mayes (38 TC 673)]
Income tax of an employee paid by the employer [Harland v. Diggins (10 TC 247)]	A reward on passing an examination [Ball v. Johnson (47 TC 155)]
A suit (taxable at 2nd hand value) provided by a tailor paid by the employer [Wilkins v. Rogerson (39 TC 344)]	Payment in consideration of entering into a restrictive covenant not to compete with the employer after termination of services [Beak v. Robson (25 TC 33)]
Payment made to a director who wished to resign but would remain on the Board in an advisory capacity [Cameron v. Prendergast (AC 549)]	Payment made by the employer bank to a genuine discretionary trust for the benefit of the employee's child [Barclays Bank Limited v. Naylor (39 TC 256)]
Free use of a car which could be surrendered for additional wages [Heaton v. Bell (46 TC 211)]	Provision of rent-free accommodation [Tennant v. Smith (3 TC 158)]*
"Plain clothes" allowances paid to a detective sergeant [Fergusson v. Noble (7 TC 176)]	A personal gift [Seymour v. Read (AC 554)]
From the year of assessment 2012/13, payments in lieu of notice made by employers to employees	

*In Hong Kong, rental value is taxable under Section 9(1)(b) of the IRO.

Items specifically chargeable to tax

Section	Benefits
9(1)(a) and 9(2A)(b)	Educational benefits
9(1)(aa)	Lump sum payments from an unrecognised retirement scheme
9(1)(ab)(i)	Lump sum payments (representing the employer's contributions) from a recognised retirement scheme by reason other than termination of service, death, incapacity or retirement of the employee
9(1)(ab)(ii)	Lump sum payments from a recognised retirement scheme by reason of termination of service
9(1)(ac)	Lump sum payments received by an employee pursuant to a judgement given under Section 57(3)(b) of the Occupational Retirement Schemes Ordinance (ORSO)
9(1)(ad)	A sum equal to so much of the accrued benefit that an employee has received, or is taken to have received, from a mandatory provident fund scheme as is attributable to contributions paid to the scheme by the employee's employer
9(1)(b)	Accommodation benefits for a place of residence provided rent-free by the employer or an associated company of the employer
9(1)(c)	Accommodation benefits for a place of residence provided by the employer or an associated company of the employer at a rent less than the rental value
9(1)(d)	Stock option gains

Educational benefits

Where a payment is made by an employer in connection with the education of the child of an employee, the amount will be subject to tax

Taxable payments include tuition fees, incidental education expenses such as boarding fees and cost of school outings.

One education benefit that is exempt from tax is the payment of education costs through a formally established education trust

Retirement benefits

Pursuant to s2 of the IRO, '**recognised retirement scheme**' means:

- a recognised occupational retirement scheme; or
- a MPF scheme.

A '**recognised occupational retirement scheme**' is an occupational retirement scheme that:

- is registered under Section 18 of ORSO;
- is exempt from registration by virtue of Section 7(1) of the ORSO;
- is operated either by a foreign government, or by a non-profit agency or undertaking of a foreign government; or
- is established by or contained in any other HK ordinance.

Comparison of ORSO and MPF

ORSO	MPF
Voluntary	Mandatory
Established under trust or insurance policy	Must be established under trust
Governed by HK or offshore law	Governed by HK law
Contributions computed on basic salary	Contributions computed on total cash income (excluding housing allowance/benefits)
Vesting table as per scheme (e.g. 30% for three years of service)	100% vesting
Few investment restrictions	With specified investment restrictions
No particular criteria on trustees	Trustees must be approved
No requirement on minimum contribution	With minimum contribution
Not portable	Fully portable
No requirement on capital preservation	Capital preservation product must be provided as an option
No requirement on preservation of accrued benefits	Accrued benefits must be preserved until one of the following events: <ul style="list-style-type: none"> ■ retirement at age 65; ■ permanent cessation of employment and attaining age 60; ■ permanent departure from Hong Kong; or ■ total disability, incapacity or death.

Lump sum payment (including employer's contributions) payable upon death, incapacity or retirement of the employee is exempt from tax.	Lump sum payment (including employer's mandatory and voluntary contributions) payable upon death, incapacity or retirement of the employee is exempt from tax.
Accrued benefits attributable to the employer's contributions in respect of the employee that exceed the proportionate benefit payable by reason of termination of service are taxable.	Accrued benefits attributable to the employer's voluntary contributions in respect of the employee that exceed the proportionate benefit payable by reason of termination of service are taxable.
Accrued benefits attributable to the employer's contributions in respect of the employee payable by reason other than termination of service, death, incapacity or retirement of the employee are taxable.	Accrued benefits attributable to the employer's voluntary contributions in respect of the employee payable by reason other than termination of service, death, incapacity or retirement of the employee are taxable.
Lump sum payment (as attributable to the employer's contributions) received by an employee pursuant to a judgement given under Section 57(3)(b) of ORSO is taxable.	N/A

Calculating lump sum payments

Proportionate benefit

Formula:

In accordance with Section 8(4)(b), the proportionate benefit is computed as follows:

$$\frac{\text{Completed month of service of the employee}}{120 \text{ months}} * \text{Accrued benefit of the employee at date of termination of service}$$

Example:

Mr X has a period of service of 5 years with his employer. His accrued benefit on termination of his service was \$100,000 and the payment received from the scheme was \$70,000.

The calculation of the proportionate benefit (section 8(5)) is:

Proportionate benefit = \$100,000 * 60/120 months = \$50,000

The taxable benefit = payment received – proportional benefit = \$20,000

Calculating accommodation benefit

Formula:

s. 9(1A)(b) states that 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. **The rental value of such accommodation is chargeable to tax.**

s. 9(2) provides that the rental value shall be deemed to be 10% of the income

If such place of residence is a hotel, hostel or boarding house, the rental value will be charged at 4% or 8% instead of 10% as follows:

Not more than one room	4%
Not more than two rooms	8%

Calculating accommodation benefit

Example:

Mrs W was provided with rent free accommodation by her employer for 2009-10. Her annual salary was \$320,000 and she was entitled to deductions of \$10,000.

Mrs W's income for the year would include the following:

	\$
Salary	320,000
Less: allowable deductions	(10,000)
Add: rental value: 10% *	
\$(320,000 – 10,000)	<u>31,000</u>
Total income	<u>341,000</u>

Calculating stock option gain

Formula:

The notional gain chargeable to tax:

Market value of the shares at the date of the exercise of the option	less	Consideration paid by the employee for the shares and the option
--	------	--

Or

Consideration received on assignment or release of the right	less	Consideration given for the grant of the right
--	------	--

DIPN 38 (Revised):

- 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
- Notional expenses (e.g., brokerage, stamp duty) can be claimed as a deduction from the notional gain

Calculating Share Award

Formula:

The actual gain chargeable to tax:

Market value of the shares at the date of the award less Consideration paid by the employee for the shares

(Assessed under s.9(1)(a))

DIPN 38 (Revised):

	Upfront approach	Back end approach
Vesting period	No.	Yes.
Timing of assessment	Time of grant.	When conditions fulfilled.
Valuation	Market value at time of grant.	Market value when conditions fulfilled.
Discount in valuation	Yes. Generally, 5% for each year of lock-up period.	No.
Distributions (Dividends, bonus shares)	Received during lock-up period: Not taxable.	Received during vesting period: Taxable.

Fringe benefits

Fringe benefit	Status under salary tax
Car/boat provided by employer for private use of employee	No – use is not charged as benefit cannot be converted to money Yes – only if ownership of car is transferred to employee
Recreational facilities/holiday homes for employee use	No – the benefit cannot be converted to money
Utilities payments by employer	No – this is a stated inclusion from income tax
Loans given at less than market interest rates	No – where cost involved with provision is the sole liability of the employer
Credit cards	Yes – if expenses are billed to and paid for by employer
Club benefits	Yes – where employer makes a payment for a specific individual membership No – if a corporate membership is transferable from one employer to the next

Exclusions

S. 8(2) and (9) lists the specific benefits which are not chargeable to salaries tax

These are summarised in the table below:

Section	Benefits
9(1)(a)(i), (ii) & (iii)	Holiday warrants/passages were exempt from tax prior to the year of assessment 2003/04. However, the exemption for holiday journey benefits was repealed with effect from 1 April 2003.
9(1A)(a)	Payment (or refund) of rent by an employer or an associated corporation. [However, rental value (if any) will be assessed.]
8(2)(c), (cb), (cc)	Lump sum payments from a recognised occupational retirement scheme / mandatory provident fund scheme upon death, incapacity, termination of service or permanent departure from Hong Kong (see Para 9.4.3)
9(5)	Receipts of share option rights

Overview

Section	Deduction
12(1)(a)	All outgoing and expenses, other than expenses of a domestic or private nature and capital expenditure, wholly, exclusively and necessarily incurred in the production of assessable income.
12(1)(b)	Depreciation allowances on machinery or plant
12(1)(c)	Loss brought forward
12(1)(d)	Allowable deductions of a spouse under joint assessment
12(1)(e)	Self-education expenses
26C	Approved charitable donations
26D	Elderly residential care expenses
26E	Home loan interest
26G	Contributions to recognised retirement schemes

Outgoings and expenses

Deductibility test:

- 1) Must be 'incurred'
- 2) Must have arisen 'wholly and exclusively' in production of income
- 3) Must have been 'necessary' in production

Machinery or plant

Employer's obligation to provide machinery or plant

Depreciation on machinery or plant is allowable

Losses brought forward

Loss is suffered when allowable deductions exceed assessable income for the year
Carried forward to offset future assessable income

Spouse under joint assessment

Allowable deductions of a spouse can be deducted from income of the other spouse

Self-education expenses

Max. Allowable deduction is \$60,000 from 2007/08

Approved charitable donations

Approved charitable donations are allowable under salaries tax if the aggregate amount is:

- (i) not less than \$100; and
- (ii) not exceeding 35% of assessable income minus allowable outgoings and expenses minus depreciation allowances; and
- (iii) not allowed as a deduction under profits tax.

Residential care expenses

Any residential care expenses are allowable under salaries tax (or personal assessment) if the parent or grandparent who at any time in that year of assessment is:

- ≥ 60 ; or
- eligible to claim an allowance under the Government's Disability Allowance Scheme.

Maximum allowable deduction = \$60,000

Increased to \$76,000 for 2012/13 onwards.

Home loan interest

Deduction period is ten years (whether continuous or not), subject to the maximum annual deduction of \$100,000. Starting from 2012/13, the deduction period is extended to 15 years.

Maximum amount allowable in each year of assessment is \$100,000.

If the person is not a sole owner of the dwelling, the loan interest (maximum allowable amount = \$100,000 or \$150,000 for 2001/02 and 2002/03) will be apportioned with regard to the person's share in the ownership of the dwelling.

If the dwelling is not used as a place of residence during the whole of the year of assessment or that the loan was not applied wholly for the acquisition of the dwelling, the allowable deduction shall be an amount considered as reasonable in the circumstances of the case.

Contributions to recognised retirement scheme

A deduction of the contributions paid by a person to a recognised retirement scheme as an employee to the scheme during any year of assessment is allowable.

The amount of deduction allowable in respect of any contributions to a recognised retirement scheme shall be the smallest of the following three amounts:

- the amount specified in Schedule 3D of the IRO (i.e., \$12,000 for 2000/01* and each year thereafter); or
- the amount of contributions by the taxpayer as an employee to the scheme; or
- the amount of the mandatory contributions that the taxpayer would have been required to pay as an employee if at all times whilst an employee during the year of assessment in question he had contributed as a participant in a MPF scheme.

Year of Assessment		2003/04	2004/05	2005/06 & 2006/07	2007/08	2008/09 to 2010/11	2011/12	2012/13
Section	Allowance	\$	\$	\$	\$	\$	\$	\$
28	Basic allowance	104,000	100,000	100,000	100,000	108,000	108,000	120,000
29	Married person's allowance	208,000	200,000	200,000	200,000	216,000	216,000	240,000
31	Child allowance – 1st to 2nd (each)	30,000	30,000	40,000	50,000	50,000	60,000	63,000
31	Child allowance – 3rd to 9th (each)	30,000	30,000	40,000	50,000	50,000	60,000	63,000
	New born child (each)				50,000	50,000	60,000	63,000
30/30A	Dependent parent/grandparent allowance – for parent aged 60 or more* (each)	30,000	30,000	30,000	30,000	30,000	36,000	38,000

		2003/04	2004/05	2005/06 & 2006/07	2007/0 8	2008/09 to 2010/11	2011/12	2012/13
30/30A	Dependent parent/grandparent allowance – for parent aged between 55 and 59 (each)	Nil	Nil	15,000	15,000	15,000	18,000	19,000
30/30A	Additional dependent parent/grandparent allowance – for parent aged 60 or more* (each)	30,000	30,000	30,000	30,000	30,000	36,000	38,000
30/30A	Additional dependent parent/grandparent allowance – for parent aged between 55 and 59 (each)	Nil	Nil	15,000	15,000	15,000	18,000	19,000
30B	Dependent brother/sister allowance (each)	30,000	30,000	30,000	30,000	30,000	30,000	33,000
31A	Disabled dependant allowance (each)	60,000	60,000	60,000	60,000	60,000	60,000	66,000
32	Single parent allowance (irrespective of the number of children being maintained)	104,000	100,000	100,000	100,000	108,000	108,000	120,000

*Also if the dependent parent/grandparent is eligible to claim an allowance under the Government's Disability Scheme

Method

Salaries tax is computed as the lower of:

- net assessable income less allowable deductions, charged at the standard rate; or
- net assessable income less allowable deductions and personal allowances, charged at progressive rates.

Formula

Assessable income		A
Less:		
Allowable outgoings and expenses [Section 12(1)(a)]		B
Depreciation allowances [Section 12(1)(b)]		C
Losses brought forward [Section 12(1)(c)]		D
Allowable outgoings and expenses/depreciation allowances/losses of a spouse not fully utilised [Section 12(1)(d)]*		<u>E</u>
Self-education expenses [Section 12(1)(e)]		F
		—
Net assessable income		G
Less:		H
Concessional deductions:		
Approved charitable donations [Section 26C]**		K
Elderly residential care expenses [Section 26D]***		<u>L</u>
Home loan interest [Section 26E] ****		M
Contribution to recognised retirement schemes [Section 26G]		<u>N</u>
		P
Personal allowances		R
		—
		<u>S</u>
Net chargeable income		T

Tax thereon:

Lower of:

- i) $[H - P] \times$ standard rate; and
- ii) $T \times$ progressive rates

*Under joint assessment

**Limited to 35% (or 25% for years of assessment 2004/05 to 2007/08; 10% for years of assessment prior to 2003/04) of $[A - B - C]$.

***Not to be claimed if Dependent Parent Allowance in respect of the same parent has been granted

****The deduction period for home loan interest is extended from 10 years to 15 years starting from the year of assessment 2012/13

There are partial tax relief for salaries tax and personal assessment for the following years of assessment as relief measures:

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
% of final tax reduction	50%	75%	100%	75%	75%	75%
Maximum limit	\$15,000	\$25,000	\$8,000	\$6,000	\$6,000	\$12,000

Overview

Two strategies

- 1) Structuring the **source of employment**
- 2) Structuring the **employment package**

Structuring the source of employment

Points to consider:

- Source of employment important for these providing services both inside and outside of HK
- HK and overseas taxation to be considered

Structuring employment package

Points to consider

- A package that provides as many tax-free benefits to employees with little cost and administration for the employer
- Fringe benefits tax considerations important
- Refund of rent paid is an effective strategy
- Free medical treatment is also exempt from salaries tax

Notes

6: Hong Kong property tax

Topic List

Scope of property tax charge

Assessable value of land or buildings/land and buildings

Allowable deductions under property tax

Property tax computation

Obligations of property owners

Decided tax cases: Property tax

Property tax is levied on the owners of any land or building in HK on the standard rate on net assessable income. The current rate is 15%. A property owner is defined under s2 of the IRO.

The assessable value of land or building or land and buildings is the consideration payable in that year in relation to the use of the land or buildings/land and buildings. There are allowable deductions under property tax which are rates, bad debts and statutory outgoings.

Accountants must be able to compute property income and the corresponding property tax liability.

Property tax

Property tax is charged for each year of assessment on the owners of any land or buildings in HK.

Tax is levied at the standard rate on assessable income

Year	2003/04	2004/05 – 2007/08	2008/09 and after
Rate	15.5%	16%	15%

Owners

'Owner' is defined under s2 of the IRO

Owner's exempt from tax are:

- government
- consular
- charities
- Corporations carrying on a business in HK (rental income under profits tax)
- Special exemptions

Property letting

Property letting and subletting by any corporation and the subletting by any other person would generally constitute a business.

Assessable value

Assessable value of land or building or land and building for each year is the **consideration**, payable in that year:

- To,
- To the order of, or
- For the benefit, of

The owner in relation to the use of land or buildings or land and buildings

Definitions

'Consideration' is any item payable regarding the provision of any service or benefits connected with, or related to, the right of its use (eg service fees).

'Premium' is the consideration payable regarding a period of the right of use not contained with any one year of assessment. Any considerations payable for a period of more than one year of assessment is deemed to be payable in equal instalments during the period for which the premium is paid up to a maximum of three years.

Scope of property
tax charge

Assessable value of land or
buildings/land and buildings

Allowable deductions
under property tax

Property tax
computation

Obligations of
property owners

Decided tax
cases: Property tax

Deduction	Conditions
Rates	If the owner agrees to pay the rates in respect of the land or buildings or land and buildings, then the rates are deductible from the assessable value. According to BOR D71/02, strictly speaking, the taxpayer cannot claim a deduction of rates paid during the period in which the property was unoccupied. However, in practice, the IRD would generally, by concession, allow the rates, as long as the taxpayer was actively looking for tenants and the property was rented out during the year.
Bad debts	Any consideration deemed irrecoverable during the year of assessment is deductible in ascertaining the assessable value. If no/ insufficient assessable value then the amount of unrelieved bad debts in that year can be carried backward and deducted from the assessable value in the latest year of assessment.
Statutory outgoings	Deduction for repairs and outgoings of 20% of the assessable value after deduction of any rates agreed to be borne and paid by an owner. Actual expenses are ignored for tax purposes.

Property tax formula

	HK\$
Consideration receivable	A
Premium (related to that year of assessment)	B
Bad debt recovery	C
	<hr style="width: 100%;"/>
	D
Less:	
Bad debts	E
Unrelieved bad debts (brought from subsequent year(s) of assessment)	F
Assessable value	<hr style="width: 100%;"/>
	G
Less:	
Rates paid by the owner	H
	<hr style="width: 100%;"/>
	J
Less:	
Statutory outgoings (20% of J)	K
Net assessable value	<hr style="width: 100%;"/>
	<hr style="width: 100%;"/>
Tax thereon at standard rate (L * tax rate)	<hr style="width: 100%;"/>
	<hr style="width: 100%;"/>
	<hr style="width: 100%;"/>

Scope of property
tax charge

Assessable value of land or
buildings/land and buildings

Allowable deductions
under property tax

**Property tax
computation**

Obligations of
property owners

Decided tax
cases: Property tax

Property tax example

Q: Compute the property tax payable by Mr. X. (Assume there is no bad debt and ignore provisional tax).

A: The property tax payable by Mr. X is computed as follows:

	2011/12 HK\$	2012/13 HK\$
Rent	240,000	120,000
Less: Statutory outgoings (20%)	<u>48,000</u>	<u>24,000</u>
Net assessable value	<u>192,000</u>	<u>96,000</u>
Tax thereon @15%	<u><u>28,800</u></u>	<u><u>14,400</u></u>

Owners' obligations

- | | |
|--|--|
| Filing of returns (s51.1) | – 1 month after issue |
| Notification of chargeability to tax (s51.2) | – 4 months after end of assessment year |
| Notification of cessation of ownership (s51.6) | – 1 month after the sale or transfer |
| Notification address change (s51.8) | – 1 month after change |
| Keeping of sufficient rental records (s51D) | – No less than 7 years rent received |
| Notification of change in exemption status (s5.2c) | – Within 30 days |
| Responsibility of joint owners or co-owners (s56A) | – Each owner is responsible in fulfilling the obligations of a property owner as if he were sole owner |
| Letting of common areas of a building | – Owners collectively responsible for reporting rental income and paying property tax |

Scope of property
tax charge

Assessable value of land or
buildings/land and buildings

Allowable deductions
under property tax

Property tax
computation

Obligations of
property owners

Decided tax
cases: Property tax

Taxpayer	Subject matter	Decision	Reference
Louis Kwan Nang Kwong & Anor	Rental income from letting a cinema as a going concern	Cinema was an ongoing concern and property tax applied	(1989) 1 HKRC 90-017
Harley Development Inc & Anor	Premiums received by corporations from letting a property	There was no exemption from property tax	(1996) 1 HKRC 90-079

7: Personal assessment

Topic List

Defining personal assessment

Persons who elect for personal assessment

Time limit for election for personal assessment

Personal assessment computation

Use of personal assessment is an important area for the practising accountants. Accountants may be asked to advise whether it is advisable for an individual or a couple who pay profits and property tax to apply for personal assessment under which the assessment for the separate heads of tax are aggregated.

There is no benefit in electing for personal assessment for individuals who only pay salaries tax.

Personal assessment

An alternative method of computing the tax liability of an individual by aggregating the taxable income under property, salaries and profits tax.

Guidance is provided through DIPN No 18 (revised).

Main points

Business losses can be offset against other taxable income which reduces overall liability.

Interest payable on monies borrowed for rental property is allowed (limited to the net assessable value of the rental property).

If no income under salaries tax then entitlement to concessional allowable.

Husband and wife must both elect for personal assessment.

Personal assessment not always beneficial.

Eligibility

Personal assessment can be elected by:

- a) An individual,
- b) Aged 18 or above (or less than if orphaned)
- c) Who is a permanent or temporary HK resident, or
- d) Whose spouse is a permanent or temporary resident

Resident

'Permanent resident': ordinarily resident in HK.

'Temporary resident' resident in HK for 180 days in year assessment is made, or 300 days in 2 consecutive years.

Procedure

Applications must be

- a) in **writing**,
- b) and **lodged with the Commissioner**.

Timeframes

Applications made:

- a) 2 years after the end of the year of assessment where the election is made
- b) 1 month after assessment of income of profits forming the total income is concluded
- c) Any other period allowed by the Commissioner

Benefits

Benefits come from the following deductions:

- interest on money borrowed for producing property income
- charitable donations
- elderly residential care expenses
- home loan interest
- business losses in the year of assessment
- losses brought forward from previous years
- personal allowances

Example question

Question: Mr. A has the following income and expenses for the year of assessment 2012/13.

	\$
Assessable profits from Business X	300,000
Charitable donations (\$100,000 already allowed in the profits tax computation of Business X)	(150,000)
Rental income – Property Y	200,000
Interest on mortgage loan used to acquire Mr. A's residence	(120,000)

Compute the tax payable by Mr. A for year of assessment 2011/12 (with no personal assessment elected).

The answer is on the following card:

Defining personal assessment

Persons who elect for personal assessment

Time limit for election for personal assessment

Personal assessment computation

Profits Tax – Business X

	\$
Assessable profits from Business X	300,000
Tax rate	15%
Tax thereon	<u>45,000</u>

Property Tax – Property Y

	\$
Rental income	200,000
Less: Statutory outgoings (20%)	<u>40,000</u>
Net assessable value	160,000
Tax rate	15%
Tax thereon	<u>24,000</u>

Total tax payable = \$69,000 (i.e. \$45,000 + \$24,000)

There is no relief for the balance of the charitable donations or the mortgage loan interest.

8: Hong Kong stamp duty

Topic List

The scope of stamp duty

Dutiable instruments

Voluntary dispositions inter vivos

Exemptions and reliefs

Stamp duty administration

Anti-avoidance measures

Stamp duty planning

Stamp duty is a tax on instruments, not transactions. It is a fixed tax and is based on the circumstances prevailing at the time. There are exemptions and reliefs available for 'dutiable' instruments. Dutiable instruments come under four 'Heads' – immovable property, Hong Kong stock, Hong Kong bearer instrument and duplicates and counterparts.

Major exemptions and reliefs for stamp duty fall under ss.39 to 46, and ss.47A and 47B of the Stamp Duty Ordinance (SDO). It is also important to apply the rules for group relief under s.45 of the SDO.

The scope
of stamp duty

Dutiable
instruments

Voluntary
dispositions inter vivos

Exemptions
and reliefs

Stamp duty
administration

Anti-avoidance
measures

Stamp duty
planning

Stamp duty

Stamp duty is a tax on **instruments** or **documents** levied under the SDO.

Stamp duty is charged on documents, **not** transactions. No stamp duty is charged if there is no change in the beneficial ownership. Stamp duty is **fixed**, or **ad valorem**.

In some instances a document must be presented for stamping for duty to be applied.

Contingency principle

Contingency principle: Duty is assessed on the basis of the circumstances prevailing at the time an instrument is executed. Liability cannot be altered by subsequent events.

Rules on stampable consideration

Contained in document	Basis for stamp duty
Consideration not ascertainable	Nil
Maximum and minimum amount provided	Maximum amount
Minimum amount provided	Minimum amount

Intentional understatement of consideration is an offence.

Stamp duty is chargeable on the higher of the value of the consideration and market value of property or stock.

Stamp duty is not applied if marriage is the consideration.

Stampable consideration

Consisting of	Stamp Duty Treatment
Nil Consideration	Treated as a voluntary disposition inter vivos, chargeable by reference to the market value of the property or stock.
Stock	Chargeable by reference to the value of the stock on the date of conveyance or transfer.
Security not being stock	Chargeable by reference to the amount due on the date of conveyance or transfer for the principal and interest upon the security.
Debts payable by the transferee	Treated as part of the consideration.
Debts waived	Treated as part of the consideration. If the debt consideration > the value of the property conveyed or stock transferred => chargeable based on the higher amount of the debt. => upon adjudication, chargeable based on the lower value of the property or stock.
Debts assigned	Treated as part of the consideration

Consisting of	Stamp Duty Treatment
<p>Periodic payments</p> <ul style="list-style-type: none">▪ payable for a definite period \leq 20 years▪ payable for a definite period > 20 years or in perpetuity or for any indefinite period not terminable with life▪ payable periodically for a life or lives	<ul style="list-style-type: none">▪ chargeable by reference to the total amount payable.▪ chargeable by reference to an amount equal to the total amount payable during the period of 20 years after the date of conveyance or contract note.▪ chargeable by reference to an amount equal to the total amount payable during the period of 12 years after the date of conveyance or contract note.
Foreign currency	Translated into HK dollars at the date of exchange prevailing on the date of the instrument.

An instrument is subject to stamp duty if it falls under the following **Heads of charge**:

Head 1: Immovable property in Hong Kong

Head 2: Hong Kong stock

Head 3: Hong Kong bearer instrument

Head 4: Duplicates and counterparts of chargeable instruments under Heads 1, 2 and 3

The principal of 'substance over form' is applied when considering whether an instrument is chargeable with stamp duty. The Collector will look at the substance, the nature of the agreement; rather than the form, the name of, or the label placed on the instrument.

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Head 1: Immovable property Hong Kong

- 1(I) Conveyance on sale
- 1(1AA) Conveyance on sale chargeable with SSD
- 1(1A) AFS of residential property
- 1(1B) AFS chargeable with SSD
- 1(2) Lease of immovable property

Head 2: Hong Kong stock

- 2(1) Contract note, not jobbing business
- 2(2) Contract note, jobbing business
- 2(3) Instrument of transfer operating as voluntary disposition inter vivos
- 2(4) Instrument of transfer of any other kind

Head 3: Hong Kong bearer instruments

- 3(1) HK bearer instrument issued in respect of any stock
- 3(2) HK bearer instrument given in substitution for a duly stamped instrument

Head 4: Duplicates and counterparts of any chargeable instruments

If stamp duty on original instrument is <\$5, the duplicate/counterpart will only attract same duty as that on the original.

In other cases, stamp duty on the duplicate/counterpart is a fixed duty of \$5.

Head 1: Immovable property Hong Kong

Immovable property is:

- (a) Land
- (b) Estate, right, interest or easement in or over land
- (c) Things attached to land or permanently fastened to anything attached to land

Instruments chargeable under Head 1(1) conveyance on sale

- (a) Deed of assignment
- (b) Deed of gift
- (c) Foreclosure order
- (d) Deed of exchange (chargeable on the higher of the equality money and the difference between the values of the exchanged properties)
- (e) Deed of partition (chargeable on the higher of the equality money and the difference between the values of the partitioned properties)
- (f) Deed of family arrangement

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Rates of stamp duty for conveyance on sale

Consideration/Market Value	Stamp duty
Up to \$2,000,000	\$100
\$2,000,001 – \$2,351,760	\$100 + 10% of the excess over \$2,000,000
\$2,351,761 – \$3,000,000	1.5%
\$3,000,001 – \$3,290,320	\$45,000 + 10% of the excess over \$3,000,000
\$3,290,321 – \$4,000,000	2.25%
\$4,000,001 – \$4,428,570	\$90,000 + 10% of the excess over \$4,000,000
\$4,428,571 – \$6,000,000	3%
\$6,000,001 – \$6,720,000	\$180,000 + 10% of the excess over \$6,000,000
\$6,720,001 – \$20,000,000	3.75%
\$20,000,001 – \$21,739,120	\$750,000 + 10% of the excess over \$20,000,000
Over \$21,739,120	4.25%

In addition to the above *ad valorem* rates, the conveyance on sale of residential property may be subject to SSD (Head 1(1AA)) for residential property acquired by a vendor on or after 20 November 2010 and resold within 24 months.

Head 1(1A) AFS

To deter speculations in the residential property markets, Head 1(1A) was introduced in 1992 to impose stamp duty on AFS of residential property. The rate of stamp duty under Head 1(1A) is the same as that under Head 1(1)

Stamp duty for transfer of immovable property

	Purchase/sale of residential property	Purchase/sale of non-residential property
Provision (Temporary)AFS	Ad valorem stamp duty under Head 1(1A), or nil if a formal AFS is executed within 14 days	No stamp duty
Formal AFS	\$100, or ad valorem stamp duty under Head 1(1A) if the formal AFS is executed within 14 days	No stamp duty
Conveyance (Assignment)	\$100, or ad valorem stamp duty under Head 1(1) if the conveyance is not executed in conformity with a duty stamped AFS	Ad valorem stamp duty under Head 1(1)

In the case of a series on AFS between different parties for the same residential property, stamp duty is chargeable on each of the AFS and the conveyance on sale.

In addition to the *ad valorem* rates, an AFS may be subject to SSD (Head 1(1B)) for residential property acquired by a vendor on or after 20 November 2010 and resold within 24 months.

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Head 1(1AA) and 1(1B) SSD

To further discourage speculation in residential properties, a SSD would be imposed on disposal of residential properties which were acquired by the vendor on or after 20 November 2010 and resold within 24 months from the date of acquisition. SSD is imposed on top of the ad valorem duty on a chargeable AFS or a conveyance on sale.

SSD is a duty imposed on residential property transactions, not a charge on the gain on sale of the property. If the sale of property constitutes a trade, the seller will still be subject to profits tax on the profits earned, but the SSD is a tax deductible expense.

Rates of SSD

Holding period	Duty rate
≤ 6 months	15%
> 6 months but ≤ 12 months	10%
> 12 months but ≤ 24 months	5%

Head 1(2) Lease

To constitute a lease, the instrument must give the tenant the right to exclusive possession. If the right of the tenant is restricted, the instrument is a license which is not chargeable to stamp duty.

Stamp duty rates for Leases

(a) With premium only	Same as conveyance on sale (\$100 or 0.75 – 4.25% in the higher of consideration and market price)
(b) With rent only	As a percentage of the average yearly rent
Lease term undefined	0.25%
Lease term \leq 1 year	0.25%
Lease term $>$ 1 year but \leq 3 years	0.5%
Lease term $>$ 3 years	1%
(c) With premium and rent	
Premium	4.25% of premium
Rent	As for rent-only lease above

Lease executed in pursuance of a duly stamped agreement for lease is chargeable at a fixed duty of \$3.

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Head 2 Hong Kong stock

Stock is:

- a) shares and marketable securities
- b) Unit trust limits
- c) Rights to subscribe for any stock (excluding employee's share options)

HK stock means the stock the transfer of which is required to be registered in HK.

Head 2(1) Contract note, not being jobbing business
Stamped at 0.2% of the consideration or value of
the stock (bought note at 0.1%, sold note at 0.1%)

Head 2(2) Contract note, jobbing business
Stamped at \$5 each

Head 2(3) Transfer operating as a voluntary
disposition inter vivos
Stamped at \$5 and 0.2% of the value of the stock

Head 2(4) Transfer of any other kind
Stamped at a fixed duty of \$5

Head 3 HK Bearer instrument

Bearer instrument is any instrument to bearer by delivery of which any stock can be transferred.

HK bearer instrument is:

- (a) a bearer instrument issued in HK; or
- (b) a bearer instrument issued elsewhere by or on behalf of a body corporate, or unincorporated body of persons established in HK

Head 3(1) HK bearer instrument issued in respect of any stock

Stamped at \$3 per \$100 (i.e. 3%) of the market value at the time of issue

Head 3(2) HK bearer instrument given in substitution for a like instrument duly stamped under Head 3(1)

Stamped at a fixed duty of \$5

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Voluntary disposition inter vivos

Section 27 empowers the Collector to charge stamp duty on the basis of the market value of the immovable property conveyed or stock transferred when:

- (a) a conveyance or transfer not expressly worded as a gift has the effect of a gift; and
- (b) a conveyance or transfer is for an inadequate consideration if it confers a substantial benefit on the purchaser

Even if the conveyance or transfer is at arm's length, in good faith and for valuable consideration, stamp duty will still be imposed on the market value.

However, a conveyance or transfer is not chargeable with stamp duty if marriage is the consideration.

Section 27 will not apply if no beneficial interest passes. This applies to a conveyance or transfer

- (a) made for a nominal consideration to secure the repayment of an advance or loan;
- (b) made to effect the appointment of a new trustee;
- (c) under which no beneficial interest in the property passes;
- (d) made to a beneficiary by a trustee or other person in a fiduciary capacity under any trust.

Major exemptions and reliefs to stamp duty are under ss.39 – 46, ss.47A and 47B of the SDO.

Main exemptions/relief

- Instruments generally exempted (s.39)
- Instruments specifically exempted (s.40)
- Exemption for government or public officer (s.41)
- Relief for leases between government/public officer and another person (s.42)
- Relief for leases of consular premises (s.43)
- Relief for gifts to exempted institutions (s.44)
- Relief for conveyance or transfer between associated bodies corporate (s.45)
- Exemption for instruments effecting immovable property made for new Government lease or exchange (s.46)
- Exemption for transfer of units under MPF schemes (s.47A)
- Exemption for instruments of transfer relating to indirect allotment or redemption of units under unit trust schemes (s.47B)

Relief under s.45

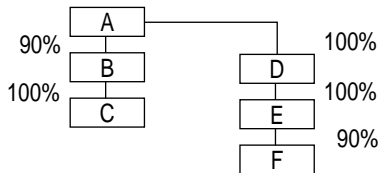
Section 45 only applies when:

- (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.

Issued share capital refers to both ordinary and preference shares at par value.

Example

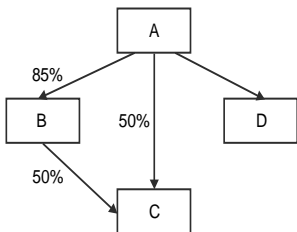
A, B, C, D, E and F are eligible for the s.45 relief. A holds directly 90% of B and indirectly 90% of C. A also effectively holds 90% or more of the shareholdings in D, E and F.



Companies held by the same individual are not eligible for the relief under s.45.

A, C and D are associated bodies corporate eligible for the relief under s.45. A holds 95% of D and, directly and indirectly, 92.5% of C ($50\% + 85\% \times 50\%$).

However, A and B, B and C as well as B and D are not associated.



s.45 relief applies to:

- (a) conveyance of immovable property
- (b) transfer of stock
- (c) AFS of residential property (s.29H) but does not apply to a lease.

s.45 relief does not apply to instruments executed in connection with an arrangement under which:

- (a) any part of the consideration was provided or received, directly or indirectly, by a person other than an associated body corporate of the transferor or transferee
- (b) beneficial interest was previously conveyed, transferred, sold or purchased, directly or indirectly, by a third person
- (c) the transferor and transferee were to cease to be associated due to a change in shareholding in the transferee within 2 years of the transfer.

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Time limit and person liable for stamping

Instrument	Time limit for stamping	Person liable
Conveyance on sale and AFS of immovable property in HK	30 days after execution	All parties (usually payable by the purchaser)
Conveyance on sale and AFS of immovable property in HK chargeable with SSD	30 days after execution	All parties (usually payable by the purchaser)
Lease and agreement for lease of immovable property in HK	30 days after execution	All parties
Contract notes of HK stock	2 days after the sale or purchase if affected in HK; or 30 days after the sale or purchase if effected outside HK	Agent or principal
Transfer as voluntary disposition of HK stock	7 days after execution if executed in HK; or 30 days after execution if executed outside in HK	Transferor and transferee

Instrument of transfer of HK stock	Before execution; or 30 days after execution if executed outside HK	Transferor and transferee
HK bearer instrument	Before issue	Issuer or agent
Duplicates and counterparts of chargeable instruments	7 days after execution or such longer period as the time for stamping the original instrument would allow	Per original document

Penalty for late stamping

Period Late	Penalty
≤ 1 month	2 times the duty
> 1 month ≤ 2 months	4 times the duty
> 2 months	10 times the duty

The collector may remit the whole or any part of the penalty.

Penalty for failure to disclose relevant information

- A fine at level 6 (ie \$100,000) and 1 year imprisonment.
- The Collector is empowered to compound any such offence.

Adjudication

Under s.13 of the SDO the Collector determines (adjudicates) whether an instrument is subject to duty and, if so, how much.

Fee = HK\$50

Adjudication is important:

- To satisfy any third party as to the correctness of stamping.
- Certain instruments will not be regarded as properly stamped unless adjudicated.
- Part of the process of appeal in any dispute as to the liability to stamp duty.
- When there is doubt as to the chargeability or amount of stamp duty payable.

Compulsory adjudication for:

- Voluntary disposition inter vivos
- Instruments exempted under s.45
- Claims that an instrument is exempt or that no person is liable for payment
- A transaction in consideration of a debt which exceeds the value of the property
- Gifts to exempted institutions
- A foreclosure order
- An appeal against an assessment

Appeals

Any person may appeal against an assessment raised by the collector after adjudication to the District Court.

Grounds for appeals

- (a) Whether a transaction is to be regarded as a voluntary disposition inter vivos
- (b) Whether there is any change in beneficial ownership
- (c) Whether the instrument is exempt
- (d) Whether a conveyance on sale forms part of a larger transaction or a series of transactions
- (e) The valuation of immovable property
- (f) the valuation of private company shares

Anti-avoidance measures

There are specific anti-avoidance provisions in the SDO, such as s.45(5A), but there are no general anti-avoidance provisions.

Therefore, the Collector can apply the Ramsay Principle to disregard a transaction for the avoidance of payment of stamp duty when:

- (a) There is a pre-ordained series of transactions or a simple composite transaction; and
- (b) There are steps inserted which have no commercial or business purpose apart from the avoidance of a liability to tax.

The Ramsay Principle had been applied in *Arrowtown Assets Ltd* case

Reducing exposure to stamp duty

Unit 1

No
document,
no duty

Share
allotment
instead of share
transfer

Transferring
shares in a non-HK
holding company

Buying
immovable
property by an
exchange of
properties

Holding immovable
property in company
name, and disposing of
the shares in the
company and not the
property

Utilising
s.45 relief

Notes

9: Introduction to tax planning

Topic List

Overview

The *Ramsay* principle

Ethical considerations in tax planning

Anti-avoidance provisions under the IRO

Penalty on tax avoidance cases

Practical considerations in tax planning

Advance rulings system

The implications of every tax scheme need to be considered in full, that is to say: whether it can be justified commercially, its complexity, the costs and benefits, the interaction with other taxes (salaries tax, property tax and stamp duty), and any overseas tax implications.

*Does the scheme conflict with any anti-avoidance provisions? It is also important to assess the scheme's morality, including whether it in any way breaches the *Ramsay* principle which prohibits engaging in artificially arranged transactions with no commercial substance purely for the sake of avoiding tax. The costs, including penalties or other implications may outweigh the benefit.*

Tax avoidance vs. tax evasion

Tax planning is the process of organising the affairs of the taxpayer in a legal and commercially realistic matter to **reduce or defer a taxpayer's tax liability**.

Tax avoidance vs. tax evasion

Tax reduction/avoidance	Tax evasion
Legal measure to avoid or reduce tax	Illegal measure to avoid or reduce tax
Probably ethical	Potentially unethical
No concealment	Concealment and camouflage
Transparent	Deceitful and attempt to obscure truth

Definition

The ***Ramsay Principle*** allows the court to disregard a pre-ordained series of transactions containing steps that are self-cancelling and inserted for no commercial or business purpose apart from the avoidance of a liability to tax.

This principle is derived from UK case law in *WT Ramsay v IRC* [(1982) AC300] and expanded in *Furniss v Dawson* [(1984) ALL ER530].

Case law

HK Board of Review uses the *Ramsay Principle*

Pertinent case law (international and HK)

- *IRC v. McGuckian* [(1997) STC908]
- *FC of T v Patcorp Investments Ltd* (76 ATC 4225)
- *Oakey Abattoir Pty Ltd v FC of T* (84 ATC 4718)
- *Stuart Investments Ltd v R* [(1984) DTC 6305]
- *CIR v Tai Hing Cotton Mill (Development) Ltd* (FACV 2/2007)
- *CIR v HIT Finance Ltd* [(2008) HKRC 90-199]
- *CSR v Arrowtown Assets Ltd* (6 HKTC 273)
- *Barclays Merchantile Business Finance Limited v Mawson* [(2005) STC 1]

HKICPA Fundamental Principles outlined in 'Code of Ethics for Professional Accountants'

1. Integrity
 2. Objectivity
 3. Professional competence and due care
 4. Confidentiality
 5. Professional behavior
- Section 430 Ethics in Tax Practice
- A. Can put forward best position for client
 - B. Should not hold out tax return / advice as beyond challenge
 - C. Responsibility of tax return primarily rests with client
 - D. Tax advice on material issues should be documented
 - E. Member must not associate with false returns
 - F. Estimates can be used if reasonable and disclosed
 - G. Can rely on client information if reasonable
 - H. Member's responsibility when he learns of a material error or omission in client's return, or of the failure of client to file a required tax return.

Refer to chapter 9, section 3 of the Learning Pack for further details.

Anti-avoidance

Anti-avoidance is the legitimate arrangement of a taxpayer's business affair to minimise his tax liability.

IRD actively **uses anti-avoidance provisions** to tackle tax avoidance schemes.

Application of *Ramsay* Principle

Board of Review uses the *Ramsay* Principle where no specific anti-avoidance measures exist.

Cases include:

CSR v Arrowtown Assets Ltd [(2002) HKRC 90-114]

CIR v Tai Hing Cotton Mill (Development) Ltd
(FACV 2/2007)

CIR v HIT Finance Ltd [(2008) HKRC 90-199]

Anti-avoidance provisions

The major anti-avoidance provisions under the IRO are as follows:

Section	Scope
61	Certain transactions and dispositions to be disregarded
61A	Transactions designed to confer a tax benefit on a person
61B	Utilisation of losses to avoid tax
9A	Remuneration under certain agreements treated as income derived from an employment of profit
15(l)(m) & 15A	Transfer of right to receive income
16(2), (2A), (2B) & (2C)	Deduction of interest expenses
16E(8) & 16EA(9)	Commissioner's power to determine the true market value of intellectual property rights
16EC	Deduction under s.16E or 16EA not allowable under certain circumstances
16G(3)(c)	Commissioner's power to determine the true market value of a prescribed fixed asset on sale
16J(4)	Commissioner's power to determine the true market value of environment protection facilities on sale
18D(2A)	Relevant profit of old business to be assessed
20	Liability of certain non-resident persons
20AE	Assessable profits of non-resident persons regarded as assessable profits of resident persons

Section	Scope
21A	Computation of deemed assessable profits under s.15(1)(a), (b) or (ba)
22B	Limited partner loss relief
38B	Commissioner's power to determine the true value of an asset on sale
39E	Depreciation allowances on leased machinery and plant

*It is not necessary for the Commissioner to personally enforce ss. 61B, 16G(3)(c), 16J(4) and 38B. Delegation of power is possible.

Overview

The *Ramsay*
Principle

Ethical
considerations

IRO anti-avoidance
provisions

Penalty on tax
avoidance cases

Practical
considerations

Advance rulings
system

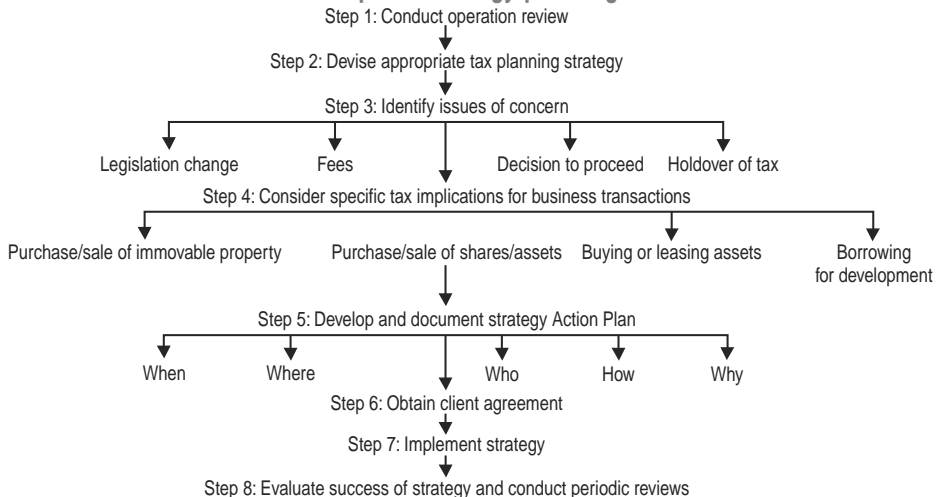
Penalty on tax avoidance cases

Penalty action for non-compliance is not just confined to evasion cases, but may also apply to tax avoidance cases to which the general anti-avoidance provisions have been successfully applied, provided that the conditions have been satisfied.

If a scheme whose possibility of success is entirely dependent upon the IRD never finding out the true facts, it is likely to be a scheme of tax evasion rather than tax avoidance.

In general, the IRD will impose penalty on the taxpayers if there were elements of dishonesty or fraudulence involving the use of artificial or fictitious devices, or where the transactions were false or unsubstantiated.

Steps for strategy planning



Tax avoidance strategies

Tax efficient organisational and operational structures for business

Minimise tax consequences of a particular transaction e.g.

- Increase allowable deductions
- Diverting income to person liable for the least amount of tax

Increase tax liability in HK to reduce tax due in countries with a higher tax rate e.g.

- Tax havens
- Setting up a holding company
- Setting up a branch or subsidiary
- Setting up a finance company
- Setting up a management or service company
- International transfer pricing

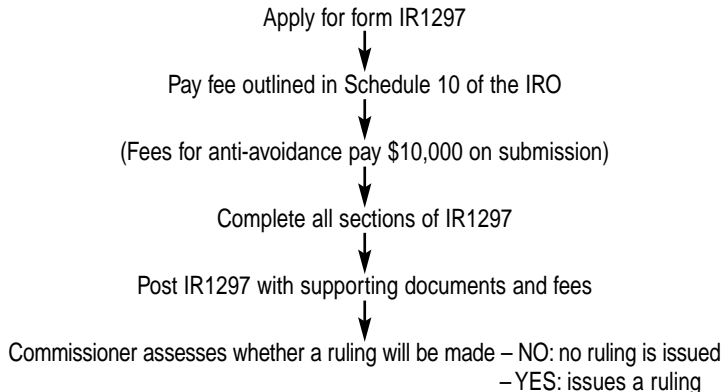
Advance rulings

To establish the position of an anticipated transaction/arrangement, taxpayers can apply for an **advance ruling** from the IRD.

Section 88A outlines the advance ruling provisions.

The IRD has selected some rulings for publication which can be found at <http://www.ird.gov.hk/eng/ppr/arc.htm>

Process



Rulings are generally valid for no more than 2 years of assessment.

Notes

10: Tax investigation and field audit

Topic List

Tax investigation and case selection

Conducting a tax investigation or field audit

Taxpayers' attitudes towards a tax investigation or field audit

Tax representative's role in a tax investigation or field audit

Importance of business records

The IRD conducts tax investigations and field audits for a variety of reasons which may include random selection of assessments, or acting upon reported suspicions. There are seven steps in conducting a field audit: pre-audit notification; initial interview; field visit; examination of books and records; post-audit meeting; assessments or additional assessments; and penal actions.

Taxpayers have rights and obligations when being subject to an investigation, and the investigation will run more smoothly if the taxpayer has a positive attitude.

Tax representatives play an important role in managing the investigation on behalf of the taxpayer and negotiating a suitable settlement and penalty, if any.

Field audit and investigation unit

The Investigation Unit is part of the IRD and conducts tax investigations and field audits

Unit aims

- Investigate taxpayer's non-lodgement of returns
- Impose penalties for non-compliance
- Deterrence
- Taxpayer education
- Recover back taxes
- Conduct field audits
- Investigate tax evasion

Case Selection

Tax return data entered into 'Assess First Audit Later' system

↓
Screen returns meeting automated assessment

↓
% selection for audit from automated assessment

↓
Case officers also manually select cases

↓
Audits also triggered by informers/media/police

Audit steps

Step	Procedure
1	Pre-audit notification
2	Initial interview
3	Field visit
4	Examination of books and records
5	Post-audit meeting
6	Assessments or additional assessments
7	Penal actions

Step 1: Pre-audit notification

Taxpayer is informed of upcoming audit via letter

Step 2: Initial interview

- At taxpayer's business premises
- Questions on daily business operations
- Investigation of accounts/book keeping
- Questions on personal affairs
- Explanation of audit procedures

Step 3: Field visit

Auditor visits taxpayer's business premises to conduct Step 2 and Step 4.

Step 4: Examination of books and records

- Carry out basic audit of books and records
- Identify areas needing more attention

Step 5: Post-audit meeting

The auditor assesses the amount of tax undercharged using:

- Direct quantification if books and records are reliable
- Assets Betterment Statement (ABS) method
- Bank deposits method
- Business economics method
- Projection method

When a basis of settlement is formulated, a meeting will be held to discuss and agree on the basis of settlement.

Assessment Betterment Statement (ABS)

FORMULA

$$\text{Betterment Profits} = \text{Increase in Net Assets} + \\ \text{Disallowable Expenditure} - \\ \text{Non-taxable Receipts}$$

Step 6: Assessments or additional assessments

On closure of the field audit, assessments or additional assessments will be raised on the agreed discrepancy; or estimated assessment if there is no agreed basis.

Step 7: Penal actions

When deciding severity of penalty, the Commissioner will consider:

- Degree of co-operation;
- Extent of voluntary disclosure;
- Time-span of non-compliance; and
- Aggravating or mitigation factors.

Penal action includes:

- Prosecution under S.82(1) for wilful tax evasion
- Prosecution under S.80(2) for incorrect returns or failure to inform chargeability to tax without a reasonable excuse
- Prosecution under S.80(1) for other offences
- Prosecution under S.80(1A) for failure to keep proper business records
- Assessments to additional tax under S.82A

Penalty policy at <http://www.ird.gov.hk/eng/pol/ppo.htm>

Positive attitude

Taxpayers should maintain a positive attitude.

Co-operation will be considered when deciding penalties.

Early settlement

To reach early settlement with the IRD:

- Identify audit process
- Identify audit reasons
- Cooperate in interview
- Evaluate settlement proposals
- Work towards compromise

Taxpayer's actions

The IRD encourages the taxpayer to:

- Disclose information
- Submit documents
- Provide audit papers
- Explain profits tax computation
- Propose settlement
- Respond to the IRD

Tax investigation
and case selection

Conducting tax
investigations

Taxpayers'
attitudes

**Tax representative's
role**

Business records

Tax representative

- Provide professional advice to client
- Protect client's interests
- Conduct preliminary audit of client's records
- Negotiate with the IRD
- Accompany client to attend interviews with the IRD
- Respond to the IRD's enquiries
- Prepare settlement proposals
- Negotiate with the IRD to resolve areas of contention
- Identify mitigating circumstances for reduced penalty
- Help improve client's future compliance
- Comply with the HKICPA's Code of Ethics

Reasons for records

1. Meet legal obligations
2. Prove returned profits if audited
3. Provide management information

S.51C outlines records to be kept by taxpayers.

Penalty for failure to keep records is \$100,000.

Types of records

Records of
Banking
Income
Assets
Debtors and creditors
Depreciation allowances
Purchases and expenses
Trading stock

11: Tax compliance and tax advisory services

Topic List

Legal and professional obligations

Tax compliance within an organisation

Management of taxation work and projects

Tax compliance services by tax representatives

Providing further information as required by the IRD

Standard tax advisory services by tax representatives

Special tax advisory services by tax representatives

The representative should have an understanding of the legal, professional and ethical obligations of tax representatives. The representative also has responsibility for the compliance work of the organisation and management of the workflow and projects.

Tax representatives are responsible for taxation compliance services including filing of profits tax, salaries tax and property tax. They must provide further information when requested by the IRD and prepare letters outlining all the relevant points.

Tax representatives also provide general and specialist tax advisory services.

Taxpayer objectives

- Comply with the law
- Minimise/defer tax liabilities lawfully
- Not incur excessive fees and charges

Tax advisor objectives

- Comply with the law
- Provide timely professional advice
- Protect client interests
- Maintain client confidentiality
- Provide information to IRD
- Observe professional ethics
- Charge fair fees

Tax authority obligations

- Enforce tax ordinances
- Provide assistance to taxpayers
- Issues DIPNs
- Maintain confidentiality
- Prosecute non-compliance
- Impose penalties
- Collect tax on due date
- Charge surcharges for late tax
- Take legal action in the Courts
- Conduct tax investigation/field audits
- Prosecute tax evaders
- Deter tax avoidance

Taxpayer's Charter

The **Taxpayer's Charter** was issued in 2000

The Charter outlines the rights and obligations of the taxpayer

Charter at: <http://www.ird.gov.hk/index.htm>

Tax Representative's Corner

Launched on website 1 April 2003

Provides tax representatives with assistance and materials

Corner accessed at:

<http://www.ird.gov.hk/eng/tax/taxrep.htm>

Professional requirements

No qualification or experience requirement to act as a tax advisor in HK

No registration system for tax advisors in HK

Board of Review has expressed concern over individual advisors

Ethical requirements (Code of Ethics for Professional Accountants (Revised June 2010))

Tax representatives should pay particular attention to s.430 'Ethics in Tax Practices')



Legal and professional obligations

Organisations' tax compliance

Management of work and projects

Tax compliance services

Providing further information

Tax advisory services

Special advisory services

Profits tax filing

Accounting Date	Code	Normal Tax Filing Deadline
1 Apr – 30 Nov	N	30 April (no extension)
1 Dec – 31 Dec	D	15 August
1 Jan – 31 Mar	M	15 November and further extension to 31 Jan for tax loss cases

Profits tax filing

Items to be filed:

- Extraordinary gains and losses
- Interest expenses
- Interest claimed to have an offshore source
- Offshore profits and apportionment of related expenses
- Fees paid
- Sub-contractors' fees
- Legal and professional fees
- Repairs and improvements
- Commission payments
- Bad debt provisions and write-offs
- Leasehold improvements
- Movements in reserves and provisions
- Purchase and sale of capital assets

Exemption from property tax

Corporations must apply for an exemption.

Applications made in property tax returns (Form BIR57).

Any change in property status exempted corporations must notify IRD within 30 days.

Salaries tax filing

In addition to the annual filing of Forms BIR 56A / IR 56B, the employer needs to submit the following returns

Return	Form	Time Limit
Employer's Return on commencement of employment.	IR 56E	3 months from date of commencement
Employer's Return on cessation of employment.	IR 56F	1 month before date of cessation
Employer's Return in respect of an employee leaving Hong Kong.	IR 56G	1 month before date of departure.

For payments made by a company to an individual, the company may, upon request, be obligated under s. 51(4) to file a form IR 56M together with the declaration form IR 6036B.

Tax liability and recording payment

Notice of assessment for profits tax – after July

Payment due dates – dependent on business accounting dates

Late payment – 5% to 10% surcharges

– Recovery action through courts

Provision for profits tax – recorded as liability

Payment planning – Plan for impact in cash flow

Form of payment – Tax Reserve Certificate (TRC)

Providing further information to IRD

Taxpayers must provide more information to IRD within 1 month of request.

Sufficient business records

Kept for at least 7 years

Penalty for non-compliance is HK\$100,000

Records to be kept:

- assets and liabilities
- trading stocks
- receipts and revenue
- payments and expenses
- bank accounts
- depreciation allowances

Managing taxation work

When assigning the taxation function in an organisation 3 factors need to be considered:

1. Type of taxation work
2. Confidentiality of work
3. Technical competence required

Deciding these three factors will enable the planner to employ the right staff and allocate work correctly

Planning taxation work

When planning tax work the advisor must:

- Ensure correct staffing
- Assign tasks
- Ensure time limits are met
- Plan so items and deadlines are “not missed”
- Ensure tax liability is included in cash flows and strategy considerations

Legal and professional obligations

Organisations' tax compliance

Management of work and projects

Tax compliance services

Providing further information

Tax advisory services

Special advisory services

Types of services

Profits tax filing

Salaries tax filing

Property tax filing

Profits tax filing

Tax returns generally issued in April each year

No requirement that profits tax must be prepared by tax advisor

Follows a Block Extension Scheme

Tax returns categorised as **N**, **D** or **M**

Advisors should send a **tax engagement letter** to confirm the services being offered

Salaries tax filing

Does not require high level technical knowledge.

No block extension applicable.

Fees paid are generally deductible.

Normally sent by IRD on first working day of May.

Salaries tax filing

IRD allows 1 extra month for filing when managed by tax representatives

Provisional salaries tax payable in two instalments

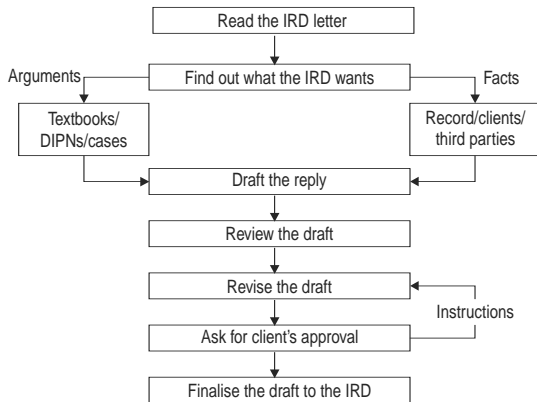
- Final tax and 75% of provisional due January to March
- Remaining 25% due after March

IRD enquiries

Advisors may need to contact or respond to IRD on the following issues:

- Respond to request for audit
- Lodgement of objections
- Lodgement of appeals
- Lodgement of 70A claim
- Application for holdover of provisional profits tax

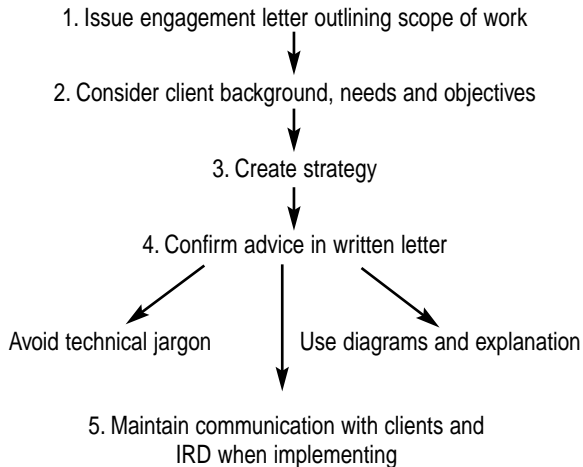
Procedure for replying to IRD



Typical tax advisory services are:

- group restructuring
- acquisition and merger
- pre-listing review
- buy or lease transaction
- securing financial arrangements such as bank loans

Advice process



Services provided

Special advisory services are:

- application for advance rulings
- tax investigation/ field audit
- appeal to the Board of Review under Section 66 against a determination
- appeal to the Board of Review under Section 82B against an additional tax assessment

Appeals

- Onus of proof lies with the taxpayer
- Burden of proof is heavy
- Time limit for appeals is 1 month
- Board of Review finding is final

12: Double taxation arrangement and agreements

Topic List

Taxation of overseas income

The OECD and Model Tax Treaty

DTA between the mainland of China and HKSAR

Double Taxation Arrangements

Other Double Taxation Arrangements

Hong Kong has entered into a number of double taxation arrangements and agreements in recent years. The most important arrangement is the Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion signed between the HKSAR and the Mainland of China. It is important to be familiar with various important articles and DIPNs.

Double taxation

Double taxation arises when a type of income, such as employment income or business profits, may be subject to tax in two or more jurisdictions.

Territoriality

The **territoriality** basis of taxation means only **income or profit sourced in HK is subject to tax**. Income or profit derived from a source outside of HK by residents is not subject to tax in HK.

Airline DTA

Airline operators are more susceptible to double taxation than other business operators.

HK has negotiated bilateral Airline DTAs.

Shipping income

Shipping operators are also more susceptible to double taxation.

HK legislation provides reciprocal tax exemption from 1 April 1998.

HK also entered into DTAs with countries that do not provide reciprocal tax exemptions.

OECD and the Model Tax Treaty

OECD = Organisation for Economic Co-operation and Development

OECD membership = 34 member countries

= More than 70 non-member countries work with OECD and subscribe to treaties

OECD and DTA = Many countries (members and non-members) enter tax treaties based on the OECD Model Tax Treaty

Model Tax Treaty

Many countries (members and non-members) enter into DTAs based on the OECD Model Tax Treaty.

The Model Tax Treaty aims to:

- Eliminate double taxation
- Prevent fiscal evasion
- Eliminate discrimination against non-resident
- Allow for exchange of information
- Provide dispute resolution

DTA between PRC and HK originally signed 1998.

Current DTA effective from 2006.

Persons covered

Resident individual – individuals who are resident of the PRC, or of HK, or of both.

Resident company – companies incorporated in HK, or ordinarily controlled in HK.

Taxes covered

In PRC	In the HKSAR
Individual income tax	Salaries tax
Corporate income tax*	Profits tax
	Property tax
	Tax charged under personal assessment-purpose

* Corporate Income Tax after the unification of tax regulations applicable to foreign enterprises, foreign investment enterprises and domestic enterprises since 1 Jan 2008.

Coverage

The DTA also covers:

- Income from immovable properties
- Business profits
- Shipping, aviation and land transport operations
- Capital gains
- Employment income
- Investment income
- Directors' fees, artistes and sportspersons

Tax planning

DTA opens up tax planning opportunities for HK advisors.

- Business profits: A HK company structures its operations in PRC to ensure it is not deemed to have a permanent establishment in China
- Staff remuneration: HK company providing services in PRC could avoid paying PRC income tax if no permanent establishment in China
- Reduction of withholding tax rate on dividends: HK company is used to hold investments in PRC
- HK holding company for capital gain: HK company used as investment vehicle by a third party country (with no tax treaty with PRC) in order to invest in PRC company

Note: All strategies are subject to HK and PRC anti-avoidance provisions

Types of double taxation

- Economic double taxation
- Juridical double taxation

DIPN45

Outlines relief from double taxation due to **transfer pricing adjustment**.

DIPN46

How IRD assesses the arm's length status of related party transactions.

- Transfer pricing methodologies
- Corresponding adjustment
- Documentation required

DIPN47

Sets out the IRD's practice on the processing and exchange of tax information upon requests from treaty partners.

DIPN48

Provides guidance for enterprises seeking an Advanced Pricing Arrangement ('APA') with the IRD. It explains the APA process and conditions.

Taxation of overseas income

The OECD and Model Tax Treaty

DTA between the mainland of China and HKSAR

Double Taxation Arrangements

Other Double Taxation Arrangements

DTA with Hong Kong	Withholding Tax charged by the host country			Taxing right of the host country		Taxing right of Capital Gain on disposal of shares of	
	Dividend	Interest	Royalty	Shipping Income	Airline Income	Company's assets >50% are immovable property	Other companies
PRC	5%/10%	7%	7%	Exempted	Exempted	Both home country and host country	< 25% shareholding – home country, others – both
Belgium	0%/5%/15%	10%	5%	Exempted	Exempted	Both, except quoted shares, reorganization, property dealing business	Home country
Thailand	10%	10% ^(iv) /15%	5%/10%/15%	50% reduction	Exempted	Both	Home country

Taxation of overseas income

The OECD and Model Tax Treaty

DTA between the mainland of China and HKSAR

Double Taxation Arrangements

Other Double Taxation Arrangements

DTA with Hong Kong	Withholding Tax charged by the host country			Taxing right of the host country		Taxing right of Capital Gain on disposal of shares of	
	Dividend	Interest	Royalty	Shipping Income	Airline Income	Company's assets >50% are immovable property	Other companies
Luxembourg	0%/10%	0%	3%	Exempted	Exempted	Both, except quoted shares, reorganisation, property dealing business	Home country
Vietnam	10%	10%	7% /10%	Exempted	Exempted	Both	< 15% shareholding – home country, others – both
Netherlands	0%/10%	0%	3%	50% reduction	Exempted	Both, except quoted shares, reorganisation, property dealing business	<5% shareholding – home country, others – both
Indonesia	5%/10%	10%	5%	50% reduction	Exempted	Both, except quoted shares, reorganisation, property dealing business	Home country

Brunei	0%	5%/10%	5%	Exempted	Exempted	Both, except quoted shares, reorganization, property dealing business	Home country
Hungary	0%/10%	0%/5%	0%/5%	Exempted	Exempted	Both, except quoted shares, reorganization, property dealing business	Home country
Kuwait	0%/5%	0%/5%	5%	Exempted	Exempted	Both, except quoted shares, reorganization, property dealing business	Home country
Austria	0%/10%	0%	3%	Exempted	Exempted	Both, except quoted shares, reorganization, property dealing business	Home country
United Kingdom	0%/15%	0%	3%	Exempted	Exempted	Both, except quoted shares, reorganization, property dealing business	Home country
Ireland	0%	0%/10%	3%	Exempted	Exempted	Both, except quoted shares	Home country
Liechtenstein	0%	0%	3%	Exempted	Exempted	Both, except quoted shares	Home country

Taxation of
overseas income

The OECD and
Model Tax Treaty

DTA between the mainland
of China and HKSAR

Double Taxation
Arrangements

Other Double
Taxation Arrangements

France	10%	0%/10%	10%	Exempted	Exempted	Both, except quoted shares	Home country
Japan	5%/10%	0%/10%	5%	Exempted	Exempted	Both, except quoted shares	Home country
New Zealand	5%/15%	10%	5%	Exempted	Exempted	Both, except quoted shares	Home country
Switzerland	0%/10%	0%	3%	Exempted	Exempted	Both, except quoted shares	Home country
Portugal	5%/10%	10%	5%	Exempted	Exempted	Both	Home country
Spain	0%/10%	5%	5%	Exempted	Exempted	Both, except quoted shares	Home country
Czech Republic	5%	0%	10%	Exempted	Exempted	Both, except quoted shares	Home country
Malta	0%	0%	3%	Exempted	Exempted	Both, except quoted shares	Home country
Jersey	0%	0%	4%	Exempted	Exempted	Both, except quoted shares	Home country
Malaysia	5%/10%	10%	8%	Exempted	Exempted	Both, except quoted shares	Home country
Mexico	0%	0%/4.9%/ 10% (xvii)	10%	Exempted	Exempted	Both, except reorganisation	Home country

Canada	5%/15% (xvii)	10%	10%	Exempted	Exempted	Both	Home country
Italy	10%	12.5%	15%	Exempted	Exempted	Both, except quoted shares	Home country
Guernsey	0%	0%	0%	Exempted	Exempted	Both, except quoted shares and reorganisation	Home country
Qatar	0%	0%	5%	Exempted	Exempted	Both, except quoted shares, reorganisation and property dealing business	Home country

Notes

13: Overview of China tax system

Topic List

The tax administration system in China

Duties of tax bureaus and tax collection

Tax disputes and appeals

Business tax

Value Added Tax

Consumption tax

Individual Income Tax

Corporate Income Tax

In addition to having a broad knowledge of Hong Kong tax law, Hong Kong accountants should also have a basic awareness of the China tax system and the main taxes in China.

- *China has three types of turnover taxes, namely, Business Tax, Value-added Tax and Consumption tax.*
- *Individual income tax and corporate income tax are income taxes applied to individuals and enterprises respectively.*

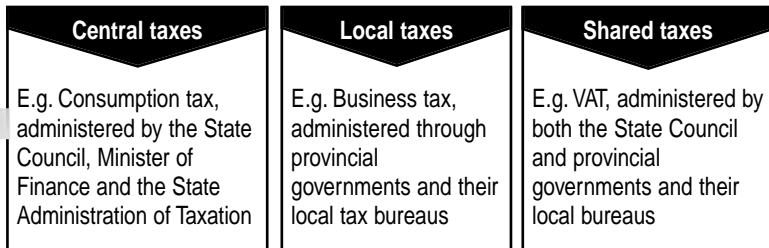
The tax administration system in China

The supreme authority to make and interpret tax legislation is vested in the **National People's Congress** and its Standing committee, in accordance with the Constitution of the People's Republic of China.

There are three types of turnover taxes in China:

Consumption tax, business tax and VAT are **turnover taxes**. There are also other forms of tax:

Income tax,
Resources tax
Special purpose tax (e.g. urban maintenance and construction tax), **Property tax**
Behaviour tax (e.g. vehicle use tax).
Agricultural tax
Customs Duty
Tax on prescribed items



Duties of tax bureaus

The major ministry concerned with tax matters is the **State Administration of Taxation (SAT)**.

There are also local tax bureaus of State tax which handle the day-to-day administration of State tax. **Local tax bureaus** handle local taxes.

Tax collection

The State Council has designated SATs to be responsible for collection and administration of central taxes and shared taxes. Local tax bureaus collect local taxes for the respective local governments.

SATs have the following powers and obligations:

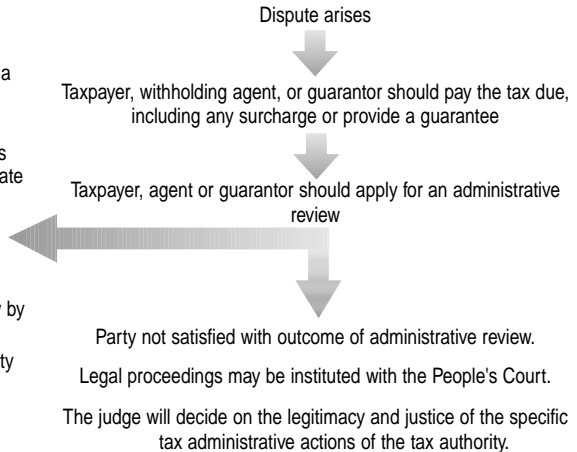
- Discretion to defer tax liabilities for a taxpayer in difficulty
- To return overpaid tax immediately upon discovery
- To apply a surcharge for under- or late payment

Tax administrative review and tax administrative prosecution both deal with disputes concerning tax administration, but their proceedings are different.

Scope of tax administrative review

- Ensure tax collected and surcharges levied are done according to the law
- Order made by tax authority to the taxpayer to provide a guarantee for tax payment
- Measure made by tax authorities to retain tax revenue
- Failure on the part of the tax authorities to lift measures for retaining tax revenue immediately where the legitimate interests of a taxpayer are jeopardised
- Tax mandatory enforcement measures made by tax authority
- Tax administrative penalty made by tax authority
- Failure to handle cases or reply in accordance with law by the tax authority
- Disqualification of VAT general taxpayers by tax authority
- Notification to the border control authority by the tax authority to prevent taxpayers from departure
- Other specific administrative actions

Tax administrative prosecution



Business tax

Business tax (BT) is an important turnover tax imposed on business activities not subject to value-added tax.

The scope of taxable services subject to business tax include:

- Transportation industry
- Construction industry
- Financial and insurance industry
- Postal & telecommunications industry
- Culture and Sports service
- Entertainment business
- Service industry
- Transfer of intangible assets
- Selling immovable properties

There are specific rules for the following special activities:

Mixed sales activity The turnover of taxable services and the sales amount of goods shall be accounted for separately.

Concurrent activities The taxpayer must account separately for items subject to business tax and items subject to VAT.

Deemed sales Transfers of limited property rights, or permanent rights, and transfers by entities of immovable properties by way of gifts to others, shall be regarded as sales of immovable properties and are subject to business tax.

Agency business The revenue from the sales of goods, is subject to VAT. The commission charge received is subject to business tax.

Alert! In practice, the determination of whether a business activity constitutes a special activity is the preserve of the relevant SAT and may be highly complex, but you should be aware of what the basic issues are

Business tax rate and calculation

A tax rate of **3%** is applicable to the following:

- Transportation industry
- Construction industry
- Post & telecommunications industry
- Culture and sports industry

A tax rate of **5%** is applicable to the following:

- Financial and insurance industry
- Service industry
- Transfer of intangible assets
- Sale of immovable properties

A tax rate of **5%** to **20%** is applicable to the entertainment industry

Billiards and bowling halls are taxed at 5% in any region.

Business tax is usually levied on the gross turnover of a business. However, a special formula applies under certain circumstances, such as:

- where work is subcontracted
 - decoration
 - advertising
 - transportation
 - tourism
 - sales of second-handed properties
- to give the 'deemed turnover' or taxable value.

Calculation using gross business turnover

Tax payable = Business turnover * Tax rate

Calculation not using gross business turnover

Tax payable = (Business turnover – Allowable adjustments) * Tax rate

Recent development in business tax

Before 1 January 2009, the provision of taxable services, transfer of intangible assets, or sale of immovable properties have to be within the territory of the PRC to be subject to business tax.

With effect from 1 January 2009, if the service recipient or provider is located in the PRC, the service provider would be subject to business tax, even if the service was performed outside the PRC.

Nevertheless, pursuant to Caishui [2009] 111, certain services provided wholly outside the PRC will not be subject to business tax. These include cultural and athletic activities, entertainment, hotel and catering, storage and other services such as hairdressing, laundering and dyeing, mounting, transcription, engraving, photocopying and packing services.

The Ministry of Finance and the State Administration of Taxation have jointly issued Announcement No. 65 which, amongst other things, sets out in more detail the criteria to determine chargeability to business tax.

Prescribed taxable services	Service recipient or service provider is located in the Mainland
Transfer of intangible assets (excluding land use rights)	Transferee of the intangible assets (or the right to use) is located in the Mainland
Transfer of land use rights	Land is located in the Mainland
Selling or leasing of immovable properties	Immovable property is located in the Mainland

VAT is a tax on turnover rather than on profits. As the name suggests, it is charged on the **value added**.

Sale of goods, processing, repair and replacement services or the import of goods, within the PRC territory, are subject to VAT.

However, the provision of 'taxable services' would be subject to business tax and not VAT.

Example of a VAT chain

Chains

		<i>Purchase price</i>	<i>Selling price</i>	<i>Appreciation value</i>	<i>VAT payable</i>
		RMB	RMB	RMB	RMB
material A	→ product B	100	200	100	$100 * 17\% = 17$
product B	→ product C	200	400	200	$200 * 17\% = 34$

In calculating VAT payable, input VAT paid on purchase costs of raw materials, fuels, powers such as electricity, heat and gas, low-value and non-durable equipment can be deductible. Starting from 1 January 2009, input VAT paid on fixed assets can be claimed as input VAT credit.

VAT Invoices

VAT is indicated on VAT special invoices issued by the merchandiser. This greatly reduces the taxpayers' workload for calculating input tax and makes tax deductions more accurate.

VAT and its interaction with business tax

VAT and business tax are mutually exclusive. A service or activity cannot be subject to both taxes.

Special activities within scope of VAT

The following are some examples of special activities subject to VAT:

- The sales of commodity futures and precious metal futures – VAT will be charged when the futures are recognised and realised;
- The sales of gold and silver by banks;
- The sale of articles for pawn;
- The production and issue of stamp products for stamp collections and for sale by entities and individuals other than the postal services

Make sure you understand these definitions and the distinctions between them and how they affect a taxpayer's liability to VAT:

Deemed sales: in business deemed sales often occur in the following circumstances:

- 1 The transfer of goods without the transfer of property rights;
- 2 Although changes have taken place for the property rights of goods, the transfer of goods is not in the form of direct sales;
- 3 The property rights of goods do not change but the goods are used for other purposes similar to sales although no actual sale has taken place.

Mixed sales: An economic activity that involves sales of goods as well as the provision of non-taxable labour services is referred to as '**mixed sales**' within a single business.

Concurrent activities: The two supplies do not form a single business but are two distinct activities, and the sales values are often accounted separately.

Tax rates and exemptions

VAT rate

The current rate of VAT is divided into three classifications:

- Lower rate of 13 % e.g. food, water, educational supplies
- Basic rate of 17 % e.g. other goods and services
- Zero rate which only applies to export goods

Note: There are thresholds set for VAT to exclude low revenue taxpayers (annual taxable sales value below RMB 500,000 starting from 1 January 2009) and special rules for small businesses.

Since 1 January 2009, the chargeable rate for the small-scale taxpayers is 3 per cent, whether the taxpayers engage in industry, commerce or not.

Exempt goods

- Agricultural products
- Contraceptive drugs and devices;
- Antique books
- Imported equipment used for scientific research, experiment and education, or as free aid or for contract processing
- Articles imported directly for specific use by the disabled;
- Second hand goods under certain conditions

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Consumption tax

VAT Reform Pilot Programme

- Caishui (2011) 110 and Caishui (2011) 111
- Starting 1 January 2012
- The applicable VAT rates for service providers who are classified as general VAT payers are as follows:
 - Leasing of movable property and tangible goods – 17%
 - Provision of transportation and construction services – 11%
 - Provision of other specific “modern services” – 6%
- “Modern services” include R&D and technology services, information technology services, design services, intellectual property services, advertising services, meeting & exhibition services and certification services

The Ministry of Finance and the SAT jointly issued *Caishui [2012] No. 71* which stipulated that the following eight areas would follow the implementation rules of the Shanghai VAT reform pilot programme.

Beijing	Since 1 September 2012
Jiangsu and Anhui	Since 1 October 2012
Fujian (including Xiamen) and Guangdong (including Shenzhen)	Since 1 November 2012
Tianjin, Zhejiang (including Ningbo) and Hubei	Since 1 December 2012

The Ministry of Finance and the SAT jointly issued *Caishui [2012] No. 53* on 29 June 2012 which stipulated that a foreign entity or individual that does not have a business establishment in China but provides international transportation services to Chinese domestic enterprises would be subject to VAT at a rate of 3% with retroactive effect from 1 January 2012.

The Ministry of Finance and the SAT issued *Caishui [2012] No. 86* on which clarifies the categorization or tax treatment of certain services. Amongst all, transportation services provided between China and Hong Kong/Macau/Taiwan and within Hong Kong/Macau/Taiwan by taxpayers registered in the pilot areas are subject to zero VAT rate. *Caishui [2012] No.86* became effective from 1 December 2012.

On 10 April 2013, the PRC State Council announced that the VAT pilot program will be expanded nationwide on 1 August 2013. The State Council also announced that the scope of “modern services” will be expanded to include the production, broadcasting and publication of radio, films and television program.

Tax rates and exemptions

Consumption tax is an important turnover tax levied on manufacturers and importers of certain consumer goods, such as jewellery, cosmetics, liquor, cars, yachts and other luxury items.

Consumption tax **can be imposed along with value-added tax** on the taxable consumer goods.

The tax rate varies according to the chargeable good.

Taxpayers include all units and individuals who manufacture, subcontract the processing of, or import and sell the chargeable taxable consumer goods.

Consumption tax calculation

Consumption tax liability = Sales value * Applicable tax rate

Filing date

The timing of consumption tax liability arising is determined respectively according to the date the account is settled and the date the transactions occurred.

Tax abatement

To protect the environment the consumption tax liability may be lowered by 30% for low emission vehicles. The calculation formula is:





Tax abatement = Consumption tax payable computed at statutory rate * 30%

Tax payable = Consumption tax payable computed at statutory rate – Tax abatement

Individual Income Tax (“IIT”)

- China nationals and foreign individuals who reside in China or have derived PRC-sourced income.
- 11 categories of taxable income.
- A PRC tax resident would be subject to IIT on his/her worldwide income.
- A PRC tax resident is an individual who habitually resides in China due to household registration, family or economic relationship.
- A non-PRC tax resident would be subject to IIT depending on the length of stay in PRC, whether he/she holds senior management position, the locality of services rendered, whether tax treaty exemption is applicable.

“Employment income” derived by a non-PRC tax resident

- ≤ 90 days or 183 days if treaty applies  Exempt unless the remuneration is borne by Chinese enterprise
- > 90 days/183 days **but** less than one full year  PRC-sourced income
- > One full year but less than five consecutive full years  PRC-sourced income **plus** Non-PRC sourced income paid/borne by Chinese enterprise
- > 5 consecutive full years  Worldwide income

Standard monthly deduction

- PRC tax resident – RMB 3,500
- Non-PRC tax resident – RMB 4,800

Progressive tax rates on employment income

- 3% to 45% (seven tax brackets)

Corporate Income Tax

All enterprises including foreign investment enterprises, foreign enterprises and Chinese domestic enterprises which derive income within China shall be liable to Corporate Income Tax ("CIT").

PRC Tax Resident

- An enterprise incorporated in China;
- An enterprise which is established under the laws of a foreign country **but** has "effective management" in China

Non-PRC Tax Resident

- An enterprise established under the laws of a foreign country **and** has its place of effective management outside China
- A foreign company which does not have an "establishment" in China

Individual
Income Tax

Corporate
Income Tax

(a) PRC Tax Resident



25% on net taxable income

(b) Non-PRC Tax Resident
with establishment in China



applies “deemed profit rate”

(c) Non-PRC Tax Resident
with no establishment in China



withholding tax at 10% on passive income
(may be reduced under respective
double taxation treaty)

Tax Administration

- Calendar year as the tax year
- Need to file provisional quarterly CIT return within 15 days after the end of each quarter and make tax payments
- Need to file annual CIT return and settle final tax payments within four months after the end of each tax year