13.5 Tax case on loss in a foreign currency

There is one tax case involving the determination of loss to be carried forward:

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

This case is discussed in **Appendix 14**.

14 Special classes of business

Topic highlights

There are specific provisions applicable to special classes of business such as FIs, insurance companies, ship and aircraft owners, clubs and trade associations.

There are specific provisions applicable to special classes of business as follows:

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.

14.1 Financial institutions

'Financial institution' is defined in s.2(1) as follows:

(a) an authorised institution within the meaning of s.2 of the Banking Ordinance;

(b) any associated corporation of such an authorised institution which, being exempt by virtue of s.3(2)(a) or (b) or (c) of the Banking Ordinance, would have been liable to be authorised as a deposit-taking company or restricted license bank under that Ordinance had it not been so exempt.

It should be noted that a registered money lender is not a FI.

14.1.1 Profits tax computations for a FI

In general, the computation of the assessable profits of a FI is the same as that for other businesses, but there are special provisions in ss.15(1)(i) and (1)(l), which apply specifically to interest income and gains from the disposal or sale of certificates of deposits and bills of exchange derived by FIs.

Both ss.15(1)(i) and (1)(l) refer to income 'through or from the carrying on of its business in Hong Kong', and the place where the credit is provided is ignored (i.e. the provision of credit test is not applicable to a FI).

There were disputes between the IRD and the FIs in Hong Kong concerning the tests for the source of income of FIs. The IRD considers the following factors as relevant:

(a) the place where the deposit is accepted;

(b) the place where the deposit is placed;

(c) the place where the credit is provided;

(d) the place where the loan is approved;

(e) the place where the interest is received;

(f) the currency of the loan/credit; and

(g) the place where the record is kept.

In 1986, there was an agreement between the IRD, the tax practitioners and their FI clients on the tax treatment of certain interest and related fee income. In addition to giving certainty to the tax affairs of FIs, the agreement reduced the large number of disputes that had arisen following the 1978 amendment to s.15(1)(i).

The agreed tax treatments as reproduced in DIPN 21 (para 54) are as follows:

	Types of income	Tax treatment
1	**Interest from loans**	
	(a) Offshore loans initiated, negotiated, approved and documented by an associated party outside Hong Kong and funded outside Hong Kong.	100% non-taxable
	(b) Offshore loans initiated, etc. by the Hong Kong institution and funded by it in/from Hong Kong.	100% taxable
	(c) Offshore loans initiated, etc. by an associated party outside Hong Kong but funded by the Hong Kong institution.	50% taxable
	(d) Offshore loans initiated, etc. by a Hong Kong institution but funded by offshore associates.	50% taxable
2	**Interest on certificates of deposit**	
	Acquisition of certificates of deposit will be treated in a similar manner as deposit placements.	100% taxable
3	**Interest from securities other than certificates of deposit**	
	Treated similarly as interest from loans.	see (1) above
4	**Participation, commitment fees etc.**	
	To follow the tax treatment accorded to the related loans.	see (1) above
5	**Active fee**	
	To be determined by reference to the ‘activity test’, i.e. services performed to earn the fee.	Depends on the particular facts of the case
6	**Guarantee/underwriting fees**	
	A principal consideration of source is related to whether or not the risk under the guarantee or underwriting commitment is evaluated and is to be borne by the Hong Kong institution.	Depends on the particular facts of the case

14.1.2 Treatment of loan interest

The tax treatment of the loan interest of a FI may be summarised as follows:

Initiation of loan	Funding of loan	Taxable interest income
Hong Kong	Hong Kong	100%
Hong Kong	Non-Hong Kong	50%
Non-Hong Kong	Hong Kong	50%
Non-Hong Kong	Non-Hong Kong	Nil

If the FI is able to exclude part of its interest income from the charge to profits tax, interest and administrative expenses attributable to the non-taxable interest income have to be disallowed in the tax computation.

14.1.3 Exchange differences, bad debts and foreign tax paid

There are other tax implications for a FI as follows:

Item	Implications	Reference
Exchange differences	Monies are the trading stocks of a FI. In general, exchange gains or losses resulting from normal business transactions in foreign currency are of a revenue nature and taxable or allowable.	*CIR v Hang Seng Bank* Ltd [(1972) 1 HKTC 583]
Bad debts	A FI, being a money lender, is able to claim bad debt deductions for loans advanced in its ordinary course of business.	S.16(1)(d)
Foreign tax paid	Foreign tax paid is allowable in respect of the FI's income chargeable under ss.15(1)(i) and (1)(l).	S.16(1)(c)

DIPN 28 provides guidance on the deductibility of foreign tax paid.

Example 75

A local licensed bank has a profit of $20 million, after taking into account the following items:

(1) A debt of $200,000 from a client who was declared bankrupt and written off.

(2) Tax of $50,000 paid in respect of redemption of a CD effected in Singapore.

(3) Profit of $1,800,000 on the disposal of branch premises in Shatin.

(4) Interest income of $480,000 from a loan provided to a customer in Macau. The loan is initiated and funded by the bank in Hong Kong.

Tax treatments of the items:

(1) Under s.16(1)(d), because of the nature of the business, i.e. money lending, the bank is able to claim a deduction of such loss on money lent.

(2) Under s.16(1)(c), foreign tax paid is specifically allowed because the profits arising from the redemption are deemed trading receipts under s.15(1)(l).

(3) This is generally regarded as a capital profit excluded from the charge to profits tax under s.14(1) .

(4) Notwithstanding that the interest income is sourced in Macau where credit is provided, it is a deemed trading receipt under s.15(1)(i) as the loan is initiated and funded by the bank in Hong Kong.

14.1.4 Branches of a foreign bank

IRR 3 stipulates the methods to assess the profits of the Hong Kong branch of a bank whose head office is outside Hong Kong.

IRR 3 states that where any accounts prepared by a bank for its own purpose disclose, in the opinion of the assessor, the true profits of the Hong Kong branch, the assessable profits shall be computed on the basis of such accounts.

If no accounts are prepared, or such accounts do not show the true profits, then the following formula will be used to compute the assessable profits of the branch:

$$\text{Assessable profits} = \frac{\text{Total HK branch assets}}{\text{Total worldwide assets}} \times \text{Worldwide profits}$$

If it is impracticable or inequitable to adopt the above method, the assessor may estimate the amount of profits of the Hong Kong branch and assess such profits accordingly (s.21).

There are special provisions for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income in relation to banks in DIPN 44.

14.1.5 Tax cases on FIs

The following cases relate to FIs:

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

These cases are discussed in **Appendix 14**.

14.2 Life insurance companies

Life insurance is often called life assurance. Unlike general insurance which insures against a risk which may never occur (e.g. a fire), life insurance 'assures' against an event (death) which, given a large enough group of individuals, can be estimated with some certainty.

In life insurance, the role of an actuary is to assess the risk involved in 'insuring' an individual's life based on characteristics such as age, sex, employment, smoking habit, location; and to devise a suitable amount of premium for that individual having regard to his or her particular circumstances. The actuary will also be responsible for ensuring the solvency of the insurance company, calculating the amount of the insurance company's liabilities to policyholders and devising new insurance products based on tables of death rates (mortality experience), future investment rates and related expenses.

Under s.23, life insurance business refers to business of the following classes as specified in Part 2 of the First Schedule to the Insurance Companies Ordinance:

(a) life and annuity;
(b) marriage and birth;
(c) linked long term; and
(d) tontines.

Section 23 provides two methods of ascertaining the assessable profits of a life insurance business. One is a simple method that produces a notional profit. The other is a more complicated

method involving actuarial valuation and is only applicable upon an election from the taxpayer. An election is only effective if the actuaries' report is submitted to the IRD within two years of the date the report is made up. Such election is irrevocable and once made, it is deemed to apply to all subsequent years of assessment.

14.2.1 Method 1 (5% method)

Assessable profits are deemed to be 5% of the premium from life insurance business in Hong Kong during the basis period for the year of assessment (s.23(1)(a)). If this method is used, no depreciation allowance can be considered and actual loss cannot be set off.

'Premium from life insurance business in Hong Kong' includes:

(a) all premiums received or receivable in Hong Kong whether from residents or non-residents; and

(b) all premiums, received or receivable elsewhere, from Hong Kong residents where the premiums are in respect of policies the proposals for which were received in Hong Kong.

Returned premiums or reinsurance premiums relating to those received may be deducted before applying the 5% (s.23(9)).

Example 76

In the year ended 31 December 2012, a life insurance company received the following:

(1) Premiums of $10 million received in Hong Kong from Hong Kong residents.

(2) Premiums of $5 million received in Toronto from Hong Kong residents (the policies concerned were proposed in Toronto).

In the same year, the company paid the following:

(3) Refund of overpaid premiums of $50,000 due to a mistake in the computation.

(4) Reinsurance premiums of $400,000 to other insurance companies.

Under the 5% method, the assessable profit is 5% of the premiums from the company's life insurance business in Hong Kong, which should not include those premiums in (2) above. Any returned premiums or reinsurance premiums are deductible before the 5% rate is applied.

Therefore, the profits tax liability for the company for the year of assessment 2012/13 is:

Assessable profit = $(10m – 50,000 – 400,000) × 5% = $477,500

Profits tax payable at 16.5% is $78,787

14.2.2 Method 2 (Adjusted surplus method)

Upon an election from the taxpayer, part of the adjusted surplus ascertained in accordance with the specific rules under s.23(1)(b) will be the assessable profits of the life insurance business.

'Adjusted surplus' is the surplus by which the life insurance fund exceeds the estimated liability of the company on the life insurance fund at the end of the period in respect of which any actuarial report is made (s.23(4)(a)). To ascertain the adjusted surplus, the following adjustments are required to be made against the surplus (s.23(4)(b)).

Additions to the surplus include:

(a) deficit of a previous period included in the life insurance fund;
(b) disallowable expenses under ss.16 and 17 charged against the life insurance fund;
(c) profits not credited to the life insurance fund;
(d) appropriations of profits or transfers to reserve, other than those made to policy holders; and
(e) balancing charge.

Deductions from the surplus include:

(f) surplus of a previous period retained in the life insurance fund;
(g) allowable expenses under s.16 not charged against the life insurance fund;
(h) capital receipts or transfers from reserve credited to the life insurance fund;
(i) appropriations to policyholders not charged against the life insurance fund; and
(j) depreciation allowances.

Since an actuarial report may cover more than one year of assessment, apportionment may be required as follows:

$$\text{Assessable profits} = \text{Adjusted surplus} \times \frac{\text{Premiums from life insurance business in HK in a basis period}}{\text{Total life insurance premiums in HK covered by the actuarial report}}$$

Example 77

Betterlife Insurance Ltd commenced a life insurance business in Hong Kong on 1 January 2009. It submitted its first actuarial report for the period from 1 January 2009 to 31 December 2012 and elected for the ascertainment of its assessable profits under s.23(1)(b). Further information is provided below:

	$
Value of life fund at 31/12/2012	4,800,000
Actual liability on policies comprising life fund at 31/12/2012	3,500,000
Premium received (4 years)	
From Hong Kong	5,000,000
($1m for 2009, $1.2m for 2010, $1.3m for 2011 and $1.5m for 2012)	
From overseas	3,500,000
($0.6m for 2009, $0.8m for 2010, $1m for 2011 and $1.1m for 2012)	
Management expenses not yet charged to the fund	250,000
Profits on disposal of fixed assets	150,000
Transfer from contingent reserves	200,000
Transfer to contingent reserves	350,000
Depreciation allowances (4 years)	75,000
A sum which has not been made to policy holders	125,000

The adjusted surplus of the life insurance fund for the period from 1 January 2009 to 31 December 2012 is ascertained as follows:

	$
Life fund at 31/12/2012	4,800,000
Liability at 31/12/2012	(3,500,000)
Excess of life fund (s.23(4)(a))	1,300,000
Add: Transfer to contingent reserves	350,000
	1,650,000
Less: Management expenses	(250,000)
Profits on disposal of fixed assets	(150,000)
Transfer from contingent reserves	(200,000)
Depreciation allowances (4 years)	(75,000)
Appropriations to policy holders	(125,000)
Adjusted surplus	**850,000**

This adjusted surplus shall be deemed to be the assessable profits for the basis periods for which the actuarial report is made. It is then allocated to each basis period according to the amount of premium arising in each period as follows:

2009/10	Year ended 31/12/2009	$850,000 × 1.6m/8.5m	= $ 160,000
2010/11	Year ended 31/12/2010	$850,000 × 2m/8.5m	= $ 200,000
2011/12	Year ended 31/12/2011	$850,000 × 2.3m/8.5m	= $ 230,000
2012/13	Year ended 31/12/2012	$850,000 × 2.6m/8.5m	= $ 260,000
			$ 850,000

The adjusted surplus may be related to the company's life insurance businesses in Hong Kong and overseas. To compute the Hong Kong sourced profits from life insurance business within Hong Kong, apportionment is made on the basis of the total premiums arising during the period of the actuarial report from life insurance business in Hong Kong to the total premiums for the period.

$$\text{Assessable profits} = \text{Adjusted surplus} \times \frac{\text{Premiums from life insurance business in HK}}{\text{Total premiums from life insurance business}}$$

Example 78

If in Example 77, premiums received from overseas are derived from proposals made overseas, then the Hong Kong portion of adjusted surplus will be:

$850,000 × 5m/8.5m = $500,000

This adjusted surplus shall be deemed to be the assessable profits for the basis periods for which the actuarial report is made. It is then allocated to each basis period according to the amount of premium arising in each period as follows:

2009/10	Year ended 31/12/2009	$500,000 × 1m/5m	= $ 100,000
2010/11	Year ended 31/12/2010	$500,000 × 1.2m/5m	= $ 120,000
2011/12	Year ended 31/12/2011	$500,000 × 1.3m/5m	= $ 130,000
2012/13	Year ended 31/12/2012	$500,000 × 1.5m/5m	= $ 150,000
			$ 500,000

14.2.3 Tax cases on life insurance business

There is no tax case relating to life insurance business.

14.3 Non-life insurance companies

Section 23A deals with the ascertainment of assessable profits of insurance businesses (whether mutual or proprietary) other than life insurance. The computation of assessable profits of a non-life insurance company in most cases follows the financial accounts, subject to the apportionment between onshore and offshore businesses and the usual statutory adjustments.

It is specifically provided under s.23A(1) that the assessable profits of non-life insurance companies are to be ascertained as follows:

Gross premiums from insurance business in Hong Kong

Add:

(a) interest or other income arising in or derived from Hong Kong;
(b) balancing charge; and
(c) reserve for unexpired risks outstanding at the commencement of the period;

Less:

(d) returned premiums;
(e) corresponding re-insurance premiums;
(f) reserve for unexpired risks outstanding at the end of the period;
(g) actual losses (less reinsurance recoveries);
(h) agency expenses;
(i) fair proportion of head office expenses; and
(j) depreciation allowances.

'Premium from insurance business in Hong Kong' includes (s.23A(2)):

(a) all premiums in respect of insurance contracts, other than life insurance, made in Hong Kong; and

(b) all premiums on insurance contracts, other than life insurance, the proposals for which were made to the company in Hong Kong.

Example 79

General Insurance Ltd carries on its business in general insurance in Hong Kong since 1 July 2009. It makes up accounts to 31 March. The following information is extracted from its accounts for the year ended 31 March 2013:

	$
Gross premiums received (Note 1)	15,600,000
Reinsurance recoveries received	350,000
Profit from investments	52,000
Profit from sale of office premises (Note 2)	1,300,000
Loss from sale of residential properties (Note 3)	(550,000)
Rental from properties let	360,000
Interest from bank deposits	30,000
Dividends from listed shares	61,000
	17,203,000
Less: Reinsurance premiums paid	(4,100,000)
Commissions paid	(3,780,000)
Claims paid and payable	(1,280,000)
Management expenses	(3,430,000)
Depreciation	(450,000)
Increase in provision for unexpired risks	(1,500,000)
Net profit	2,663,000

Notes:

(1) All insurance contracts were executed in Hong Kong.

(2) The office premises, which had been used for 15 years, were sold when the company moved to new office premises.

(3) The properties were acquired 18 years ago for rental income only.

(4) Depreciation allowances as agreed with the Assessor are $240,000.

Required:

Prepare the profit tax computation for General Insurance Ltd for the year of assessment 2012/13.

Solution

Profits tax computation for General Insurance Ltd
Year of assessment 2012/13
Basis period: year ended 31 March 2013

	$
Net profit per accounts	2,663,000
Add: Depreciation	450,000
	3,113,000
Less: Profit from sale of office premises (Note 2)	(1,300,000)
Interest from bank deposits	(30,000)
Dividends from listed shares	(61,000)
Depreciation allowances	(240,000)
Assessable profits	1,482,000
Profits tax payable at 16.5%	244,530

Explanations:

(1) Profits from sale of the office premises are capital in nature and not taxable.

(2) Profits from investments are taxable while losses from sale of residential properties are deductible (*Sincere Insurance and Investment Co Ltd v CIR* (1973) 1 HKTC 602).

(3) Dividends are exempt under s.26(a).

(4) Interest income is exempt from profits tax under the Exemption Order.

A non-resident insurance company with limited business transacted in Hong Kong may be permitted to ascertain its assessable profits by reference to the proportion of the total profits and income of the company corresponding to the proportion which its premiums from insurance business in Hong Kong bear to its total premiums or on any other basis which appears to the Commissioner to be equitable (s.23A(1) proviso).

14.3.1 Qualifying reinsurance business

Pursuant to s.23A(2), where a non-life insurance company carries on the business of reinsurance of offshore risk as a professional reinsurer, the assessable profits derived from such business for a year of assessment shall be ascertained in accordance with the following formula:

Formula to learn

$$A = \frac{B}{C} \times D$$

A means such assessable profits;

B means the assessable profits of the non-life insurance company during that basis period for that year of asesssment as computed in accordance with s.23A(1) (see **section 14.3** above);

C means the aggregate of the total income earned by or accrued to that non-life insurance company during that basis period for that year of assessment; and

D means the aggregate of offshore reinsurance income earned by or accrued to that non-life insurance company during that basis period for that year of assessment.

Pursuant to s.14B, the assessable profits of a non-life insurance company derived from the business of reinsurance of offshore risks as a professional reinsurer within the meaning of s.23A(2) are, upon an irrevocable election by the company in writing, chargeable to profits tax at 50% of the tax rate as a concessionary trading receipt.

14.3.2 Definitions in s.23A(2)

'Professional reinsurer' means a company authorised to carry on, in or from Hong Kong, reinsurance business only, under s.8 of the Insurance Companies Ordinance.

'Offshore reinsurance income' means any sums derived from, attributable to, or in respect of:

(a) premiums from reinsurance of offshore risks;

(b) gains or profits from offshore reinsurance investments.

'Premiums from reinsurance of offshore risks' means premiums received by a professional reinsurer in respect of the reinsurance of any risk outside Hong Kong or in transit in Hong Kong, and:

(a) in relation to facultative general reinsurance, the reinsured is not a person resident in Hong Kong or a PE maintained in Hong Kong.

(b) in relation to treaty general reinsurance, not less than 75% of the total risk in terms of gross premiums is outside Hong Kong or is in transit in Hong Kong.

'Gains or profits from offshore reinsurance investments' mean any sums derived from, attributable to, or in respect of gains or profits arising from the sale or other disposal of, or on the redemption on maturity or presentment of, and any interest received on:

(a) investments made with premiums from reinsurance of offshore risk.

(b) investments representing the whole or any part of the technical reserves of a professional reinsurer referable to premiums from reinsurance of offshore risks.

14.3.3 Tax cases on non-life insurance companies

There are two cases involving non-life insurance companies:

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

These cases are discussed in **Appendix 15**.

14.4 Mutual insurance companies

Mutual insurance companies are owned by the policyholders who share the profits made by the insurance companies, usually by way of lower premiums or higher bonuses.

Under s.23AA, a mutual insurance company shall be deemed to carry on an insurance business, the surplus from which shall be ascertained in the manner provided in ss.23 and 23A for ascertaining the assessable profits and shall be deemed to be assessable profits chargeable to tax under s.14.

14.5 Ship owners

Section 23B lays down the scope of charge on ship owners and provides for the ascertainment of assessable profits for the shipping operations in Hong Kong.

'Ship owner' includes an owner or a charterer of a ship who carries on a business of chartering (letting of a ship under a charter party) or operating ships in Hong Kong. It does not include one who is only involved with dealing in ships or shipping agency business (i.e. with demise of the vessel).

There are three main types of charter party (the contract or agreement between the ship owner and the charterer for the hiring of a ship):

(a) bareboat charter;
(b) time charter; and
(c) voyage charter.

Chartering a ship out on **bareboat charter** is similar to letting out an unfurnished house by a landlord. The charterer has to:

(a) employ and pay the crew;
(b) control the management and operation of the ship; and
(c) ensure that the ship is adequately insured.

Bareboat charter may be referred to as 'charter with demise of the ship' and the charterer as 'despondent owner' of the chartered ship.

Chartering a ship out on **time charter** is similar to letting out a fully furnished house with support staff and services provided by a landlord. The charter hire will cover:

(a) crew and related expenses;
(b) food, water, stores, supplies, equipment etc.; and
(c) repairs and maintenance, hull and machinery insurance, annual and special survey fees, etc.

Voyage charter is for hiring a ship from one port to another port (i.e. one voyage). The charter hire paid by the charterer is usually based on a tonnage basis.

Under s.23B, a ship owner is deemed to carry on a business of chartering or operating ships in Hong Kong if:

(a) the business is normally controlled or managed in Hong Kong (s.23B(1)(a)); or

(b) the person is a company incorporated in Hong Kong (s.23B(1)(b)); or

(c) in any other case, any ship owned by the ship owner calls at any location within the waters of Hong Kong (s.23B(2)).

For non-resident ship owners (a company which is neither incorporated nor managed and controlled in Hong Kong), where the call of a ship in Hong Kong is casual, and further calls are not likely, the Commissioner may direct that the non-resident ship owner shall not be deemed to be carrying on a business of chartering or operating ships in Hong Kong by reason of a casual call (s.23B(6)).

A non-resident ship owner may be regarded as having a reciprocity status if the Commissioner is satisfied that the shipping income of a Hong Kong ship owner is exempt from tax of substantially the same nature as profits tax in the territory which is resident by the non-resident ship owner. The shipping income of a non-resident ship owner who has a reciprocity status is not chargeable to tax in Hong Kong.

Ship dealing business or agency business in connection with shipping is outside the scope of s.23B. However, profits from these businesses should be considered under the principles applicable to the operation of the basic charge under s.14(1); i.e. the two-limb test of whether the business is carried on in Hong Kong, and whether the profits from such business carried on in Hong Kong are sourced in Hong Kong.

14.5.1 Profits tax computations for a ship owner

The formula for computing the assessable profits of a ship owner in a year of assessment is the same for both resident and non-resident ship owners as follows (s.23B(3)):

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

However, for a non-resident ship owner, where the assessor is of the opinion that the above formula cannot be satisfactorily applied, the assessable profits for a year of assessment may be computed on the basis of a fair percentage of the aggregate of the relevant sums (s.23B(4)). Where the assessable profits have been computed on a fair percentage basis, the non-resident ship owner is entitled to elect in writing at any time within two years from the end of the year of assessment for his assessable profits for that year to be re-computed by using the above formula (s.23B(5)).

All other income which is outside the scope of s.23B (such as interest income, ship dealing income and agency income) are excluded from the total shipping profits. After the assessable profits have been ascertained, the excluded other income (net of expenses) will be added back to arrive at the assessable profits of the whole shipping company.

'Relevant sums' refers to sums, other than exempt sums, derived from, attributable to, or in respect of:

(a) carriage of goods and/or passengers, etc; shipped in Hong Kong except goods in transit and re-embarking passengers. **'Shipped in Hong Kong'** means shipped aboard a ship at any location within Hong Kong waters; (in the case of passengers, **'shipped'** means embarked)

(b) towage operations within Hong Kong waters, or commencing from any location within Hong Kong waters;

(c) dredging operations within Hong Kong waters;

(d) charter hire and the ship operates solely or mainly within Hong Kong waters;

(e) charter hire under any charter party where one of the parties is a limited partnership, and the main asset of the limited partnership is a ship or an interest in a ship; and

(f) half of any charter hire income for a ship operating between Hong Kong waters and the river trade limits.

In *CIR v Zim Israel Navigation Co Ltd* (1972) [1 HKTC 573], it was decided that the grants given to the company to cover its operating losses of passenger vessels should be caught by the words 'in respect of the carriage of passengers'.

'Goods in transit' means goods specified in a bill of lading as emanating from and going to a foreign port and are brought to Hong Kong solely for onward shipping elsewhere, and the onward freight charges from Hong Kong are not payable in Hong Kong.

'Re-embarking passengers' means passengers whose tickets indicate that neither their place of departure nor their destination for that voyage is Hong Kong.

'Charter hire' means any sums earned by or accrued to an owner of a ship under a charter party in respect of the operation of the ship, but does not include any sums so earned or accrued where that charter party does not, or does not purport to, extend to the whole of that ship. Charter hire not extended to the whole of a ship will be treated as income from carriage of goods or passengers.

'River trade limits' means waters between Hong Kong waters and ports within the Pearl River Delta, i.e. Macau and the Chinese ports in the Pearl River Delta.

'Exempt sums' means:

(a) income from carriage of goods or passengers aboard a registered ship at any location within the Hong Kong waters and proceeding to sea from that location or any other location within those waters.

(a) income from any towage operation undertaken by a registered ship proceeding to sea from any location within the Hong Kong waters.

(c) sums derived by a non-resident ship owner who has a reciprocity status from:

  (i) the carriage of goods and/or passengers aboard a ship at any location within the Hong Kong waters and proceeding to sea from that location or any other location within those waters; or

(ii) any towage operation undertaken by a ship proceeding to sea from any location within the Hong Kong waters.

A **'registered ship'** means a ship which is registered in Hong Kong under the Merchant Shipping (Registration) Ordinance. The exclusions relating to registered ships in Hong Kong apply from 3 December 1990, the date that the Merchant Shipping (Registration) Ordinance became effective and introduced the new Hong Kong Shipping Register. The purpose of such exemptions is to attract ship owners to register their ships in Hong Kong.

'Total shipping income' refers to the worldwide income from the operation of a shipping business other than ship dealing income, ship agency income and other investment income (e.g. interest income or dividend). It includes operating subsidies, interest on overdue accounts, casual salvage awards and those Hong Kong shipping incomes that are excluded from the relevant sums in the case of Hong Kong registered ships.

'Total shipping profits' refers to the worldwide shipping profits. If such profits have been computed on a basis which differs materially from Hong Kong profits tax, the profits may be adjusted so as to correspond as nearly as may be to the sum that would have been arrived at in accordance with the provisions in Part IV of the IRO (s.23E). The more usual adjustments are to exclude profits or losses on sale of ships, agency profits, capital receipts and expenditures, and to replace accounting depreciation by depreciation allowances.

Example 80

HK Shipping Ltd is a company incorporated in Hong Kong. It owns a fleet of ships, all of which are registered on the Hong Kong Shipping Register established under the Merchant Shipping (Registration) Ordinance. It is controlled and managed in Hong Kong. Its business includes the chartering and operating of ships as well as shipping agencies and dealing in ships. Its operating results for the year ended 31 March 2013 are as follows:

	$
Net profit per accounts	21,000,000
Total turnover for the year ended 31 March 2013 amounted to $92,760,000, comprising the following items:	
(A) Sums derived from, attributable to or in respect of:	
(i) carriage of goods and passengers shipped in HK within HK waters	8,300,000
(ii) carriage of goods and passengers shipped in HK to foreign ports	26,000,000
(iii) carriage of goods shipped to HK from Taiwan	1,000,000
(iv) towage and dredging operations undertaken within HK waters	3,000,000
(v) charter hire where the ships navigated within HK waters	5,000,000
(vi) charter hire where the ships navigated between HK waters and the river trade waters	11,500,000
	54,800,000
(B) Gross receipts from shipping agencies	2,900,000
(C) Proceeds from sale of ships in HK (cost $27m)	35,000,000
(D) Income from HK dollar deposits placed with local banks	60,000

The attributable overhead costs as agreed by the assessor are as follows:

(a) Agency receipts – 40% of income

(b) Ship dealing – 10% of sale proceeds

The remaining overhead costs charged in the accounts are attributable to the total shipping income.

Required:

Prepare the profit tax computation for General Insurance Ltd for the year of assessment 2012/13.

Solution

Profits tax computation for HK Shipping Ltd
Year of assessment 2012/13
Basis period: year ended 31 March 2013

	$
(a) Total shipping profits	
Net profit per accounts	21,000,000
Less: Net agency receipts ($2.9m × 60%)	(1,740,000)
Net ship dealing income ($35m × 90% – $27m)	(4,500,000)
Interest income	(60,000)
	14,700,000
(b) Relevant sums	
Carriage of goods and passengers shipped in HK within HK waters	8,300,000
Towage and dredging operations undertaken within HK waters	3,000,000
Charter hire where the ships navigated within HK waters	5,000,000
Charter hire where the ships navigated between HK waters and the river trade waters ($11.5m × 50%)	5,750,000
	22,050,000
(c) Total shipping income	54,800,000

(d) Assessable profits of business as an owner of ships

$$= \text{total shipping profits} \times \frac{\text{Relevant sums}}{\text{Total shipping income}}$$

= $14,700,000 × $22,050,000 / $54,800,000

= $5,914,872

(e) Total assessable profits	$
Business as an owner of ships	5,914,872
Add: Net agency receipts	1,740,000
Net ship dealing income	4,500,000
Total assessable profits	12,154,872
(f) Profits tax payable at 16.5%	2,005,553

Explanations:

(1) Sums in A(i), (iv) and (v) are relevant sums because the operations were solely in Hong Kong.

(2) Sums in A(ii) are exempt sums because the goods and passengers were shipped aboard registered ships in Hong Kong.

(3) Sums in A(iii) are not relevant sums because the goods were not shipped aboard a ship in Hong Kong.

(4) Half of the sums in A(iv) are relevant sums because the ships operated between Hong Kong and the river trade limits.

(5) Interest income is exempt from profits tax under the Exemption Order.

Self-test question 9

Identify the 'relevant sums' of a ship owner under the IRO and complete the following table.

Sums derived from, attributable to, or in respect of:	Relevant sums
Carriage of passengers, goods etc	
(a) Within Hong Kong waters	
(b) From Hong Kong to waters within the river trade limits (ports within the Pearl River Delta)	
(c) From Hong Kong to waters outside the river trade limits (overseas)	
(i) a ship owner who has a reciprocity status	
(ii) a Hong Kong registered ship	
(iii) other ships	
(d) From overseas to Hong Kong	
(e) Trans-shipments	
Towage operations	
(a) Within Hong Kong waters	
(b) From Hong Kong to waters within the river trade limits (ports within the Pearl River Delta)	
(c) From Hong Kong to waters outside the river trade limits (overseas)	
(i) a ship owner who has a reciprocity status	
(ii) a Hong Kong registered ship	
(iii) other ships	
(d) From overseas to Hong Kong	
Dredging operations	
(a) Within Hong Kong waters	
(b) Outside Hong Kong waters	
Charter hire	
(a) For a charter party with a limited partnership	
(b) For a ship operated within Hong Kong waters	
(c) For a ship operated within the river trade limits (ports within the Pearl River Delta)	
(d) For a ship operated outside Hong Kong waters and the river trade limits	

(The answer is at the end of the chapter)

14.5.2 Double taxation relief (Income from shipping operations) (United States of America) Order 1989

On 29 August 1989, an Order was made (with retrospective effect to years on or after 1 January 1987) under s.49 to ratify the arrangement made in respect of the taxation of income derived by residents of Hong Kong and the United States from the international operation of ships (not including aircrafts).

Under the arrangement, no US tax shall be imposed on the gross income derived from the international operation of ships by Hong Kong residents and Hong Kong controlled and managed corporations. Correspondingly, Hong Kong will not charge profits tax on US-based ship owning businesses under the old s.23C (repealed on 3 June 1992).

DIPN 19 provides guidance on the double tax arrangement ('DTA') between Hong Kong and the US on international shipping income.

14.5.3 Double taxation arrangement with other countries

In November 2003, there was another DTA on shipping and air services income with Singapore. A similar agreement with Sri Lanka was entered into in November 2004. There are also 5 DTAs on shipping income with the United Kingdom, the Netherlands, Germany, Norway and Denmark on international shipping income. Shipping income chargeable to Hong Kong profits tax by virtue of s.23B(2) are exempted if the owners are resident of Korea or New Zealand, and *vice versa*.

The Avoidance of Double Taxation on shipping and air services income is also covered by the comprehensive DTAs signed by Hong Kong Government. As of 1 June 2013, Hong Kong has signed 29 comprehensive DTAs with jurisdictions including Belgium, Thailand, the Mainland of China, Luxembourg, Vietnam, Brunei, the Netherlands, Indonesia, Hungary, Kuwait, Austria, the United Kingdom, Ireland, Liechtenstein, France, Japan, New Zealand, Switzerland, Portugal, Spain, the Czech Republic, Malta, Jersey, Malaysia, Mexico, Canada, Italy, Guernsey and Qatar.

For details, refer to **chapter 12 'Double Taxation Arrangements and Agreements'**.

14.5.4 The Arrangement for the Avoidance of Double Taxation between the Mainland and the HKSAR

Pursuant to Article 2 of The Arrangement between the Mainland of China and the Hong Kong SAR on for the Avoidance of Double Taxation on Income, the shipping income from operations carried on by Hong Kong residents in the Mainland would be exempt from enterprise income tax and business tax in the Mainland. The shipping income of Mainland residents from operations carried on in Hong Kong would be exempt from Hong Kong profits tax.

DIPN 32 provides guidance on the original DTA between the HKSAR and the Mainland.

The Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion was signed between the HKSAR and the Mainland on 21 August 2006. Article 8 of the Arrangement provides that revenue and profits derived by an enterprise of the Mainland or Hong Kong from the operation of ships in shipping transport businesses in the Other Side (except when the ship is operated solely between places in the Other Side) shall be exempt from tax in that Other Side (see DIPN 44).

14.5.5 Tax case on non-resident ship owner

There is one case relating to a non-resident ship owner:

Taxpayer	Subject matter	Reference
Zim Israel Navigation Co Ltd	Grants from Government	(1972) 1 HKTC 573

This case is discussed in **Appendix 16**.

14.6 Hong Kong aircraft owners

Section 23C applies to resident aircraft owners. Under this section, the chargeable person is an aircraft owner (either the owner or the charterer of an aircraft) who carries on a business of chartering (letting of an aircraft under a charter party) or operating aircraft in Hong Kong. Similar to the letting of a ship, an aircraft may be chartered on bareboat charter, time charter and flight charter.

'Aircraft owner' includes a person who charters an aircraft from another person, but does not include one whose business only involves dealing in aircraft or aircraft agency.

'Aircraft' includes a helicopter. Aircraft dealing business or agency business in connection with air transport is outside the scope of s.23C. However, profits from these businesses should be considered under the principles applicable to the operation of the basic charge under s.14(1); i.e. the two-limb test of whether the business is carried on in Hong Kong, and whether the profits from such business carried on in Hong Kong are sourced in Hong Kong.

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

(a) the business is normally controlled or managed in Hong Kong (s.23C(1)(a)); or

(b) the owner is a company incorporated in Hong Kong (s.23C(1)(b)).

14.6.1 Profits tax computations for a resident aircraft owner

The formula in computing the assessable profits of a resident aircraft owner is laid down in s.23C(2) as follows:

Formula to learn

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

All other income which is outside the scope of s.23C (such as interest income, aircraft dealing income and agency income) are excluded from the total aircraft profits. After the assessable profits have been ascertained, the excluded other income (net of expenses) will be added back to arrive at the assessable profits of the whole aircraft company.

'Relevant sums' refers to sums derived from, attributable to, or in respect of:

(a) carriage of goods and/or passengers; by air shipped in Hong Kong except goods or passengers in transit. **'Shipped in Hong Kong'** means shipped aboard an aircraft at any aerodromes or airport within Hong Kong (in the case of passengers, **'shipped'** means embarked);

(b) flight charter;

(c) time charter;

(d) charter hire which is not attributable to a PE outside Hong Kong;

(e) charter hire in respect of flights between aerodromes or airports within Hong Kong; and

(f) half of any charter hire income for flights between Hong Kong and Macau.

'Goods in transit' means goods specified in any 'airway bill' or a 'post office delivery bill' as emanating from and going to another country, which are brought to Hong Kong solely for onward carriage to another country, and whose onward freight charges from Hong Kong are not payable in Hong Kong (s.23C(5)).

'Passengers in transit' means passengers whose tickets do not specify Hong Kong as the place of destination; or who fly to Hong Kong and leave again by the same carrier having been in Hong

Kong for not more than 24 hours and whose destination is different from their place of departure (s.23C(5)).

'Charter hire' means any sums earned by or accrued to an owner of an aircraft under a charter party by demise in respect of the operation of the aircraft, but does not include any sums so earned or accrued where that charter party does not, or does not purport to, extend to the whole of that aircraft (s.23C(5)). Charter hire not extended to the whole of an aircraft will be treated as income from carriage of goods or passengers.

'Charter party by demise' means a charter party under which the charterer has the possession of the aircraft and has sole control of all matters relating to the flying and operation of the aircraft including the employment of the air crew members. If the aircraft owner provides the aircraft master and crew, there is no demise of the aircraft and the hire income is income from carriage of goods and/or passengers. The following types of **charter party without demise** are deemed to be income from carriage of goods and/or passengers:

(a) Flight charter (without demise) – amount attributable to any outward flight commencing in Hong Kong is included as a relevant sum (s.23C(4)(a)).

(b) Time charter (without demise) – the following sum is included as a relevant sum:

$$\text{Charter hire income} \times \frac{\text{Total flying hours for outward flights commencing in HK}}{\text{Total flying hours under the time charter party}}$$

'Permanent establishment' for the purpose of determining whether a charter hire is a relevant sum, means a branch, management or other place of business, but does not include an agency unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of his principal (s.23C(5)).

'Total aircraft income' refers to the worldwide income from the operation of an aircraft business but excluding aircraft dealing income, aircraft agency income and other investment income (e.g. interest income or dividend): s.23C(5).

'Total aircraft profits' refers to the worldwide profits from the operation of an aircraft business. If such profits have been computed on a basis which differs materially from Hong Kong profits tax, the profits may be adjusted so as to correspond as nearly as may be to the sum that would have been arrived at in accordance with the provisions in Part IV of the IRO (s.23E). The more usual adjustments are to exclude profits or losses on sale of aircrafts, agency profits, capital receipts and expenditures, and to replace accounting depreciation by depreciation allowances.

Example 81

A Hong Kong-based aircraft company owns a number of aircrafts engaged in both chartering and operating aircraft activities. It has the following turnover during the year ended 31 March 2013:

	$
(a) (i) Carriage of passengers transported from HK to other countries (including $1,000,000 in respect of carriage of passengers in transit)	6,000,000
(ii) Carriage of passengers transported to HK from other countries	3,000,000
(b) (i) Carriage of goods transported from HK to other countries (including $500,000 in respect of goods transhipped to HK from the Mainland solely for onward carriage to other countries. 50% of these freight charges were billed in and payable in HK)	2,000,000
(ii) Carriage of goods transported to HK from other countries	1,500,000
(c) Charter hire by demise for aircrafts operated outside HK	1,200,000
(d) Charter hire by demise concluded by the Taiwan branch for aircrafts operated outside HK	800,000
(e) Charter hire by demise for flights between HK and Macau	1,000,000

	$
(f) Charter hire not by demise for time charters (flight hours from HK to destinations were 500 out of 1,500 total flight hours)	900,000
(g) Dividend income	100,000
	16,500,000

Analysis of turnover:

	$
(a) (i) A relevant sum except for passengers in transit, i.e. those who arrive and leave by the same carrier and do not stay longer than 24 hours.	5,000,000
(ii) Not a relevant sum because it is not in respect of passengers uplifted in Hong Kong.	---
(b) (i) $1.5 million is a relevant sum because it is in respect of goods uplifted in Hong Kong. Half of $500,000 is also a relevant sum because those goods in transit do not qualify for exclusion since the freight charges were payable in Hong Kong.	1,750,000
(ii) Not a relevant sum because it is not in respect of uplifting of goods in Hong Kong.	---
(c) A relevant sum because the charter party is not attributable to a PE outside Hong Kong	1,200,000
(d) Not a relevant sum because the charter party is attributable to a PE outside Hong Kong	---
(e) For flights between Hong Kong and Macau, only half of the sum is a relevant sum.	500,000
(f) Deemed relevant sum = $900,000 × 500/1500	300,000
(g) Not a relevant sum for not being aircraft income under s.23C.	---
Total relevant sums	**8,750,000**

Self-test question 10

Identify the relevant sums of a resident aircraft owner under the IRO, and complete the following table.

Sums derived from, attributable to, or in respect of:	Relevant sums
Carriage of passengers, goods etc	
(a) Within Hong Kong	
(b) From Hong Kong to overseas	
(c) From overseas to Hong Kong	
(d) Trans-shipments	
Charter hire (charter party by demise)	
(a) For an aircraft operated within Hong Kong	
(b) For an aircraft operated between Hong Kong and Macau	
(c) For an aircraft operated outside Hong Kong (charter party not attributable to a PE outside Hong Kong)	
(d) For an aircraft operated outside Hong Kong (charter party attributable to a PE outside Hong Kong)	

Sums derived from, attributable to, or in respect of:	Relevant sums
Charter hire (charter party without demise)	
(a) For an aircraft operated within Hong Kong	
(b) For flights from Hong Kong to overseas	
(i) flight charter	
(ii) time charter (on proportion of outward flights flying hours/total flying hours)	
(c) For flights from overseas to Hong Kong	
Charter hire (charter party not extended to the whole aircraft)	
(a) For an aircraft operated within Hong Kong	
(b) For flights from Hong Kong to overseas	
(c) For flights from overseas to Hong Kong	

(The answer is at the end of the chapter)

14.6.2 Double tax arrangements on international aviation income

With effect from 17 May 1996, 'relevant sums' earned by or accrued to any person under a DTA by virtue of s.49 shall include any sums derived from, attributable to, or in respect of any relevant carriage shipped in an arrangement territory and charter hire in respect of the operation of an aircraft flying between aerodromes or airports within an arrangement territory. The amendment enables the IRD to tax resident airlines' income from operations in other countries, provided Hong Kong had entered into a tax treaty that exempted the income from tax in those countries.

The 'relevant sums' specified above shall not apply to any sums derived from, attributable to, or in respect of any relevant carriage shipped in an arrangement territory and any relevant charter hire attributable to an arrangement territory where such sums are chargeable to tax in an arrangement territory.

A DTA on shipping and air services income was entered into with Singapore in November 2003. A similar agreement with Sri Lanka was entered into in November 2004. In respect of international aviation income, Hong Kong has entered into 29 DTAs with Bangladesh, Belgium, Canada, Croatia, Denmark, Estonia, Ethiopia, Fiji, Finland, Germany, Iceland, Israel, Jordan, Kenya, Korea, Kuwait, Laos (pending order by Chief Executive in Council), Macau SAR, the mainland of China, Maldives, Mauritius, Mexico, the Netherlands, New Zealand, Norway, the Russian Federation, Sweden, Switzerland and the United Kingdom.

Pursuant to Article 2 of The Arrangement Between the Mainland of China and the Hong Kong SAR for the Avoidance of Double Taxation on Income signed in 1998, the aviation income from operations carried on by Hong Kong residents in the Mainland would be exempt from enterprises income tax and business tax in the Mainland (see DIPN 32). The aviation income of Mainland residents from operations carried on in Hong Kong would be exempt from Hong Kong profits tax.

The Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion that was signed between HKSAR and the Mainland on 21 August 2006 also includes such exemptions. Article 8 of the Arrangement provides that revenue and profits derived by an enterprise of the Mainland or Hong Kong from the operation of aircraft in air transport businesses in the Other Side (except when the aircraft is operated solely between places in the Other Side) shall be exempt from tax in the Other Side (see DIPN 44).

The Avoidance of Double Taxation on air services income is also covered by the comprehensive DTAs signed by Hong Kong Government. As of 1 June 2013, Hong Kong has signed 29 comprehensive DTAs with jurisdictions including Belgium, Thailand, the Mainland of China, Luxembourg, Vietnam, Brunei, the Netherlands, Indonesia, Hungary, Kuwait, Austria, the United Kingdom, Ireland, Liechtenstein, France, Japan, New Zealand, Switzerland, Portugal, Spain, the

Czech Republic, Malta, Jersey, Malaysia, Mexico, Canada, Italy, Guernsey and Qatar. For details, refer to **chapter 12** 'Double Taxation Arrangements and Agreements'.

14.7 Non-resident aircraft owners

Section 23D deals with any owner or charterer whose aircraft lands at any aerodrome or airport within Hong Kong, but who does not come within the definition of Hong Kong aircraft owners in s.23C.

Such persons are deemed to be carrying on a business of chartering or operating aircraft in Hong Kong and thus liable to Hong Kong profits tax. Where the Commissioner is satisfied that the landing of an aircraft at any aerodrome or airport within Hong Kong is casual, and further landings are improbable, he may direct that the non-resident aircraft owner shall not be deemed to be carrying on a business of chartering or operating aircraft in Hong Kong by reason of casual landing (s.23D(5)).

Article 8 of the Arrangement for the Avoidance of Double Taxation on Income and the Prevention of Fiscal Evasion provides that revenue and profits derived by an enterprise of the Mainland from the operation of aircraft in air transport businesses in Hong Kong (except when the aircraft is solely operated between places in Hong Kong) shall be exempt from tax in Hong Kong (see DIPN 44).

14.7.1 Profits tax computation for non-resident aircraft owners

The formula for computing the assessable profits of a non-resident ship owner is laid down in s.23D(2) as follows:

Formula to learn

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

Where the assessor is of the opinion that the above formula cannot be satisfactorily applied to compute the assessable profits of a non-resident aircraft owner, the assessable profits for a year of assessment may instead be computed on the basis of a fair percentage of the aggregate of the relevant sums. Where the assessable profits have been computed on a fair percentage basis, the non-resident aircraft owner is entitled to elect in writing at any time within two years from the end of the year of assessment that his assessable profits for that year be re-computed by the above formula (s.23D(4)).

The **'total aircraft profits'** and **'total aircraft income'** have the same meaning as that in s.23C applicable to resident aircraft owners. **'Relevant sums'** are computed on a similar basis as for a resident aircraft owner, except that the sum to be included from charter hire is limited to that attributable to a PE in Hong Kong. This is the main difference between the resident and non-resident aircraft owners.

Example 82

Assume the same facts as in the **Example 76**, except that the company is incorporated in Singapore and is therefore a non-resident aircraft owner. Analysis of the turnover will be the same, except that the sum in (c) will not be a relevant sum because the charter party is not attributable to a PE in Hong Kong.

On the other hand, if it is further assumed that the sum in (d) is concluded by the branch in Hong Kong, the sum will then be a relevant sum because the charter party is attributable to a PE in Hong Kong.

Self-test question 11

Identify the relevant sums of a non-resident aircraft owner under the IRO, and complete the following table.

Sums derived from, attributable to, or in respect of:	Relevant sums
Carriage of passengers, goods etc	
(a) Within Hong Kong	
(b) From Hong Kong to overseas	
(c) From overseas to Hong Kong	
(d) Trans-shipments	
Charter hire (charter party by demise)	
(a) For an aircraft operated within Hong Kong	
(b) For an aircraft operated between Hong Kong and Macau	
(c) For an aircraft operated outside Hong Kong (charter party attributable to a PE in Hong Kong)	
(d) For an aircraft operated outside Hong Kong (charter party not attributable to a PE in Hong Kong)	
Charter hire (charter party without demise)	
(a) For an aircraft operated within Hong Kong	
(b) For flights from Hong Kong to overseas	
(i) flight charter	
(ii) time charter (on proportion of outward flights flying hours/total flying hours)	
(c) For flights from overseas to Hong Kong	
Charter hire (charter party not extended to the whole of an aircraft)	
(a) For an aircraft operated within Hong Kong	
(b) For flights from Hong Kong to overseas	
(c) For flights from overseas to Hong Kong	

(The answer is at the end of the chapter.)

14.7.2 Tax case on non-resident aircraft owner

There is one tax case relating to non-resident aircraft owners with a loss denominated in a foreign currency:

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

This case is discussed in **Appendix 17**.

14.8 Clubs and trade associations

14.8.1 Clubs

'Club' is not defined in the IRO. In general, a club refers to an association of persons who gather together for their mutual benefits (other than financial advantages) and is usually in receipt of mutual profits which are not taxable.

Section 24(1) lays down a test to determine whether the receipts of a club are business receipts and the profits arising therefrom are chargeable to profits tax. The test is as follows:

(a) If not less than half of the club's gross receipts on the revenue account (including entrance fees and subscriptions) are from voting members, the club is deemed not to carry on a business.

(b) Otherwise, the club is deemed to carry on a business. All the club's receipts (including entrance fees) are deemed to be trading receipts chargeable to profits tax.

'Members' means those with voting rights (s.24(3)). **Non-members** include non-voting members and outsiders.

If a club is not chargeable to profits tax under s.14 because of the compliance with the minimum test laid down under s.24(1), it may still be subject to other taxes. For example, it may be subject to property tax if it has rental income from the letting of property in Hong Kong.

14.8.2 Trade associations

There is no definition for a 'trade, professional or business association' in the IRO. In general, a trade association refers to a body of persons that is formed for the purpose of furthering the trade interests of its members.

In *Kowloon Stock Exchange*, the Privy Council decided that an association formed by traders to hold and manage premises for the purposes of their trade was a trade association.

As with a club, in order to decide whether the receipts of a trade association are business receipts, the following test in s.24(2) is applied:

> Where more than half of the receipts from subscriptions are from persons who either claim or would be entitled to claim, that their subscriptions are allowable deductions against their own business profits under s.16, the association is deemed to be carrying on a business and the whole of its income (including entrance fees and subscriptions) is subject to profits tax.

It should be noted that even if the above test is satisfied, s.24(2) does not operate to deem the trade not to be carrying on a business. Its profits might still be chargeable to profits tax under s.14(1) if it is in fact carrying on a trade (based on the badges of trade) or business.

Same as for clubs, **'members'** refers to those with voting rights (s.24(3)), and **'receipts'** include entrance fees (s.241)).

'Subscriptions' refer to those recurrent payments and do not include founders' contributions and entrance fees.

If a trade association is not chargeable to profits tax, it may still be subject to property tax if it has rental income from the letting of property in Hong Kong.

Example 83

The Garment Manufacturers Recreational Club was established in 2011. A summary of its income and expenditure accounts for the two years ended 31 December 2012 is provided below:

	Year ended 31/12/2011	Year ended 31/12/2012
Income	$	$
Members' subscription (1)	400,000	450,000
Rent (3)	33350,000	100,000
Restaurant receipts (4)	200,000	150,000
Car parking fees (4)	100,000	100,000
Concert receipts (5)	–	1,000,000
Donations (6)	50,000	–
	1,100,000	1,800,000
Expenditure		
Administrative expenses	(950,000)	(900,000)
Restaurant expenses	(175,000)	(125,000)
Surplus/(deficit)	(25,000)	775,000

Additional information:

(1) All members have voting rights at the Club's general meetings.

(2) Members' entrance fees were directly credited to the Club's Accumulated Fund in the following amounts:

Year ended 31 December 2011	$100,000
Year ended 31 December 2012	$100,000

(3) The Club owns a property which is normally used as the sports centre for its members. Occasionally, part of the centre would be leased to non-members at members' recommendation. Rent received from non-members was reported to the IRD and property tax has been paid as follows:

Year ended 31 December 2011	$42,000
Year ended 31 December 2012	$12,000

The property tax paid has been included in the 'Administrative Expenses' in the Income and Expenditure Account.

(4) The Club's restaurant and car park are for the exclusive use of members only.

(5) On the New Year Eve of 2012, the Club held a fund-raising concert. All tickets were sold to non-members and all receipts were used to subsidise the Club's operation.

(6) The donations arose from a fund-raising campaign contributed by non-members. All of the donations were used to finance the operating expenses of the Club.

(7) Administrative expenses included property tax paid as detailed in note (3) above. Other expenses were all normal tax deductible operating expenses.

The tax position of Garment Manufacturers Recreational Club is determined as follows:

Whether or not the Club is subject to profits tax depends on whether it is deemed under s.24(1) to be carrying on a business in Hong Kong. A person who carries on a club or similar institution, which receives less than half of its gross receipts from its members on revenue account will be deemed to be carrying on business. As a result, the whole of its income will be deemed business receipts and subject to profits tax. For the purposes of calculating the 'gross receipts' on revenue

account, entrance fees and subscriptions are taken into account. Moreover, 'members' refer to those persons entitled to vote at the club's general meeting.

In the case of Garment Manufacturers Recreational Club:

	Year ended 31/12/2011	*Year ended 31/12/2012*
Receipts from members	$	$
Entrance fees	100,000	100,000
Subscriptions	400,000	450,000
Restaurant receipts	200,000	150,000
Car parking fees	100,000	100,000
	800,000	800,000
Receipts from non-members		
Rent	350,000	100,000
Concept receipts	-	1,000,000
Donations	50,000	-
Surplus/(deficit)	400,000	1,100,000
Total gross receipts	1,200,000	1,900,000
% of members' receipts	66.7%	42.1%

Garment Manufacturers Recreational Club will be deemed to be carrying on business in respect of the year ended 31 December 2012. All receipts will be subject to profits tax. For the year ended 31 December 2011, no profits tax is payable but property tax is payable in respect of the rental income received.

For the year ended 31 December 2012, profits tax is calculated as follows:

	$
Surplus for the year	775,000
Add: Property tax included in administrative expense	12,000
Entrance fees	100,000
Assessable profits	887,000
Profits tax at 15% (unincorporated rate)	133,050
Less: Property tax set off under s.25	(12,000)
Profits tax payable	121,050

14.8.3 Tax cases on clubs and trade associations

The following cases relate to clubs and trade associations.

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

These cases are discussed in **Appendix 18**.

Appendix 1

List of cases relating to the source concept

Each case has its own merits. The purpose of this list is to highlight the level of authority reached by individual cases and the diversity of views and determination at different levels of authority.

Taxpayer [Ref.]	Subject matter	Board of Review	High Court/ Court of First Instance	Court of Appeal	Privy Council/ Court of Final Appeal
Karsten Larssen & Co (HK) Ltd [(1951) 1 HKTC 11] (discussed in **App. 6**)	Agency commission	Offshore	Onshore	-	-
The Hong Kong & Whampoa Dock Co Ltd [(1960) 1 HKTC 85] (discussed in **App. 6**)	Salvage income	Offshore	Onshore	Offshore	-
International Wood Products Ltd [(1971) 1 HKTC 551] (discussed in **App. 6**)	Agency commission	Offshore	Offshore	-	-
Sinolink Overseas Co Ltd [(1985) 2 HKTC 127 (discussed in **App. 4**)	Trading profit	-	Onshore	-	-
Exxon Chemical International Supply S.A. [(1989) 1 HKRC 90-019] (discussed in **App. 4**)	Trading profit	Onshore	Onshore	-	-
Bank of India [(1990) 1 HKRC 90-029] (discussed in **App. 4**)	Profit from discounting bills of exchange	Onshore	Onshore	-	-
Hang Seng Bank Ltd [(1990) 1 HKRC 90-044] (discussed in **App. 4**)	Profit on sale of certificates of deposit	Offshore	-	Offshore	Offshore
HK-TVB International Ltd [(1992) 1 HKRC 90-064] (discussed in **App. 8**)	Sub-licensing fees	Offshore	Onshore	Offshore	Onshore
Wardley Investment Services (Hong Kong) Ltd [(1993) 1 HKRC 90-068] (discussed in **App. 6**)	Rebates	Offshore	Onshore	Onshore	-
Euro Tech (Far East) Ltd [(1995) 1 HKRC 90-074] (discussed in **App. 4**)	Trading profit	Offshore	Onshore	-	-
Magna Industrial Co Ltd [(1997) 1 HKRC 90-082 (discussed in **App. 4**)	Trading profit	Offshore	Onshore	Offshore	-
Orion Caribbean Ltd [(1997) 1 HKRC 90-089] (discussed in **App. 7**)	Interest on loans	Offshore	-	Offshore	Onshore

Taxpayer [Ref.]	Subject matter	Board of Review	High Court/ Court of First Instance	Court of Appeal	Privy Council/ Court of Final Appeal
Indosuez W I Carr Securities Limited [(2007) HKRC 90-191] (discussed in **App. 6**)	Brokerage commission	Partly offshore but no apportionment allowed	Apportionment is possible	Application for judicial review by taxpayer was dismissed	Apportionment is possible (by way of consent)
Consco Trading Co Ltd [(2004) HKRC 90-132] (discussed in **App. 4**)	Trading profit	Onshore	Onshore	-	-
Kwong Mile Services Ltd [(2004) HKRC 90-135] (discussed in **App. 9**)	Underwriting profits	Offshore	Onshore	Onshore	Onshore
Lam Soon Trademark Ltd [(2005) HKRC 90-171] (discussed in **App. 8**)	Royalty	Onshore	Onshore	Onshore	Onshore
ING Baring Securities (Hong Kong) Ltd [(2007) FACV 19/2006] (discussed in **App. 6**)	Brokerage commission and marketing income	Onshore	Offshore	Onshore	Offshore
Kim Eng Securities (Hong Kong) Ltd [(2007) FACV 11/2006] (discussed in **App. 6**)	Brokerage commission, consulting fees and interest income	Onshore	Onshore	Onshore	Onshore
Datatronic Ltd [(2009) CACV 275/2008] (discussed in **App. 5**)	Manufacturing profit	50% onshore 50% offshore	50% onshore 50% offshore	Onshore	-
C G Lighting Limited [(2010) CACV 119/2010] (discussed in **App. 5**)	Manufacturing profit	50% onshore 50% offshore	Onshore	Onshore	-
Li & Fung (Trading) Limited [(2010) HCIA 1/2010] (discussed in **App. 6**)	Agency commission	Offshore	Offshore	Offshore	-

Appendix 2

List of cases relating to trading receipts and capital receipts

Each case has its own merits. The purpose of this list is to highlight the level of authority reached by individual cases and the diversity of views and determination at different levels of authority.

Taxpayer [Ref.]	Subject matter	Board of Review	High Court/ Court of First Instance	Court of Appeal	Privy Council/ Court of Final Appeal
Sincere Insurance and Investment Co Ltd [(1973) 1 HKTC 602]	Profit on disposal of property	Not taxable	Taxable	-	-
Dr Chang Liang Jen [(1977) HKTC 975]	Profit on disposal of shares	Not taxable	Not taxable	-	-
Central Enterprises Ltd [(1989) 1 HKRC 90-005]	Profit on disposal of property	Taxable	Taxable	Taxable	-
Chinachem Investment Co Ltd [(1989) 1 HKRC 90-007]	Profit on disposal of property	Taxable	Taxable	Taxable	-
Richfield International Land and Investment Co Ltd [(1989) 1 HKRC 90-020]	Profit on disposal of property	Taxable	Not taxable	Taxable	Taxable
Wing On Cheong Investment Co Ltd [(1990) 1 HKRC 90-035]	Profit on disposal of property	Taxable	Not taxable	-	-
Waylee Investment Ltd [(1990) 1 HKRC 90-048]	Profit on disposal of shares	Not taxable	Not taxable	Taxable	Not taxable
Beautiland Co Ltd [(1991) 1 HKRC 90-053]	Profit on disposal of shares	Taxable	Not taxable	Taxable	Not taxable
Winfat Enterprise (HK) Ltd [(1992) 1 HKRC 90-058]	Compensation on resumption of land	Taxable	Taxable	-	-
Crawford Realty Ltd [(1992) 1 HKRC 90-060]	Profit on disposal of property	Taxable	Taxable	-	-
All Best Wishes Ltd [(1992) 1 HKRC 90-067]	Profit on disposal of property	Taxable	Taxable	-	-
Chanway Investment Co Ltd [(1998) 1 HKRC 90-092]	Profit on disposal of property	Taxable	Taxable	Taxable	-
Hong Kong Oxygen & Acetylene Co Ltd [(2001) 1 HKRC 90-108]	Payments from property developer	Taxable	Taxable	-	-
Aust-key Co Ltd [(2001) 1 HKRC 90-109]	Profit from deemed disposal of property	Taxable	Taxable	-	-
Brand Dragon Ltd (in members' voluntary liquidation) and Harvest Island International Ltd (in members' voluntary liquidation) [(2002) HKRC 90-115]	Profit on disposal of property	Taxable	Taxable	-	-

Taxpayer [Ref.]	Subject matter	Board of Review	High Court/ Court of First Instance	Court of Appeal	Privy Council/ Court of Final Appeal
Southtime Ltd [(2002) HKRC 90-119]	Profit on disposal of property	Taxable	Taxable	-	-
Kaifull Investments Ltd [(2002) HKRC 90-120]	Profit on disposal of property	Taxable	Taxable	-	-
Wah Hing Fat Realty Co Ltd [(2003) HKRC 90-125]	Profit on disposal of property	Taxable	Taxable	-	-
Stanwell Investments Ltd [(2003) HKRC 90-130]	Profit on disposal of property	Taxable	Not taxable	-	-
Hui King-yin [HCIA 6/ 2003]	Profit on disposal of property	Taxable	Taxable	-	-
Common Empire Ltd [(2006) 90-174]	Profits on disposal of agricultural	Taxable	Taxable	-	-
China Map Ltd & Others [(2008) FACV 28, 29, 30 & 31/2007]	Profit on disposal of landed properties	Taxable	Taxable	Taxable	Taxable
Real Estate Investments (NT) Ltd [(2008) FACV 3/2007]	Profit on disposal of landed property	Taxable	Taxable	Taxable	Taxable
Lee Yee Shing and Yeung Yuk Ching [(2008) FACV 14/2007]	Loss on disposal of shares	Taxable	Taxable	Taxable	Taxable
Church Body of the Hong Kong Sheng Kung Hui [HCIA 2 & 3/2009]	Profit on property redevelopment	Taxable	Taxable	Taxpayer had filed a notice of appeal	
Nice Cheer investment Ltd. [(2012) CACV 135/2011] (discussed in **section 6.3.4**)	Unrealised gain	-	Not taxable	Not taxable	
Aviation Fuel Supply Company [(2009) HCIA 6/2009] (discussed in **App. 11**)	A lump sum to buy out the right to receive income over the remaining 15 years	-	Not taxable	Not taxable	The CIR had filed a notice of appeal

Appendix 3

List of cases relating to deductions under profits tax

Each case has its own merits. The purpose of this list is to highlight the level of authority reached by individual cases and the diversity of views and determination at different levels of authority. These cases are discussed in **Appendix 13**.

Taxpayer [Ref.]	Subject matter	Board of Review	High Court/ Court of First Instance	Court of Appeal	Privy Council/ Court of Final Appeal
Hang Seng Bank Ltd [(1972) 1 HKTC 583]	Exchange differences	Allowable	Allowable	-	-
Swire Pacific Ltd [(1979) HKTC 1145]	Payment to end a strike	Allowable	Allowable	Allowable	-
Li & Fung Ltd [(1980) HKTC 1193	Exchange differences	Allowable	Not allowable	-	-
Lo and Lo [(1984) 2 HKTC 34]	Provision for long service payment	Not allowable	Allowable	Allowable	Allowable
Banque National De Paris Hong Kong Branch [(1985) 2 HKTC 139]	Interest to head office	Not allowable	Not allowable	Not allowable	-
County Shipping Co Ltd [(1990) 1 HKRC 90-034]	Interest	Allowable	Not allowable	-	-
Overseas Textiles Ltd [(1990) 1 HKRC 90-042]	Compensation payments	Not allowable	Not allowable	-	-
Asia Securities International Ltd [(1991) 1 HKRC 90-052]	Bad debts	Allowable	Allowable	-	-
AP Fahy [(1992) 1 HKRC 90-062]	Medical expenses	Not allowable	Not allowable	-	-
Chinachem Finance Co Ltd [(1992) 1 HKRC 90-066]	Exchange differences	Allowable	Allowable	Allowable	-
Wharf Properties Ltd [(1997) 1 HKRC 90-085]	Interest	-	Not allowable	Not allowable	Not allowable
General Garment Manufactory (Hong Kong) Ltd [(1997) 1 HKRC 90-090]	Exchange differences	Allowable	Allowable	-	-
Cosmotron Manufacturing Company Ltd [(1997) 1 HKRC 90-091]	Severance pay	Allowable	Allowable	Allowable	Allowable
National Mutual Centre (HK) Ltd [(1998) 1 HKRC 90-094]	Interest	Allowable	Allowable	Allowable	-
Secan Ltd / Ranon Ltd [(2001) 1 HKRC 90-107]	Interest incurred during period of property development	Not allowable	Allowable	Allowable	Not allowable

Taxpayer [Ref.]	Subject matter	Board of Review	High Court/ Court of First Instance	Court of Appeal	Privy Council/ Court of Final Appeal
So Kai Tong, Stanley trading as Stanley So & Co [(2004) HKRC 90-131	Equipment rental, office facilities charges and entertainment expenses	Partly allowed	Partly allowed	-	-
Zeta Estates Ltd [FACV 15/2006]	Interest attributable to payment of dividend	Not allowable	Not allowable	Not allowable	Allowable
Chu Fung Chee [HCIA 10/2005]	Costs of disciplinary proceedings	Allowable	Not allowable	-	-
Tai Hing Cotton Mill (Development) Ltd [(2007) FACV 2/2007]	Expenses paid to a related company	Allowable	Not allowable	Allowable	Not allowable
HIT Finance Ltd HK International Terminals Ltd [(2007) FACV 8 & 16 / 2007]	Interest expenses	Not Allowable	-	Case remitted to BoR, CIR appealed to CFA	Not allowable
Shui On Credit Company Ltd [(2009) FACV 1/2009]	Deferred expenditures	Not allowable	Not allowable	Not allowable	Not allowable
Canton Industries Ltd [(2008) HCIA 6/2007]	Expenditure for the acquisition of permanent quota	Not allowable	Not allowable	-	-
Braitrim (Far East) Limited [(2012) CACV 45/2012]	Expenditure for the acquisition of moulds	Not allowable	-	Not allowable	Taxpayer appealed to CFA

Appendix 4

Tax cases on source of trading profits

The following cases relate to the determination of the source of trading profits:

Taxpayer	Subject matter	Reference
Sinolink Overseas Co Ltd	Trading profits	(1985) 2 HKTC 127
Exxon Chemical International Supply S.A	Trading profits	(1989) 1 HKRC 90-019
Bank of India	Trading profits	(1990) 1 HKRC 90-029
Hang Seng Bank Ltd	Trading profits	(1990) 1 HKRC 90-044
Euro Tech (Far East) Ltd	Trading profits	(1995) 1 HKRC 90-074
Magna Industrial Co Ltd	Trading profits	(1997) 1 HKRC 90-082
Consco Trading Co Ltd	Trading profits	(2004) HKRC 90-132

Sinolink Overseas Co Ltd [(1985) 2 HKTC 127]

The facts: The taxpayer, a company incorporated and carrying on business in Hong Kong, made its sales mainly in China. The taxpayer had no office or PE outside Hong Kong. The China sales were negotiated and concluded by employees dispatched from Hong Kong. After concluding the sales contracts in China, the employees would return to Hong Kong to arrange for supplies either locally or from overseas. Shipment of goods was effected by overseas suppliers to China via Hong Kong. The taxpayer claimed that its trading profits were derived from outside Hong Kong. The Commissioner disallowed the taxpayer's offshore claim.

Decision: The case was transferred to the High Court bypassing the BOR. The High Court judge took into account the taxpayer's pre-contract and post-contract activities and concluded that the taxpayer's profit was derived from Hong Kong where its business was managed and controlled.

Exxon Chemical International Supply S.A. [(1989) 1 HKRC 90-019]

The facts: This was a classic re-invoicing case. The taxpayer, a company incorporated outside Hong Kong, was part of a multi-national group which sold products to affiliated companies throughout the Asia Pacific region. When a purchase order was received from an overseas affiliate, the company would send the information to the US where the request for goods would be entered into the group's central computer. This would result in an order being placed with suppliers that were affiliates. The taxpayer's role was passive as it did not have any authority in determining the price of the goods. No processing or shipment of the goods was done in Hong Kong.

Decision: The BOR decided in favour of the Commissioner. On appeal, the High Court also decided that the taxpayer's profits were derived from Hong Kong. The judge was of the view that the essence of trading operations was where the buyer's orders were obtained and where the sales orders were placed and all these were done in Hong Kong.

Bank of India [(1990) 1 HKRC 90-029]

The facts: The taxpayer was a bank carrying on business in Hong Kong. It was active in trade financing through the discounting of foreign bills, which were originated from international trade, via agents outside Hong Kong. Upon application of the customers the bank would discount the bills and pay the proceeds to the customers in Hong Kong, while collection of the value of the bills on maturity was performed overseas by its agent. The bank derived profits being the difference between the costs to the bank of the bills and the proceeds due to the bank upon maturity of the bills.

Decision: Both the BOR and the High Court decided in favour of the Commissioner. The operations test was applied and profits were held taxable as business was carried out predominantly in Hong Kong. The High Court rejected the taxpayer's argument that the operations test was not the right test in Hong Kong but that the so-called Dixon principle should qualify. The taxpayer argued that

source should be determined by the *"acts / operations which are more immediately / proximately / directly responsible for the receipt of the particular income"*, a question which stems from a test developed by Dixon J in *Commissioner of Taxation (NSW) v Hillsdon Watts Ltd* (1937). However, the High Court rejected this approach in favour of a test based on the operations of the bank, as this would mean that it was appropriate to look only to the presentation of the bills to the overseas bank in determining the source of the profit from the transaction, which was not regarded as the crucial operation responsible for the profit under the operations test.

Hang Seng Bank [(1990) 1 HKRC 90-044]

The facts: The taxpayer was a bank carrying on business in Hong Kong. It had a foreign exchange department in Hong Kong which, on a daily basis, monitored its foreign currency requirements as against its foreign currency investments, and then managed the matching of its commitments with its investments. The foreign exchange department would invest substantial funds of the taxpayer (acquired from its general banking activities in Hong Kong) in foreign currency certificates of deposit and bonds. The certificates were acquired on either the London or Singapore markets through agents (correspondent banks) on the (telexed) instructions of the foreign exchange department of the taxpayer. The securities were then sold in the same way, usually a few days before maturity. In the relevant period, such certificates formed a substantial part of the taxpayer's assets. The IRD was of the view that the profits from resale of the certificates and bonds arose from a source in Hong Kong as the taxpayer was carrying on business in Hong Kong and that the instructions and funding of the certificates were all from Hong Kong.

Decision: The BOR, the COA and the Privy Council all decided in favour of the taxpayer by applying the operations test.

The Privy Council, in its determination, gave comments as follows:

(i) The structure of s.14 presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located in Hong Kong, others overseas. The former are taxable but the latter are not. A distinction must be made between profits arising in or derived from Hong Kong and profits arising in or derived from a place outside Hong Kong according to the nature of the different transactions by which the profits are generated (multi-source concept).

(ii) Whether the gross profit resulting from a particular transaction arose in or was derived from one place or another is always a question of fact depending on the nature of the transaction. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profits in question. There may be cases where the gross profits deriving from an individual transaction will have arisen in or derived from different places. In such a case the absence of a specific provision for apportionment in the Ordinance does not obviate the necessity to apportion the gross profit as having arisen partly in Hong Kong and partly outside Hong Kong.

Note: With regard to the *Hang Seng Bank* case, s.15(1)(l) was enacted in 1986 and profit from sale of certificates of deposit by a FI carrying on business in Hong Kong has since then been subject to tax under the deeming provisions.

Euro Tech (Far East) Ltd [(1995) 1 HKRC 90-074]

The facts: Similar to the case of Exxon Chemical, this was also a re-invoicing case. The taxpayer, a subsidiary of a company incorporated in the United Kingdom, entered into distributorship agreements with companies in Korea and Singapore. Orders were sent by the Korean and Singaporean companies to the taxpayer which would then send orders to the UK holding company. The goods were shipped directly to the Korean or Singaporean company.

Decision: The BOR found that the taxpayer did not derive its profit in Hong Kong. They were of the view that the taxpayer was no more than a mere puppet of its holding company as it did nothing more than processing pieces of paper and collecting and paying money.

On appeal, the High Court decided in favour of the Commissioner on the grounds that what the taxpayer did was to bring together the complementary needs of the sellers and buyers and such

activity was performed in Hong Kong. The company received orders from its distributors, confirmed these orders and issued proper invoices, placed confirmatory orders with the suppliers in the UK, called for shipping documents and made all proper and necessary financial arrangements in Hong Kong. Its profits arose from its activities in Hong Kong and were therefore chargeable to Hong Kong profits tax.

Magna Industrial Co Ltd [(1997) 1 HKRC 90-082

The facts: The taxpayer's sales were negotiated and concluded by independent agents outside Hong Kong while its purchases were from its wholly owned subsidiary in Hong Kong.

Decision: The BOR was of the opinion that the sale of goods which were effected by the taxpayer's independent agent overseas was the originating cause of its trading profits.

The High Court held a different view and decided that the establishment of the subsidiary in Hong Kong so as to hide the identity of the ultimate suppliers was an essential operation giving rise to the profits and that the taxpayer's profits were sourced in Hong Kong.

On appeal to the COA, the judges decided in favour of the taxpayer by employing a similar approach as that of the BOR. Both the BOR and the COA placed emphasis on the sales of the goods in determining the source of the trading profit of the taxpayer. The IRD's view pursuant to DIPN 21 (1996 edition) that the taxpayer's trading profits should be fully taxable as its purchases were made in Hong Kong, was rejected as incorrect.

Since the judges of the COA did not provide further comments on the other operations of the taxpayer, this case indeed adds additional doubts and uncertainty about the source concept relating to trading profits.

Consco Trading Co Ltd [(2004) HKRC 90-132]

The taxpayer was incorporated in Hong Kong in 1985 and commenced business in the trading of polysilicon in 1994. It does not have any overseas office or any other form of PE outside Hong Kong. The goods were produced by Beijing Sanjing, a PRC entity, in the PRC for direct shipment to the customers without routing through Hong Kong.

Decision: In this case, five activities were identified by the BOR, namely:

(i) pre-contract negotiations;

(ii) making of the contracts of purchase;

(iii) making of the contracts of sale;

(iv) post-contract performance such as arrangement for finance, preparation of shipping documents, delivery of goods and effecting receipts and payments; and

(v) making of the processing agreements, with the supplier, Beijing Sanjing, in the PRC, and effecting payment thereunder.

The taxpayer claimed that the sale and purchases were concluded outside Hong Kong. However, the travelling documents of the taxpayer's director showed that he was in Hong Kong during the conclusion of some of the contracts. The BOR applied the 'totality of facts' approach by taking into consideration certain factors such as finance arrangement, payment of raw materials and processing fees, arrangement for receipt of payment from purchasers for the finished product and pre-contract negotiations and decided that the taxpayer's trading profits were 'sourced' in Hong Kong.

The CFI noted it could interfere with the BOR's decision only if the BOR had misdirected itself in law or it had drawn inferences or come to conclusions which could not stand because the primary facts found by it did not admit such inferences or conclusions. The Court noted that the BOR had considered the judicial authorities relevant to the issue. The Court opined that in its analysis of the three representative transactions, the BOR had directed its mind to the relevant authorities and adopted the proper approach. Other factors such as finance arrangement, payment for raw material processing fees, arrangement for receipt payment from purchasers and pre-contract negotiations were also correctly considered. Therefore the Court upheld the BOR's decision.

Appendix 5

Tax cases on source of manufacturing profits

The following cases relate to the determination of the source of manufacturing profits:

Taxpayer	Subject matter	Reference
Datatronic Limited	Manufacturing profits	HCIA 3&4/2007, CACV 275/2008
C G Lighting Limited	Manufacturing profits	HCIA 8/2009, CACV 119/2010, FAMV 23/2011

These cases are relevant only for import processing companies seeking for apportionment of profits.

Datatronic Limited [HCIA 3&4/2007, CACV 275/2008]

The facts: Datatronic is a Hong Kong private company engaged in the manufacturing and sales of electronic components. The manufacturing operation was conducted by Datatronic (Shunde) Corporation (DSC), which is Datatronic's wholly owned subsidiary in the PRC under a processing agreement. In order to fulfil the PRC legal requirement, the transactions that took place between Datatronic and DSC were in the form of import processing. The machinery, equipment, raw materials and technical know-how of DSC all originated from Datatronic. Datatronic also sent its Hong Kong staff to DSC to monitor, train and supervise DSC's staff. The deputy general manager and three other Hong Kong staff members stationed at DSC were employed by Datatronic and on its payroll.

Decision: The BOR rejected the taxpayer's contentions that an agency relationship existed between the taxpayer and the PRC subsidiary, or the import processing arrangement was operated as that of a contract processing agreement. However, the BOR ruled that Datatronic was a manufacturer because of its substantial involvement in the manufacturing process in DSC. The involvement included providing technical know-how, design, management, training and supervision for the local work force in the PRC, and providing manufacturing plant and machinery to DSC. Accordingly 50:50 apportionment was granted as part of Datatronic's profit were derived from the operations in the PRC even though the transactions with DSC were under an import processing arrangement.

The CFI upheld the BOR's decision, and also ruled that agency relationship and the type of processing agreement are irrelevant. The Commissioner appealed to the COA.

On July 15, 2009, the COA handed down its judgment which overturned the CFI's decision finding in favour of the Commissioner that the profits in question were fully taxable.

The COA held that Datatronic's profits were not manufacturing profits, agreeing with the BOR's initial finding that DSC manufactured the products which were then sold to Datatronic. The COA also considered DSC not to be Datatronic's agent and the manufacturing activities carried out by DSC were not the activities of Datatronic. Further, the arrangement between the parties was import processing instead of contract processing.

The Court held that the BOR was wrong to conclude that Datatronic had undertaken operations in the Mainland of China and such operations were important operations and attributable to the profits in question.

The COA's decision is based on the principles laid down in *Kwong Mile* and applied in *ING Baring* as extracted below:

> *"… this Court noted the absence of a universal test but emphasised 'the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters.' The focus is, therefore, on establishing the geographical location of the taxpayer's profit-producing transactions themselves 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."

The COA considered Datatronic's activities in the Mainland were commercially essential to the operations and profitability of Datatronic's business, but they were merely antecedent or incidental to the profit-generating activities. Datatronic had derived its assessable profit from its trading activities by selling the finished goods bought from DSC rather than from manufacturing in the Mainland.

It appears the decision of the COA supports the IRD's practice that the '50:50 apportionment' only applies to contract processing but not to import processing. Although the Taxpayer applied for leave to appeal to the COA, the application was subsequently withdrawn by the Taxpayer.

C G Lighting Limited [HCIA 8/2009, CACV 119/2010, FAMV 23/2011]

The facts: CG Lighting Ltd (CGL) initially entered into a typical contract processing agreement with a third party in the Mainland and its profits were allowed to be taxed on a 50:50 basis by the IRD. In 1994, CGL formed a wholly owned subsidiary, CG Electrical (Shenzhen) Ltd (CGES), a FIE in the Mainland, to take up the manufacturing operations under an import processing agreement. Despite the change in legal form, CGL's mode of operations remained unchanged in substance. CGL continued to provide CGES with raw materials, technical know-how, management staff, production skills, computer software, product designs, product testing and prototype production (such work was carried out partly in Hong Kong and partly at CGES in the Mainland), skilled labour, training, supervision and manufacturing machinery and plant at no cost. CGES provided factory premises and labour for the production of lighting fixtures in return for monthly processing fees paid by CGL. The processing fees were no greater than CGES's operating costs and overheads. There were no sales of materials by CGL to CGES, or of finished products by CGES to CGL. However, for the purpose of bringing the goods from the Mainland to Hong Kong, sales documents were prepared by CGES for custom clearance. However, the sale of goods was disputed by CGL, which maintained that the sales documents did not reflect the reality and were produced to satisfy the requirements of the Mainland authorities.

Decision: The BOR accepted that the accounts and invoices of CGES were prepared to satisfy the requirements of the Mainland authorities and did not reflect the reality of CGL's situation. CGL obtained the finished goods by way of a contract processing arrangement. The transactions between CGL and CGES did not involve any sale. CGL purchased raw materials and supplied them to CGES for processing and assembling at zero cost; and obtained the finished goods from CGES by way of a contract processing fee at a cost-recovery basis. The practical commercial reality is that, *in substance*, CGL's participation in the production process in the Mainland is part of CGL's profit-producing transaction and therefore part of the profits should be offshore, despite that CGL's arrangement takes the *legal form* of import processing. The BOR allowed the appeal and remitted the case back to the IRD to decide the appropriate apportionment.

On appeal, the CFI decided in favour of the Commissioner. The Court was required to consider precisely the operations of CGL which produced the profits in question, not all the operations which produced them: per *ING Baring*. As the BOR found that CGES, not CGL, was the manufacturer and did not find that CGES was CGL's agent in the production of the lighting fixtures, the Court concluded that the activities of CGL in relation to the manufacturing process itself were simply antecedent or incidental to the profit-producing transactions and were not the operations which produced that ultimate profits of CGL. Even though the BOR made a clear finding of fact that there was no sale of the finished products by CGES to CGL, the fact remains that CGL did not manufacture the finished goods and only had them transferred to it pursuant to the sub-contacting arrangements between it and CGES. The profit-producing transactions of CGL consisted of the acquisition of the finished goods from CGES, for which CGL paid a processing fee, and the on-selling of the same to its customers. Those sales were effected in Hong Kong, profits were sourced in Hong Kong and so chargeable under s.14. The BOR was wrong to conclude that CGL's participation in the production process was as much a part of its profit-producing transactions as

the obtaining of a purchase order, and the BOR's treatment of CGL's antecedent or incidental activities as an integral part of the profit-producing operation was inconsistent with the principles of law established in *ING Baring*, *Datatronic* and *Ngai Lik*.

The COA upheld the ruling of the CFI that a taxpayer's profits derived from the sale of goods acquired under an import processing arrangement in the Mainland are subject to Hong Kong profits tax in full. The COA endorsed the CFI's judgment that CGL was a trader with no distinguishable difference from that of the taxpayer in *Datatronic*, who bought and sold goods, rather than being a manufacturer of products that it sold at a profit. The relevant profits were derived from the profit-producing transactions in relation to the sale of the products in Hong Kong. CGL's application for leave to appeal to the CFA was heard and dismissed on 24 August 2011.

Appendix 6

Tax cases on source of service fees, commissions and rebates

The following cases relate to service fees, commissions and rebates:

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

Karsten Larssen & Co (HK) Ltd [(1951) 1 HKTC 11]

The facts: The taxpayer, a firm of ship brokers, maintained no establishment outside Hong Kong. It employed the services outside Hong Kong of other ship brokers in various locations. The charterers were found in Shanghai by an independent outport broker and the taxpayer received a commission income from the ship owners.

Decision: The BOR decided that the commission income of the taxpayer was derived from outside Hong Kong from services of the outport brokers.

On appeal, the High Court decided that the agency commission of the taxpayer was taxable on the grounds that the outport brokers were not subagents of the taxpayer as they were named separately in the charter parties as recipients of commission and could not bring an action for commission against the taxpayer. The taxpayer's commission income was therefore not earned through or from the activities of its subagents outside Hong Kong, but rather through its own activities of certain subsidiary and administrative functions in Hong Kong.

The Hong Kong & Whampoa Dock Co Ltd [(1960) 1 HKTC 85]

The facts: This was a landmark case on the operations test. The taxpayer, a company incorporated and managed in Hong Kong, had no establishment outside Hong Kong. It maintained its shipbuilding and salvaging organisation in Hong Kong and kept all plant and equipment here, including tugs and salvage experts. On receipt of a phone call from the owners of motor vessel Bintang advising that the ship was aground on the Paracel Islands, the taxpayer sent its tug Kowloon Docks to provide salvage services. The captain had full powers to negotiate and finalise any salvage contract. Bintang was refloated and first towed to a sheltered anchorage in the Paracel Islands and put into a condition to be towed to Hong Kong. The salvage award was agreed at $680,000 which was paid to the taxpayer in Hong Kong. The IRD assessed the profit from the salvage operation and the taxpayer appealed.

Decision: The BOR decided in favour of the taxpayer but that decision was reversed by the High Court.

However, by applying the operations test, the COA decided that the profit was derived from the salvage operations performed outside Hong Kong. Although the towing of the motor vessel was partly done in Hong Kong waters, the COA was of the view that no apportionment could be made in the circumstances and the whole of the profits were not taxable.

International Wood Products Ltd [(1971) 1 HKTC 551]

The facts: The taxpayer, a company incorporated and carrying on business in Hong Kong, was appointed by two companies in the Philippines as their exclusive agent for sales of wood products outside the Philippines. The agency agreements, which were made in the Philippines, provided for payment to the taxpayer a commission equal to 5% of the price of all goods sold to buyers outside the Philippines. The taxpayer then entered into several sub-agency agreements with independent third parties located in various countries in the Philippines and agreed to pay the subagents a portion of the commission it would receive on the making of sales. The subagents made all the non-Philippines sales and communicated with the principal in the Philippines. The taxpayer essentially did nothing but received a substantial amount of net commission income.

Decision: The BOR decided in favour of the taxpayer on the grounds that the commission income of the taxpayer was derived outside Hong Kong as the sales activities were performed by its subagents overseas.

The High Court also decided in favour of the taxpayer. Its determination supports the view that the operations test applies not only to operations undertaken by the taxpayer directly, but also to operations of independent agents of the taxpayer that produce profits for the taxpayer. It supports the maxim ‘he who acts through another, acts himself.’ This case was an important judicial precedent for looking at the operations of overseas agents in applying the operations test.

Wardley Investment Services (Hong Kong) Ltd [(1993) 1 HKRC 90-068]

The facts: The taxpayer, a subsidiary of the Hong Kong Bank, managed investment portfolios for its clients. The purchase and sale of securities on behalf of its clients were done by local and overseas brokers. There was an agreement between the taxpayer and its clients that allowed the taxpayer to receive rebates from the brokers and to retain such rebates. The taxpayer claimed that the rebates from overseas brokers were not subject to tax in Hong Kong.

Decision: The BOR decided in favour of the taxpayer that the rebates were not sourced in Hong Kong.

On appeal, the High Court decided in favour of the Commissioner that the rebates were attributable to the taxpayer's activities in Hong Kong.

The COA, by majority, also decided in favour of the Commissioner on the grounds that the rebates, being additional remuneration to the taxpayer derived from the investment management agreements, were chargeable to tax in Hong Kong despite that part of the portfolio consisted of overseas securities. The judges were of the view that the taxpayer was carrying out its contractual duties to its clients and performing services under the management agreement in Hong Kong. It did nothing abroad. It was the terms of the agreement that enabled the taxpayer to credit the rebates to itself rather than to its clients. With the rebates, the overseas brokers charged the taxpayer a discounted commission. The taxpayer’s profit was from its clients in Hong Kong who paid it the full commission and allowed it to retain part of it.

Indosuez W I Carr Securities Limited [(2002) 90-117, (2005) HKRC 90-157, (2007) HKRC 90-191]

The facts: The taxpayer was a member of an international stockbroking group. The taxpayer’s office in Hong Kong served as the centre or headquarters of the group for the Asia Pacific region. The taxpayer derived income from brokerage commission both in respect of the Hong Kong and overseas market. There were HK clients and overseas clients appointing the taxpayer to manage

their share investments. The taxpayer instructed overseas brokers to execute orders for its clients in overseas market.

Decision: The commission from Hong Kong market was returned for tax. However, the IRD considered the commission from overseas market was also chargeable to tax. The BOR was of the view that the commission income from overseas clients in overseas market was non-taxable offshore income but the commission earned from Hong Kong customers from overseas market was partly onshore and partly offshore. However, the BOR considered it was not allowed to apportion the commission earned from Hong Kong customers from overseas market.

The CFI held a different view and considered it was possible to apportion the commission income earned from HK clients for managing their overseas share investments. The case was remitted to the BOR for amendment. After the second BOR's determination, which held that part of the commission income earned from Hong Kong customers for orders executed in overseas market were sourced from Hong Kong, the Commissioner's application for case stated to court was refused by the BOR. The Commissioner has applied for judicial review against the BOR's refusal. By a judgment issued on 4 January 2006, the Commissioner's application was allowed and the BOR was asked to accede to the Commissioner's request. The taxpayer's appeal to the COA was dismissed. By consent summons filed with the CFA, the parties agreed to the finalisation of the case on the basis of the BOR decision handed down after the case had been remitted to the BOR with the opinion of the CFI by an order dated 30 January 2002 and a further order dated 24 April 2003, i.e. based on the second BOR's determination where part of the commission income derived from Hong Kong customers for orders executed in overseas market were held as derived outside Hong Kong and hence not taxable.

ING Baring Securities (HK) Limited [(2007) FACV 19/2006]

The facts: The taxpayer was engaged in the 'agency brokerage' business. The key issue in this case is whether the brokerage income and the marketing income derived by the taxpayer from trades in securities on behalf of the clients of Baring group on exchanges outside Hong Kong were sourced outside Hong Kong, even when the client was located in Hong Kong, or instructions to execute such trades were given to the taxpayer in Hong Kong.

Decision: The BOR decided in favour of the Commissioner on the ground that the taxpayer failed to discharge its burden of proof of demonstrating that the assessments were incorrect and the source of these incomes were not in Hong Kong. The taxpayer appealed to the CFI that the BOR erred in law in applying the source principle in determining the source of these incomes and in concluding the profits were earned by activities in Hong Kong.

In the judgment issued by the CFI, the judge pointed out that the relevant activities were the operations of the taxpayer and its overseas agents. For the brokerage or commission income, the taxpayer's role was to act as an interposed person between the clients and the overseas agents who executed the trades on the overseas stock exchange. Although the Hong Kong office of the taxpayer conducted sales and research and these activities only developed relationships with clients, the actual operations that generated the brokerage were the execution of the individual securities transaction by the agents outside Hong Kong. The Court held the BOR erred in its decision and concluded that the brokerage income was sourced outside Hong Kong. The marketing income was generated based on the sharing agreements which were entered into by the taxpayer with its overseas associates within the group. Under the agreement, the taxpayer received a share of the commission for the introduction to the overseas associates a customer who traded securities on the overseas stock exchange. As the introduction was from the taxpayer to overseas associates for the purpose of executing trades of securities at overseas stock exchanges, the Court concluded that the operation that gave rise to the marketing income should be regarded as having taken place overseas.

The Commissioner appealed to the COA against the judgment dated 1 June 2005 of Barma J. At the conclusion of the appeal hearing, the Commissioner's appeal was allowed and the appeal by way of case stated from the BOR was dismissed. The taxpayer lodged an appeal to the CFA.

The CFA overruled the decision of the COA, restored the judgment of Barma J, and decided in favour of the taxpayer. In its judgment, it stated that the administrative and supportive activities carried out in Hong Kong, while essential for the operation of the business, are not relevant in determining the source of profits.

In respect of the source of the relevant income, the CFA held:

(i) the governing source for brokerage commission was the 'place of execution of trades';

(ii) the critical steps in earning the commission income were the execution of the sale and purchase of securities outside Hong Kong – income was not earned until transactions were executed;

(iii) the placement income was derived upon successful allotment of new shares issued/listed outside HK; and

(iv) the marketing income was payable only upon completion of trade in securities which took place on overseas stock exchanges.

The decision of the case reaffirmed the 'operations test', i.e. what were the operations which produced the relevant profits and where those operations took place. In this regard, the operations test requires one to look into the critical steps leading to the derivation of profits, not the whole of the taxpayer's operation or business activities. While rejecting the taxpayer's argument that an agency relationship exists between the taxpayer and the overseas brokers, the CFA ruled that it is not necessary to have an agency relationship before the acts of others could be taken as that of the taxpayer, as long as the other party carried out the activities on the taxpayer's behalf and under the taxpayer's instruction.

Kim Eng Securities (Hong Kong) Limited [(2007) FACV 11/2006]

The facts: The taxpayer is incorporated in Hong Kong and a member of the Hong Kong Stock Exchange. In about 1990, the Kim Eng Group adopted a system to circumvent the minimum commission rules prescribed by the Singapore Stock Exchange. Stockbrokers in Singapore were permitted to give rebates at a maximum of one half of the commission to foreign brokers. If the taxpayer were to place orders for trades on the Singapore Stock Exchange on behalf of clients, the Group as a whole could provide a cheaper, and thus more competitive, service to their clients. The taxpayer argued that the profits arose in Singapore or the other countries where the securities were purchased or sold because it was those trades which generated the profits.

Decision: In the BOR's decision, what the taxpayer was doing to earn its share of the commission was bringing together the complementary needs of the customer (to pay less than the minimum commission) and the overseas broker (to earn a portion of the minimum commission from customers who were not prepared to pay the minimum commission), and that bringing together was done by the taxpayer in Hong Kong by:

(a) opening a trading account for a customer upon notification by an overseas account executive, or in the case of a customer solicited by its own account executive;

(b) taking note of settlement procedure/instructions;

(c) booking trades as confirmed by the overseas account executive and executing broker;

(d) matching confirmations;

(e) generating contract notes and related settlement and accounting documents for trade;

(f) following up on settlement of trades with the account executive and the executing broker (if necessary) and updating records accordingly;

(g) making book entries of the transactions and reconciling statements; and

(h) preparing/generating reports on commission.

The taxpayer's direct appeal to the COA was dismissed. In the judge's view, the BOR was correct. In addition, the profit arose because it was the taxpayer that charged the customer and, in effect,

had to pay less to the overseas broker than it charged the customer. It was able to do so because the taxpayer had contracts with the customers. As to whether the BOR should have considered the question of apportionment, the BOR refused to do so because the issue as to whether there should be apportionment was raised very late during the hearing before the BOR. Moreover, the BOR had little or no material on which to assess the matter. The judges of the COA pointed out that the BOR's approach is correct.

The taxpayer's appeal to the CFA was dismissed. The CFA upheld the COA's decision that the commission income and other income of Kim Eng from customers for dealings with foreign exchanges were taxable. The CFA was of the opinion that the income was not derived from activities performed by its agent outside Hong Kong. Kim Eng was in substance a booking vehicle and earned the income from the dressing-up activities it did in Hong Kong.

Li & Fung (Trading) Limited [(2010) HCIA 1/2010]

The facts: Li & Fung (Trading) Ltd ('LFT') provides services to its customers as their agent in sourcing products from suppliers (manufacturers) outside Hong Kong and overseeing their manufacturing process to ensure that satisfactory goods are supplied to its customers. LFT is headquartered in Hong Kong and has affiliates in various countries. It enters into agency agreements with its customers as a result of the efforts of its senior staff based in Hong Kong. Services provided by LFT to its customers include the following:

(a) Locating suppliers, arranging manufacturing, placing orders in the territory of the suppliers on its customers' behalf;

(b) Monitoring suppliers' production;

(c) Maintaining quality control on the merchandise;

(d) Arranging shipment and assisting suppliers with the preparation of export documentation;

(e) Settling possible merchandise claims on its customers' behalf;

(f) Advising customers of new developments in the suppliers' markets; and

(g) Signing or countersigning contracts/purchase orders/commitments on its customers' behalf.

Upon delivery of the finished goods by the suppliers to its customers, LFT is usually paid a commission equal to 6% of the total FOB value of the customer's export sales.

Where both the customers and suppliers are located outside Hong Kong, LFT entered into separate service agreements with its overseas affiliates under which the latter performed the above services for LFT outside Hong Kong. LFT paid its affiliates 4% of the total FOB value of the customer's export sales for their services.

The Commissioner argued that LFT operated a "supply chain management business" in Hong Kong. While the overseas affiliates earned their 4% commission offshore, LFT earned its 2% commission onshore by managing its own activities and those of the affiliates in Hong Kong. The Commissioner further argued that the affiliates acted as subcontractors and earned the 4% commission for activities abroad, while LFT earned the 2% commission for its activities performed in Hong Kong.

Decision: The BOR rejected the Commissioner's argument and held that LFT was a "commission agent", selling its services for the commission income. LFT's business was that of undertaking, on behalf of its customers, the sourcing of merchandise. The BOR applied the legal principles as articulated by the CFA in *ING Baring*: in establishing the geographic location or the source of a profit, what matters are the proximate or immediately direct profit-producing transactions themselves, not activities that are antecedent or incidental to those transactions.

The BOR found that the overseas affiliates were LFT's agents. The profit-producing transactions of LFT were the sourcing services undertaken on its behalf by its overseas affiliates outside Hong Kong, regardless of whether the affiliates did so as its agents or sub-contractors. On this basis, the BOR ruled that LFT's net commission income was earned in the place where the overseas affiliates carried out LFT's instructions and hence was offshore.

On appeal, the CFI rejected the Commissioner's argument that apportionment of the 6% gross commission as to 4% offshore and 2% onshore was warranted. The Court confirmed both the decision and the analysis of the BOR, and agreed to the BOR's finding that the activities which *directly* led to the payment of the gross commission of 6% were the sourcing and agency activities which LFT carried out through its overseas affiliates outside Hong Kong. While LFT maintained back office or support services for its affiliates at its Hong Kong headquarters, the BOR was entitled to disregard these as merely antecedent or incidental activities, which although commercially essential to the operations and profitability of LFT, were not relevant to determining the source of its net commission income.

The Court also confirmed that the "brain analogy" (the place where the decision-makers of a business are located) is irrelevant to determining the source of a profit, which is to be determined by the nature and situs of the direct profit-producing transactions, and not by where the taxpayer's business is administered or its commercial decisions taken.

The Commissioner appealed against the decision. On 19 March 2012, the COA upheld the CFI's decision that the commission income, earned by LFT through the buying agency services performed by the overseas affiliates for LFT's customers outside Hong Kong, was non-taxable offshore income. The COA's decision is now final as the Commissioner decided not to appeal further.

Appendix 7

Tax case on source of interest income

There is one case involving the determination of the source of the taxpayer's profits from borrowing and lending of money:

Taxpayer	Subject matter	Reference
Orion Caribbean Ltd	Loan interests	(1997) 1 HKRC 90-089

Orion Caribbean Ltd [(1997) 1 HKRC 90-089]

The facts: The taxpayer, a company incorporated in the Cayman Islands, was a wholly owned subsidiary of Orion Royal Pacific Limited ('ORPL'). ORPL was a FI carrying on business in Hong Kong and an indirect subsidiary of the Royal Bank of Canada. The taxpayer had entered into a service agreement with ORPL under which ORPL agreed to provide management, administration and accounting services to the taxpayer in return for a fee. ORPL recommended syndicated loan opportunities to the taxpayer. Such recommendations would be considered by the taxpayer's directors in the Cayman Islands and ORPL was authorised to sign the loan agreements on behalf of the taxpayer under a power of attorney. ORPL would raise funds for the loans and deposit the money into the taxpayer's bank accounts in New York, Tokyo and Frankfurt for on-lending to the borrowers in the US, Japan and Germany. The taxpayer derived interest income from the loans.

Decision: The BOR found that the taxpayer was carrying on a business of money lending but concluded that the interest income of the taxpayer was sourced outside Hong Kong. However, the BOR was of the view that the interest income was taxable pursuant to s.15(1)(i) as the taxpayer, being an associated company of a FI, was within the definition of a FI.

On appeal, the COA decided that the taxpayer was not a FI as it had not taken any deposits or made any lending in Hong Kong. Applying the provision of credit test, as money was made available to the borrowers outside Hong Kong, the interest was offshore and therefore not taxable in Hong Kong.

The Privy Council reversed the decision of the COA by finding that the taxpayer's interest was sourced in Hong Kong. The Privy Council was of the view that the provision of credit test was not applicable in the circumstances as the taxpayer's activities were different from that of a person lending its own funds. The taxpayer had to borrow funds from its Hong Kong parent. It acted as a channel between its Hong Kong parent and the overseas borrowers. Having regard to the services of its parent in Hong Kong (negotiation and conclusion of loan agreements, raising of funds), its interest income was sourced in Hong Kong and chargeable to profits tax under s.14.

Appendix 8

Tax cases on source of sublicensing income

There are two cases involving the determination of the source of the taxpayer's profits from sublicensing (Note: *Emerson Radio Corporation v CIR* [(2005) 5 HKTC 122] is related to the place where a trademark is used):

Taxpayer	Subject matter	Reference
HK-TVB International Ltd	Sublicensing fees	(1992) 1 HKRC 90-064
Lam Soon Trademark Ltd	Licensing fees	(2005) HKRC 90-171

HK-TVB International Ltd [(1992) 1 HKRC 90-064]

The facts: The taxpayer ('HK-TVBI'), a wholly owned subsidiary of the Hong Kong Television Broadcast Ltd ('HK-TVB'), acquired the non-Hong Kong rights to films produced by HK-TVB and sublicensed these rights to overseas television stations and film distributors. HK-TVBI had no office or establishment outside Hong Kong. An employee of HK-TVBI was authorised to negotiate and conclude the sublicensing agreements outside Hong Kong.

Decision: The BOR decided in favour of HK-TVBI that the licensing fees were derived from outside Hong Kong.

The High Court reversed the BOR's decision. On appeal, the COA reversed the High Court's decision and decided in favour of the taxpayer.

The Privy Council finally decided in favour of the Commissioner on the grounds that the relevant business of HK-TVBI was the exploitation of film rights exercisable overseas and that it was a business carried on in Hong Kong. The Privy Council was of the view that, in the absence of any financial interest in the subsequent exercise of the rights by the sublicensee overseas, the fact that the rights were only exercisable outside Hong Kong was irrelevant in determining the source of the taxpayer's profits.

Lam Soon Trademark Limited [(2005) HKRC 90-171]

The facts: The taxpayer formed part of the well-known Lam Soon Group of Companies and its controlling company was Lam Soon Hong Kong Limited (LSHK). The taxpayer had directors in Hong Kong, Singapore and the Cook Islands. Pursuant to a decision of a management meeting held in Hong Kong, LSHK's trademark was transferred to the taxpayer, a company incorporated in December 1987 in the Cook Islands. The taxpayer licensed the right to use the trademark to its associated companies.

Decision: The CFI upheld the BOR's decision that the royalty earned by the taxpayer was sourced from Hong Kong on the grounds that:

(1) the effective decision to acquire the trademark and to grant licenses were all made in Hong Kong;

(2) the negotiation for and the agreements to grant the licenses were made in Hong Kong;

(3) the trademarks were registered in Hong Kong; and

(4) the steps taken to protect the trademark were all traceable to directions from Hong Kong.

The CFI also held that s.60 was wide enough to apply to the present case, i.e. additional assessments to charge the taxpayer under s.14 could be issued even though the taxpayer has been charged under s.15(1)(b) previously. Both the COA and the CFA upheld the CFI's decision in this regard. The CFA held that an additional assessment under s.60 was not precluded by tax having originally been assessed on the basis of what ss.15 and 21A deem, and such original assessment having become final and conclusive.

Appendix 9

Tax case on source of underwriting income

There is one case involving the determination of the source of the taxpayer's profits from underwriting:

Taxpayer	Subject matter	Reference
Kwong Mile Services Ltd	Underwriting income	(2004) HKRC 90-135

Kwong Mile Services Ltd [(2004) HKRC 90-135]

The facts: The taxpayer was formed as a special purpose vehicle for underwriting the sale of a commercial and residential property (Regent House) in Guangzhou. The underwriting agreement was entered into in the Mainland. The marketing activities were handled by the taxpayer's holding company in Hong Kong. The sale of the units of the property was advertised in the *Sing Tao Daily* on 8 and 9 January 1992. 119 out of the 122 purchasers were Hong Kong residents. All the purchase prices were paid in Hong Kong. The taxpayer made a profit of HK$6.8 million, which was computed as the sale prices of the individual units less the amount paid to developer.

Decision: The BOR, by majority, decided in favour of the taxpayer that the profit was offshore profit on the grounds that underwriting was not service. The reward of the underwriter arose from the assumption of the risk. The risk was assumed in the Mainland where the underwriting agreement was signed and where the subject matter of the underwriting agreement was situated. The profit had arisen before the subsequent events of the marketing and sale of the units in Hong Kong.

On appeal, the CFI decided in favour of the Commissioner on the following grounds:

(i) At the time of entering into the underwriting agreement and assuming the risk, no profit was produced.

(ii) The profit only arose when the units were sold to the purchasers and the sale proceeds exceeded the underwritten sum.

(iii) The assumption of the risk in Guangzhou materialised into profits only because of the marketing activities in Hong Kong.

(iv) Having so recognised the causal connection, the only reasonable conclusion is that the profit of underwriting arose in or derived from those activities in Hong Kong.

Both the COA and the CFA decided in favour of the Commissioner, and confirmed that in applying the broad guiding principle to determine the source of profit, one should grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters.

Appendix 10

Tax case on sums chargeable under ss.15(1)(a), (b) or (ba)

There is one case involving the determination of whether sums for the right to exhibit the television programmes is chargeable under ss.15(1)(b) or (ba).

Taxpayer	Subject matter	Reference
Turner Entertainment Networks Asia, Inc for Muse Communication Company Limited	Sublicensing fees and technical costs	(2012) HCIA 4/2010

Turner Entertainment Networks Asia, Inc for Muse Communication Company Limited [(2012) HCIA 4/2010]

The facts: Turner Entertainment Networks Asia, Inc (Turner) carried on an entertainment business in Hong Kong. Muse Communication Company Limited (Muse), a non-Hong Kong resident company not carrying on business in Hong Kong, held rights to certain television programmes in Taiwan in the language of Chinese Mandarin with Chinese subtitles. Under two license agreements entered into in 2005 and 2006, Muse granted Turner the right to exhibit the relevant television programmes in Taiwan in return for license fees. Turner also paid technical costs to Muse for providing dubbed and subtitled tracks for the relevant television programmes.

Income generated by Turner from exhibiting the relevant television programmes in Taiwan was fully taxable in Hong Kong; and Turner was entitled to claim a deduction for the license fees and technical costs.

The Assessor considered that the license fees and technical costs received by Muse from Turner should be chargeable to tax under s.15(1)(ba), and charged Muse in the name of Turner (being the person who paid or credited the relevant sums to Muse) under s.20B(2). Turner appealed on behalf of Muse, and agreed with the Commissioner to transfer the appeal to be heard directly by the CFI.

Decision: The CFI accepted the Commissioner's argument that a person who has the right to use an IPR is a person who can exploit that right or the IP. If not for entering into the two license agreements, Turner would not have had the right to exhibit the relevant television programmes in Taiwan. The exhibition of the relevant television programmes involved the use of, or right to use, the copyright materials which subsisted in the relevant television programmes, and the license fees were paid for that right. As Turner was entitled to claim the fees as tax deductible in Hong Kong, the license fees were caught by s.15(1)(ba).

As an alternative argument, Counsel for Turner submitted that as a matter of statutory construction, 'copyright material' in ss.15(1)(b) and (ba) does not include 'media works'; and it has always been the legislative intention to treat sums relating to the exhibition of media works under its own regime under s.15(1)(a), and not under the more general provisions in s.15(1)(b) or (ba). However, the CFI considered that because the various paragraphs of s.15(1) were intended to deal with different situations, they need not necessarily be mutually exclusive. The fact that the provisions of the various paragraphs may overlap does not mean they are inconsistent, most likely it is the opposite. Exhibition rights of television programmes can fall within the meaning of 'copyright materials' or 'other property of a similar nature' in s.15(1)(b), and the existence of s.15(1)(a) does not preclude the application of s.15(1)(b).

As for the technical costs, the CFI considered that although the delivery of the tapes dubbed in Mandarin and subtitled with traditional Chinese characters was to be at the cost of Turner, the payment of technical costs was to put the tapes into the final form as agreed to be shown, and for which the license was granted. The payment of technical costs was for the provision of material ready for the license, not for the right to use the material under the license.

Hence, by a judgement dated 22 October 2012, the CFI decided that the license fees, but not the technical costs, were chargeable to tax under s.15(1)(ba). Turner has lodged an appeal to the COA.

Appendix 11

Tax case on capital receipts and balancing adjustment

There is one tax case relating to capital receipts and balancing adjustment:

Taxpayer	Subject matter	Reference
Aviation Fuel Supply Company	Capital receipts and making of balancing charge	(2011) HCIA 6/2009 (2012) CACV 150/2011

Aviation Fuel Supply Company [(2011) HKIA 6/2009] & [(2012) CACV 150/2011]

Under a franchise agreement, the taxpayer ('AFSC') designed and constructed an aviation fuel supply facility for the Airport Authority ('AA') in the new airport to supply fuel to aircrafts. Under a lease agreement, AFSC was granted a land lease in respect of the land upon which the facility was located for 20 years. AFSC can either itself be, or nominate another person to be, the operator of the facility. It was also agreed that AFSC was to claim tax depreciation allowances in respect of the facility, which was disclosed as a fixed asset in AFSC's accounts.

Under an operating agreement, the operator (AFSC's nominee) would charge users of the facility for each gallon of aviation fuel delivered into an aircraft. Under the franchise agreement, the AA undertook to procure the operator to pay AFSC a certain portion of the operator's revenue as facility payments on a monthly basis. The facility payments were so computed to ensure that AFSC would recover its costs of financing and constructing the facility over the 20 year term of operation of the facility with an internal rate of return of 15%. However, the AA can elect to make an accelerated payment to AFSC at any time from the 5th year. Upon receipt of the accelerated payment, the franchise and lease agreements would terminate and the operator would thereafter pay the facility payments to the AA instead of AFSC. The facility payments thereafter paid to the AA would be calculated based on the accelerated payment and would be less than those previously paid to AFSC.

On 23 October 2002, the AA exercised the option to make the lump sum accelerated payment on 7 July 2003 to buy out AFSC's right to receive the income for the remaining 15 years.

The Commissioner argued that the effect of the lump sum payment was to transfer to the AA AFSC's right to receive the facility payments from the operator, which was derived from the property, namely the land lease of the facility. Furthermore, the Commissioner contended that the sum was received by AFSC as consideration for the transfer of the right to receive the facility payments without AFSC also transferring the legal or equitable interest in the land lease as the underlying property. The lump sum was therefore chargeable under ss.15(1)(m) and 15A.

The CFI held that ASFC carried on a business of designing and constructing the facility to earn the income over the 20 years. It did not carry on a business of constructing and selling the facility for a lump sum and therefore was not chargeable to profits tax under s.14.

The CFI took the view that there was no transfer of AFSC's right to receive the facility payments to the AA because the AA's right to receive the facility payments were already in place under the pre-existing terms of the operating agreement. The payment of the accelerated payment extinguished AFSC's right to future facility payments and triggered the AA's right to receive future facility payments from the operator, but there was no transfer of right. The CFI also drew support from the fact that the facility payments to be made to the AA were to be calculated on a basis different from that previously used for payment to AFSC.

Even if there was a transfer of right to receive the facility payments from AFSC to the AA, the lump sum was not caught by ss.15(1)(m) and 15A as it fell within the s.15A(3) exception. As the facility was a fixture attached to the property (the land lease), the legal and equitable interests of AFSC in the facility would appear to have been transferred on the termination of the lease. As such, the underlying property from which the right to receive income was derived was transferred to the AA,

along with the right to receive income from it. Therefore, the CFI held that the lump sum was not chargeable under ss.15(1)(m) and 15A.

The CIR filed a notice of appeal to the COA. Before the COA, Counsel for the Commissioner also argued that the lump sum constituted sale or compensation monies in respect of the facility, thus a balancing charge in respect of depreciation allowances previously claimed should be made.

By a judgment dated 4 December 2012, the COA upheld the CFI's decision and dismissed the Commissioner's appeal. The COA held that the relevant assets for which depreciation allowances were claimed had passed from AFSC to the AA by way of succession. Therefore, no balancing charge was required.

The Commissioner applied for leave to appeal to the CFA, which is scheduled to be heard on 16 August 2013.

Appendix 12

Tax cases on property and share transactions

The following cases involve the determination of taxability of the profit from property and share transactions:

Taxpayer	Subject matter	Reference
Sincere Insurance and Investment Co Ltd	Profit on disposal of property	(1973) 1 HKTC 602
Dr Chang Liang Jen	Profit on disposal of shares	(1977) HKTC 975
Central Enterprises Ltd	Profit on disposal of property	(1989) 1 HKRC 90-005
Chinachem Investment Co Ltd	Profit on disposal of property	(1989) 1 HKRC 90-007
Richfield International Land and Investment Co Ltd	Profit on disposal of property	(1989) 1 HKRC 90-020
Wing On Cheong Investment Ltd	Profit on disposal of property	(1990) 1 HKRC 90-035
Waylee Investment Ltd	Profit on disposal of shares	(1990) 1 HKRC 90-048
Beautiland Co Ltd	Profit on disposal of shares	(1991) 1 HKRC 90-053
Winfat Enterprise (HK) Ltd	Compensation on resumption of land	(1992) 1 HKRC 90-058
Crawford Realty Ltd	Profit on disposal of property	(1992) 1 HKRC 90-060
All Best Wishes Ltd	Profit on disposal of property	(1992) 1 HKRC 90-067
Chanway Investment Co Ltd	Profit on disposal of property	(1998) 1 HKRC 90-092
Hong Kong Oxygen & Acetylene Co Ltd	Payments from property developer	(2001) 1 HKRC 90-108
Aust-Key Co Ltd	Profit on disposal of property	(2001) 1 HKRC 90-109
Brand Dragon Ltd (in members' voluntary liquidation) and Harvest Island International Ltd (in members' voluntary liquidation)	Profit on disposal of property	(2002) 1 HKRC 90-115
Southtime Ltd (2002) 1 HKRC 90-119	Profit on disposal of property	(2002) 1 HKRC 90-119
Kaifull Investments Ltd	Profit on disposal of property	(2002) 1 HKRC 90-120
Wah Hing Fat Realty Co Ltd	Profit on disposal of property	(2003) HKRC 90-125
Stanwell Investments Ltd	Profit on disposal of property	(2003) HKRC 90-130
Hui King-yin	Profit on disposal of property	HCIA 6/2003
Common Empire Ltd	Profit on disposal of landed property (taxpayer's cross-appeal)	(2006) HKRC 90-174
China Map Ltd & Others	Profit on disposal of landed properties	HCIA 4/2005 (2007) CACV 341, 342, 343 & 344/2006 (2008) FACV 28, 29, 30 & 31/2007

Taxpayer	Subject matter	Reference
Real Estate Investments (NT) Ltd	Profit on disposal of landed property	CACV 15/2006 (2008) FACV 3/2007
Lee Yee Shing and Yeung Yuk Ching	Loss arising from the disposal of shares by an individual	(2008) FACV 14/2007
Church Body of the Hong Kong Sheng Kung Hui	Profits on property redevelopment, change of intention, exemption under s.88	HCIA 2 & 3/2009

Some of these cases are discussed below.

Hong Kong Oxygen & Acetylene Co Ltd [(2001) 1 HKRC 90-108]

The Court upheld the decision of the BOR that the taxpayer had changed its intention (from investment to trading) before the subject property was transferred to the taxpayer's wholly owned subsidiary, Hong Kong Development Co Ltd, and the joint venture agreement was executed between the taxpayer, its subsidiary and a property developer. Two sums of $90 million ($180 million in total) received by the taxpayer from the property developer for relocating the taxpayer's business to a new site were held to be trading receipts and taxable.

Aust-Key Co Ltd [(2001) 1 HKRC 90-109]

The BOR found that the taxpayer had changed its intention (from investment to trading) when certain shop premises were sub-divided into 87 shop units and the taxpayer was taxable on the notional profits from the deemed disposal of the property. The IRD submitted a valuation of $16 million for the property while the taxpayer submitted a valuation of $30 million. However, the BOR assessed the value of the property in early November 1988 at $25.5 million. On appeal, the CFI held that the BOR was entitled to make its own finding after having considered the evidence and it was under a duty to do so.

Wah Hing Fat Realty Company Ltd [(2003) HKRC 90-125]

The taxpayer claimed that it had changed its intention (from trading stock to investment) and that the gains on disposal of its property were capital gains. Four different dates were put forward as possible dates of change of intention. The director of the company was unable to explain to the satisfaction of the BOR why he was not sure when exactly the change took place. Both the BOR and the CFI held that the gains are taxable.

Common Empire Ltd [(2006) HKRC 90-174]

The taxpayer acquired some lots of agricultural land in January 1990 ('the first acquisition') and March 1991 ('the second acquisition'). In May 1990, the taxpayer sold two lots of land acquired from the first acquisition ('the First Lots') and derived a gain of $321,616. This gain was treated as a capital gain in the taxpayer's account. For the year ended 31 December 1996, the taxpayer made a gain of $3,527,970 comprising a gain of $37,053 from the sale of one lot of land from the first acquisition ('the Second Lot') and a gain of $3,490,917 from the resumption of land under the second acquisition by the Government ('the Third Lots'). In January 1998, the taxpayer sold further lots of land from the first acquisition ('the Fourth Lots') and made a gain of $15,479,734. All gains from the sale of land were not offered for assessment. The taxpayer's appeal to the CFI was directed to the acquisition and sale of the Fourth Lots only. The taxpayer submitted that it was not a trader in property and the land lots were acquired with the intention of redeveloping them into resort houses for investment. It had been holding the lots for six to eight years and it applied to the District Lands Office for certificates of exemption and land exchange. Its plans were frustrated by the refusal by the District Lands Office of its applications and redevelopment plans. The BOR held that the gain on disposal of the Fourth Lots was not capital in nature based on the following findings:

(i) the taxpayer sold the First Lots within four months of the first acquisition;

(ii) the taxpayer had not produced any evidence as to the development plan, and took no step to build any houses on the land lots;

(iii) there was no evidence on the taxpayer's financial ability to build and hold the houses for an indefinite period.

The CFI noted the BOR's finding which was negative to the taxpayer, i.e. the taxpayer's inexplicable refusal to produce redevelopment plans to the District Lands Office neutralised the inference of capital investment that could be drawn from the taxpayer's efforts in applying for certificates of exemption and land exchange. The CFI upheld the BOR's decision on the ground that the taxpayer failed to discharge its burden of proof. It failed to prove the lots were acquired as capital assets for investment and not for trading purposes.

China Map Ltd & Others [(2007) HKRC 90-192]

The taxpayers were engaged in property holding and were subsidiaries of the same parent company. The ultimate plan of the parent company was to acquire the whole of 304-312 Jaffe Road and 325-327 Lockhart Road, Wanchai for property redevelopment. From July 1988 to April 1993, the taxpayers acquired various lots of land along Jaffe Road and Lockhart Road ('the subject lots'). However, another company was also attempting to acquire the same lots for the same purpose and held some of the lots which the taxpayers intended to acquire. At the end, all the relevant lots (including the subject lots) were sold to the developer who subsequently redeveloped the site. Profits of about $192 million were made by the taxpayers and were assessed to profits tax in the year of assessment 1994/95.

The taxpayers' appeal to the BOR was rejected on the grounds that they failed to discharge the burden of proof. The BOR found that the taxpayers' stated intention before the BOR regarding the subject lots was to redevelop them into offices of their group company and for rental purpose. However, the taxpayers had put forth different versions of intention at various stages earlier. There was insufficient evidence to conclude that the taxpayers' stated intention of redevelopment was genuinely held, realistic and realisable. The taxpayers' appeal to the CFI was also dismissed. The CFI held that the BOR was correct not to make any finding on the issue of the taxpayers' intention, as it would be highly speculative to do so in view of the lack of evidence regarding the intended use of the yet-to-be redeveloped property. The CFI held that the BOR was correct in dismissing the appeal on the basis that the taxpayers had not discharged the onus of proof. The taxpayers' appeal to the COA was also dismissed because they failed to provide evidence that the profits were capital in nature. The decision of the COA was upheld by the CFA.

Real Estate Investment (NT) Ltd [(2008) FACV 3/2007]

The taxpayer was a joint venture between the Chinachem Group and the Sun Hung Kai Group. The taxpayer was the owner of a building situated at No. 49 Conduit Road, Mid-Level, Hong Kong ('the Property') which it acquired in December 1979 and finished redeveloping in June 1996. The taxpayer contended that the Property was acquired as a capital asset and the intention changed upon completion of the redevelopment. Therefore, the market value of the Property as at June 1996 should be used in computing the assessable profit on the disposal of the Property. The BOR was unable to come to a positive finding on the intention of the Taxpayer at the time it acquired the Property and hence dismissed the appeal. Both the CFI and COA upheld the BOR's decision on the ground that the BOR had considered the circumstances of the case before reaching its conclusion. The CFA also upheld the previous two lower level courts' decision. The CFA held that the stated intention of the Taxpayer is not conclusive and the BOR had considered all the circumstantial factors in making its decision. This case demonstrated that the crucial factor is the intention of the taxpayer when it acquired the Property and that such intention must be supported by evidence. The length of ownership was less important.

Lee Yee Shing Jacky and Yeung Yuk Ching [(2008) FACV 4/2007]

The taxpayers claimed their losses incurred on share transactions were trading in nature and hence deductible. Mr Lee was a director of a number of family firms and he received directors' fees from these firms. From about 1992, Mr Lee spent much time buying and selling shares and futures

in his own name and also through his wholly owned and controlled company, YS Tide Ltd. Losses were resulted from these transactions up to 1997. Mr Lee sought to elect for personal assessment and deduct the losses from his share transactions. The IRD disallowed any deductions for his share transactions loss on the basis that he was not carrying on a trade or business. The BOR found Mr Lee not carrying on a business mainly because the onus of proof had not been discharged, and Mr Lee and his assistant were not very truthful and honest witnesses. Both the CFI and COA upheld the BOR's decision. The COA held that the taxpayers failed to provide adequate evidence that the only conclusion the BOR could reasonably have come to was that Mr Lee was carrying on a trade. The CFA also dismissed the taxpayers' appeal. The CFA held that it was reasonably open to the BOR to find that Mr Lee's dealings were not so systematic and organised that they amounted to the carrying on of a trade or business. The CFA took the view that no doubt Mr Lee's dealings went well beyond trading in shares for enjoyment, amusement or past-time. Nevertheless, because of the absence of any findings as to what system or method he used, it was open to the BOR to find that his undoubted profit-making intention and the very large volume and value of his share trades, when examined in the light of the other facts that the BOR must be taken to have found, did not make his buying and selling of shares a trade or business.

The taxpayers have applied for a judicial review against the case stated procedures. The judicial review was heard by the CFI on 18 January 2011. The CFI dismissed the judicial review on 20 February 2011, and the taxpayers have filed an appeal to the COA.

Church Body of the Hong Kong Sheng Kung Hui v CIR [(2010)HCIA 2/2009] *Hong Kong Sheng Kung Hui Foundation v CIR* [(2010)HCIA 3/2009]

The case is concerned about whether the Church had, at some point, embarked on a business or trade in relation to one of its investment properties. In the CFI, the issues in dispute were whether on the facts found by the BOR:

(i) the only true and reasonable conclusion was that when the Church redeveloped its old orphanage site in Tai Po into a low-rise residential estate there was a change of intention such that the Church was embarking on a business or trade;

(ii) that the latest that this change of intention took place was September 1989 or December 1990; and

(iii) it was open to the BOR to conclude that the tax-exempt provision of s.88 (which is relevant to charitable institutions) should not, in this instance, apply to the Church.

Whether the redevelopment of the old orphanage site amounted to a business or trade

The Church argued that the old orphanage site was a trust property held under a charitable trust by the Church and that its Constitution prevented it from entering into a trade or business by way of the redevelopment of the trust property.

The judge pointed out that the contention that the old orphanage site was a trust property was not stated before the BOR and he must therefore be wary of entertaining this argument on an appeal to the Court.

The judge also considered that the fact that the Constitution of the Church expresses 'desire' to exemplify the teachings of Christ does not necessarily mean the Church is prevented from engaging in a trade or business. He noted that there is no self-evident contradiction between a Christian life and engaging in a trade.

The judge therefore rejected the Counsel's argument that the redevelopment was merely a means of enabling the old orphanage site to be sold at the best possible price in accordance with the duties of the trustees and the objects of the Church's redevelopment of the old orphanage site amounted to its embarking on a trade or business.

Whether the Church changed its intention towards the old orphanage site from investment to trading at the latest in September 1989 or December 1990

Prior to its redevelopment, the old site had been used as an orphanage since 1935. The CIR accepted that the site was originally a capital asset of the Church. The CIR however contended

that the Church changed its intention, in relation to the site, sometime between the late 1970s and the late 1980s.

The CIR assessed the Church based on the difference between the sale proceeds of the redeveloped residential units shared by the Church and the deemed tax cost of the site of $300 million (based on the open market value of the site on the challenged date of the change of intention).

The BOR held that the Church changed its intention towards the old orphanage site (from holding as an investment to embarking on a trade) at the latest in September 1989 to December 1990 and the deemed tax cost of $300 million allowed by the CIR to the Church in computing its tax liabilities was appropriate.

In the CFI, Counsel for the Church argued that September 1989 or December 1990 were the wrong dates for a change of intention, simply because the Church was not irrevocably bound to develop the old orphanage site at that point in time. The Counsel submitted that it was not until 1993 when the Church entered into a joint venture with the Cheung Kong Group that the Church was contractually bound to go through with the redevelopment. As such, everything before 1993, including the Church's appointment of architects to plan for the redevelopment and the application to the town planning BOR for the change of use of the old site, was thus merely exploratory and tentative. Hence, the Counsel argued that the change of intention, if any, occurred in 1993 (if so, the deemed tax cost for the old site would be about $1.1 billion instead of the $300 million allowed by the CIR).

The judge acknowledged that the Counsel's argument may be one way to read the facts. However, he ruled that the BOR's conclusion that the change of intention occurred at the latest in September 1989 or December 1990 was not perverse or unreasonable and therefore was sustainable as a matter of law.

Whether the Church was tax-exempt under s.88 of the IRO

Under s.88, "... where a trade or business is carried on by any such [charitable] institution or trust the profits derived from such trade or business shall be exempted and shall be deemed to have been exempted from tax only if such profits are applied solely for charitable purposes and are not expended substantially outside Hong Kong and either:

(a) the trade or business is exercised in the course of the actual carrying out of the expressed objects of such institution or trust; or

(b) the work in connection with the trade or business is mainly carried on by persons for whose benefit such institution or trust is established."

The BOR held that the Church did not present any evidence that the profits from the redevelopment were not expended substantially outside Hong Kong. Nor was the BOR satisfied that the redevelopment of the old orphanage site was undertaken in the course of the actual carrying out of the Church's expressed objects or that the trade or business was carried on by the persons for whose benefit the Church was established. Therefore, the BOR dismissed the Church's tax-exempt claim under s.88.

Despite the Counsel's argument that the Church's Constitution was evidence that it must have used its monies solely for charitable purposes and asking the judge to read the various findings of the BOR in a way that fitted his argument, the judge was not convinced.

The judge also rejected the Counsel's argument that as the redevelopment was undertaken by the committee members of the Church (who are part of mankind or the Anglican communion) and the Church (an Anglican one) started centuries ago to benefit mankind or the Anglican communion, the tax-exempt requirements of sub-paragraph (b) of the provision to s.88 were met. The judge noted that there was simply no evidence of this and that the BOR made no such finding of fact in this regard. The judge opined that s.88 envisages something much narrower, namely that the particular persons who carried out a business or trade are the specific persons for whose benefit a charity was formed or, at least, are persons belonging to a specific class (as distinct from mankind or the Anglican communion in general) for whose benefit a charity was established. Therefore, the CFI held that the Church was not tax-exempt under s.88. The taxpayers filed a notice of appeal to the COA, which is scheduled to be heard on 24 and 25 October 2013.

Appendix 13

Tax cases on deductions under profits tax

The following cases relate to deductions under profits tax:

Taxpayer	Subject matter	Reference
Hang Seng Bank Ltd	Exchange differences	(1972) 1 HKTC 583
Swire Pacific Ltd	Payment to end a strike	(1979) HKTC 1145
Li & Fung Ltd	Exchange differences	(1980) HKTC 1193
Lo and Lo	Provision for long service payment	(1984) 2 HKTC 34
Banque National De Paris Hong Kong Branch	Interest to head office	(1985) 2 HKTC 139
County Shipping Co Ltd	Interest	(1990) 1 HKRC 90-034
Overseas Textiles Ltd	Compensation payments	(1990) 1 HKRC 90-042
Asia Securities International Ltd	Bad debts	(1991) 1 HKRC 90-052
AP Fahy	Medical expenses	(1992) 1 HKRC 90-062
Chinachem Finance Co Ltd	Exchange differences	(1992) 1 HKRC 90-066
Wharf Properties Ltd	Interest	(1997) 1 HKRC 90-085
General Garment Manufactory (Hong Kong) Ltd	Exchange differences	(1997) 1 HKRC 90-090
Cosmotron Manufacturing Company Ltd	Severance pay	(1997) 1 HKRC 90-091
National Mutual Centre (HK) Ltd	Interest	(1998) 1 HKRC 90-094
Secan Limited / Ranon Ltd	Interest incurred during period of property development	(2001) 1 HKRC 90-107
So Kai Tong, Stanley trading as Stanley So & Co	Office facilities charges, equipment rental and entertainment expenses	(2004) HKRC 90-131
Zeta Estates Ltd	Interest attributable to payment of dividend	FACV 15/2006
Chu Fung Chee	Costs of disciplinary proceedings	HCIA 10/2005
Tai Hing Cotton Mill (Development) Ltd	Expenses paid to a related company	[CACV 343/2005] (2007) FACV 2/2007
HIT Finance Ltd *HK International Terminals Ltd*	Interest expenses	HKIA 14 & 15/2005 (2007) FACV 8 and 16/2007
Shui On Credit Company Ltd	Deferred expenditures	(2008) HCIA 2/2007 (2008) CACV 85/2008 (2009) FACV 1/2009
Canton Industries Ltd	Acquisition cost of permanent quota	(2008) HCIA 6/2007
Braitrim (Far East) Limited	Acquisition cost of moulds	[(2012) CACV 45/2012]

Hang Seng Bank [(1972) 1 HKTC 583]

The facts: The taxpayer suffered an exchange loss of over $3 million on the currencies held in sterling and US dollars. The Commissioner agreed to allow the loss on the sterling balance held for foreign exchange dealings which produced profits chargeable to tax but refused to allow the exchange loss on balances held on deposits which did not generate taxable income.

Decision: The BOR decided in favour of the taxpayer. The BOR was of the view that the foreign currencies were the taxpayer's stock in trade and that the exchange loss was a revenue loss allowable for deduction.

On appeal, the High Court upheld the BOR's decision that the exchange loss was deductible.

Swire Pacific Ltd [(1979) HKTC 1145]

The facts: In 1972, the taxpayer was about to merge its business with that of the Hong Kong and Whampoa Dock Co. Ltd. In order to end the strike of its workers, it made payments amounting to $22,416,202. The Commissioner refused to allow $18,156,748 on the grounds that the payments were not made in the production of assessable profits but for the purpose of the merger.

Decision: The BOR decided in favour of the taxpayer. The BOR was of the view that the paramount purpose of the taxpayer in settling the strike by the payment of the retirement grants was to avoid substantial damages that would have been suffered had the strike continued, and the expenditure was therefore incurred in the production of assessable profits.

The High Court upheld the BOR's decision that the payments were allowable.

The COA also decided in favour of the taxpayer that the sums were incurred in the production of assessable profits. The judges were of the view that the payments were made for the purpose of enabling the taxpayer's business to continue and did not bring into existence any asset.

Li & Fung Ltd [(1980) HKTC 1193]

The facts: The taxpayer was a general trader which sold goods to the US and received the sale proceeds in US currency. The receipts were placed in the US on seven-day call deposit and the funds and interest would be remitted to Hong Kong when better rates of exchange could be obtained. The taxpayer suffered a loss when the US dollar devalued in 1973.

Decision: The majority of the BOR allowed the exchange loss based on a view that the income from trading did not lose its identity as trading income by being retained in the US.

On appeal, the High Court decided in favour of the Commissioner on the grounds that the nature of the trading receipts had been altered to that of capital investment when the receipts were accumulated and placed on deposit in US banks with the intention of obtaining more favourable exchange rates.

Lo and Lo [(1984) 2 HKTC 34]

The facts: The taxpayer, a firm of solicitors, introduced a system in 1977 to provide a lump sum payment on retirement to its employees with ten years of service. The amount of payment was to be based on the final salary of the retiring employee. For the year of assessment 1977/78, a provision for staff retirement benefits amounting to $770,000 was provided in the firm's accounts. The Commissioner refused to allow the deduction of the provision on the grounds that it did not fall within the phrase "...expenses incurred during the basis period ..." under s.16(1).

Decision: The BOR decided in favour of the Commissioner although it accepted that the calculation of the provision was 'reasonably accurate' in the circumstances.

The High Court reversed the BOR's decision. The COA also decided that the provision was allowable.

Finally, the Privy Council also decided in favour of the taxpayer on the grounds that deductions allowable under s.16. were not confined to sums actually paid. Since the taxpayer had an

obligation to pay the retirement benefits, the provision was deductible (i.e. the liability has been crystallised).

Banque National De Paris Hong Kong Branch [(1985) 2 HKTC 139]

The facts: The taxpayer's head office was in France. In the years of assessment 1977/78 and 1978/79, profits made by the taxpayer's Hong Kong Branches in Hong Kong were not repatriated to the overseas Head Office but retained and used by the taxpayer in Hong Kong. The Commissioner refused to allow as a deduction the interest charged on the retained profits.

Decision: The BOR decided in favour of the Commissioner on the grounds that the bank and its branches, being one judicial person, could not borrow from or pay interest to itself.

The High Court upheld the BOR's decision.

The taxpayer further appealed to the COA by relying on IRR 3 which prescribed the method of ascertainment of the profits of a Branch bank. The COA decided in favour of the Commissioner on the grounds that the IRR, being subsidiary legislation, could not override provisions of the IRO and that the taxpayer's branches could not be regarded as independent enterprises engaged in business on their own account and no interest had therefore been 'incurred' by the taxpayer.

County Shipping Co. Ltd [(1990) 1 HKRC 90-034]

The facts: The taxpayer incurred interest expenses in the production of assessable profits but none of the conditions set out in s.16(2) . were satisfied.

Decision: The BOR allowed the deduction based upon the view that the specific paragraph in s.16(1)(a) and other subsections were merely inclusive and not in any way limiting.

On appeal, the High Court decided in favour of the Commissioner on the grounds that in construing the word 'including', the full context in s.16. including subsection (2) had to be examined and the interest in question would only be allowed if the provisions of one of the paragraphs of subsection (2) were satisfied.

Overseas Textiles Ltd [(1990) 1 HKRC 90-042]

The facts: In 1976, the taxpayer, a textile manufacturer, decided to cease its textile manufacturing business, demolish its factory premises on the land, and redevelop the land. On cessation of the textile manufacturing business, the taxpayer sold its stock of raw materials at a profit. It also had certain outstanding spinning and weaving contracts that it was unable to complete and compensations for breach of contract were then paid. The Commissioner decided that the surplus on sale of the raw materials was taxable and the compensation payments were not deductible as they were capital payments incurred to enable the taxpayer to cease its manufacturing business.

The taxpayer appealed to the BOR claiming that either the compensation payments should be allowed from the taxable surplus arising from the sale of raw materials or alternatively if the compensation payments could not be deducted, then the surplus on disposal of the raw materials should not be subject to tax.

Decision: Both the BOR and the High Court decided in favour of the Commissioner that the compensation payments were not deductible and the surplus on disposal of the taxpayer's trading stock was taxable.

Asia Securities International Ltd [(1991) 1 HKRC 90-052]

The facts: The taxpayer's main sources of income were rental income and interest from fixed deposits. Some of its deposits were irrecoverable when the FI went into compulsory liquidation. The Commissioner disallowed the bad debts on the grounds that the taxpayer had been investing its funds and had not been carrying on the business of money lending.

Decision: On appeal, the BOR decided in favour of the taxpayer on the grounds that a person is effectively lending money by placing it on deposit with a FI and that the bad debts were allowable.

The High Court upheld the BOR's decision that the irrecoverable deposits were of a revenue nature.

AP Fahy [(1992) 1 HKRC 90-062]

The facts: The taxpayer, the sole proprietor of a practising accounting firm, suffered an accident and incurred medical expenses amounting to over $100,000 for inserting metal rods into his injured leg. The taxpayer likened the metal rods to the supply of machinery or plant for the purposes of carrying on a business and was of the view that there should not be any difference when the 'machinery' or 'plant' was installed in his body rather than in his office.

Decision: On appeal, both the BOR and the High Court decided in favour of the Commissioner on the grounds that the medical expenses had a dual purpose, partly of a domestic or private nature, and partly for the purposes of the preservation of the taxpayer of his own person as an asset to the business and such expenses were not allowable as there could not be any sensible basis of apportionment.

Chinachem Finance Co. Ltd [(1992) 1 HKRC 90-066]

The facts: The taxpayer, a company of the Chinachem Group, borrowed money in US dollars and converted it into Hong Kong dollars and then lent on to its affiliates. An exchange loss was suffered on four US dollar loans which were payable on demand with lengths from less than one year to nine and a half years. The Commissioner disallowed the exchange loss on the grounds that the loans were neither part of the day-to-day incidents of carrying on the taxpayer's business nor temporary or fluctuating.

The BOR decided in favour of the taxpayer on the grounds that the taxpayer's loans were revenue transactions and not accretions to capital and that the exchange losses were allowable deductions.

Decision: On appeal, both the High Court and the COA also decided in favour of the taxpayer on the grounds that the taxpayer's business consisted of borrowing and lending money. Since borrowing money was an ordinary activity of running the taxpayer's business, the loss suffered on the borrowing was therefore of a revenue nature.

Wharf Properties Ltd [(1997) 1 HKRC 90-085]

The facts: The taxpayer, a company of the Wharf Group, acquired the tram depot at Sharp Street East by short-term loans and developed it into a commercial complex known as Times Square. Interest amounting to $327,347,847 was paid during the years of assessment 1987/88 and 1988/89. During the same period, license fees of $6,160,000 (1987/88) and $8,991,613 (1988/89) were received from Tramways for the use of the depot. The Commissioner determined that interest amounting to $15,151,613 was allowable as being incurred in the production of the license fee income and disallowed the balance of the interest expense on the grounds that it was of a capital nature. The taxpayer appealed against the determination relying on the decision in *Travelodge Papua New Guinea Ltd v Chief Collector of Taxes [(1985) ATC 4432]* in which interest expenses incurred in constructing a hotel were held to be allowable.

Decision: The case was transferred directly to the High Court. The High Court judge decided in favour of the Commissioner on the grounds that although interest cannot be capital, the interest in question was of a capital nature having regard to the circumstances of the whole case.

The COA also decided that the interest was not allowable under s.17.

The Privy Council upheld the COA's decision by applying the principle that "the cost of creating, acquiring or enlarging the permanent structure of which the income was to be the produce or fruit was of a capital nature, while the cost of earning that income itself or performing the income-earning operations was a revenue expense". The interest incurred by the taxpayer during the period was done so for a capital purpose, namely, as consideration for the use of the money which enabled the taxpayer to acquire the tramway depot and hold it pending its conversion by redevelopment into an income-earning capital asset. That interest was of a capital nature and therefore not deductible under profits tax.

General Garment Manufactory (Hong Kong) Ltd [(1997) 1 HKRC 90-090]

The facts: The taxpayer, a garment manufacturer and trader, made several purchases of Japanese Yen and suffered exchange losses of $7.5 million on the Yen deposits. The Commissioner refused to allow the deduction of the exchange losses on the grounds that the losses were of a capital nature.

Decision: The BOR decided in favour of the taxpayer. The BOR found that the taxpayer's activities in relation to the Yen purchases constituted trading and that the exchange losses were sourced in Hong Kong.

On appeal, the CFI, having regard to the taxpayer's intention at the time of acquisition of the Yen, which was to dispose of it quickly for a profit, also decided in favour of the taxpayer that the exchange losses were allowable.

Cosmotron Manufacturing Company Ltd [(1997) 1 HKRC 90-091]

The facts: The taxpayer, a metal product manufacturer, made severance payments in accordance with the Employment Ordinance on cessation of business in 1991. The Commissioner disallowed the deduction on the grounds that the severance payments were not incurred in the production of assessable profits but for the purpose of closing down the taxpayer's business.

Decision: The BOR decided in favour of the taxpayer as the obligation to make the severance payment arose from the terms upon which the employees had been engaged and had remained in employment.

Both the High Court and the COA upheld the BOR's decision.

The Privy Council also decided that the severance payments were allowable under s.16(1) as being incurred in the production of assessable profits for any period.

National Mutual Centre (HK) Ltd [(1998) 1 HKRC 90-094]

The facts: In 1987, the taxpayer borrowed a sum of money from a consortium of banks (the principal lenders) and its parent company (the subordinated lender). Under the loan agreements, although interest would accrue on the debt due to the taxpayer's parent company, no payment would be made until the debts to the principal lenders were fully settled. The Commissioner refused to allow the deduction of interest expenses accrued but not paid.

Decision: The BOR decided in favour of the taxpayer. The BOR found that the interest expenses were incurred and payable within the meaning of s.16(1)(a) .. The interest payable was also chargeable to tax under the then s.28(1) (abolished in 1989) and thus fulfilled the criterion of s.16(2)(c) ..

On appeal, the High Court and the COA also decided in favour of the taxpayer that the interest accrued but not yet paid was deductible.

Secan Limited / Ranon Limited [(2001) 1 HKRC 90-107]

The facts: Secan Ltd and Ranon Ltd are companies of the Cheung Kong Holdings Group. As the issues of the two cases are identical, the taxpayers and the Commissioner agreed to concentrate on the facts of the *Secan* case.

In early 1988, Secan acquired a piece of land at Ap Lei Chau for redevelopment. The majority portion of the redevelopment project (more than 97.7%) related to resale of residential units from which liability to profits tax arose.

The land acquisition costs and the development costs were financed by way of interest bearing loans from banks and the Cheung Kong Holdings Group companies. In the accounts of Secan for the years of assessment 1989/90 and 1990/91, its related interest expenses were reflected in arriving at the respective year's operating results but then credited and capitalised to 'properties under development'. Up to 31 December 1991, total financing costs of $873 million was incurred

for the interest on loans and the loan arrangement fees. In submitting its tax computations for the years up to 1990/91, Secan did not make any claim for deduction of financing charges.

The occupation permit related to Phase I of the development was issued in November 1991. In its accounts for the year of assessment 1991/92, Secan showed a profit from sales of flats after deducting the costs of the flats sold which included a portion of financing costs totalling $63 million.

In submitting its 1991/92 profits tax computation, Secan deducted all the remaining capitalised financing costs ($873 million less $63 million = $810 million). The IRD disallowed the $810 million financing costs claimed. Secan appealed to the BOR.

Decision: The BOR decided in favour of the Commissioner with its reasons as follows:

(i) Secan had adopted the accounting treatment of capitalisation of interest and related charges.

(ii) The ordinary commercial principles should be applied in computing the true profits or gains in the year in question.

(iii) Secan's directors approved the accounts and its auditors had expressed the view that those accounts 'give a true and fair view' of the state of its affairs for the relevant periods.

(iv) Secan adopted the practice in capitalising interest that involved the deduction of the whole of the interest incurred during the period but the crediting against them of a closing figure for unsold stock and for work in progress as a notional receipt.

Secan appealed to the CFI. The CFI decided in favour of the taxpayer. The COA also upheld the decision of the CFI. However, the CFA finally ruled in favour of the Commissioner that according to the accounting policy adopted by the taxpayer, the interest formed part of the cost of its trading stock and should only be deducted when the stock was sold.

The comments from the CFA are as follows:

(i) Both profits and losses must be ascertained in accordance with the ordinary principles of commercial accounting as modified to conform with the IRO.

(ii) Where the taxpayer may properly draw its financial statements on either of two alternative bases, the Commissioner is both entitled and bound to ascertain the assessable profits on whichever basis the taxpayer has chosen to adopt.

(iii) The taxpayer is bound by its own choice. There is no basis on which a taxpayer can challenge an assessment based on its own financial statements, so long as these are prepared in accordance with ordinary accounting principles, show a true and fair view of its affairs and are not inconsistent with a provision of the IRO.

(iv) Sections 16 and 17 are enacted for the protection of the revenue, not the taxpayer, and s.16. is to be read in a negative sense. In this respect there is no difference between the law of Hong Kong and the law of England.

(v) There can be no inconsistency between s.16, which is concerned with debits, and the capitalisation of interest, which is concerned with credits.

(vi) The acquisition of an asset at a value equal to its cost gives rise to neither profit nor loss.

(vii) The taxpayers cannot arrive at the profits of the year without taking into account the value of the stock they have at the beginning of, and at the end of, the accounting year.

(viii) In order to ascertain the profits or losses of each year of account separately, each year is treated as if it were a different trader. The value of the closing stock of one year is treated as sold to the next year and becomes the cost of purchasing the opening stock of that year.

(ix) In the computation of losses in the taxpayers' accounts, interest was properly deducted by debiting and setting off against the corresponding increase in the value of property under development. The losses in respect of capitalised interest now claimed by the taxpayers are fictitious and arise from double counting.

Based on the decision of *Secan* and *Ranon*, the Commissioner is of the opinion that assessable profits must be ascertained in accordance with the ordinary principles of commercial accounting, as modified to conform with the IRO. As a result, the IRD issued DIPN 40 in October 2002, indicating tax treatment should follow the accounting treatment of prepaid revenue expenses if the treatment in the taxpayer's accounts is in accordance with the prevailing generally accepted principles of commercial accounting and is not inconsistent with any provision in the IRO. Pursuant to DIPN 40, any amortised revenue expenses appeared as prepaid or deferred revenue expenses in the balance sheet will, with effect from the year of assessment 2002/03, no longer be deducted from the assessable profits in the year in which the expenses are incurred.

So Kai Tong, Stanley Trading as Stanley So & Co [(2004) HKRC 90-131]

The facts: The taxpayer was a sole proprietor carrying on business as a certified public accountant. The IRD disallowed certain expenses (including equipment rental, office facilities charges and entertainment expenses) claimed to have been incurred by the taxpayer for 1996/97 and 1997/98.

Decision: On appeal to the BOR, the BOR allowed a part of the expenses but not the balance as the taxpayer was unable to demonstrate to the satisfaction of the BOR that the expenses were incurred in the production of his assessable profits. The taxpayer appealed to the CFI on the ground that the BOR refused to grant an adjournment to him for the purpose of producing further supporting details to support his deduction claim. The Court decided in favour of the Commissioner as it would only intervene where the decision of the BOR was inconsistent with a true and reasonable conclusion on the facts found.

Zeta Estates Ltd [CACV 191/2005; FACV 15/2006]

The facts: The taxpayer is jointly owned by three corporate shareholders and engaged in redevelopment of properties for resale and rental income. Profits were made between 1993 and 1998 and were retained in the company as working capital. These profits were all then distributed as dividends to the shareholders as interim dividends and final dividends between 1998 and 1999. The payments of dividends resulted in deficiency in working capital. In order to raise fresh working capital, the shareholders did not receive these dividends in cash. Instead they allowed the dividend payables converted into interest-bearing loans. Interests were paid on these loans.

The taxpayer argued the loans were borrowed to finance the working capital of the company and interests thereon were incurred for the purpose of producing chargeable profits. The Commissioner, however, challenged the loans were not borrowed for the purpose of producing profits but for the purpose of dividends and hence not tax deductible.

Decision: The BOR found that as there were no actual payments of the dividends and if the taxpayer was in need of fresh working capital, it should not distribute the dividends in the first place. The BOR concluded that the loans and interests were attributable to the payments of dividends and were not incurred for the purpose of producing chargeable profits.

The case was appealed to the CFI on the ground that the BOR was wrong in its conclusion. The Court ruled that the BOR was correct as the payment of dividends and the borrowing were one transaction and the true purpose of the loans was to finance the payments of dividends.

The taxpayer's appeal to the CFA was allowed. The comments from the CFA are as follows:

(i) Details of Zeta's balance sheet and profit and loss account for the year ended 28 February 1999 are highly important. These figures show a company with very substantial net assets, very substantial accumulated profits but very little liquidity.

(ii) S.16(1)(a) refers to '… the purpose of producing … profits'. However, the word 'producing' should not be given a restricted literal meaning. If the purpose of the borrowing is to maintain an existing profit producing capacity, the requirement of the statutory provision would be satisfied. If it is apparent that the purpose of the borrowing in question is to maintain the profit-earning capacity of the company by avoiding the need to sell profit-earning assets, or, as the case might be, to preserve in some other way the profit-earning capacity of the assets, the borrowing should be regarded as satisfying the s.16(1)(a) requirement that the

borrowing is for the purpose of producing profits, and the interest on the borrowing should be deductible accordingly.

Chu Fung Chee [HCIA 10/2005]

The facts: The taxpayer was a practising barrister in Hong Kong. Complaints were lodged against him for alleged misconduct while he pursued a study at the University of Hong Kong and some of the complaints were found proven against him. He was required to pay to the Bar Association the costs of the Bar Council and Bar Disciplinary Tribunal incurred for the disciplinary proceedings brought against him. Profits tax assessments were raised with the costs paid by the taxpayer disallowed.

Decision: The BOR found that the costs were revenue in nature as the taxpayer should be regarded as undergoing maintenance or damage control to a structural asset which was his right to practise. The BOR also did not accept the costs were equivalent to a fine.

The Commissioner appealed to the CFI. The Court ruled that the disciplinary proceedings concerned the taxpayer's dealing with the University of Hong Kong when the taxpayer applied for postgraduate studentship. The application has nothing to do with his practice as a barrister. The costs were ordered under s.37 Cap 159 and were akin to a fine or penalty. Further, on the facts found, the costs paid by the taxpayer can only be for the purpose of preserving his practice as a barrister and were hence capital expenditure.

Tai Hing Cotton Mill (Development) Ltd [CACV 343/2005; FACV 2/2007]

The facts: The taxpayer acquired a piece of land from its parent company, with the price based on the formula under which the parent company could get a share of future profits in the land's development, and NOT on the land's market value of $800 million at the time of transfer. The taxpayer finally paid $1,084 million to the parent company as the purchase price.

The Commissioner accepted the parent company's claim that the receipt for sale of the land was non-taxable capital receipt but rejected the deduction claim by the taxpayer that was in excess of the land's market value at the time of transfer, by invoking s.61A.

Decision: On appeal, the BOR ruled in favour of the taxpayer and held that s.61A was not applicable as the transfer of the land from the parent company to the taxpayer did not provide a tax benefit to the taxpayer. The taxpayer would have no tax liability with or without the land transfer. The BOR also held that the main purpose of the transaction was not to obtain a tax benefit, noting that the sale of land in exchange for a share of future profits in its development was a common, commercially justified transaction.

The CFI overturned the BOR's decision on the two contentious issues. The COA upheld the BOR's decision and held that the sole or dominant purpose of the land transfer was not to obtain a tax benefit and therefore s.61A should not apply.

The CFA overturned the COA's decision and upheld the s.61A assessment on the taxpayer. The CFA considered that the sale of the land from the parent company to its wholly owned subsidiary, the taxpayer, was not at arm's length. The taxpayer's sole or dominant purpose for using a formula to fix the land price was to obtain a tax benefit and the Commissioner was entitled to substitute the market value as the price. The s.61A issue is discussed in further detail in **chapter 9, section 4.3**.

HIT Finance Ltd; HK International Terminals Ltd [HKIA 14 & 15/2005; FACV 8 and 16/2007]

The facts: This case involved a group's self-subscribed part of the Luxembourg-listed debentures issued by HIT Finance Ltd of the Hutchison Whampoa Group. The Commissioner rejected the deduction claim for the interest with respect to the self-subscribed loan by invoking s.61A, and assessed both HIT Finance and HK International Terminals Ltd (HITL).

Decision: The BOR upheld the assessments and held that the sole or dominant purpose of the transaction was to obtain a tax benefit in the form of additional interest deduction. The COA took the view that the BOR was too pre-occupied with the idea that the circular flow of money on the

self-subscribed portion of loan notes did not involve real money. As such the BOR did not ask the right questions as to the sole or dominant purpose of the transaction. The COA returned the case to the BOR for re-consideration. The Commissioner then appealed to the CFA.

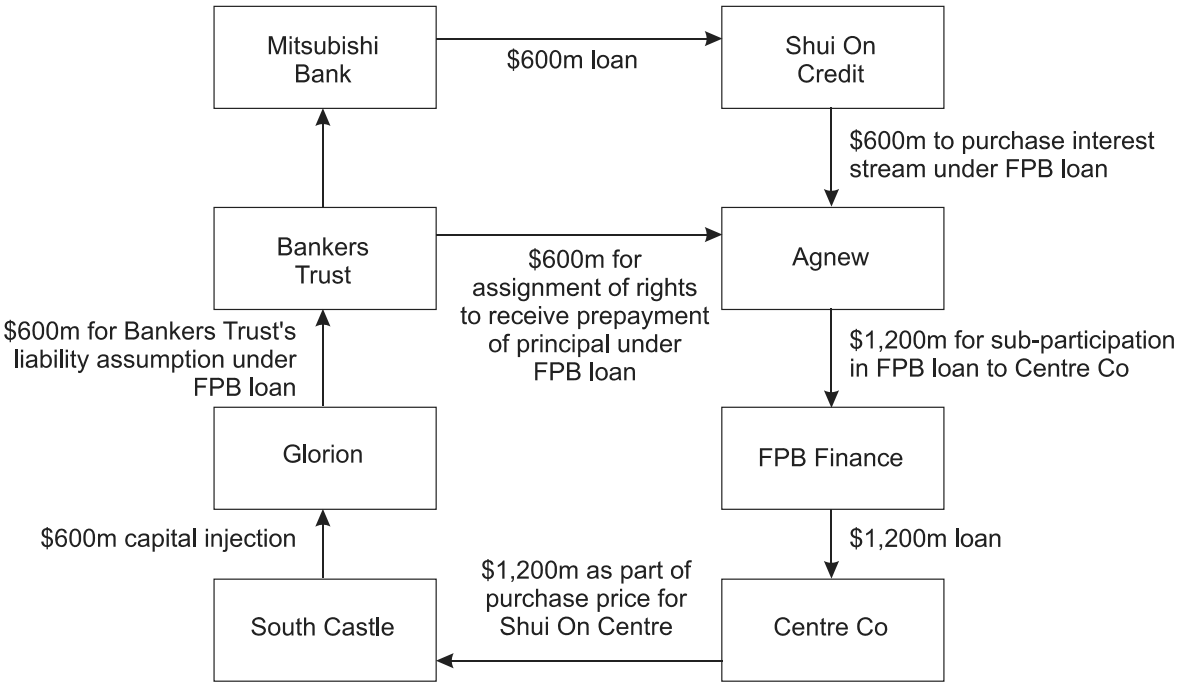
The CFA judge, Lord Hoffman, disagreed with the COA's view. He opined that the heart of the case was the 'remarkable' arrangement where HIT Finance issued loan notes in an amount three times as much as what could be taken by the market and self-subscribed for two-thirds of the notes through Strategic Investments International Ltd. He concluded that the evidence suggesting some non-tax purposes of the arrangement was sparse and unconvincing. The CFA held that the transaction was entered into for the sole or dominant purpose of obtaining a tax benefit, and upheld the s.61A assessment on HITL. The assessment on HIT Finance was annulled as the CIR had achieved her objective of counteracting the tax benefit.

Shui On Credit Company Ltd [(2008) HCIA 2/2007, (2008) CACV 85/2008 & (2009) FACV 1/2009]

The facts: South Castle is a company within the Shui On Group. It is 100% owned by Shui On Properties which in turn is 100% owned by Shui On Investment. Shui On Investment is 100% held by Shui On Holdings (formerly Shui On Group Ltd). At the relevant time South Castle had three wholly-owned subsidiaries: the Taxpayer, Centre Co. and Glorion.

In 1985 South Castle acquired Shui On Centre in Wanchai with finance obtained from HSBC. By early 1988, the group was interested in re-financing South Castle's liability with HSBC. At the time, Shui On Centre's units had all been leased with an annual rental income of $100 million anticipated. Some $358 million remained due to HSBC.

In May 1988, companies within the Shui On Group entered into the Refinancing Scheme as depicted in the diagram below. The net result of the Scheme was that Mitsubishi Bank's $600 million loan 'ended up in South Castle'. The Mitsubishi loan was in essence split into two sums, one in the sum of about $358 million, the other in the sum of about $242 million. The taxpayer in effect used these funds to pay Agnew for the interest stream under the Centre Co. Loan. The BOR found that there was an 'artificial flow of funds'.



Having purchased the interest stream of the Centre Co. Loan from Agnew for $600 million, the taxpayer became entitled to receive an income equivalent to 9.375% per annum of $1,200 million from Centre Co. This income receivable was, however, cancelled out by the taxpayer's obligation, as a result of the Swap and Supplemental Swap Agreements, to pay Centre Co. an identical amount of interest.

As a result of the Swap and Supplemental Swap Agreements, the taxpayer also acquired the right to receive payments at a floating rate from Centre Co. This income receivable was equivalent to (and so cancelled out by) the taxpayer's repayments of principal and interest under the Mitsubishi loan.

Decision: The CFI took the view that the taxpayer paid the consideration of $600 million to acquire a chose in action. The chose was not trading stock acquired for the purpose of being traded. Instead the chose formed the taxpayer's sole profit-yielding structure during the relevant years of assessment. The chose yielded an interest stream returnable as taxable income for the Taxpayer for a period of eight years. The amortised consideration was described as a 'deferred expenditure' in the taxpayer's profit and loss account. But the taxpayer's own classification cannot be determinative. It was held that the deferred expenditure was a non-recurring or once and for all payment incurred to obtain an income stream. It was of a capital nature and not deductible. The CFI also held that the Scheme was entered into for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit of tax deduction of the $600 million consideration for the interest income stream and hence s.61A is applicable.

The COA upheld the CFI's decision. It dismissed the taxpayer's contention that as the tax benefit ceased to exist once the Court confirmed the non-deductibility of the deferred expenditure, the assessment issued under s.61A was thus void, and that the Commissioner is prevented from statutory time bar from issuing assessment after six years. It confirmed that s.61A is not a charging provision but a section which empowers the Commissioner to ignore or adjust the effect of a transaction in particular circumstances. It was the Commissioner's function to determine the nature of the purported expenditure that was claimed to be deductible. It was open to the Commissioner to say that there was more than one reason why the relevant amounts were not deductible. It also rejected the taxpayer's contention that as the rental income stream was received by Centre Co, the tax was charged on the wrong party, stating that the taxpayer did receive an income stream that would be the taxpayer's taxable profit, subject to legitimate deduction. The COA took the view that the disputed deductions, as generated from the circular flow of fund, were no more than paper entries of little, if any, reality. The COA confirmed that if the amounts claimed to be deductible under s.16 had not been expenditure of a capital nature within the meaning of s.17(1)(c), the Commissioner clearly was entitled to apply the provisions of s.61A to deny the deduction.

The CFA upheld the decisions of the BOR, the CFI and the COA. Once again, the CFA confirmed that s.61A is not a separate charging provision but to extend the scope of the ordinary charging provision in the IRO. The CFA also commented that a tax benefit is a prerequisite for applying s.61A.

The CFA judge opined that s.61A serves as an aid to the charging provisions of the IRO by enabling the Commissioner to take measures to counteract a tax benefit in the process of assessing a taxpayer's liability to tax under a particular charging provision. Section 61A could be invoked only after the IRD exhausts all other provisions of the IRO to deny the said tax benefit. Nonetheless, even if an assessment is expressively made under s.61A, the Commissioner can rely on any provisions of the IRO to uphold an assessment in any appeal to the BOR, provided that the challenge under s.61A is raised as an alternative to challenges under any of the other provisions of the IRO.

The CFA judge also took the view that if the supposed tax benefit would not have been achieved even in the absence of s.61A, logically s.61A cannot apply, as there would be no tax benefit in the statutory sense. It also confirmed that the 'deferred expenditure' formed the sole profit-yielding structure of the taxpayer, was a non-recurring or one-and-for-all payment incurred to obtain the income stream and thus was capital in nature and non-deductible.

The CFA judge rejected the taxpayer's argument that as a finance company, money or the interest stream acquired by it was analogous to its stock in trade and, as such, the consideration paid for the acquisition of the same should be regarded as being revenue expenditure. The CFA judge noted the taxpayer was a single-purpose vehicle, brought into existence in order to perform its predetermined function in the tax-avoidance scheme. In the circumstances, the CFA judge considered that the taxpayer did not acquire the income stream with the intention of selling it or

otherwise turning it to account and the taxpayer's function was to hold the assigned income stream and to serve as a conduit between Centre Co and Mitsubishi Bank.

Canton Industries Ltd [(2008) HCIA 6/2007]

The facts: Canton Industries ('Canton') is in the textile business. Its claim for deductions in respect of the acquisition cost of permanent quotas was disallowed by the IRD. During the years assessed, it was not possible to export textiles to Europe or the United States without quota. At the time there were two types of transfers of textile quota in Hong Kong. One type concerned the transfer of permanent quota. Under this type, a transferee (such as Canton) obtained the right to use a quota allocation year after year for the life of the quota, provided only that one used a certain percentage of the allocation in any previous year. The other type concerned the transfer of temporary quota. Effectively, a transferee obtained the right to use transferred quota for a relevant year. The transferee's use of the transferred quota would be attributed to the transferor and no further quota would be allocated to a transferee in a succeeding year.

Canton acquired both permanent and temporary quotas as part of its business. Its accounting policy was to write off permanent quotas as being utilised on a straight-line basis over the useful economic lives of the same. The permanent quotas were classified in Canton's balance sheet as non-current assets at their written-down value (net of annual utilisation). In contrast, Canton charged the cost of temporary quotas against its profits and loss account as part of the cost of textile sales.

As a consequence of the Mainland's membership in the World Trade Organisation, it was anticipated that the quota system would come to an end on 31 December 2004. The permanent quotas acquired by Canton over the relevant years therefore had a short life span.

Decision: The CFI took the view that with the acquisition of permanent quotas, Canton obtained an enduring benefit. That benefit was the ability to conduct business continuously over the duration of the quotas. Although the life of the quotas may not have been long, such shortness cannot be conclusive. In contrast to the temporary quota which was purchased from time to time as and when required by a business in a given year, the acquisition of permanent quota was a once and for all expenditure. Having acquired the permanent quota, provided that it maintains exports at a certain level, a permanent-quota holder can exploit the bundle of exclusive rights which comes with the quota to generate profits for its trade over the life of the quota. Thus, once acquired, the permanent quota became incorporated into Canton's profit-making structure or fixed capital. The Court also opined that the expenditure on permanent quota does not have a circulating or recurrent nature, nor does expenditure on permanent quota has the character of a regular outlay incurred as part of the process of bringing regular returns through the trading of garments. It was therefore held that the expenditure on acquiring the permanent quota was capital in nature and not deductible.

Braitrim (Far East) Limited [(2012) CACV 45/2012]

This is the first case on the deduction for moulds as prescribed fixed assets under s.16G to have reached the court.

Facts: The taxpayer (BFE) carried on the business of supplying plastic garment hangers to end-customers in the United Kingdom until it ceased business in 2002. The hangers were manufactured in the Mainland by two unrelated manufacturers using moulds provided by BFE. The moulds were used only to manufacture hangers supplied to BFE and no monies were paid by the manufacturers for using the moulds. Ownership of the moulds remained with BFE.

BFE's profits were treated as fully taxable in Hong Kong. In computing its assessable profits, BFE claimed a deduction for the cost of the moulds as 'prescribed fixed assets' pursuant to s.16, in the amount of $11 million, $3 million and $4 million for the years of assessment 2000/01, 2001/02 and 2002/03, respectively. Prescribed fixed assets are defined to include assets used in a manufacturing process, but exclude assets in which any person holds rights as a lessee under a lease.

The issue involves the interpretation of the term 'lease' in s.16G(6) and whether it should follow the statutory definition under s.2(1). If the statutory definition were to apply, BFE's manufacturing

assets would fall within the definition of 'excluded fixed assets' not qualifying for a deduction under s.16G.

Decision: The BOR held that the statutory definition should apply. Bypassing the CFI, BFE appealed to the COA, which upheld the decision of the BOR that the provision of moulds by BFE to the manufacturers constituted a 'lease' arrangement under which a right to use the moulds was granted by BFE to the manufacturers; and that the moulds were 'excluded fixed assets' not qualifying for any tax deductions under s.16G. The COA found that the right to use came within the definition of a lease in s.2(1). The COA agreed with the Commissioner that the historical circumstances indicated that the statutory definition under s.2 was intended by the legislature to apply to s.16G. The COA also agreed that it was the intention of the legislature to allow a deduction only for those fixed assets failing within the statutory definition of 'prescribed fixed assets'.

BFE applied for leave to appeal to the CFA. The application is scheduled to be heard on 19 April 2013.

Appendix 14

Tax cases on Financial Institutions

The following cases relate to FIs:

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

Hang Seng Bank Ltd [(1972) 1 HKTC 583]

This case is discussed in **Appendix 13** 'Deductions under profits tax'.

Banque National De Paris Hong Kong Branch [(1985) 2 HKTC 139]

This case is discussed in **Appendix 13** 'Deductions under profits tax'.

Bank of India [(1990) 1 HKRC 90-029]

This case is discussed in **Appendix 4** 'Tax cases on source of trading profits'.

Hang Seng Bank Ltd [(1990) 1 HKRC 90-044]

This case is discussed in **Appendix 4** 'Tax cases on source of trading profits'.

Appendix 15

Tax cases on non-life insurance companies

There are two cases involving non-life insurance companies:

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

Sincere Insurance and Investment Co Ltd [(1973) 1 HKTC 602]

The facts: The taxpayer had carried on the business of fire and workmen's compensation insurance. In the year of assessment 1970/71, it had profits on the disposal of three pre-war properties which had been held for 36, 28 and 41 years respectively. Since 1950, the taxpayer had 'turned over' between 10 and 15 properties.

Decision: The BOR, by majority, decided in favour of the taxpayer that the properties were held as capital assets and that the profits on disposal were not taxable.

On appeal, the High Court decided that the realisation of the properties was a normal step in carrying on the insurance business and that the profits on disposal of the properties were taxable. It is relevant that they held the properties in the insurance fund.

Carlingford Life and General Assurance Co. Ltd and Carlingford Insurance Co. Ltd [(1989) 1 HKRC 90-025]

The facts: The taxpayers had carried on the business of general insurance and derived offshore interest in the years of assessment 1984/85 and 1985/86. The IRD assessed the taxpayers' offshore interest to tax pursuant to the then s.15(1)(f), which was amended in 1984 to impose tax on corporations' offshore interests.

Decision: The BOR decided in favour of the taxpayers on the grounds that the taxpayers' offshore interest was not taxable pursuant to s.23A, a specific section for non-life insurance businesses.

On appeal, the High Court also decided in favour of the taxpayers on the grounds that the amendment to s.15(1)(f) did not amend s.23A by implication and that the provisions governing insurance companies continued to apply, notwithstanding the amendment made to s.15(1)(f).

Note: Section 15(1)(f) was amended again in 1986 to exclude corporations' offshore interests from tax liability.

Appendix 16

Tax case on non-resident ship owner

There is one case relating to a non-resident ship owner:

Taxpayer	Subject matter	Reference
Zim Israel Navigation Co Ltd	Grants from Government	(1972) 1 HKTC 573

Zim Israel Navigation Co Ltd [(1972) 1 HKTC 573]

The facts: The taxpayer was incorporated in Israel and operated passenger and cargo services. The Government of Israel, that owned 80% of the share capital of the taxpayer, granted annual sums to supplement the taxpayer's income in order to cover its operating losses.

Decision: The BOR, by majority, decided that although the grants were income of the taxpayer, such sums were not sums 'in respect of the carriage of passengers...' and therefore should not be included in the computation of the taxpayer's world shipping income and total world shipping profits.

On appeal, the High Court decided that the grants given to the taxpayer to cover its operating losses of passenger vessels were caught by the wording of the then s.23C(1) 'in respect of the carriage of passengers ...', and were to be included in the taxpayer's world shipping income and in its total shipping profits.

Appendix 17

Tax case on foreign currency loss made by non-resident aircraft owner

There is one tax case relating to non-resident aircraft owner with a loss in foreign currency:

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

Malaysian Airline System Berhad [(1994) 1 HKRC 90-070]

The facts: The taxpayer, a company incorporated outside Hong Kong, carried on an airline business in Hong Kong. Its principal accounts were maintained in a foreign currency, namely, Malaysian ringgits ('the base currency'). The IRD converted the taxpayer's losses into Hong Kong dollars for each year of assessment while the taxpayer carried on its losses in the base currency. According to the calculation of the IRD, the taxpayer's profits for 1987/88 and 1988/89 exceeded the amount of the accumulated losses brought forward in Hong Kong dollars and profits tax assessments were raised on the taxpayer. According to the taxpayer's calculation, its profits in the base currency did not exceed the losses brought forward in the same currency.

Decision: The BOR decided in favour of the taxpayer that the losses could be carried forward in its base currency.

On appeal, the High Court decided in favour of the Commissioner on the grounds that s.19C(4) only worked sensibly if losses were calculated and fixed at the same time as profits.

Appendix 18

Tax cases on clubs and trade associations

The following cases relate to club and trade associations:

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

Far East Exchange Ltd [(1979) 1 HKTC 1036]

The facts: The taxpayer, a company limited by guarantee, was formed to establish an Exchange for its members, which were limited to 150 by its Articles of Association. The Articles of Association stated that the entrance fees were deemed to be capital and not refundable. The IRD assessed the taxpayer's entrance fees as taxable and the taxpayer claimed that the entrance fees, being receipts of a capital nature, should be excluded from tax pursuant to s.14.

Decision: The BOR decided in favour of the taxpayer that the entrance fees were not taxable.

On appeal, the COA also upheld the BOR's decision.

The Privy Council reversed the decision of the COA. It ruled that it was not necessary to decide whether or not the entrance fees were capital in nature, because s.14, the charging section of profits tax, opens with the words 'subject to the provisions of this Ordinance' and, by reason of s.24(2), the entrance fees are deemed to be receipts of the business which is deemed to be carried on by the company. Therefore, entrance fees must be chargeable to profits tax if the s.24(2) test is fulfilled.

Kowloon Stock Exchange [(1984) 2 HKTC 99]

The facts: The taxpayer, a company limited by guarantee, was formed to establish an Exchange for its members. The IRD assessed the taxpayer as a trade association deemed to be carrying on business under s.24(2). The taxpayer tried to claim that it was a club and as more than half of its receipts came from its members, it was not chargeable to tax, or alternatively, the subscriptions under s.24(2) should cover founders' contributions and entrance fees.

Decision: Both the BOR, the COA and the Privy Council decided in favour of the Commissioner that the taxpayer was a trade association and was deemed to be carrying on a business under s.24(2).

The Privy Council decided as follows:

(i) The company could not properly be described as a club for the reason that it existed to aid the profit-making activities of its members.

(ii) An association formed by traders to hold and manage premises for the purposes of their trade was a trade association.

(iii) In the context of s.24(2), subscription does not include entrance fees. Founders' contributions, like entrance fees, were once-for-all payments lacking the recurrent nature of subscriptions.

Appendix 19

List of provisions relating to sums specifically chargeable to profits tax

The following is a brief guidance on sums specifically chargeable to profits tax:

Section	Sums specifically chargeable to profits tax
15(1)(a)	Sums received by or accrued to a person for the exhibition or use in Hong Kong of cinematograph or television 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 Hong Kong any patent, design, trademark, copyright material, secret process or formula or other similar property, or for imparting knowledge in connection with the use in Hong Kong of any such properties.
15(1)(ba)	Sums received by or accrued to a person for the use of or right to use outside Hong Kong any intellectual properties listed in s.15(1)(b), or for imparting knowledge in connection with the use outside Hong Kong of any such properties, which are deductible in ascertaining the assessable profits of a person under profits tax. Section 21A provides that the assessable profits of a person's income as described in s.15(1)(a), (b) or (ba) shall be taken as 30% of the sums. Where the relevant sum is derived from an associate, 100% of the sum will be treated as assessable, unless the Commissioner is satisfied that no person carrying on a trade, profession or business in Hong Kong has at any time, wholly or partly, owned the property.
15(1)(c)	Grants, subsidies or other similar financial assistance received by or accrued to a person in connection with a trade, profession or business carried on in Hong Kong, 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 Hong Kong. There is no specifically identifiable assessable profit, and this must be ascertained as a question of fact. Failing an ascertainment of the true profit arising in Hong Kong, s.21 provides that it may be computed on a fair percentage of the receipt.
15(1)(f)	Interest derived from Hong Kong received by or accrued to a corporation carrying on a trade, profession of business in Hong Kong. To determine if interest is derived from Hong Kong, the provision of credit test is normally applied. The source is determined by the place where the fund in respect of which interest is received is provided.
15(1)(g)	Interest derived from Hong Kong received by or accrued to a person other than a corporation carrying on a trade, profession of business in Hong Kong, and the interest is in respect of funds of the trade, profession or business. With effect from 22 June 1998, interest on local bank deposits received by or accrued to a corporation or a person other than a corporation carrying on a trade, profession or business in Hong Kong, is exempt from the payment of profits tax under the Exemption from Profits Tax (Interest Income) Order 1998.
15(1)(h)	Refund of contributions made by a person as an employer to a RORS 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 Hong Kong, notwithstanding that the source of interest income is outside Hong Kong. That is, the provision of credit test will not apply.

Section	Sums specifically chargeable to profits tax
15(1)(j)	Gains or profits arising in or derived from Hong Kong 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 of business in Hong Kong. Whether the profits arise in or derive from Hong Kong is determined by the contract effected test, i.e. the place where the contracts of sale and purchase are effected.
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 of business in Hong Kong, 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 on of its business in Hong Kong, notwithstanding that the source of profit is outside Hong Kong.
15(1)(m) and 15A	Sums received as consideration for the transfer of the right to receive income (such as rent, interest or royalty) which is subject to profits tax. The transfer is done by assigning the income to another person without assigning the underlying asset, e.g. transferring the right to interest income without assigning the loan, or transferring the right to rental income without assigning the real property.
15(2)	Where a deduction has been allowed for a trade debt which is subsequently released, the part released is a deemed trading receipt upon release in that year.
16(1)(d)(ii)	Recovery of bad debts previously allowed under s.16(1)(d)(i).
16B(3)	Proceeds from sale of machinery or plant used for R&D previously allowed as a deduction under s.16B(1). The taxable amount is limited to the amount of the deduction.
16E(3)	Proceeds from sale of patent rights or rights to know-how previously allowed as a deduction under s.16E(1) . The taxable amount is limited to the amount of the deduction.
16EB(2)	Proceeds from sale of specified IPRs previously allowed as a deduction under s.16EA(2) 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 PFA previously allowed as a deduction under s.16G(1). The taxable amount is limited to the amount of the deduction.
16J(2) and (2A)	Proceeds from sale of an EPM or EFV previously allowed as a deduction under s.16I(2). The taxable amount is limited to the amount of the deduction.
16J(3)	Proceeds from sale of an EPI previously allowed as a deduction under s.16I(3) that exceeds the unallowed amount (if any). The taxable amount is limited to the amount of the deduction.
18F(1)	Balancing charges on disposal of machinery or plant.

Appendix 20

List of provisions relating to sums specifically exempt from profits tax

The following is a brief guidance on sums specifically exempt from profits tax:

Section	Sums specifically exempt from profits tax
14(1)	Profits not arising in or deriving from Hong Kong, and profit arising 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	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 a Tax Reserve Certificate issued by the Government.
26A(1)(b)	Interest on a bond 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 presentment 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 presentment of an Exchange Fund debt instrument.
26A(1)(f)	Interest on a Hong Kong dollar denominated multilateral agency debt instruments.
26A(1)(g)	Any profit on the sale or other disposal or on the redemption on maturity or presentment of a Hong Kong 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 presentment of a 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: (i) that is authorised as a collective investment scheme under s.104 of the SFO; or (ii) 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.

Section	Sums specifically exempt from profits tax
87	Interest on local bank deposits received by or accrued to companies other than FIs (incorporated or unincorporated), after deduction of all allowable outgoings and expenses incurred in producing such interest, is exempt from the payment of profits tax under the Exemption from Profits Tax (Interest Income) Order 1998. The Exemption Order applies to deposits with an authorised institution (a bank, a restricted licence bank or a deposit-taking company recognised by the Banking Ordinance), regardless of the currency in which the deposit is denominated. The exemption applies whether or not a deposit is evidenced by a certificate of deposit. However, it does not apply to: (i) interest income of FIs, (ii) interest on deposits which is used to secure or guarantee money borrowed from a FI, if the borrowing fulfils s.16(1)(a), any of the conditions in s.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.

Appendix 21

List of provisions relating to allowable deductions

The following is a brief guidance on the allowable deductions under profits tax.

Section	Allowable deductions	Conditions
16(1)	All outgoings and expenses	• Incurred in the production of assessable profits. • Not prohibited by s.17.
16(1)(a)	Interest, legal fees and related borrowing expenses	• As prescribed in s.16(2)(a) to (f) and ss.16(2A) to 16(2H) .
16(1)(b)	Rent	• For land and/or buildings occupied for the purpose of producing assessable profits. • For rent paid to the tenant's spouse, or to the partner(s) or their spouses, the allowable amount cannot exceed the assessable value of the property.
16(1)(c)	Foreign tax paid	• Income on which the foreign tax has been paid is chargeable to profits tax under s.15(1)(f), (g), (i), (j), (k) or (l). • No double tax relief has been granted.
16(1)(d)	Bad debts	• Proved to the satisfaction of the assessor to have become bad. • Being a trading receipt or money lent in a money lending business.
16(1)(e)	Repairs	• Made to assets employed in the production of assessable profits.
16(1)(f)	Replacement of implement, utensil or article	• Employed in the production of assessable profits. • No depreciation allowances have been claimed.
16(1)(g)	Expenses on registration of trade mark, design or patent	• Used in the production of assessable profits.
16(1)(ga)	Payments and expenditure specified in ss.16AA, 16B, 16C, 16E, 16EA, 16F, 16G and 16I	• As prescribed in ss.16AA, 16B, 16C, 16E, 16EA,16F, 16G and 16I.
16(1)(h)	Deductions as may be prescribed by the IRRs	• As prescribed in the IRRs.
16A	Special payment under a RORS or contributions other than regular contributions to a MPFS	• Not previously provided for and allowed. • Allowable by five equal instalments (20% per year of assessment).

Section	Allowable deductions	Conditions
16AA	Mandatory contributions to a MPFS in self-employment cases	• Not otherwise deductible. • Not exceeding $15,000 with effect from 2013/14).
16B	Expenditure on R&D, including expenditure on machinery or plant	• Incurred by the taxpayer or paid to approved research institutions. • The research is related to the taxpayer's trade, profession or business or a class of trade, profession or business in which the taxpayer's trade, profession or business belongs. • Not being expenditures on land or buildings or alternations to buildings. • Apportionment is required if the expenditure is incurred outside Hong Kong and the trade, profession or business is carried out partly outside Hong Kong.
16C	Payments for technical education	• Being payments made to institutions approved by the Commissioner in writing. • Being technical education of a kind specially requisite for persons employed in the class of trade, profession or business to which the taxpayer's trade, profession or business belongs.
16D	ACDs	• Not otherwise deductible. • Not less than $100. • Not exceeding 35% of the assessable profits.
16E	Purchase of patent rights or rights to know-how	• Used in Hong Kong in the production of assessable profits. • Not purchased from an associate. • Apportionment is required if used partly for non-business purpose.
16EA – EC	Purchase of copyright, registered design / trade mark	• Used in Hong Kong in the production of assessable profits. • Not purchased from an associate. • Allowable by five equal instalments (20% per year of assessment). • Apportionment is required if used partly for non-business purpose.

Section	Allowable deductions	Conditions
16F	Expenditure on building refurbishment	• Being expenditures on renovation or refurbishment (not for initial construction or decoration) of a building or structure other than a domestic building or structure. • No depreciation allowance has been claimed. • Allowable by five equal instalments (20% per year of assessment).
16G	Capital expenditure on the provision of a PFA	• Not otherwise deductible. • No depreciation allowance has been claimed. • Not being a leased asset or an asset under a hire-purchase agreement. • Apportionment is required if used partly for non-business purpose.
16H – K	Capital expenditure on the provision of EPM and EFV	• Not otherwise deductible. • No depreciation allowance has been claimed. • Not being a leased assets or an asset under a hire-purchase agreement. • Apportionment is required if used partly for non-business purpose.
16H – K	Capital expenditure on the provision of EPI	• Not otherwise deductible. • No depreciation allowance has been claimed. • Not being a leased assets or an asset under a hire-purchase agreement. • Allowable by five equal instalments (20% per year of assessment). • Apportionment is required if used partly for non-business purpose.

Appendix 22

Inland Revenue Rule 2: Rates of depreciation

TABLE

FIRST PART

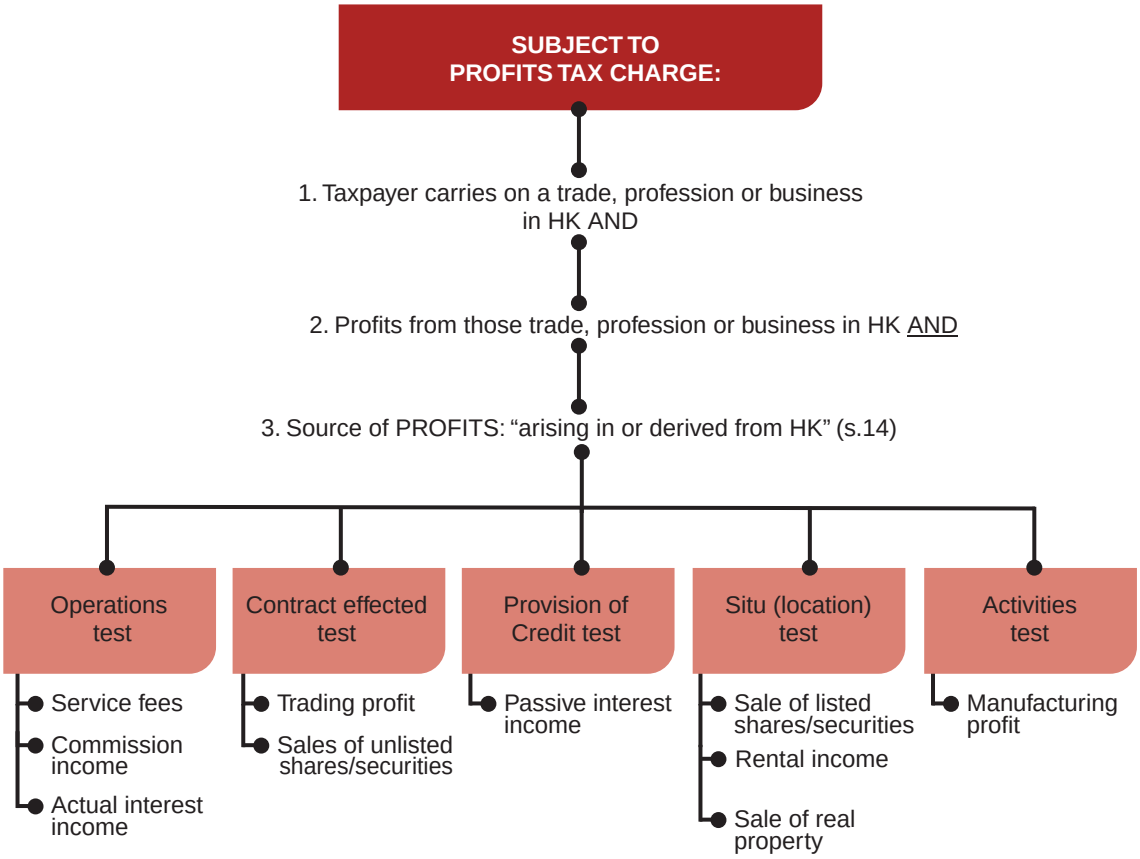
Item	Rate of Depreciation
1. Air-conditioning plant excluding room air-conditioning units	10%
2. Bank safe deposit boxes, doors and grills	10%
3. Broadcasting transmitters	10%
4. Cables (electric)	10%
5. Lamp standards (street)-gas or electric	10%
6. Lifts and escalators (electric)	10%
7. Mains (gas or water)	10%
8. Oil tanks	10%
9. Shipping-	
Ships, junks and sampans	10%
Lighters	10%
Tugs	10%
10. Sprinklers	10%
11. Domestic appliances	20%
12. Furniture (excluding soft furnishings)	20%
13. Room air-conditioning units	20%
14. Shipping-	
Launches and ferry vessels	20%
Hydrofoils	20%
15. Taxi meters	20%
16. Type and blocks (if not dealt with on renewals basis)	20%
17. Aircraft (including engines)	30%
18. Bar syphon apparatus	30%
19. Bicycles	30%
20. Bleaching and finishing machinery and plant	30%
21. Concrete pipe moulds	30%
22. Electric cookers and kettles	30%
23. Electronic data processing equipment	30%
24. Electronics manufacturing machinery and plant	30%
25. Motor vehicles	30%
26. Plastic manufacturing machinery and plant including moulds	30%
27. Shipping-	
Outboard motors	30%
28. Silk manufacturing machinery and plant	30%
29. Sulphuric and nitric acid plant	30%
30. Tank lorries	30%
31. Textile and clothing manufacturing machinery and plant	30%
32. Tractors-bull dozers and graders	30%
33. Weaving, spinning, knitting and sewing machinery	30%
34. Machinery or plant, not specified in items 1 to 33, and used for the purposes of a transport, tunnel, dock, water, gas or electricity undertaking or a public telephone or public telegraphic service	10%
35. Any other machinery or plant, not specified in items 1 to 34	20%

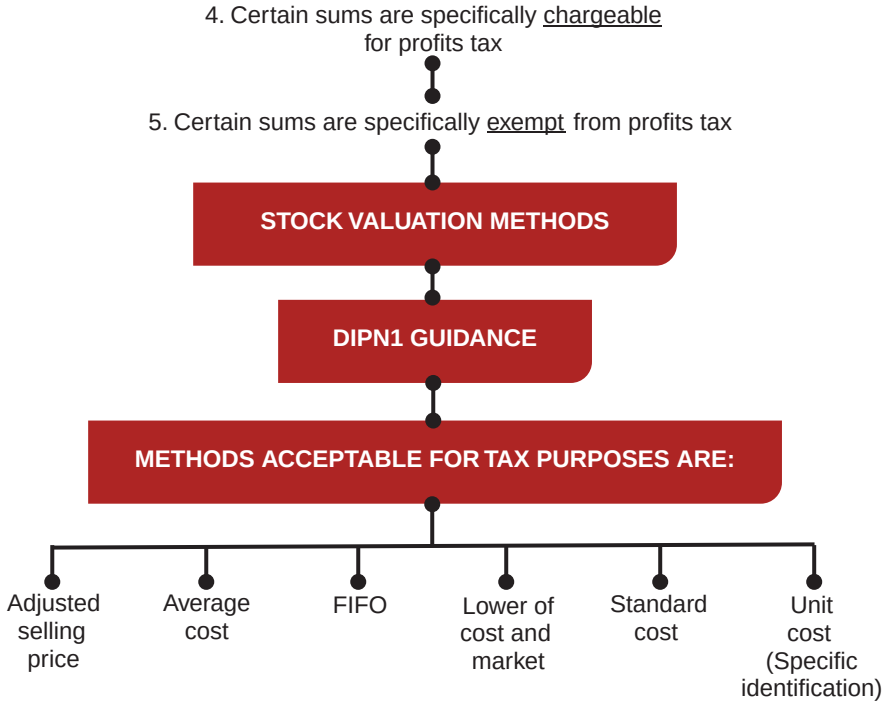
SECOND PART

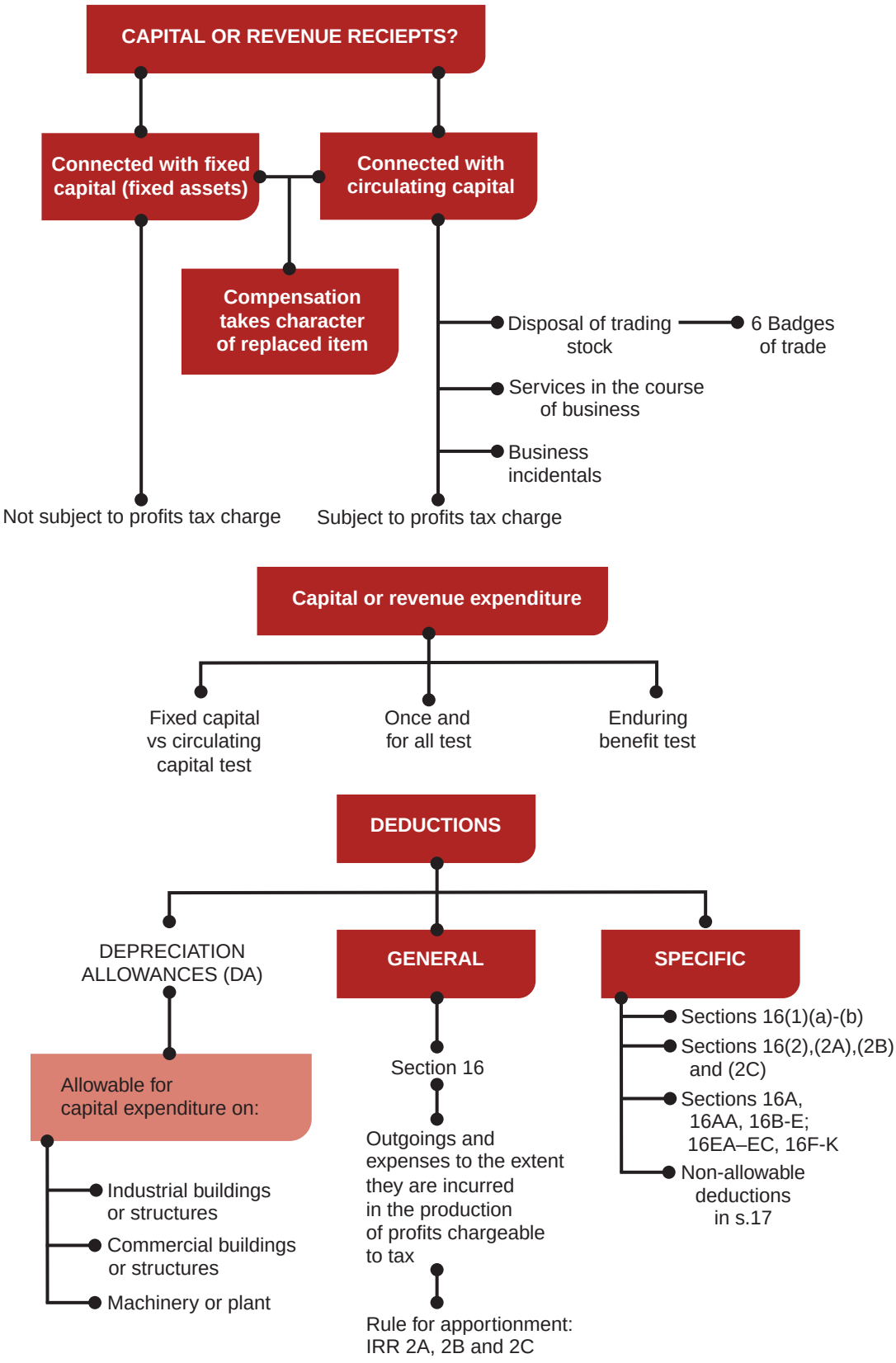
Item

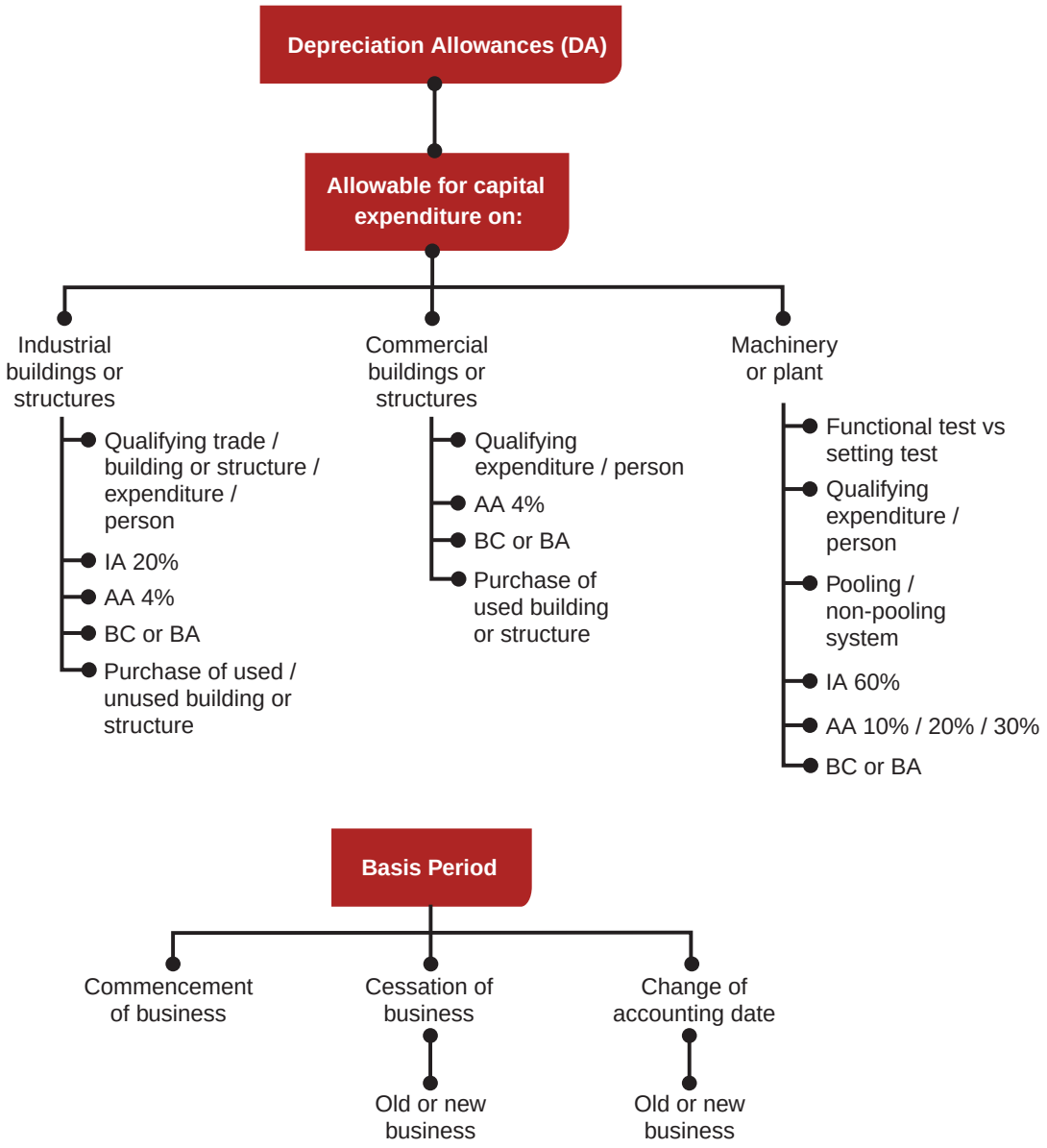
1. Belting.
2. Crockery and cutlery.
3. Kitchen utensils.
4. Linen.
5. Loose tools.
6. Soft furnishings (including curtains and carpets).
7. Surgical and dental instruments.
8. Tubes for X-ray and infra-red machines.

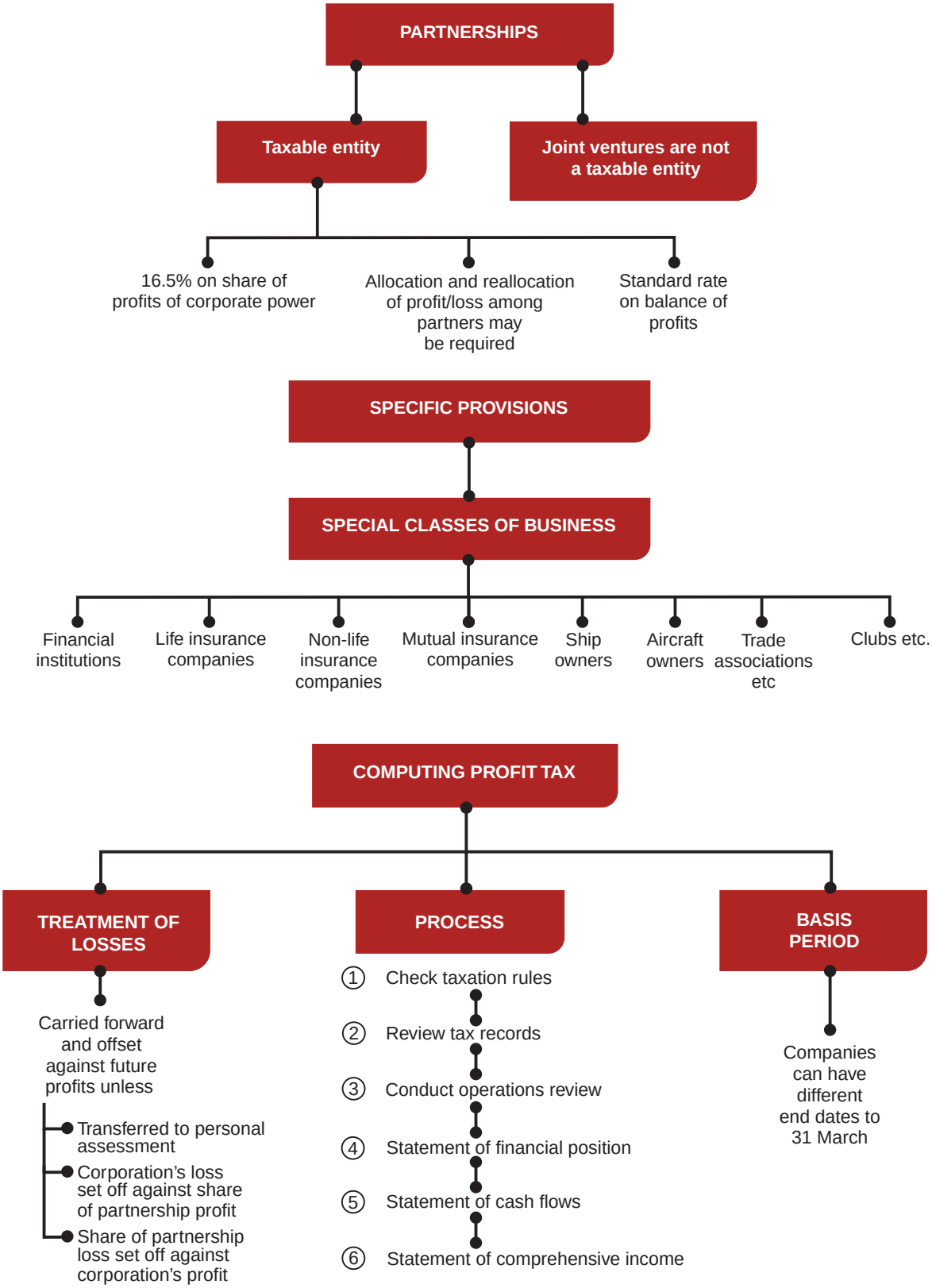
Topic recap






CAPITAL OR REVENUE RECIEPTS?
Connected with fixed capital (fixed assets)
Connected with circulating capital
Compensation takes character of replaced item
Disposal of trading stock
6 Badges of trade
Services in the course of business
Business incidentals
Not subject to profits tax charge
Subject to profits tax charge
Capital or revenue expenditure
Fixed capital vs circulating capital test
Once and for all test
Enduring benefit test
DEDUCTIONS
DEPRECIATION ALLOWANCES (DA)
GENERAL
SPECIFIC
Allowable for capital expenditure on:
Industrial buildings or structures
Commercial buildings or structures
Machinery or plant
Section 16
Outgoings and expenses to the extent they are incurred in the production of profits chargeable to tax
Rule for apportionment: IRR 2A, 2B and 2C
Sections 16(1)(a)-(b)
Sections 16(2),(2A),(2B) and (2C)
Sections 16A, 16AA, 16B-E; 16EA–EC, 16F-K
Non-allowable deductions in s.17


Depreciation Allowances (DA)
Allowable for capital expenditure on:
Industrial buildings or structures
Qualifying trade / building or structure / expenditure / person
IA 20%
AA 4%
BC or BA
Purchase of used / unused building or structure
Commercial buildings or structures
Qualifying expenditure / person
AA 4%
BC or BA
Purchase of used building or structure
Machinery or plant
Functional test vs setting test
Qualifying expenditure / person
Pooling / non-pooling system
IA 60%
AA 10% / 20% / 30%
BC or BA
Basis Period
Commencement of business
Cessation of business
Old or new business
Change of accounting date
Old or new business


PARTNERSHIPS
Taxable entity
Joint ventures are not a taxable entity
16.5% on share of profits of corporate power
Allocation and reallocation of profit/loss among partners may be required
Standard rate on balance of profits
SPECIFIC PROVISIONS
SPECIAL CLASSES OF BUSINESS
Financial institutions
Life insurance companies
Non-life insurance companies
Mutual insurance companies
Ship owners
Aircraft owners
Trade associations etc
Clubs etc.
COMPUTING PROFIT TAX
TREATMENT OF LOSSES
Carried forward and offset against future profits unless
Transferred to personal assessment
Corporation's loss set off against share of partnership profit
Share of partnership loss set off against corporation's profit
PROCESS
1 Check taxation rules
2 Review tax records
3 Conduct operations review
4 Statement of financial position
5 Statement of cash flows
6 Statement of comprehensive income
BASIS PERIOD
Companies can have different end dates to 31 March

Answers to self-test questions

Answer 1

The gain on sale of Property A should not be taxable for the following reasons:

(a) Property A is the matrimonial home of John and Mary. It is not held for trading purposes.

(b) There is no intention to trade.

(c) The sale was merely the disposal of one long term investment and to deploy the capital funds to finance another long term investment.

(d) As there is no evidence suggesting an adventure in the nature of trade, the capital gains on disposal of Property A would not be taxable.

Answer 2

Under s.14, profits derived from Hong Kong from a business carried on in Hong Kong are chargeable to profits tax. It is likely that Zoda Inc would be regarded as carrying on business in Hong Kong through its branch, a PE. IRR 5(1) defines a PE to include a branch.

The issue is therefore whether the profits earned from the branch operation are derived from (sourced in) Hong Kong, In deciding this issue, the broad guiding principle is to ascertain what the taxpayer has done to earn the profits and where it is done (see *Hang Seng Bank* and *TVBI*).

For trading profits as in the present case, the IRD considers that the location of the profits is determined by the place where the contracts of purchase and sale are effected. However, this does not only mean the place where contracts are legally executed but contemplates all relevant operations carried out to earn the profits, including solicitation of orders, negotiation, conclusion, trade financing, shipment and performance of contracts.

Furthermore, the IRD's practice is where both the contracts of purchase and sale are effected in Hong Kong, or where either the contract of purchase or the contract of sale is effected in Hong Kong, the whole of the profits will be chargeable. The IRD does not accept apportionment for trading profits.

In the present case, although both the suppliers and customers are situated outside Hong Kong, it does not necessarily follow that the IRD will accept that the contracts of purchase and sale are effected offshore. Evidence is needed to substantiate how and where the contracts are initiated, negotiated, concluded and executed.

In addition, more information is needed about the operations of the company's branch in Hong Kong. It should be noted that the following will all be used by the IRD to determine the source of the profits in question (see *Magna Industrial* and *Consco Trading:*

(a) How the goods were procured and stored;

(b) How the sales were solicited;

(c) How the orders were processed;

(d) How the goods were shipped;

(e) How the financing was arranged; and

(f) How payment was effected.

Answer 3

Referring to fundamental principles, a person will be subject to profits tax if (a) it carries on a business in Hong Kong, and (b) its profits from that business 'arise in or are derived from' (i.e. sourced in) Hong Kong.

Applying these principles to a typical re-invoicing company, the first condition is satisfied, because the Company is performing business activities in Hong Kong. The real issue for debate concerns the second condition, namely, whether the Company's profits from its re-invoicing activities are derived from Hong Kong.

The general rule for determining the source of profits is to look at where the Company conducted the activities that gave rise to its profits. In the question, the Company (through Philip) does not appear to do anything outside Hong Kong, and it therefore follows that all of its activities are conducted in Hong Kong. To demonstrate otherwise the Company would have to point to activities that it itself conducts outside Hong Kong that are responsible for generating the profits.

It is significant that the Company does not have any premises nor employees of its own in Hong Kong, and the real decision-making authority rests with the US client, NR Inc, who has no presence in Hong Kong. It appears that none of the active negotiations with suppliers are conducted in Hong Kong, but rather by NR Inc dealing directly with the factories in the Mainland. To this extent, one could say that, realistically, all that is happening in Hong Kong is that profits are merely 'booked' in the Company. Philip likely performs the necessary 'paperwork' activities in Hong Kong on behalf of the Company, and does so in his capacity as a professional service provider who does not actively participate in the Company's business.

It therefore logically follows that all of the operations that the Company itself performs that give rise to its profits take place in Hong Kong, through the activities of Philip. In this regard, candidates should refer to the definition of 'profits arising in or derived from Hong Kong' in s.2, which defines the term to 'include all profits from business transacted in Hong Kong, whether directly or through an agent'.

Of course, it is also necessary to evaluate activities performed on the Company's behalf by an agent abroad. It is noted that the real negotiations were conducted by NR Inc who, in a sense, was dealing with the Mainland factories on behalf of the Company. However, there is nothing in the facts that indicates the existence of a formal agency arrangement – the Company did not formally appoint NR Inc as its agent for the purpose of negotiating and, at least in substance, concluding the necessary arrangements with the Mainland factories. Entering into a formal agency agreement may have proved advantageous for profits tax purposes as might also have been the case if NR Inc had signed the purchase and sale contracts outside Hong Kong on behalf of the Company.

The IRD would unlikely accept this position because, according to DIPN 21, the IRD would generally only attribute to the Company activities of an agent where the overseas agent is 'fully accredited': para 26. It is not clear what this means. DIPN 21 states that an agent is regarded as 'fully accredited' if he has and habitually exercises a general authority to negotiate and conclude contracts on behalf of the Company.

Answer 4

The compensation should be chargeable to profits tax because of the following:

(a) JL is a garment manufacturer and the contract with the US brand was just one of the manufacturing contracts which JL entered into with its customers. Being a sum to compensate for the termination of such a contract, the compensation should be regarded as a business receipt in the ordinary course of business: see *Short Bros Ltd v CIR* [(1927) 12 TC 955] and *Kelsall Parsons & Co v CIR* [(1938) 21 TC 608].

(b) The contract with the US brand only contributed to 15% of JL's turnover. Its termination did not affect the entire framework of the business: see *Fleming v Bellow Machine Co Ltd* [(1965) 42 TC 308].

(c) The compensation was computed with reference to the profits which JL would have earned from the contract. It was more akin to compensation for the loss of profits rather than the loss of capital assets.

Answer 5

The commercial building generated rental income to P Ltd. Interest expenses on the loan raised for its acquisition were incurred in producing chargeable profits and *prima facie* deductible under s.16(1)(a), subject to satisfying any one condition in s.16(2).

Sections 16(2)(f) and 16(2C)

In this case, condition (f) in s.16(2) is relevant, because debentures are involved. It is however necessary to ascertain whether the overseas stock exchange on which the debentures were listed is recognised by the Commissioner. A list may be found on the IRD's website. F Ltd is clearly an associated company of P Ltd and the loan to P Ltd came entirely from the proceeds of the issue of the debentures, i.e. the first part of s.16(2)(f)(iii) is satisfied.

It is then necessary to find out the amount of interest paid by F Ltd on the debentures, because the amount deductible to P Ltd is restricted to the amount paid by F Ltd to the debenture holders (s.16(2)(f)(iii)).

However, Q Ltd received interest payable on the debentures. It is a wholly-owned subsidiary of P Ltd and is clearly a connected person of P Ltd, the borrower. Section 16(2C) hence applies to restrict the interest deductible to P Ltd.

Assuming that the interest of $7 million paid by P Ltd is not more than the amount of interest paid by F Ltd on the debentures, the amount to be disallowed should be computed as follows:

$7m × $60m/$100m × 152 days/365 days = $1,744,262 (where 152 represents the number of days from 1 November 2012 to 31 March 2013).

As Q Ltd does not carry on business in Hong Kong, it is unlikely that the interest income it received from the debentures, which were listed outside Hong Kong, is chargeable to profits tax. There is also no indication that Q Ltd is a 'market maker' as defined in s.16(2H). The exception to s.16(2C) as provided in s.16(2G) is therefore not applicable.

Sections 16(2)(c) and 16(2B)

Condition (c) in s.16(2) is also relevant, because F Ltd is apparently a person other than a FI. Further information about F Ltd's operations is necessary to decide whether it carries on business in Hong Kong (for this purpose the fact that it issued debentures in Hong Kong is relevant) and whether its interest income from the debentures is chargeable to profits tax.

Even if s.16(2)(c) is satisfied, as Q Ltd, a connected person of P Ltd, indirectly received part of the interest paid by P Ltd, s.16(2B) will operate to reduce the amount of interest deductible in a similar way as discussed above.

Answer 6

(a) The expenditures are all capital in nature and thus they would not be deductible under s.17(1)(c).

A Ltd carries on a qualifying trade for the purpose of IBA. If the building was put into use by A Ltd, A Ltd would be entitled to IBA on the qualifying expenditure it incurred.

However, the building was sold before it was used. Section 35B(a) provides that no allowances may be claimed by A Ltd. If initial allowance is granted to A Ltd on the capital expenditure incurred by it on the construction of the building, additional assessments will be raised by the IRD to withdraw the allowance previously granted.

(b) B Ltd carries on a qualifying trade for the purpose of IBA.

The seller A Ltd is not a property developer. Under s.35B(b)(ii), B Ltd as purchaser will receive an initial allowance based on the lesser of the net purchase price and the actual cost of construction.

Cost of construction incurred by A Ltd	$
Architect fees	200,000
Construction cost	9,500,000
Loan interest to finance construction (800,000 x 9,700/19,400)	400,000
	10,100,000

Since the purchase price of $15 million exceeds the cost of construction of $10.1 million, B Ltd is entitled to claim IBA on the construction cost of $10.1 million.

Use of building

G/F was used for a non-qualifying purpose and the floor area of G/F exceeded 10% of the total area of the building. B Ltd can only claim a CBA.

1/F to 4/F were used for qualifying purposes. B Ltd can claim an IBA.

5/F to 7/F. The nature of the tenant's business is not one of the qualifying trades for the purpose of IBA (see *Tai On Machinery Works Ltd*). B Ltd can only claim a CBA.

Qualifying expenditures

For the purpose of IBA, $10.1m × 4/8 = $5,050,000
For the purpose of CBA, $10.1m × 4/8 = $5,050,000

B Ltd is entitled to initial allowance in the year in which the building was acquired, i.e. year of assessment 2011/12.

The building was only put to use in May 2012. Therefore, for the purposes of calculating IBA and CBA, no annual allowance is due for the year of assessment 2011/12.

Year of assessment 2011/12	*IBA calculation*	*CBA calculation*
	$	$
Cost of construction	5,050,000	
Less: Initial allowance at 20%	(1,010,000)	
	4,040,000	
Year of assessment 2012/13		
Cost of construction		5,050,000
Less: annual allowance at 4%	(202,000)	(202,000)
WDV c/f	3,838,000	4,848,000

Answer 7

According to the Hong Kong Companies Ordinance, the first annual general meeting of a newly incorporated Hong Kong company must be held within 18 months of its incorporation and the company's financial statements (income statement and statement of financial position) must be tabled at the company's annual general meeting.

From the Hong Kong profits tax perspective, if the taxpayer's first accounts are for a period exceeding a year, in practice, the Commissioner would apportion the taxpayer's profits with reference to the normal accounting date. This is consistent with the provisions in s.18C(1)(b). In the present case, the company was incorporated and commenced business on 1 January 2012 and its financial year end date is 30 June annually (i.e. the first accounts would be made up to 30 June 2013). The company's assessable profits derived during 1 January 2012 to 30 June 2012 would be assessed in the year of assessment 2012/13 whilst the assessable profit derived for the period from 1 July 2012 to 30 June 2013 would be assessed in the year of assessment 2013/14. There would be no assessment for the year of assessment 2011/12 (year of commencement).

For the subsequent years of assessment, the normal basis period for a profits tax assessment is the accounting period ending in the assessment year (the 'current year' basis) (refer to s.18B(2)).

Based on the above, the basis period for the year of assessment 2014/15 would be 1 July 2013 to 30 June 2014 (the accounting year ending 30 June 2014).

Therefore, for NT Co, the basis periods likely to be adopted by the IRD would be as follows:

2011/12	N/A (No assessment)
2012/13	1 January 2012 – 30 June 2012
2013/14	1 July 2012 – 30 June 2013
2014/15	1 July 2013 – 30 June 2014

If the accounting year end date is changed, s.18E(1) provides that the Commissioner has the discretion in deciding the basis periods for the year of change and the preceding year. At times, this may result in double taxation. If NT Co intends to change its accounting year end date, it should assess whether there is any risk of double taxation.

Losses in the accounting period would not be allowed twice, irrespective of the basis periods adopted.

Answer 8

(a) Losses incurred by HKCO, if agreed by the IRD, can be carried forward for set off against future assessable profits in line with the provisions in s.19C(1).

There is no time limit on the loss carried forward for set-off purposes.

(b) (i) Kowloon Ltd cannot utilise the losses in HKCO. There are no provisions in the IRO for group loss relief.

(ii) The tax position is the same for the case where Kowloon Ltd is a subsidiary of HKCO. A parent company's tax losses cannot be used for setting off against a subsidiary's assessable profits. There are no provisions in the IRO for group loss relief.

(c) If HKCO is a partner in HK-Kowloon Partnership, its losses can be used for setting off against its 50% share of the assessable profits of HK-Kowloon Partnership (s.19C(4)). HKCO can utilise its own losses to set off against its share of profits in the HK-Kowloon Partnership (i.e. limited to $20 million for the year of assessment 2013/14).

(d) (i) If the management decided to close down HKCO in 2014 and leave it dormant, the agreed tax loss could still be carried forward. There is no time limit for the setting off of losses. Once the company is reactivated, the carried forward loss could still be used to set off against future assessable profits.

(ii) If the management decided to liquidate the company, the loss will lapse.

(iii) If the shareholders decided to sell their investment in HKCO to Paris CO, the tax loss in HKCO would still be carried forward. If there are commercial reasons for Paris CO to acquire the shares in HKCO, and the sole or dominant purpose is not for the purpose of utilising the tax losses, then the anti-avoidance provisions in s.61B would not be applicable and the agreed tax loss in HKCO can still be carried forward for setting off against its future assessable profits.

(The anti-avoidance provision, s.61B, is discussed in **chapter 9, section 4.4** on 'Utilisation of losses to avoid tax'.)

Answer 9

'Relevant sums' - Shipping

A summary of the tax treatment of the shipping income of a ship owner is as follows:

Sums derived from, attributable to, or in respect of:	Relevant sums
Carriage of passengers, goods etc.	
(a) Within Hong Kong waters	Yes
(b) From Hong Kong to waters within the river trade limits (ports within the Pearl River Delta)	Yes
(c) From Hong Kong to waters outside the river trade limits (overseas)	
(i) a ship owner who has a reciprocity status	No
(ii) a Hong Kong registered ship	No
(iii) other ships	Yes
(d) From overseas to Hong Kong	No
(e) Trans-shipments	No
Towage operations	
(a) Within Hong Kong waters	Yes
(b) From Hong Kong to waters within the river trade limits (ports within the Pearl River Delta)	Yes
(c) From Hong Kong to waters outside the river trade limits (overseas)	
(i) a ship owner who has a reciprocity status	No
(ii) a Hong Kong registered ship	No
(iii) other ships	Yes
(d) From overseas to Hong Kong	No
Dredging operations	
(a) Within Hong Kong waters	Yes
(b) Outside Hong Kong waters	No
Charter hire	
(a) For a charter party with a limited partnership	Yes
(b) For a ship operated within Hong Kong waters	Yes
(c) For a ship operated within the river trade limits (ports within the Pearl River Delta)	Yes, 50%
(d) For a ship operated outside Hong Kong waters and the river trade limits	No

Answer 10

A summary of the tax treatment of the aviation income of a resident aircraft owner is as follows:

Sums derived from, attributable to, or in respect of:	Relevant sums
Carriage of passengers, goods etc.	
(a) Within Hong Kong	Yes
(b) From Hong Kong to overseas	Yes
(c) From overseas to Hong Kong	No
(d) Trans-shipments	No
Charter hire (charter party by demise)	
(a) For an aircraft operated within Hong Kong	Yes
(b) For an aircraft operated between Hong Kong and Macau	Yes, 50%
(c) For an aircraft operated outside Hong Kong (charter party not attributable to a PE outside Hong Kong)	Yes
(d) For an aircraft operated outside Hong Kong (charter party attributable to a PE outside Hong Kong)	No
Charter hire (charter party without demise)	
(a) For an aircraft operated within Hong Kong	Yes
(b) For flights from Hong Kong to overseas	
(i) flight charter	Yes
(ii) time charter (on proportion of outward flights flying hours/total flying hours)	Yes
(c) For flights from overseas to Hong Kong	No
Charter hire (charter party not extended to the whole aircraft)	
(a) For an aircraft operated within Hong Kong	Yes
(b) For flights from Hong Kong to overseas	Yes
(c) For flights from overseas to Hong Kong	No

Answer 11

A summary of the tax treatment of the aviation income of a non-resident aircraft owner:

Sums derived from, attributable to, or in respect of:	Relevant sums
Carriage of passengers, goods etc.	
(a) Within Hong Kong	Yes
(b) From Hong Kong to overseas	Yes
(c) From overseas to Hong Kong	No
(d) Trans-shipments	No
Charter hire (charter party by demise)	
(a) For an aircraft operated within Hong Kong	Yes
(b) For an aircraft operated between Hong Kong and Macau	Yes, 50%
(c) For an aircraft operated outside Hong Kong (charter party attributable to a PE in Hong Kong)	Yes
(d) For an aircraft operated outside Hong Kong (charter party not attributable to a PE in Hong Kong)	No
Charter hire (charter party without demise)	
(a) For an aircraft operated within Hong Kong	Yes
(b) For flights from Hong Kong to overseas	
(i) flight charter	Yes
(ii) time charter (on proportion of outward flights flying hours/total flying hours)	Yes
(c) For flights from overseas to Hong Kong	No
Charter hire (charter party not extended to the whole of an aircraft)	
(a) For an aircraft operated within Hong Kong	Yes
(b) For flights from Hong Kong to overseas	Yes
(c) For flights from overseas to Hong Kong	No

Exam practice

New Happy Inn

77 minutes

Joseph Chan moved to Brazil twenty years ago to work in the family's restaurant business. The restaurant specialised in Brazilian barbeques. During this time, he invented his own special barbeque sauce. This was used exclusively in his father's restaurant known as Happy Inn. Last year, his father passed away. He closed down the business and returned to Hong Kong.

On his way back to Hong Kong, Joseph spent a few weeks in London visiting his cousin. His cousin, who is a lawyer, recalled the delicious barbeque sauce at Happy Inn and recommended that Joseph should take necessary legal procedures to register his secret recipe/formula. Joseph accepted his advice and undertook the necessary legal registration procedures and registered his recipe in Country X. The legal owner of this intellectual property is J Co, a company incorporated in Country X, and the shareholders are Joseph and members of the Chan family.

Once Joseph returned to Hong Kong, he set up his own restaurant New Happy Inn. He imported very expensive special ovens and grillers from Brazil. He also engaged a special consultant from Brazil to assist with the installation of the ovens. The consultant also visited Hong Kong on a regular basis to inspect the ovens and conduct regular repairs.

Joseph's restaurant business was very successful. It became a popular spot for expatriates living in Hong Kong. They found his barbeque sauce unique and tasty. Over time, it was also regarded as one of the tourists' favourites in Hong Kong.

In order to lure local customers, Joseph modified his recipe and invented a new sauce to cater for the taste of local residents. He also registered his new secret recipe to safeguard his intellectual property rights. Furthermore, he registered the new trade name 'New Happy Inn'. These registrations took place in Hong Kong. He incorporated a company 'New Happy Inn' in Hong Kong to own the trade name as well as the new recipe.

Some overseas investors learnt about the popularity of 'New Happy Inn' and its famous barbeque sauces. They would like to set up a similar restaurant business in their own jurisdictions and thus they would like to obtain the license to use the trade name 'New Happy Inn' and the old and new recipes.

As his business grew, Joseph travelled to Shanghai and Macau to investigate whether he should set up branches in these cities.

Required:

(a) Advise Joseph of the tax implications of:

(i) the import of ovens and grillers from Brazil and the engagement of the consultant from Brazil to assist with the installation and regular repairs; and

(ii) any other profits tax issues relating to the commencement of business.

(12 marks)

(b) Joseph had incurred substantial costs in launching an advertising campaign in Hong Kong. Advise Joseph whether such costs are deductible. **(4 marks)**

(c) Advise Joseph whether the fees incurred on travelling to Shanghai and Macau to explore business opportunities would be deductible. **(2 marks)**

(d) Advise Joseph of the tax implications of the relevant income received by New Happy Inn and J Co when they license the rights to use the trade name and the secret recipes to the overseas investors. **(15 marks)**

(e) What is J Co's tax position if investors in Hong Kong pay J Co for the right to use the formula in Hong Kong to manufacture and export the sauce to customers in Japan?

(4 marks)

(f) A customer was injured while dining at the restaurant, and took legal action against New Happy Inn for negligence. The case was settled out of court, and New Happy Inn agreed to pay HK$1 million as compensation. Advise whether such a payment is deductible.

(2 marks)

(g) Joseph required funds to finance the expansion of his restaurant business in Hong Kong. His uncle in Brazil agreed to lend him US$5 million. He was also able to obtain a loan from a local FI. Advise the deductibility of interest payments in respect of the aforementioned loans.

(3 marks)

(Total = 42 marks)

HKICPA December 2010 (amended)

*(**Note**: attempting the above question, when assume that Hong Kong has not signed any comprehensive double taxation agreement with Country X).*

HKCO Ltd

72 minutes

HKCO Ltd ('HKCO') is the Hong Kong subsidiary of ABC Inc which is incorporated in Country X. ABC Inc was in financial difficulties and will not be able to give HKCO any financial support. The bankers were refusing to extend further credit facilities to HKCO.

HKCO's board of directors held an emergency meeting and resolved the following:

(a) To decrease head count by 10%. Redundancy payments would be around $10 million. The management agreed to examine if they should maintain the Product A business unit or simply close it down as it has not been profitable for 5 years running.

(b) To stop hiring.

(c) To accept an emergency loan (interest bearing) form a fellow UK subsidiary (assume that the subsidiary has not carried on business in Hong Kong and it is not a FI).

(d) To ask another fellow subsidiary in Belgium to provide a financial subsidy since HKCO has been helping them to market their products in Hong Kong / the Mainland of China. If they do not subsidise the marketing cost, HKCO would not be able to maintain the marketing team.

(e) To relocate to another commercial complex with a cheaper rent. HKCO would need to pay compensation to the landlord of $5 million.

(f) To accept a government subsidy to finance the upgrading of computer equipment.

Due to the world economic conditions, HKCO realised substantial exchange losses in foreign currencies. Furthermore, despite the overseas loan and subsidies, HKCO still experienced liquidity strain. HKCO decided to dispose of two properties in Repulse Bay which had been used as directors' quarters. The proceeds from sale should be able to assist HKCO with their liquidity problems.

HKCO concluded a consulting contract with a client in Dubai. The contract revenue is US$20 million. HKCO immediately sent a team of experts to Dubai to conduct preliminary studies. The management was so thrilled to have secured this contract that they spent $100,000 to give their Finance Director, who would retire at the end of the month, a farewell party.

Required:

(a) List out the tax implications, if any, arising from the board's resolutions. **(19 marks)**

(b) What are the tax implications surrounding the disposal of the Repulse Bay properties? **(12 marks)**

(c) Suppose the Commissioner issued a determination concluding that the profits from the sale of the Repulse Bay properties are taxable and HKCO resolved to engage legal advisors to defend its position through the normal appeals channel, would such legal costs be deductible? **(2 marks)**

(d) Discuss whether the exchange losses are deductible. List the ground for deductibility and/or any challenges against deductibility. **(3 marks)**

(e) Discuss whether the money spent on the farewell party is deductible. **(4 marks)**

(Total = 40 marks)

HKICPA September 2009 (amended)

A Ltd

41 minutes

A Ltd ('the Company') was a leading supplier of audio and visual equipment in Hong Kong. In the early nineties, the Company closed its factory in Hong Kong and subcontracted the manufacturing process to four unrelated contractors in mainland China ('the Mainland'). Whist the Company had its own representative office in the Mainland to liaise with the contractors, it did not involve itself in the production work. In Hong Kong, the Company maintained a sales department to solicit orders from customers and a merchandising department to source raw materials and arrange shipments of the raw materials and finished products. Most of its directors also stationed themselves in Hong Kong to manage the daily operation of the Company.

All along the Company had been assessed as per its profits tax returns without query, until recently when the IRD commenced an audit on the tax affairs of the Company for the years of assessment 2010/11 to 2012/13. Upon a review of the relevant documents and records for two months, the Assessor revealed the following:

(1) The Company claimed that half of its profits were derived from the manufacturing activities outside Hong Kong. It also claimed depreciation allowance in respect of the plant and machinery which had been provided to the Mainland contractors for production without consideration.

(2) One of the audio and visual products sold by the Company involved a patented technology held by B Inc, a US company which had no relationship with the Company and did not carry on any business in Hong Kong. During the relevant years, the Company paid substantial royalties in respect of the technology and charged the payments in its accounts. It did not, however, report to the IRD the receipt of royalties by B Inc.

(3) An item under the label of 'China Tax' was charged in the income statement for the year ended 31 December 2010. The Company explained that the item represented the business tax paid on the profit derived from the sale of an office unit by its representative office in the Mainland.

Required:

(a) Evaluate the following claims made by A Ltd:

  (i) Half of its profits were derived outside Hong Kong. **(8 marks)**

  (ii) It was entitled to depreciation allowance in respect of the plant and machinery used by the Mainland entities. **(4 marks)**

  (iii) The business tax was deductible under profits tax in Hong Kong. **(3 marks)**

(b) Discuss whether A Ltd has acted properly under the IRO in respect of the royalty payments made to B Inc. **(8 marks)**

(Total = 23 marks)

HKICPA June 2011 (amended)

Dr A

36 minutes

Dr A operates a medical practice in his own name in Hong Kong. Apart from treating patients from the general public, he was also contracted by Company B to provide medical services to its employees. With the implementation of the Mainland and Hong Kong Closer Economic Partnership Arrangement, Dr A has also been engaged as a visiting doctor at a Mainland hospital.

In the accounts for the year ended 31 December 2012, Dr A recorded, among others, the following income and expenses for his medical practice:

(1) Income

(i) Consultation fees of RMB100,000 from the Mainland hospital ('the Consultation Fees'). To earn the Consultation Fees, Dr A provided medical treatment to a patient in the Mainland. At the patient's request, he also prepared in Hong Kong a medical report for the purpose of an insurance claim.

(b) Compensation payment of HK$1 million for the termination of Dr A's service contract with Company B ('the Compensation Payment'). The Compensation Payment was determined with reference to the consultation fees that Dr A would have derived during the remaining period of the contract. According to past records, the service fees derived from this service contract would account for about 10% of Dr A's annual income.

(2) Expenses

(i) Medical expenses of $250,000 in relation to Dr A's injuries in a traffic accident;

(ii) Additional tax of $5,000 imposed under s.82A of IRO due to late submission of tax return; and

(iii) Expenditures of $300,000 on the renovation of the existing clinic and $500,000 on the initial decoration of a new branch clinic. Both clinics are located in office buildings in prime locations.

Required:

(a) Discuss the following issues in respect of the Consultation Fees and the Compensation Payment:

(i) Whether the Consultation Fees from the Mainland hospital were sourced in Hong Kong. **(3 marks)**

(ii) Whether the Compensation Payment from Company B was capital or revenue in nature. **(3 marks)**

(b) Analyse whether the following items are deductible under profits tax. For items (i) and (ii), cite the relevant case law to support your analysis.

(i) Dr A's medical expenses; **(3 marks)**

(ii) Additional tax due to late submission of tax return; and **(4 marks)**

(iii) Expenditures on the renovation of the existing clinic and the initial decoration of the new clinic. (Note: If deductible, compute the maximum amounts of deductions allowable under the IRO for the year of assessment 2012/13.) **(7 marks)**

(Total = 20 marks)

HKICPA December 2012 (amended)

Manchester Knitting Ltd

34 minutes

Manchester Knitting Ltd ('MKL') is a company established in Hong Kong carrying on a garment trading business. The accounts and information for the year ended 31 March 2013 are provided below.

	Notes	$	$
Income			
Sales		35,900,000	
Less: Cost of sales		(21,300,000)	
Gross profit	1	14,600,000	
Exchange gain (net)	2	115,000	
Gain on disposal of fixed assets	3	14,000	
Interest income	4	18,000	14,747,000
Expenses			
Consultancy fee	5	300,000	
Depreciation	6	84,000	
Interest expenses	7	98,000	
Office rental		1,480,000	
Other deductible expenses		5,090,000	
Rental allowance	8	240,000	
Salaries		3,586,000	(10,878,000)
Profit before taxation			3,869,000
Less: Taxation			(500,000)
Profit for the year			3,369,000

Notes:

(1) The goods sold by MKL were mainly purchased from its PRC wholly owned subsidiary and were manufactured in mainland China. MKL reported all its trading profits as onshore in prior years and will continue to maintain this filing basis for the year 2012/13.

(2) Details of net exchange gain were as follows:

	$
Exchange gain on trade debts	125,000
Exchange loss on foreign currency bank deposit	(10,000)
	115,000

(3) Details of the gain on disposal of fixed assets were as follows:

	$	$
Sale proceeds of office furniture (ranked into respective pool claiming for depreciation allowance in prior years)		30,000
Original cost	150,000	
Accumulated depreciation	(134,000)	(16,000)
Gain on disposal		14,000

(4) Details of interest income were as follows:

	$
Interest from local bank deposit pledged as loan security (per Note 7 below)	8,800
Interest from local bank deposit denominated in Euro Dollar	5,500
Interest from overseas overdue trade debts	3,700
	18,000

(5) MKL paid a fee of $300,000 to an individual to provide consultancy work regarding the company's daily business activities.

(6) Depreciation and additional information on fixed assets:

Accounting depreciation of $84,000 was calculated on the straight-line basis.

MKL acquired a motor vehicle on 1 August 2012 under a hire purchase scheme with a local bank and used it for business purposes. The cash price of the vehicle was $300,000. An initial payment of $120,000 was made upon acquisition, and the balance was repaid over 20 monthly instalments of $10,000 each which commenced on 1 September 2012. The hire purchase interest was evenly allocated into each instalment.

MKL did not have any tax written down value brought forward from the prior year in any pool claiming depreciation allowances.

(7) Details of interest expenses were as follows:

	$
Interest on bank loan secured by deposit (per Note 4 above) placed in the same bank, and on hire purchase of the motor vehicle (per Note 6 above)	16,800
Interest to overseas unrelated suppliers on overdue trade debts	66,000
Interest on loan from individual director	15,200
	98,000

(8) The amount was a cash allowance paid to a director of MKL. During the year the director leased a residential flat with an unrelated landlord and paid the rental of $240,000. MKL fully subsidised the rental expenses of the director by paying a rental allowance to him without setting any restriction on the usage of the amount.

Required:

(a) Calculate the depreciation allowance that MKL was entitled to claim for the year of assessment 2012/13. **(3 marks)**

(b) Calculate the profits tax liabilities of MKL for the year of assessment 2012/13 (ignore provisional tax). **(8 marks)**

(c) Explain the tax treatment of the following items:

(i) interest income **(4 marks)**

(ii) interest expenses **(4 marks)**

(Total = 19 marks)

HKICPA June 2012 (amended)

World Corp

22 minutes

World Corp is a large international company incorporated in Country X. It has many subsidiaries in Europe and the United States. The group would like to carry out the following restructuring plans:

(1) World Corp would set up a new subsidiary New Ltd in Hong Kong to strengthen their market position in Asia. New Ltd will be responsible for the marketing and sale of group products in Asia.

(2) New Ltd will also set up a branch in Country Y to market and sell group products in Country Y.

Required:

(a) Comment on the Hong Kong tax implications of New Ltd's operations in Hong Kong. **(10 marks)**

(b) Discuss whether the branch profits will be subject to tax in Hong Kong. If tax is payable in Country Y on the branch profits, comment on the deductibility of the tax under profits tax in Hong Kong. **(2 marks)**

(Total = 12 marks)

HKICPA June 2011 (amended)

Further reading

Suggested References

When studying this topic we suggest the following references:

Primary References

Advanced Taxation in Hong Kong, Pearson (Chapters 9 to 18)

Hong Kong Master Tax Guide (Chapters 6 and 7)

Hong Kong Taxation – Law & Practice, The Chinese University Press (Chapters 4 and 5)

Hong Kong Taxation and Tax Planning, Pilot Publishing Co Ltd (Chapters 14 to 23, 25 to 31, and 34)

Inland Revenue Ordinance (Part IV, Part VI)

DIPN 1 (Revised) Profits Tax – Part A: Valuation of Stock-in-trade and Work-in-progress; Part B: Ascertainment of Profits and the Valuation of Work-in-progress; (A) Building and Engineering Contracts; (B) Property Development and Property Investment

DIPN 2 (Revised) Profits Tax – Part A: Industrial Buildings Allowances; Part B: Commercial Buildings Allowances

DIPN 3 (Revised) Profits Tax – Apportionment of Expenses

DIPN 4 (Revised) Lease Premiums / Non-returnable Deposits / Key or Tea Money / Construction Fees etc.

DIPN 5 (Revised) Profits Tax Deductions for Expenditure on (A) Research and Development, (B) Technical Education, (C) Patent Rights, etc., (D) Building Refurbishment, (E) Prescribed Fixed Assets, (F) Environment Protection Facilities

DIPN 7 (Revised) Machinery and Plant – Depreciation Allowances

DIPN 8 (Revised) Profits Tax – Losses

DIPN 12 (Revised) Commissions, Rebates and Discounts

DIPN 13 (Revised) Profits Tax – Taxation of Interest Received

DIPN 13A Profits Tax – Deductibility of Interest Expense

DIPN 19 The Agreement between the United States of America and Hong Kong in respect of Taxation of Shipping Profits

DIPN 20 (Revised) Units Trusts, Mutual Fund Corporations and Similar Collective Investment Schemes

DIPN 21 (Revised) Locality of Profits

DIPN 22 (Revised) Computation of Assessable Profits from Cinematograph Films, Patents, Trade Marks, etc.

DIPN 23 (Revised) Recognised Retirement Schemes

DIPN 26 (Revised) Specified Securities for the purposes of s.15E of the IRO

DIPN 27 (Revised) Profits Tax – Stock Borrowing and Lending

DIPN 28 Profits Tax – Deductibility of Foreign Taxes

DIPN 32 Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income

DIPN 33 Insurance Agents

DIPN 34 (Revised) Exemption from Profits Tax (Interest Income) Order 1998

DIPN 39 Profits Tax – Treatment of Electronic Commerce

DIPN 40 (Revised) Profits Tax – Prepaid or Deferred Revenue Expenses

DIPN 42 Profits Tax – Part A: Taxation of Financial Instruments; Part B: Taxation of Foreign Exchange Differences

DIPN 43 (Revised) Profits Tax – Profits Tax Exemption for Offshore Funds

DIPN 44 (Revised) Arrangement between the Mainland of China and The Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on income

DIPN 45 Relief from Double Taxation due to Transfer Pricing or Profit Reallocation Adjustments

DIPN 46 Transfer Pricing Guidelines – Methodologies and Related Issues

DIPN 49 Part A: Profits Tax Deduction of Capital Expenditure on Relevant Intellectual Property Rights; Part B: Taxation of Royalties derived from Licensing of Intellectual Property Rights

Supplementary Reference

Hong Kong Tax Manual, CCH Asia Pte Ltd (Para 15 and 20)

chapter 4

Non-resident persons

Topic list

Learning focus

The concept of residence in Hong Kong was of little importance in the past except where there was an election for personal assessment. However, its relevance increased with time when more special provisions were introduced into the IRO through the years. In particular, there are provisions relating to deemed trading receipts and exemptions for offshore funds.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Taxation of businesses		
2.14	**Scope of profits tax charge**	
2.14.03	Identify the relevant issues in relation to residents and non-residents • Compare and contrast the tax treatment for residents and non-residents • Explain the methods used by the IRD in assessing a non-resident person to tax in Hong Kong • Explain what is meant by the agent of a non-resident person • Calculate the amount of tax which is to be withheld by a Hong Kong resident from payments made to non-residents • Explain and apply DIPN 17 and DIPN 30	3
2.24	**Exemption for offshore funds**	3
2.24.01	Explain the exemption for offshore funds	
2.24.02	Explain and apply DIPN 43	

1 Tax implications of residence and non-residence

Topic highlights

Although residence is not a criterion upon which taxes under the IRO are imposed, there are special provisions relating to non-resident persons, especially for recovery purposes.

As Hong Kong adopts a territorial basis, the concept of residence is of little importance except for isolated purposes such as the eligibility to elect for personal assessment (see s.41(4)), business with non-resident persons and the exemptions available to non-resident persons. There are no definitions for 'resident' and 'non-resident' under the IRO except in the case of aircraft owners (see ss.23C and 23D) and offshore funds (see s.20AB(3)).

For the purpose of ss.20A and 20B, the IRD has accepted that a 'non-resident' is a person who has no permanent business presence in Hong Kong (DIPN 17). Pursuant to IRR 5, 'PE' means a branch, management or other place of business, but does not 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. Having no PE in Hong Kong does not mean that the non-resident person is exempt from tax in Hong Kong. A non-resident person may be liable to property tax, salaries tax or profits tax if he has income arising in or derived from Hong Kong falling within the scope of charge of these three taxes. The same rates of tax apply to both resident persons and non-resident persons.

2 Provisions concerning non-resident persons

Topic highlights

There are special provisions relating to non-resident persons, especially for recovery purposes.

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 advisers 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

2.1 Assessing a non-resident person's liability

There are three alternative methods of assessing a non-resident person's liability to tax in Hong Kong:

Section	Method of assessment
20A	Direct assessment on the non-resident person
20A	Assessment raised in the name of the non-resident person's agent in Hong Kong
20B	Assessment raised in the name of any person in Hong Kong who has directly or indirectly paid or credited a non-resident person who is entitled to receive payment of royalties or license fees from Hong Kong, or who is an entertainer or sportsman and has performed in Hong Kong

Pursuant to IRR 5, the profits of the Hong Kong branch of a person whose head office is situated elsewhere than in Hong Kong, will be ascertained as follows:

(a) Where accounts are kept which disclose the true profits arising in or derived from Hong Kong, those accounts will be adopted and adjusted in accordance with the provisions of the IRO;

(b) Where accounts do not disclose the true profits arising in or derived from Hong Kong or accounts are not kept;

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

(c) Where the assessor is of the opinion that it would be impracticable or inequitable to adopt (a) or (b) above, he may compute the assessable profits on a fair percentage of the Hong Kong turnover.

Method (c) also has support from s.21. Pursuant to s.21, where it is difficult to determine the true assessable profits of a non-resident person, the profits may be computed on a fair percentage of the turnover of the trade or business in Hong Kong.

Similarly, pursuant to IRR 3, the profits of the Hong Kong branch of a bank whose head office is situated elsewhere than in Hong Kong, will be ascertained as follows:

(a) Where accounts are kept which disclose the true profits arising in or derived from Hong Kong, those accounts will be adopted and adjusted in accordance with the provisions of the IRO;

(b) Where accounts do not disclose the true profits arising in or derived from Hong Kong or accounts are not kept;

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

(c) Where the assessor is of the opinion that it would be impracticable or inequitable to adopt (a) or (b) above, he may estimate the assessable profits of the branch.

If the person disagrees with the assessment raised by the assessor under IRR 3 or 5, he might lodge an objection under s.64(1).

2.2 Deemed trading receipts of non-resident persons

2.2.1 Deemed trading receipts under s.15(1)

A non-resident person who does not carry on any trade, profession or business in Hong Kong may still be chargeable to profits tax if he or she has the following income:

Section	Deemed trading receipts
15(1)(a)	Sums not otherwise chargeable to profits tax, received by or accrued to a person from the exhibition or use in Hong Kong of cinematograph or television film or tape, sound recording, or any connected advertising material.
15(1)(b)	Sums not otherwise chargeable to profits tax, received by or accrued to a person for the use of or right to use in Hong Kong any patent, design, trade mark, copyright material, secret process or formula or other similar property, or for imparting knowledge connected with the use in Hong Kong of any such properties.
15(1)(ba)	Sums not otherwise chargeable to profits tax, received by or accrued to a person for the use of or right to use outside Hong Kong any intellectual properties listed in s.15(1)(b), or for imparting knowledge connected with the use outside Hong Kong of any such properties, which are deductible in ascertaining the assessable profits of a person under profits tax.
15(1)(d)	Sums received by or accrued to a person by way of hire, rental or similar charges for the use of or right to use movable property in Hong Kong.

2.2.2 Tax cases on taxability of royalty income

The application of s.15(1)(b) was examined in the following cases:

Taxpayer	Subject matter	Reference
Emerson Radio Corporation	Royalty income	(2000) HKRC 90-102
Lam Soon Trademark Limited	Royalty income	(2005) HKRC 90-171

CIR v Emerson Radio Corporation [(2000) HKRC 90-102]

Facts: Emerson Radio Corporation in the USA ('Emerson US') licensed to its subsidiary Emerson Radio (Hong Kong) Ltd ('Emerson HK'), the right to use the trade mark 'Emerson' on products sold by Emerson HK to customers in the USA. The goods of Emerson HK were manufactured by unrelated contract manufacturers in Hong Kong, PRC, Japan, Korea, Malaysia, Thailand and Taiwan. The royalties paid to Emerson US were based on a percentage of the price received by Emerson HK from its customers in the USA. There were no sales activities in Hong Kong. The Commissioner contended that all of the royalties received by Emerson US were assessable to profits tax pursuant to s.15(1)(b) on the ground that the royalties were paid for the right to use the trade mark in Hong Kong, while Emerson US was of the view that none of the sums received as royalties should be subject to profits tax as the trade mark was only 'used' in the place where the products were sold.

Decision: Although there were diverging views, the CFA upheld the decision of the COA that the trade mark royalties paid by Emerson HK to its US parent were only partly taxable in Hong Kong. Two of the judges were of the view that Emerson HK had used the trade mark in Hong Kong by virtue of affixing the mark to goods made in Hong Kong during the manufacturing process. As such, the royalties could be apportioned between those relating to the use of the trade mark in Hong Kong and those relating to the use of the trade mark elsewhere (whether in manufacturing or sales).

To counteract the impact of the CFA's decision, s.15(1)(ba) was enacted. Effective from 25 June 2004, even if the use of (or right to use) the trade mark was outside Hong Kong, the royalties would still be assessable if they were deductible in ascertaining the assessable profits of a person under profits tax.

Lam Soon Trademark Limited v CIR [(2005) HKRC 90-171]

The facts: The taxpayer formed part of the well-known Lam Soon Group of Companies and its controlling company was Lam Soon Hong Kong Limited ('LSHK'). The taxpayer had directors in

Hong Kong, Singapore and the Cook Islands. Pursuant to a decision of a management meeting held in Hong Kong, LSHK's trade mark was transferred to the taxpayer, a company incorporated in December 1987 in the Cook Islands. The taxpayer licensed the right to use the trade mark to its associated companies.

Decision: The CFI upheld the BOR's decision that the taxpayer was carrying on business in Hong Kong and the royalty earned by the taxpayer was sourced from Hong Kong on the grounds that:

(1) the effective decision to acquire the trade mark and to grant licenses were all made in Hong Kong;

(2) the negotiation for and the agreements to grant the licenses were made in Hong Kong;

(3) the trade marks were registered in Hong Kong; and

(4) the steps taken to protect the trade mark were all traceable to directions from Hong Kong.

The CFI also held that s.60 was wide enough to apply to the present case, i.e. additional assessments to charge the taxpayer under s.14 could be issued even though the taxpayer has been charged under s.15(1)(b) previously. Both the COA and the CFA upheld the CFI's decision in this regard. The CFA held that an additional assessment under s.60 was not precluded by tax having originally been assessed on the basis of what ss.15 and 21A deem, and such original assessment having become final and conclusive.

2.2.3 Assessable profits from deemed trading receipts under s.15(1)(a), (b) or (ba)

Pursuant to s.21A, the assessable profits from the deemed trading receipts under s.15(1)(a), (b) or (ba) are deemed to be either 30% or 100% as follows:

Situation	Deemed profits
Payment is made by an associate and the intellectual property was previously owned by a person carrying on business in Hong Kong	100%
Other cases	30%

Note: In DIPN 22, the IRD accepts that the word 'owned' refers to direct ownership.

The provisions deeming 100% of the payment made by an associate as profits of the non-resident for the use of an intellectual property previously owned by a person carrying on business in Hong Kong were enacted in 1993. The purpose of the amendment is to prohibit persons within the same group from obtaining a tax benefit by entering into a sale and lease back transaction of intellectual property.

The withholding tax rate is also dependent on whether Hong Kong has signed a comprehensive double taxation agreement with the territory of which the recipient is a resident.

Example 1

A develops and owns a trade mark in Hong Kong. A intends to sell the trade mark to B, a non-resident, for $10 million and then license it back for use in its manufacturing business carried on in Hong Kong at $1 million per annum.

The Hong Kong tax implications are as follows:

Any gain/loss on disposal of the trade mark made by A is capital in nature and therefore will not be taxable/deductible. The license fee paid by A will be tax deductible as it is incurred in the production of assessable profit.

B will be deemed to have derived a profit from licensing the trade mark for use in Hong Kong under s.15(1)(b).

If the deemed profit is 30% of the payment, A and B as a whole will enjoy a tax benefit of $115,500 ($1 million × 16.5% – $1 million × 30% × 16.5% = $115,500).

If the deemed profit is 100% of the payment, A and B as a whole will get no tax benefit from the arrangement ($1 million × 16.5% – $1 million × 100% × 16.5% = Nil).

2.3 Withholding obligations on Hong Kong agents

A non-resident person may be assessed directly, or in name of his agent jointly or severally. An assessment can be raised on an agent irrespective of whether or not he has receipt of the profits, and the tax shall be recoverable by all means provided in the IRO out of the assets of the non-resident person or from the agent. The agent is required to deduct, at the time he or she pays or credits the non-resident person, a sum sufficient to meet the non-resident person's tax liability in Hong Kong. The agent is statutorily indemnified against claims by the non-resident person in respect of such withholding.

Key terms

The term **'agent'**, in relation to a non-resident person, is defined under s.2(1) to include:

(a) the agent, attorney, factor, receiver, or manager of the non-resident person in Hong Kong; and

(b) any person in Hong Kong through whom a non-resident person receives any profits or income arising in or derived from Hong Kong.

However, the definition of 'agent' does not apply to a person who makes a direct payment to a non-resident person on a principal-to-principal basis.

In *CIR v Asia Television Ltd* ('*ATV* case') [(1989) 1 HKRC 90-002], a non-resident film distribution company had been paid licence fees for the broadcast of films in Hong Kong directly by ATV outside Hong Kong. The non-resident person did not receive its income through, but rather from, ATV. The High Court therefore found that ATV was not an agent of the non-resident person, and could not be assessed to tax on the non-resident person's behalf. The only alternative for the IRD was direct assessment on the non-resident person.

To overcome the limitations imposed by the interpretation of agent in the *ATV* case, s.20B was introduced to provide for the taxation of a non-resident person in the name of any person who pays or credits certain payments to the non-resident person (see **section 2.4** below).

DIPN 17 provides guidance on the taxation of persons chargeable to profits tax on behalf of non-residents.

2.4 Withholding obligations on resident persons paying or crediting certain payments to non-resident persons

Section 20B imposes a withholding obligation on a resident person who pays or credits a non-resident person (not necessarily the one who is chargeable) the following sums:

(a) sums chargeable under ss.15(1)(a), (b) or (ba);

(b) sums which are derived from a performance given in Hong Kong by a non-resident entertainer or sportsman in his or her character as an entertainer or sportsman on or in connection with a commercial occasion or event including:

  (i) any appearance made in connection with the promotion of a commercial occasion or event; and

  (ii) any participation in or for sound recording, films, videos, radio, television or similar transmissions (whether live or recorded).

The phrases 'entertainer or sportsman' and 'commercial occasion or event' are defined in s.20B(4).

Key terms

'Entertainer or sportsman' means a person, other than a corporation, who gives performances in his or her character as entertainer or sportsperson in any kind of entertainment or sport, including any physical activity which the public is permitted to see or hear. It does not matter whether the activity is live or recorded, or whether the public is required to pay for admission.

'Commercial occasion or event' is defined to include any description of occasion or event:

(a) for which an entertainer or sportsman (or other person) might, by virtue of his performance of the activity, receive or become entitled to receive anything by way of cash or any other form of property; or

(b) which is designed to promote commercial sales or activity by advertising, the endorsement of goods or services, sponsorship, or other promotional means of any kind.

With regard to non-resident entertainers and sportsmen performing in Hong Kong, the resident sponsor or agent is required to submit a Form IR 623 'Notification of Arrival in Hong Kong of Non-resident Entertainer(s) / Sportsmen' to the IRD. The IRD has issued a pamphlet 'Taxation of non-resident entertainers and sportsmen in Hong Kong, which can be downloaded from the IRD's website**: http://www.ird.gov.hk**.

Where s.20B applies, a non-resident person is chargeable to tax in the name of the Hong Kong person who paid or credited sums to him or any other non-resident person. The Hong Kong person is required to deduct a sum at the time he or she pays or credits the non-resident person which will be sufficient to meet the non-resident person's tax liability. The amounts to be withheld are as follows:

Situation	Tax to be withheld on behalf on a non-resident person
Sums taxable under ss.15(1)(a), (b) or (ba)	Standard rate or corporate profits tax rate on 30% or 100% of the sums (s.21A).
Sums payable for the performance of a non-resident sportsman or entertainer in connection with a commercial occasion or event	Standard rate or corporate profits tax rate on $^{2}/_{3}$ of the sums (s.21).*

* In the case of entertainers and sportsmen, the IRD's practice is to allow the payer to assume that allowable expenses amount to one third of the payments (DIPN 17, para 14). The non-resident may claim a larger deduction but he/she must be able to prove that any extra expenses are properly deductible.

DIPN 17 states that in terms of s.20B(2) the Hong Kong person would remain chargeable to tax on behalf of the non-resident person even if the payment or credit was made to a non-resident person other than the non-resident person who is chargeable by virtue of s.20B(1). This applies, for example, where the payment is made to the manager of a non-resident entertainer who is himself a non-resident person. Section 20B would also be applicable where sums falling within subsection (1) were paid by a Hong Kong person to another Hong Kong person for the account of a non-resident person. In this situation the other Hong Kong person would be chargeable on behalf of the non-resident person.

In addition, s.20B(2) provides that the tax so charged is recoverable by all means provided in the IRO from the Hong Kong person. The IRD will issue a Profits Tax Return – In Respect of Non-resident Persons (Form BIR 54), to the resident person for completion. The Hong Kong resident person must retain the sum until a demand note calling for payment is received from the IRD. He or she is indemnified, by virtue of s.20B(3), against any person in respect of the deduction.

Example 2

A Ltd, a Hong Kong company, has been appointed the organiser of a pop music concert to be staged in Hong Kong in December 2013. A Ltd has appointed another Hong Kong company, B Ltd, as the coordinator of the performances by various overseas artists in the concert. B Ltd has entered into a contract with U Ltd, a company incorporated in the UK, under which U Ltd will procure the performance of a UK based pop star in the concert at a fee of $4,500,000 payable by B Ltd. The fee is to be paid by A Ltd to B Ltd which would then pay the fee to U Ltd. The fee payable by U Ltd to the UK pop star is $3,000,000.

The Hong Kong tax implications are as follows:

The arrangement involves a sum payable in respect of the performance in Hong Kong by a non-resident entertainer in connection with a commercial occasion or event. Section 20B applies. The relevant sum in this case is the fee of $4,500,000 payable by B Ltd to U Ltd, not the sum of $3,000,000 receivable by the non-resident entertainer.

U Ltd, the non-resident person, is chargeable to tax in respect of the fees in the name of the resident person who pays or credits the fee to it, which is B Ltd in this case (s.20B(2)). B Ltd is obliged, at the time it pays or credits the fee to U Ltd, to deduct from the fee a sum sufficient to pay the tax on the fee and B Ltd is indemnified against any person in respect of its deduction of such a sum (s.20B(3)).

In deciding the amount of the sum to be withheld for the payment of tax, the IRD accepts that one-third of the fee payable to U Ltd can be allowed as a deduction for expenses. In other words, two-thirds of the fee would be treated as assessable profits. This arrangement has legal support under s.21 which enables the assessable profits of a non-resident to be computed on a percentage of turnover. However, U Ltd is entitled to make claims for deductions for more than one-third of the fee by producing sufficient evidence.

It should be noted that the amount to be withheld by B Ltd is the tax payable. This means B Ltd has to apply the appropriate tax rate to the deemed assessable profits, in this case 16.5%, as the non-resident, U Ltd, is a corporation. The amount to be withheld is therefore $495,000 ($4,500,000 × 2/3 × 16.5%).

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2.5 Goods on consignment

Under s.20A(3), when a person sells goods in Hong Kong on behalf of a non-resident person, he or she must furnish quarterly returns (Form BIR 52B) to the Commissioner showing the gross proceeds from the sales. The person is also required to pay 1% of the sale proceeds (the so-called 'consignment tax') to the Commissioner. A lesser sum may be paid if the Commissioner agrees. In practice, only 0.5% is payable.

From the assets that come into the person's possession or control on behalf of the non-resident person, the person must retain an amount that is sufficient to meet the tax liability of the non-resident person. The person is indemnified against any person in respect of the retention of the non-resident person's assets (s.20A(2)).

The Commissioner may exempt any person from the withholding obligation on such conditions as he thinks fit. In practice, this is usually limited to cases where an undertaking has been provided by the non-resident principal to settle his tax liability directly with the IRD.

Whilst s.20A(3) covers sale of goods in Hong Kong by an agent on behalf of a non-resident principal, if the agent constitutes a PE, the non-resident principal may be chargeable under s.14; and its assessable profits will be ascertained in accordance with IRR 5. Nevertheless, in practice, 'consignment tax' is usually regarded as the final liability. It is, however, open for a non-resident principal to produce financial statements to show that his liability is less than the consignment tax.

2.6 Stockbrokers and approved investment advisers not to be treated as agents of non-resident persons

From 1996/97 onwards, where the conditions are met, s.20AA(1) excludes stockbrokers and approved investment advisers from potential profits tax liability as agents in respect of securities trading and investment profits derived by the non-resident persons for whom they act.

Key terms

'Approved investment adviser' means:

(a) a corporation licensed to carry on a business in advising on securities or asset management under Part V of the SFO; or

(b) an authorised FI registered for carrying on such a business under that part, only to the extent that the FI carries on such a business.

'Broker' means:

(a) a corporation licensed to carry on a business in dealing in securities under Part V of the SFO; or

(b) an authorised FI registered for carrying on such a business under that Part, only to the extent that the FI carries on such a business.

2.6.1 Conditions for exclusion – ss.20AA(2), (3), (4) and (5)

In order for a broker or approved investment adviser to be deemed not to be an agent in respect of the 'taxable profits' arising from a transaction carried out for a non-resident person, the following conditions must be satisfied:

Transaction through a broker	Transaction through an approved investment adviser
(a) At the time of the transaction, the broker was carrying on the business of a broker. The person concerned need not be carrying on business exclusively as a broker. It is acceptable for the relevant activities to form only part of a wider business. The exclusion will apply as if that part were a separate business, but will not apply to activities performed by the agent for the non-resident person other than as a broker (DIPN 30, paras 10(a), 13 & 14).	(a) At the time of the transaction, the approved investment advisor was carrying on the business of an approved investment adviser. The person concerned need not be carrying on business which consists exclusively of providing investment advice services. The services may be provided as part of a business with a wider range of activities. The exclusion will apply as if that part were a separate business, but will not apply to activities performed by the agent for the non-resident person other than as an approved investment adviser (DIPN 30, paras 12(a), 13 & 14).
(b) The transaction was carried out by the broker for the non-resident person in the ordinary course of the business. This requirement will not be satisfied if a transaction has unusual features, which make it stand out from the common flow of business of the broker or if it reflects a special relationship with a client, such	(b) The transaction was carried out by the approved investment adviser for the non-resident person in the ordinary course of the business. The transaction must fall within Type 4 (advising on securities) or Type 9 (asset management) of Part I of Schedule 5 (Regulated Activities) of the SFO. The

Transaction through a broker	Transaction through an approved investment adviser
as where a transaction is carried out in respect of a discretionary account. However, the transaction need not be carried out by the broker personally. He or she may give instructions for it to be carried out by another person (DIPN 30, para 10(b)).	meaning of asset management includes securities or futures contracts management (DIPN 30, para 12(b)).
(c) The remuneration received by the broker for providing the services to the non-resident person is not less than the customary rate for the class of business. The IRD will look at whether the arrangements for remuneration were in line with those generally acceptable within the industry at the relevant time, having regard to the nature and volume of the transaction involved (DIPN 30, para 10(c)).	(c) The remuneration received by the approved investment adviser for providing the services to the non-resident person is not less than the customary rate for the class of business. The IRD will regard this requirement as satisfied where the remuneration is in line with what is considered reasonable in the industry. Provided that the terms are not abnormal, incentive or performance fees are acceptable (DIPN 30, para 12(c)).
(d) The broker was not the non-resident person's agent in relation to any other chargeable profits for the same year of assessment. This requirement would not be satisfied if, apart from acting as a broker, the person concerned also acted as an agent of the non-resident person in some other capacity (unless as an approved investment adviser) through which the non-resident person derived chargeable profits. However, the non-resident person may derive chargeable profits through other agents in Hong Kong without it having any bearing on the application of the exclusion in relation to the broker (DIPN 30, para 10(d)).	(d) The approved investment adviser was not the non-resident person's agent in relation to any other chargeable profits for the same year of assessment. This requirement will not be satisfied if, apart from acting as an adviser (or as a broker), the person concerned also acted as an agent of the non-resident person in some other capacity (e.g. in relation to some other business activity) through which the non-resident person also derived chargeable profits. However, the non-resident person may derive chargeable profits through other agents in Hong Kong without it having any bearing on the application of the exclusion in relation to the approved investment adviser (DIPN 30, para 12(d)).
(e) The broker was not an associate of the non-resident person during the year of assessment. However, where a transaction is carried out through a broker at the request of a non-resident person who is an associate of the broker, it does not necessarily follow that the exclusion cannot apply to the broker in respect of the transaction. The exclusion will still apply if the non-resident associate is in turn acting as an agent in relation to the transaction for another non-resident person who is not	(e) The approved investment adviser was not an associate of the non-resident person during the year of assessment. Where a transaction is carried out through an approved investment adviser at the request of a non-resident person who is an associate of the adviser, the exclusion can still apply in respect of the adviser if the non-resident person is in turn acting as an agent in relation to the transaction for another non-resident person who is not an associate of the adviser. In other words, the IRD will apply the associate test in respect of the relationship between the

Transaction through a broker	Transaction through an approved investment adviser
an associate of the broker. In other words, the IRD will apply the associate test in respect of the relationship of the broker to the non-resident principal who derived the profits in question (DIPN 30, para 10(e)).	adviser and the non-resident principal who derives the profits in question (DIPN 30, para 12(e)).
(f) Not applicable.	(f) The approved investment adviser acted for the non-resident person in an independent capacity. An approved investment adviser is not regarded as acting in an independent capacity when acting on behalf of a non-resident person unless, having regard to the legal, financial and commercial characteristics between the parties, it is a relationship between persons carrying on independent businesses dealing with each other at arm's length (DIPN 30, para 15).

The word 'associate' is widely defined in s.20AA(6), and essentially follows the definition used elsewhere in the IRO.

DIPN 30 provides guidance on the application of s.20AA.

2.7 Business with closely connected resident persons

Under s.20(2), where a non-resident person carries on business with a resident person with whom he is closely connected and the course of such business is so arranged that it produces to the resident person either no profits which arise in or derive from Hong Kong, or less than the ordinary profits which might be expected to arise in or derive from Hong Kong, the business done by the non-resident person in pursuance of his connection with the resident person shall be deemed to be carried on in Hong Kong. The non-resident person shall then be chargeable to tax in respect of his profits from such business in the name of the resident person as if the resident person were his agent, and all the provisions of the IRO shall apply accordingly.

A person is closely connected with another person where the Commissioner in his discretion considers that such persons are substantially identical, or that the ultimate controlling interest of each is owned or deemed to be owned by the same person or persons (s.20(1)(a)). The controlling interest of a company shall be deemed to be owned by the beneficial owners of its shares, whether held directly or through nominees, and shares in one company held by or on behalf of another company shall be deemed to be held by the shareholders of the last-mentioned company (s.20(1)(a)). However, the term 'substantially identical' is not defined in the IRO.

Section 20 is designed to counteract the diversion of profits from Hong Kong to a closely connected non-resident person. It is different from most of the transfer-pricing provisions in other jurisdictions, as it does not seek to substitute an arm's-length price for the transaction between related parties. Specifically, it deems the business done by the non-resident person to be carried on in Hong Kong and the profits arising therefrom are to be taxed in the name of the resident person as if the resident person were the agent of the non-resident person.

There are doubts on the validity of s.20 as taxing the full profit of the non-resident person appears to be *ultra vires* where the profits do not have a source in Hong Kong. In practice, the IRD seldom invokes s.20, other than in blatant avoidance cases.

Example 3

Mr A is the Managing Director of X Ltd, a manufacturing company established in Country B. He was told by a Hong Kong sales agent, Y Ltd, that one of the consumer products of X Ltd, Product C, could be sold in Hong Kong. He is now considering the following alternatives:

Alternative 1

X Ltd will appoint Y Ltd as its agent in Hong Kong for the distribution of Product C in Hong Kong. Y Ltd will not have a general power to negotiate and conclude contracts on behalf of X Ltd. However, it will occasionally keep a small amount of stock of Product C in Hong Kong for fast delivery to customers. It is responsible for collecting the sale proceeds for remittance to X Ltd by the end of each month. The estimated sales amount of Product C is $5 million each year. Y Ltd will be entitled to a sales commission of 5% on the sales made in Hong Kong.

Alternative 2

A wholly owned subsidiary, Z Ltd, will be established in Hong Kong. X Ltd will sell Product C to Z Ltd in Hong Kong at $20 each (a fair market price). Z Ltd will then sell the products to Hong Kong customers at $30 each. It is expected that Z Ltd will make a trading profit of $2 million each year.

The Hong Kong tax implications of the two alternatives are as follows:

Alternative 1

As Y Ltd does not have general authority nor keep stock, X Ltd has no PE in Hong Kong. Hence, X Ltd is not carrying on any business in Hong Kong and its profits from sale of Product C in Hong Kong are not chargeable to profits tax. However, Y Ltd, being the agent of X Ltd in Hong Kong, is required, under s.20A(3), to furnish quarterly returns to the Commissioner showing the gross proceeds from the sale. Y Ltd is also required to pay 1% (in practice, 0.5%) of the sale proceeds to the Commissioner, which is sometimes called a consignment tax. Therefore, Y Ltd is responsible to retain an amount, which is sufficient to meet the tax liability of X Ltd, before remitting the sale proceeds to X Ltd, and is indemnified against any person in respect of the retention of X Ltd's assets under s.20A(2).

The 5% commission received by Y Ltd is subject to profits tax as the sales services are performed in Hong Kong.

Alternative 2

X Ltd is not carrying on any business in Hong Kong and its profits from sale of Product C in Hong Kong is not chargeable to profits tax. Although Z Ltd is controlled by X Ltd, it is unlikely that the IRD will invoke s.20 to assess the trading profits of X Ltd in Hong Kong as the price of Product C charged by X Ltd is at fair market price. It is also thought that the IRD may only invoke s.20 when the resident person is selling to a non-resident rather than buying from a non-resident.

Z Ltd is carrying on a trading business in Hong Kong and its profits from sale of Product C in Hong Kong ($2 million) are chargeable to profits tax at 16.5%.

2.8 Exemption for offshore funds

In order to reinforce the status of the HKSAR as an international financial centre by increasing its attractiveness to offshore fund managers, the Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006 ('the 2006 Ordinance') was passed on 10 March 2006. The 2006 Ordinance introduced two sets of provisions into the IRO – the exemption provisions and the deeming provisions. The IRD issued DIPN 43 to clarify its practice in this regard.

2.8.1 The exemption provisions

Under s.20AC, the following profits of a non-resident person who only carries on a trade, profession or business in Hong Kong are exempt from profits tax:

(a) profits from dealing in 'specified transactions' carried out through or arranged by a 'specified person' (s.20A(2));

(b) profits from transactions incidental to the carrying out of the specified transactions provided that the trading receipts from the incidental transactions do not exceed 5% of the total trading receipts from both the specified transactions and the incidental transactions (s.20AC(4)).

The exemption is applicable with retrospective effect from the year of assessment 1996/97 onwards. An application for revision of a previous year's assessment can be made under s.70AB within (i) 12 months after 10 March 2006 or (ii) 6 years after the end of the relevant year of assessment, whichever is the later.

Key terms

Schedule 16 to the IRO contains the list of **'specified transactions'**:

(a) a transaction in securities (excluding shares/debentures of a private company);

(b) a transaction in futures contracts;

(c) a transaction in foreign exchange contracts;

(d) a transaction consisting in the making of a deposit other than by way of a money-lending business;

(e) a transaction in foreign currencies; and

(f) a transaction in exchange-traded commodities.

Appendix C of DIPN 43 sets out the IRD's view on whether particular transactions are covered by the specified transactions.

Under s.20AC(6), a **'specified person'** is defined as:

(a) In relation to a transaction carried out before 1 April 2003:

  (i) a bank within the meaning of s.2(1) of the Banking Ordinance;

  (ii) a person registered as a dealer or commodity trading adviser under Part IV of the Commodities Trading Ordinance repealed under s.406 of the SFO;

  (iii) a person registered as a dealer or an investment adviser under Part VI, or as a securities margin financier under Part XA, of the Securities Ordinance repealed under s.406 of the SFO; or

  (iv) a person licensed as a leveraged foreign exchange trader under Part IV of the Leveraged Foreign Exchange Trading Ordinance repealed under s.406 of the SFO.

(b) In relation to a transaction carried out on or after 1 April 2003, a corporation licensed, or an authorised FI registered, under Part V of the SFO for carrying on a business in any regulated activity within the meaning of Part 1 of Schedule 5 to the SFO.

Conditions for exemption

To qualify for the exemption,

(a) the non-resident person must not carry on any trade, profession or business in Hong Kong involving any transactions other than those that attract the exemption (s.20AC(3)); and

(b) the dealing in securities or futures contracts or the leveraged foreign exchange trading needs to be carried out through a licensed broker, a FI, or an authorised automated trading system (s.20AC(2)).

Meaning of non-resident person

Under s.20AB(3), a 'non-resident person' is a person who is not a 'resident person'. Under s.20AB(2), a 'resident person' means:

(a) an individual who (i) ordinarily resides in Hong Kong (has a permanent home in Hong Kong where he or his family lives) or (ii) stays in Hong Kong for more than 180 days in the relevant year of assessment or more than 300 days in two consecutive years of assessment, one of which is the relevant year of assessment (in counting the number of days, part of a day is treated as one day);

(b) a company, partnership or trustee of a trust estate whose central management and control is exercised in Hong Kong in the relevant year of assessment.

Determining the central management and control

The IRD clarifies its practice on determining the 'central management and control' in the revised DIPN 43 (2010). In the previous DIPN 43 (2006), the IRD stated that the location of 'central management and control' is wholly a question of fact. In general, if the 'central management and control' of a company is exercised by directors in board meetings, the relevant locality is where those meetings are held. In the revised DIPN 43, the IRD now states that the residence of individual directors will not generally be a relevant factor to consider. The mere fact that the majority of the directors of the management board of the company are resident in Hong Kong does not of itself mean that the company is centrally managed and controlled in Hong Kong, and hence would not adversely affect application of the exemption. However, this does not mean that an individual director's residence can be completely ignored in all cases. Para 16 of the revised DIPN 43 states:

> *"The place of board meetings also is not necessarily conclusive ... In cases where central management and control of a company is in fact exercised by an individual…, the relevant locality is the place where the controlling individual exercises his power. As central management and control is a question of fact and reality, when reaching a conclusion in accordance with case law principles, only factors which exist for genuine commercial reasons will be accepted."*

In reality, the residence of individual directors could be a relevant factor. For instance, where all or majority of the individual directors are Hong Kong residents and there are no genuine commercial reasons for holding board meetings overseas, the IRD may contend that such board meetings are only a formality and that the 'central management and control' of the company is actually exercised by the directors in Hong Kong through other means. Appendix B in DIPN 43 sets out the IRD's views on the residency status of various forms of investment vehicles commonly adopted in holding and managing investment portfolios.

The above discussion is in the context of a corporation. However, the IRD has indicated that a similar test would apply to determine the residence of a partnership or trust.

Incidental transactions

The term 'incidental transaction' is not defined in the IRO. The word 'incidental' will be accorded its common meaning, which should cover the various modes of operation of different offshore funds. Whether particular transactions carried out by an offshore fund are incidental transactions is a question of fact, which can only be determined by reference to the particular mode of operation of the offshore fund concerned. Typical incidental transactions include custody of securities, and receipts of interest or dividend on securities acquired through the specified transactions (DIPN 43, para 37).

'Trading receipts' for the purposes of applying the 5% threshold means gross receipts that should have been chargeable to tax but for the exemption. Hence, receipts that all along are non-taxable without relying on the exemption provisions (e.g. capital gains and tax-exempt dividends or interest income) are excluded in applying the 5% threshold (DIPN 43, para 38).

Example 4 (Adapted from DIPN 43, Examples 1 and 2)

A-Fund Ltd is a non-resident company. It had the following business receipts in the year of assessment 2012/13:

(1)	Dividends from Hong Kong listed companies	$300,000
(2)	Receipts from other incidental transactions	$260,000
(3)	Receipts from specified transactions	$5,000,000

The 5% threshold will be applied by reference to 'receipts from specified transactions' and 'receipts from other incidental transactions'. Dividends, which all along are tax-exempt, will not be taken into account. As the 'receipts from other incidental transactions' only represent 4.94% ($260,000 / ($5,000,000 + $260,000)) of the total receipts, the 'receipts from other incidental transactions' together with the 'receipts from specified transactions' will be exempt from profits tax.

If the amount of 'receipts from other incidental transactions' is $270,000, the 5% threshold will be exceeded ($270,000 / ($5,000,000 + $270,000) = 5.12%); and the 'receipts from other incidental transactions' will be chargeable to profits tax. However, the 'receipts from specified transactions' will remain tax-exempt.

2.8.2 Loss sustained by tax-exempt offshore funds

Profits from the specified transactions are exempt from tax. As a matter of symmetry, losses sustained by a tax-exempt offshore fund from the specified transactions in a year of assessment are not available for set off against any of its assessable profits for any subsequent years of assessment (s.20AD and DIPN 43, para 41).

2.8.3 The deeming provisions (anti-avoidance provisions)

To prevent resident persons taking advantage of the exemption by investing through non-resident entities, anti-avoidance provisions are introduced as s.20AE and are effective from the year of assessment 2006/07 onwards.

Under ss.20AE(1), (2) and (3), a resident person who:

(a) alone or jointly with his associates, holds direct and/or indirect beneficial interest of 30% or more in a tax-exempt offshore fund; or

(b) holds any percentage in a tax-exempt offshore fund if the offshore fund is his associate;

will be deemed to have derived assessable profits in respect of the trading profits earned by the offshore fund from specified transactions and incidental transactions carried out by the offshore fund in Hong Kong; regardless of whether the resident person has received any profit distribution from the offshore fund (s.20AE(4)).

The amount of deemed profits is ascertained by reference to the percentage of the resident person's beneficial interest in the offshore fund and the length of ownership within the relevant year of assessment.

However, the deeming provision will not by itself deem the resident person to be carrying on a business in respect of his other activities, will not impose any new tax, and will not be invoked in respect of offshore profits, capital gains nor dividend income.

The deeming provisions will not apply to a resident person

(a) where the offshore fund is a fund authorised by the Securities and Futures Commission; or

(b) if the Commissioner is satisfied that beneficial interests in the offshore fund are *bona fide* widely held (s.20AE(8)).

The term '*bona fide* widely held' is not defined in the IRO. The '*bona fide* widely held' requirement is satisfied if, **at no time** during the year of assessment in question:

(a) fewer than 50 persons hold (or have the right to become the holders of) all of the units or shares in the offshore fund; and

(b) fewer than 21 persons hold (or have the right to become the holders of) units or shares that entitle the holders, directly or indirectly, to 75% or more of the income or property of the offshore fund (DIPN 43, para 64).

If the above benchmark figures are not met, the requirement will still be satisfied if the fund is established with a view to wide public participation and there is nothing to suggest that the offshore fund is intended to be a closely held investment vehicle (DIPN 43, para 65).

Determining the direct beneficial interest

In Schedule 15, the extent of a resident person's direct beneficial interest in a non-resident person is determined as follows:

(a) the percentage of the issued share capital held by the resident person (where the non-resident person is a corporation);

(b) the percentage of the profits of the partnership to which the resident person is entitled (where the non-resident person is a partnership); or

(c) the percentage in value of the trust estate in which the resident person is interested (where the non-resident person is a trustee of a trust estate).

A fund manager of an offshore fund may hold non-profit participating shares for the sole purpose of managing the offshore fund. To apply the deeming provisions fairly to a fund manager or other persons holding such non-profit participating shares, DIPN 43 (para 49) states that the issued shares of a corporation that do not entitle their holders to receive dividends, whether in cash or in kind, and a distribution of the corporation's assets upon its dissolution (other than a return of capital), are excluded in computing the percentage of the issued share capital of the corporation held by a person (s.20AB(9)).

Example 5 (Adapted from DIPN 43, Example 3)

B-Fund Ltd has 10,000 issued shares, out of which 500 shares are 'management shares' which entitle their holders to special management rights but not dividends or distributions of assets upon dissolution. L Ltd, a resident fund management company, was appointed as B-Fund Ltd's fund manager and the 500 'management shares' were allotted to it. L Ltd also acquired further 1,500 issued shares of B-Fund Ltd.

The extent of L Ltd's direct beneficial interest in B-Fund Ltd is computed as:

$$\frac{1{,}500}{(10{,}000 - 500)} \times 100\% = 15.79\%$$

The 500 'management shares' are excluded in ascertaining L Ltd's beneficial interest in the fund.

Determining the indirect beneficial interest

In Schedule 15, the extent of a resident person's indirect beneficial interest in a non-resident person is determined as follows:

(a) where there is one interposed person, by multiplying the percentage of the resident person's beneficial interest in the interposed person by the percentage of the interposed person's beneficial interest in the non-resident person; or

(b) where there are a series of two or more interposed persons, by multiplying the percentage of the resident person's beneficial interest in the first interposed person by the percentage of the first interposed person's beneficial interest in the next interposed person and so on; and finally by the percentage of the last interposed person's beneficial interest in the non-resident person.

In determining the extent of beneficial interest, both direct and indirect beneficial interests as well as beneficial interests held by associates (whether resident or non-resident) are taken into account (see **Examples 6 and 7** below).

However, s.20AE(9) provides that a resident person is not liable to tax in respect of the deemed assessable profits if any of the interposed resident person, through whom he holds an indirect beneficial interest in an offshore fund, is liable to tax under the deeming provisions in respect of the assessable profits of the same offshore fund (see **Example 9** below).

Example 6 (Adapted from DIPN 43, Example 4)

M Ltd, a resident company, directly holds 20% of the issued shares of C-Fund Ltd, a tax-exempt offshore fund. Through other companies, M Ltd also indirectly holds 15% of C-Fund Ltd.

The deeming provisions will apply to M Ltd. Its direct and indirect beneficial interests in C-Fund Ltd (20% + 15% = 35%) exceed the '30% or more' threshold. Hence, 35% of the exempt profits of C-Fund Ltd will be deemed to be the assessable profits of M Ltd.

Example 7 (Adapted from DIPN 43, Example 5 and 6)

N Ltd and O Ltd are resident companies with the same holding company. They hold 20% and 25% respectively of the issued shares of D-Fund Ltd, a tax-exempt offshore fund.

N Ltd and O Ltd are associates as they are under the control of the same company. As their beneficial interests in D-Fund Ltd in total exceed the 30% threshold (20% + 25% = 45%), the deeming provisions will apply to both of them. Hence, 20% and 25% of the exempt profits of D-Fund Ltd will be deemed to be the assessable profits of N Ltd and O Ltd respectively.

If O Ltd is a non-resident company, it will not have any tax liability since the deeming provisions do not apply to a non-resident person. However, the deeming provisions will still apply to N Ltd as its beneficial interest together with that of O Ltd in D-Fund Ltd exceed the 30% threshold. 20% of the exempt profits of D-Fund Ltd will be deemed to be the assessable profits of N Ltd.

Example 8 (Adapted from DIPN 43, Example 7)

P Ltd, a resident company, holds 20% of the issued shares of E-Fund Ltd, a tax-exempt offshore fund and an associate of P Ltd.

Although the beneficial interest held by P Ltd is less than 30%, the deeming provisions will still apply as it holds some beneficial interest in E-Fund Ltd which is its associate.

Example 9 (Adapted from DIPN 43, Example 13)

T Ltd holds 90% of the issued shares of U Ltd which in turn holds 70% of the issued shares of V Ltd. V Ltd holds 50% of the issued shares of I-Fund Ltd, a tax-exempt offshore fund. T Ltd, U Ltd and V Ltd are all resident companies.

Under the deeming provisions, deemed assessable profits representing 50% of the exempt profits of I-Fund Ltd would be imposed on V Ltd.

Under s.20AE(9), no deemed assessable profits would be imposed on T Ltd and U Ltd notwithstanding that they both hold indirect beneficial interests of more than 30% (T Ltd = 90% $\times$ 70% $\times$ 50% = 31.5%; U Ltd = 70% $\times$ 50% = 35%) in I-Fund Ltd. Deemed assessable profits in respect of the same exempt profits of I-Fund Ltd have already been imposed on V Ltd.

Ascertaining the deemed assessable profits

The amount of deemed assessable profits imposed on a resident person for a year of assessment is ascertained in accordance with Schedule 15 by adding up the assessable profits of the non-resident person which are tax exempt for each day in the period in that year of assessment during which the resident person has a direct or indirect beneficial interest in the non-resident person.

The exempt profits of the non-resident person for a particular day in a year of assessment (which is the deemed assessable profits of the resident person) are calculated using the following formula set out in Schedule 15.

Formula to learn

$$A = \frac{B \times C}{D}$$

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 of the offshore fund in which the particular day falls

D means the total number of days in the accounting period of the offshore fund in which the particular day falls

Ascertainment of deemed assessable profits is made by reference to the year of assessment from 1 April to 31 March, irrespective of the accounting dates of the non-resident person and the resident person.

Non-taxable items (e.g. capital gains, dividends and interests) are excluded in computing the deemed assessable profits. On the other hand, there is no deduction for the expenses incurred by the resident person in generating the deemed assessable profits.

Example 10 (Adapted from DIPN 43, Examples 8 - 12)

G-Fund Ltd, a tax-exempt offshore fund, adopts 31 December as its accounting date. It derived assessable profits of $10 million and $12 million from specified transactions respectively for the years ended 31 December 2011 and 2012. During the year ended 31 December 2012, it also received dividends of $1 million from a Hong Kong listed company and interests of $2 million on a long term debt instrument (within the meaning of s.26A).

R Ltd, a resident company, held 20% of the issued shares of G-Fund Ltd during the period from 1 July 2011 to 30 September 2011; and 50% from 1 October 2011 to 30 September 2012. R Ltd adopts 30 April as its accounting date. R Ltd incurred general administration expenses of $800,000 and $1,200,000 during the two years ended 30 April 2012 and 2013, and sought to deduct such expenses against the deemed assessable profits.

As noted above:

(a) Ascertainment of deemed assessable profits is made by reference to the year of assessment from 1 April to 31 March. The accounting dates of G-Fund Ltd, the tax-exempt offshore fund (i.e. 31 December) and R Ltd, the resident person (i.e. 30 April), are irrelevant.

(b) Non-taxable items (dividends and interests) are excluded in computing the deemed assessable profits. On the other hand, there is no deduction for the administration expenses incurred by R Ltd. Any expenses incurred by G-Fund Ltd in earning the profits from the specified transactions would have been deducted in ascertaining G-Fund Ltd's assessable profits, which are deemed to be the assessable profits of R Ltd.

Therefore, the deemed assessable profits imposed on R Ltd are computed as follows:

$$\text{Deemed assessable profits for each day for which R Ltd has an interest in G-Fund Ltd} = \frac{B \times C}{D}$$

Year of assessment 2011/12

$$= \frac{50\% \times \$10m}{366 \text{ days}} \times 92 \text{ days} + \frac{50\% \times \$12m}{366 \text{ days}} \times 91 \text{ days} = \$2,748,633$$

'92 days' refer to the period from 1 October 2011 to 31 December 2011 and '91 days' refer to the period from 1 January 2012 to 31 March 2012, during which R Ltd held a beneficial interest of 50% in G-Fund Ltd. The period from 1 July 2011 to 30 September 2011 during which R Ltd only held a beneficial interest of 20% (less than the 30% threshold) need not be taken into account.

Year of assessment 2012/13

$$= \frac{50\% \times \$12m}{365 \text{ days}} \times 183 \text{ days} = \$3,008,219$$

'183 days' refer to the period from 1 April 2012 to 30 September 2012, during which R Ltd held a beneficial interest of 50% in G-Fund Ltd.

No deemed loss for resident persons

The IRD mentions in DIPN 43 that the deeming provisions are intended disincentives to resident persons for taking advantage of the exemption by carrying out round-tripping. In this regard, the deeming provisions only impose deemed profits but not losses on a resident person. A resident person, therefore, will not be entitled to claim any proportionate amount of the losses sustained by a tax-exempt offshore fund in which he holds a beneficial interest (DIPN 43, para 61).

Loss set off against deemed assessable profits by resident persons

A resident corporation may set off the deemed assessable profits by losses sustained in its other businesses in accordance with the provisions of s.19C. However, such set-off is not allowable for a resident individual or resident partnership, unless the holding of the beneficial interest in the offshore fund is part and parcel of his/its other business. The individual or partners of the partnership can obtain the set-off under personal assessment (DIPN 43, para 62).

2.8.4 Reporting requirements

The IRO does not have any provisions on the statutory requirements for offshore fund profits tax exemption application or registration. However, as with other persons chargeable to tax, a resident person with deemed assessable profits derived under s.20AE bears the legal obligation of complying with other provisions of the IRO on reporting chargeability, lodgment of returns, providing information, payment of tax, etc. (DIPN 43, para 67). The resident person has to report the deemed assessable profits as a separate item in its profits tax return with breakdown of how the amount is arrived at. The IRD mentions in DIPN 43 that penalties under Part XIV may be imposed for failures to comply with the relevant statutory provisions.

2.9 Tax overpaid by non-resident persons

Pursuant to s.79(3), when a non-resident has been assessed in the name of another person under s.20A or s.20B and the tax has been paid by the other person, either that other person or the non-resident person may claim repayment of any tax overpaid (see DIPN 17).

3 Avoidance of double taxation

Topic highlights

As of 1 June 2013, Hong Kong has signed 29 comprehensive double taxation agreements and arrangements ('DTAs').

Hong Kong entered into a DTA with the United States of America in 1989 in respect of the taxation of income derived by residents of Hong Kong and the United States from the international operation of ships (not including aircrafts). In November 2003, there was another DTA on shipping and air service income with Singapore. A similar agreement with Sri Lanka was entered into in November 2004. There are also 5 DTAs on shipping income with the United Kingdom, the Netherlands, Germany, Norway and Denmark on international shipping income. Shipping income chargeable to Hong Kong profits tax by virtue of s.23B(2) are exempted if the owners are resident of Korea or New Zealand, and *vice versa*.

In respect of international aviation income, Hong Kong has entered into 25 DTAs with Bangladesh, Canada, Croatia, Denmark, Estonia, Ethiopia, Finland, Germany, Iceland, Israel, Jordan, Kenya, Korea, Kuwait, Laos (pending order by Chief Executive in Council), Macau SAR, Maldives, Mauritius, Mexico, New Zealand, Norway, Russian Federation, Sweden, Switzerland and the United Kingdom.

The Avoidance of Double Taxation on shipping and air service income is also covered by the comprehensive DTAs signed by the Hong Kong Government.

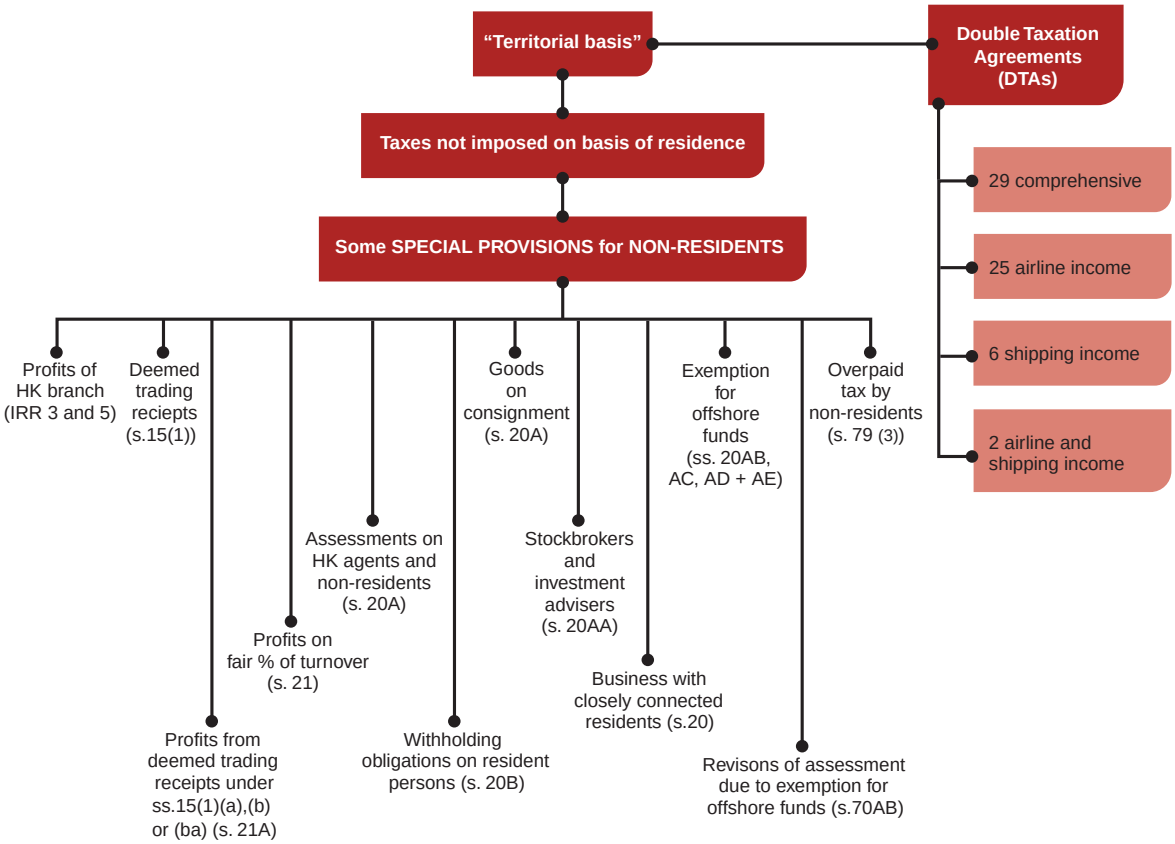
As of 1 June 2013, Hong Kong has concluded comprehensive DTAs with 29 jurisdictions including Belgium, Thailand, the Mainland of China, Luxembourg, Vietnam, Brunei, the Netherlands, Indonesia, Hungary, Kuwait, Austria, the United Kingdom, Ireland, Liechtenstein, France, Japan, New Zealand, Switzerland, Portugal, Spain, the Czech Republic, Malta, Jersey, Malaysia, Mexico, Canada, Italy, Guernsey and Qatar.

For details, refer to chapter 12.

DIPN 45 was issued in April 2009 to clarify the IRD's position on the issue of double taxation resulted from transfer pricing adjustment made by overseas jurisdictions on a Hong Kong person or entity.

DIPN 46 was issued in December 2009 to clarify the IRD's practice on the methodologies and issues related to transfer pricing adjustments.

Topic recap



Exam practice

Aaron Inc. 41 minutes

Aaron Inc ('AI') is a company incorporated in the United States with diversified businesses. It recently set up two subsidiaries – Aaron Australia Pty Ltd ('AA') in Sydney and Aaron Ltd ('Aaron'), a private company, in Hong Kong. AI owns beneficially 60% of both AA and Aaron directly. Aaron also owns beneficially 10% of the shares in AA. Due to the recent boom in the securities industry in Hong Kong, AA's income comes mainly from its trading of securities listed on the Hong Kong Stock Exchange. AA's other income (being profits from transactions incidental to the trading of Hong Kong listed securities) accounts for less than 2% of its total trading receipts of Hong Kong listed securities. The Board of Directors' meetings of AI and AA are held in New York. Aaron's Board of Directors' meetings are held in Hong Kong. Mr. Weber, the director of Aaron, is proposing Aaron should directly deal in securities in Hong Kong instead of AA. Assume Aaron, AA and AI are all licensed under the Securities and Futures Ordinance to deal in the trading of listed securities on the Hong Kong Stock Exchange.

Required:

Outline the tax implications for Aaron, AA and AI in respect of AA's profits (including other income) of (a) the trading of listed securities carried out in Hong Kong; and (b) Mr. Weber's proposal for Aaron.

(23 marks)

HKICPA September 2007 (Amended)

Newco 28 minutes

An investor in the US would like to participate in the securities market in Hong Kong by establishing a fund in the form of a limited company (Newco) with the objective of enjoying the profits tax exemption for an offshore fund as stipulated in the IRO. Newco will be incorporated in Bermuda and will have two individuals as directors.

Required:

(a) Elaborate on how Newco should be structured and participate in Hong Kong securities market so that it can enjoy the profits tax exemption for an offshore fund.

(11 marks)

(b) Discuss the circumstances in which the profits derived from the abovesaid offshore fund structure and participation in accordance with the profits tax exemption provisions in the IRO for the offshore fund would still be subject to profits tax.

(3 marks)

(c) Briefly state the tax reporting obligations, if any, for the offshore fund under the IRO.

(2 marks)

(Total = 16 marks)

HKICPA December 2012 (Amended)

Further reading

Suggested References

When studying this topic we suggest the following references:

Primary References

Advanced Taxation in Hong Kong, Pearson (Chapters 11 and 23)

Hong Kong Master Tax Guide, CCH Hong Kong Ltd (Chapter 6)

Hong Kong Taxation – Law & Practice, The Chinese University Press (Chapter 4)

Hong Kong Taxation and Tax Planning, Pilot Publishing Co Ltd (Chapters 14, 34 and 35)

Inland Revenue Ordinance (Part IV, Part XIII)

DIPN 17 (Revised) The Taxation of Persons Chargeable to Profits Tax on behalf of Non-residents

DIPN 22 (Revised) Computation of Assessable Profits from Cinematograph Films, Patents, Trade Marks, etc.

DIPN 30 (Revised) Profits tax: Section 20AA Persons not Treated as Agents

DIPN 43 (Revised) Profits tax – Profits Tax Exemption for Offshore Funds

Supplementary Reference

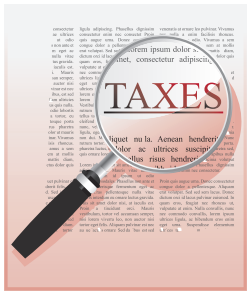
Hong Kong Tax Manual, CCH Hong Kong Ltd (Para 15)

Part C

Salaries tax, property tax and personal assessment

Learning focus

Salaries tax and property tax represent the other two important taxes other than profits tax. Like profits tax, both are income taxes. Salaries tax covers income from office, employment and pension. Property tax, on the other hand, charges on every person being owners of any land or buildings, or land and buildings wherever situated in Hong Kong. Personal assessment is not another charge of tax. Under certain circumstances, the taxpayer would pay less tax if he or she elects personal assessment. There are, of course, criteria for the election.



chapter 5

Hong Kong salaries tax

Topic list

Learning focus

Salaries tax is one of the important sources of revenue for Hong Kong. Individual taxpayers and tax advisors should be familiar with its computation as well as various salaries tax issues like location of employment, various incomes from employment, the 60-day rule, deductibility criteria, concessionary deductions, personal allowances, housing benefits, share and option benefits and so on. Students must familiarise themselves with the relevant practice notes, all of which are readily available from the IRD website: **www.ird.gov.hk**

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Salaries tax on employees and directors		
2.04	**Scope of salaries tax charge**	2
2.04.01	Identify the scope of salaries tax	
2.04.02	Discuss various exemptions available under salaries tax	
2.04.03	Describe the rules governing the source of income from office, employment and pension	
2.04.04	Compute the assessable income from an office, employment and pension	
2.04.05	Explain and apply DIPN 10	
2.05	**Expenses and deductions**	3
2.05.01	Explain the rules governing the deduction of expenses and depreciation allowance allowable under salaries tax	
2.05.02	Explain the rules governing the concessionary deductions including approved charitable donations, elderly residential care expenses, home loan interest and contributions to recognised retirement schemes	
2.05.03	Explain and apply DIPNs 9, 23, 35, 36 and 37	
2.06	**Time basis assessment**	3
2.06.01	Describe the circumstances under which time apportionment is applicable and compute the assessable income with time basis apportionment	
2.06.02	Explain and apply DIPN 10	
2.07	**Personal allowances**	2
2.07.01	Describe the provisions under the IRO which govern the claims for various personal allowances	
2.07.02	Explain and apply DIPN 18	
2.08	**Benefits in kind, housing benefit, share options**	3
2.08.01	Identify and explain the taxation of benefits in kind and housing benefit	
2.08.02	Explain the rules governing the taxation of employee share-based benefits	
2.08.03	Explain the rules governing the taxation of holiday journey benefits	
2.08.04	Explain and apply DIPNs 16, 38 and 41	
2.09	**Treatment of lump sum receipts and losses**	2
2.09.01	Explain the taxation of lump sum receipts	
2.09.02	Explain the taxation of retirement scheme benefits	
2.09.03	Explain the treatment of losses	
2.09.04	Explain and apply DIPN 23	

		Competency level
2.10	**Separate taxation on spouses and joint assessment**	2
2.10.01	Identify and explain the issues relating to the joint assessment of husband and wife	
2.10.02	Explain and apply DIPN 18	
2.11	**Ascertainment of salaries tax liability**	3
2.11.01	Ascertain net assessable income	
2.11.02	Ascertain net chargeable income	
2.11.03	Ascertain allowable outgoings and expenses, deductions and allowances	
2.11.04	Compute salaries tax payable including provisional salaries tax under separate or joint assessment	

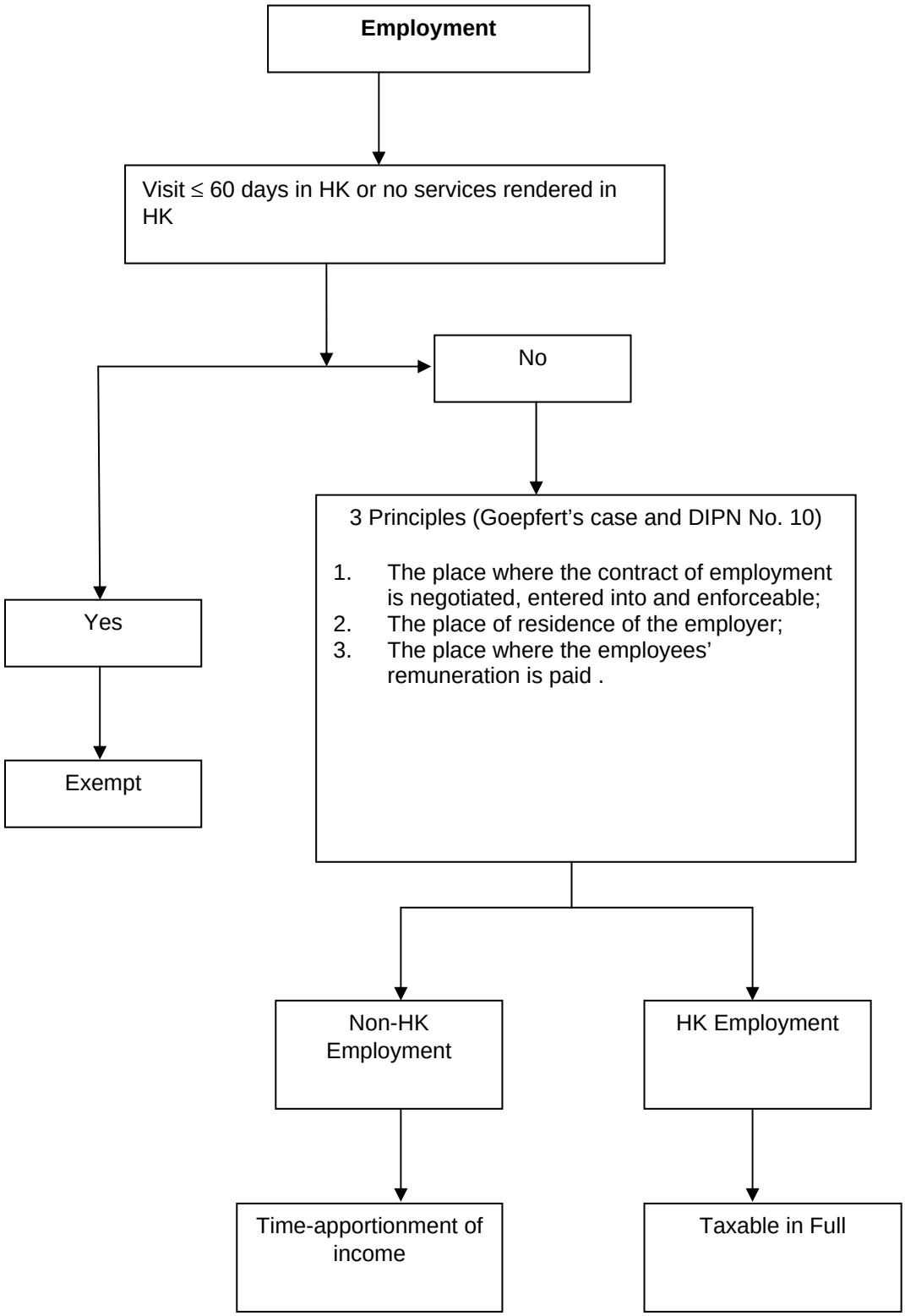
1 Introduction

Topic highlights

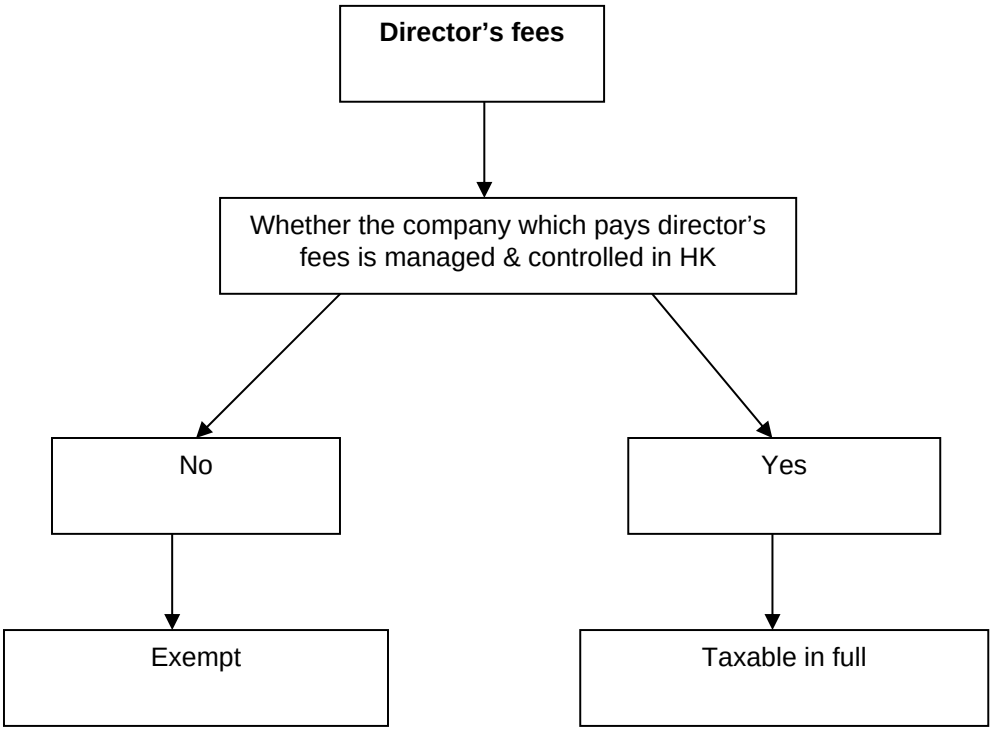
Under s.8(1) of the IRO, salaries tax is imposed on a person's income arising in or derived from Hong Kong from the following sources:

(a) any office or employment of profit.

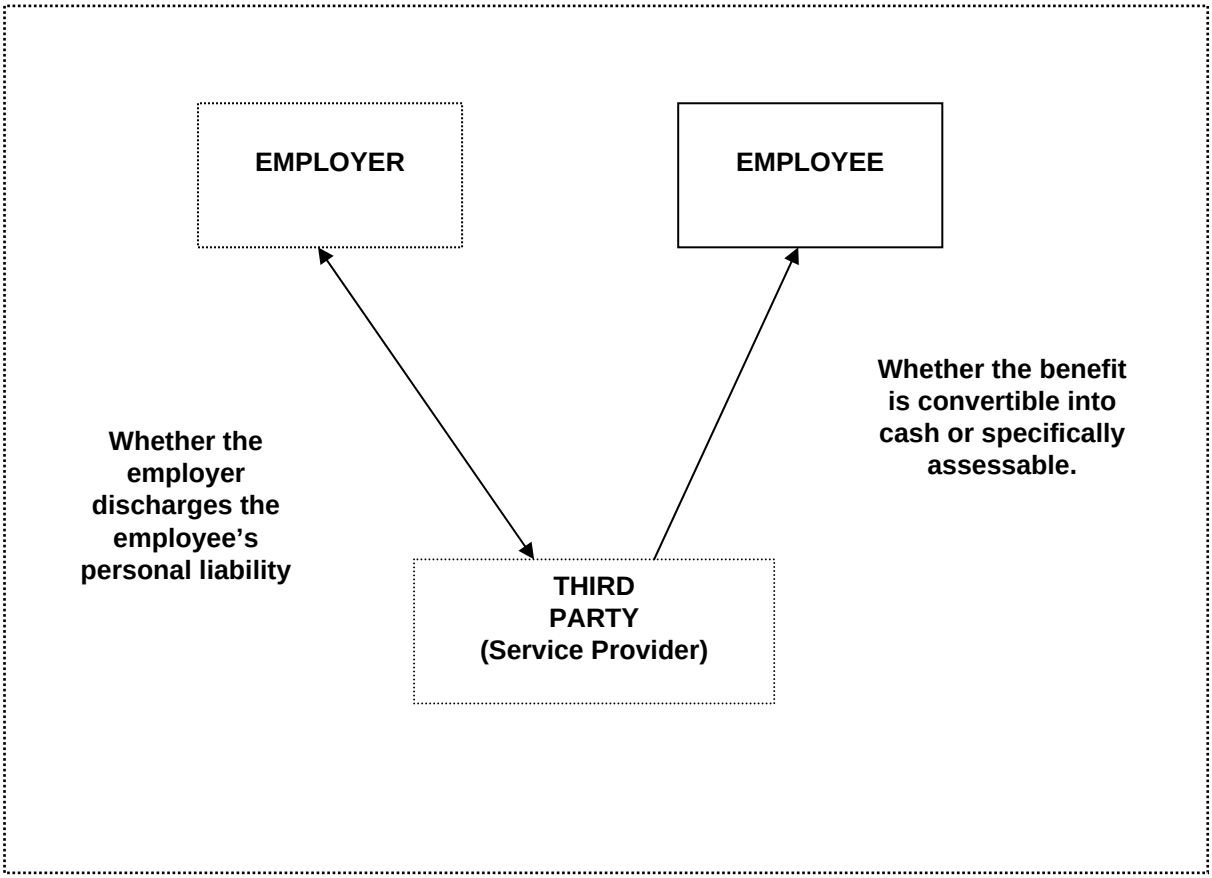
(b) any pension.



Note:
Income related to non-Hong Kong services is exempt under s.8(1A)(c) provided that conditions are met.


Director's fees
Whether the company which pays director's fees is managed & controlled in HK
No
Yes
Exempt
Taxable in full

Whether a **Fringe Benefit is taxable for salaries tax purposes**



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

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: 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.

S.8(1) is the basic charge of salaries tax and s.8(1A)(a) is an extended charge on employment income which covers income for services rendered in Hong Kong from a non-Hong Kong employment.

	Exemption under 60 days rule	Time Apportionment
HK Employment	Yes, if "visit" not more than 60 days	No
Non-HK Employment	Yes	Yes

(Refer to section 2.2 for details)

S.8(1A)(c) is an exemption under the IRO, which applies in the situation where part of the employee's income has been subject to tax similar to salaries tax in another territory.

Under the Double Tax Arrangement between the Mainland and the Hong Kong SAR, Hong Kong residents are exempt from PRC individual income tax if they spend no more than 183 days in any 12-month period commencing or ending in the taxable period concerned, and if their income is not paid by a PRC party or borne by a permanent establishment or fixed base of their employer in the PRC (please see DIPN No. 44 (Revised) for details).

With regard to the cross-border activities, the IRD has issued a pamphlet 'Income from personal services' (see **http://www.ird.gov.hk/eng/pdf/pam72e.pdf**). In the pamphlet, the IRD outlined a two-tier test in the counting of days:

- The first tier
  - In determining the taxing right (i.e. the 183-day rule) in the Mainland, any day in which a Hong Kong resident is physically present in the Mainland will be included and part of a day is counted as one day. A day trip to the Mainland is counted as one day under the 183-rule ('the N days rule').
  - For example, if a Hong Kong resident visits Shenzhen in the morning and returns to Hong Kong in the afternoon, he is regarded as present in the Mainland for one day for the purpose of the 183-day rule.
- The second tier
  - Once the individual's presence in the Mainland exceeds 183 days, he or she would be subject to PRC Individual Income Tax ('IIT'). If the individual resided in the Mainland for less than 5 years, he/she would be assessed on a time-apportioned basis. In determining the PRC IIT liabilities, both the day of arrival and the day of departure are counted as 0.5 day. In other words, the number of days for this purpose is physical presence minus 1 (the N-1 day rule).

– For example, if the Hong Kong resident goes to Shenzhen on April 1 to work and returns to Hong Kong on April 3, he is treated as having rendered services for two days in Shenzhen. However, if he goes to Shenzhen in the morning to work and returns to Hong Kong in the afternoon to continue working in the Hong Kong office, it is accepted that half-day's service is rendered in the Mainland and half-day's in Hong Kong in determining his tax liabilities.

For Hong Kong cross-border employees who have worked in the Mainland and paid PRC IIT, they are entitled to exclude that portion of their income that has been taxed in the Mainland from their income chargeable to salaries tax in Hong Kong pursuant to s.8(1A)(c). Proper documentary evidence, such as copies of tax payment certificates and tax returns, should be furnished to the Hong Kong tax authority.

With effect from the year of assessment 1989/90, a husband and wife are separately assessed for salaries tax, unless a valid election for joint assessment is made under s.10(2).

DIPN No.10 (Revised) provides guidance on the charge for salaries tax.

DIPN No. 44 (Revised) provides guidance on the Arrangement between the Mainland of China and The Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on income. This Arrangement is effective from the year of assessment 2007/08.

For the years of assessment from 1998/99 to 2006/07, DIPN No. 32 (Revised) provides guidance on the Arrangement between the Mainland of China and The Hong Kong Special Administrative Region for The Avoidance of Double Taxation on Income.

2 Office, employment and pension

Topic highlights

Office is a permanent position which has an existence independent from the people within it. Employment involves a contract *of* service whereas self-employment involves a contract *for* services. The distinction between employment and self employment is decided by looking at all the facts of the engagement. Pension refers to an annuity or other recurring periodic payments for consideration of past services.

The terms 'office', 'employment' and 'pension' are not defined in the IRO.

2.1 Office

Key term

In *Great Western Railway Co v Bater* [(1922) 8 TC 231], '**office**' was defined as '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'.

In Hong Kong, a company is statutorily required to fill the following office positions:
- Company Director
- Company Secretary

The location of an office is the place where the central management and control of the company is located. Accordingly, the source of directors' fees is the place where the company exercises its central management and control.

Income from a Hong Kong office is chargeable to salaries tax. The fact that the person receiving the income is absent from Hong Kong during the year of assessment is irrelevant. On the other hand, income from a non-Hong Kong office is exempt from salaries tax.

2.2 Employment

For an employment to exist, there must be a relationship of employer and employee. Guidance was provided in the case of *Fall v Hitchen* [(1972) 49 TC 433] to distinguish a 'contract of service' (i.e. an employer-employee relationship) from a 'contract for service' (i.e. a principal-independent contractor relationship) by asking the following question:

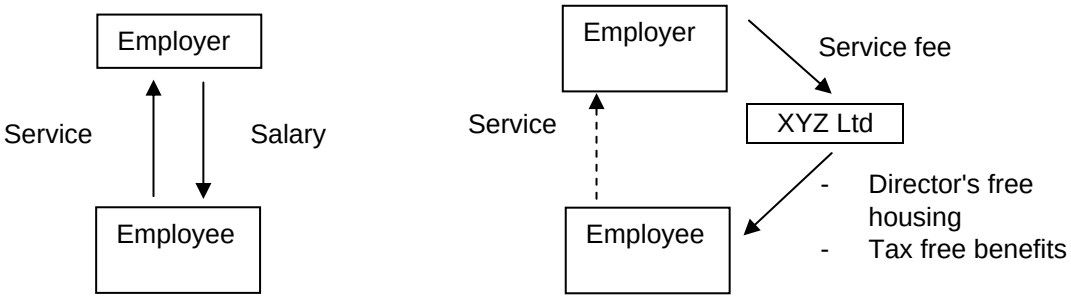
'Is the person who has engaged himself to perform these services performing them as a person in business on his own account?'

If the answer to the question is yes, then it is a contract for service. Otherwise, it is a contract of service.

There are occasions where other factors have to be considered in determining whether a person is in business on his own account. Such factors include the following:

Control	This refers to the degree of control (e.g. restrictions imposed on the working for others; strict compliance with rules and regulations; stipulated office hours; approval of leave) exercised by the party demanding the services. In general, an employer will exercise a higher degree of control on how the services of an employee are to be performed.
Integration	This refers to the identity of the person providing the services. Whether he or she has 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 for an employer-employee relationship.
Economic reality	This refers to the financial risk undertaken by the person providing the services. Whether he or she is required to risk his or her own capital; whether his or her risk is a general entrepreneurial risk or a risk arising only if he or she does not undertake his or her duties with due care and precision. It is rather unlikely that an employee needs to provide his or her own capital, equipment or assistants under a contract of service.

As the rules on allowable deductions under salaries tax are much more stringent than those under profits tax, there were arrangements between employers and employees to conceal the employer-employee relationship by paying the remuneration of the individuals to companies controlled by them as service fees rather than salaries.



S.9A was enacted in 1995 to counteract such arrangements. DIPN No. 25 provides guidance on the application of s.9A and the relevant factors in distinguishing a contract of service from a contract for service.

DIPN No. 33 provides guidance on the tax position of insurance agents. In brief, insurance agents who are self-employed (with regard to the criteria in DIPN No. 25) are assessed under profits tax whereas those who are employees are assessed under salaries tax.

Hong Kong vs Non-Hong Kong Employment

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

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

These three factors are not conclusive. The Commissioner may need to look further than the external or superficial features of the employment or examine other factors in determining a person's situs of employment. In DIPN No. 10 (Revised), the IRD outlined the information required to substantiate the situs of employment of a taxpayer:

The place where the employment contract is negotiated, concluded and enforceable

- Initial written contract currently in force, including subsequent amendments (if no written contract exists, confirmation from the employer regarding the terms and conditions of the employment is required)
- Parties to contract (e.g. information submitted to the Immigration Department for applying an employment visa will be taken into account to determine whether the sponsoring company has any employment relationship with the employee)
- Which entity has the legal liability to pay or control over the employee
- The capacity in which the employee represents himself to third parties (e.g. the company stated on his name card)
- Where and when the negotiation and conclusion of the contract took place
- Where the contract is legally enforceable

The residence of the employer

- Place of central management and control of the employer
- Identities and capacities of the persons involved
- Tasks undertaken by such persons and their physical location
- Minutes of board meetings
- Directors' reports

The place where the employee's remuneration is paid

- Details of bank accounts and documentary proof of payment

Generally, the residence of the employer and where the contract is enforceable is more relevant than where the remunerations are paid.

Income of Hong Kong civil servants is chargeable to Hong Kong salaries tax irrespective of where the services are rendered.

Income of seafarers and aircrew will be exempted from Hong Kong salaries tax if the taxpayer was present in Hong Kong for not more than:

(a) a total of 60 days in the basis period for that year of assessment; and

(b) a total of 120 days falling partly within each of the basis periods for two consecutive years of assessment, one of which is that year of assessment.

The income from Hong Kong employment of persons other than government employees, seafarers and aircrew, is chargeable to Hong Kong salaries tax pursuant to s.8(1)(a). These persons may claim exemption from salaries tax if they have rendered all their services outside Hong Kong pursuant to s.8(1A)(b). Income from non-Hong Kong employment will also be subject to Hong Kong salaries tax pursuant to s.8(1A) if the person has visited Hong Kong for more than 60 days in a year of assessment and services have been rendered during his or her visit in Hong Kong.

The tax position can be summarised as follows:

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 exemption under s.8(1A)(c) .

The meaning of 'visit' is important for the application of s.8(1B). There is no definition of 'visit' in the IRO.

The Shorter Oxford English Dictionary defines 'visit' as a short or temporary stay at a place. In D11/84, the Board of Review was of the view that the return of a Hong Kong resident to his home in Hong Kong did not constitute a 'visit' to Hong Kong.

Again, the word 'day' is not defined in the IRO. The Shorter Oxford English Dictionary defines 'day' as the space of 24 hours.

In D12/94, the Board of Review was of the view that part of a day should be counted as a day. The IRD, in DIPN No. 38 (Revised), indicates that for the purpose of determining whether s.8(1B) is applicable (ie in ascertaining whether or not services were rendered in Hong Kong during visits exceeding a total of 60 days), they would follow the basis of counting days as that in D12/94. In general, for time-in-time-out apportionment, the IRD usually adopts the midnight rule (ie, the days of arrival and departure would be treated as one day) for calculating the total number of days in Hong Kong.

Example

Day In	Day Out	For 60 day rule calculation	For time apportionment calculation
Feb 1	Feb 4	4	3
Feb 1	Feb 1	1	½

In D90/03, a taxpayer wanted to claim exemption under s.8(1A)(b)(ii) despite having visited Hong Kong for most than 60 days as the taxpayer only attended meetings in Hong Kong. It was held that attendance at a meeting would constitute services rendered and therefore not be eligible for exemption.

2.3 Pension

Key term

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

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

Self-test question 1

Ms Betty, a US resident, is single, and working as the Asia Pacific quality assurance manager for a US company ('the Company'). She has come to Hong Kong intermittently to visit the Company's customers, agents and her friends but, apart from this, the Company has not carried on any activities in Hong Kong.

The following shows the time-table of Betty's visits to Hong Kong in the period December 2010 to December 2011:

10 December 2010 to 31 December 2010
1 January 2011 to 20 January 2011
1 February 2011 to 18 February 2011
1 April 2011 to 21 April 2011
1 May 2011 to 30 July 2011 (including 10 days of annual leave)
8 August 2011 to 31 August 2011
1 October 2011 to 21 October 2011
15 November 2011 to 20 December 2011

Required

Based on the information provided, determine whether Betty will be subject to salaries tax in Hong Kong in respect of the employment income she receives from the US company for either or both of the years of assessment 2010/11 and 2011/12.

(The answer is at the end of the chapter)

3 Income chargeable to salaries tax

Topic highlights

S.9 gives an inclusive definition of income that is chargeable to salaries tax. S.9(1)(a) covers the general emoluments that are chargeable to salaries tax.

Pursuant to s.9 of the IRO, income from any office or employment includes:

Section	
9(1)(a)	Any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others, **except**: (i) repealed; (ii) repealed; (iii) repealed; **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 mandatory provident fund ('MPF') scheme.

Section	
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 s.8(5).
9(1)(ac)	Any payment received by an employee pursuant to a judgment given under s.57(3)(b) of the Occupational Retirement Schemes Ordinance ('ORSO') that is attributable to his employer's contributions to the occupational retirement scheme in respect of which the judgment was given.
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 ('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 s.8(5) .
9(1)(b)	The rental value of any place of residence provided rent-free by the employer or an associated company.
9(1)(c)	The excess of the rental value over the rent paid for a place of residence provided by the employer or an associated company at a rent less than the rental value.
9(1)(d)	Any gain realised by the exercise of, or by the assignment or release of, a right to acquire shares or stock in a corporation obtained by a person as the holder of an office or an employee of that or any other corporation.

S.9(2A) **specifically states** that the following items are **not to be excluded from 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.

Summary

Amounts included in ss.9(1)(a)-(d) are assessable **except** if paid by employer to a third party to discharge employer's liability **unless** specifically assessable under s.9(2A).

3.1 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. In general, it should be made in consideration of services (past, present or future). Whether it is made by the employer or an other is irrelevant. Taxi tips, although not paid by the employer of the taxi driver, are taxable as a reward for services.

On the other hand, jury fees, compensation for loss of office etc., are not 'emoluments' chargeable to tax as they are not payments for services. With regard to payments received upon the termination of employment, information could be obtained from the following website: **http://www.gov.hk/en/residents/taxes/salaries/salariestax/chargeable/termination.htm**.

Prior to the year of assessment 2012/13, payments in lieu of notice made by employers to employees in accordance with the terms of employment contracts or the provisions of the Employment Ordinance were not taxable for Hong Kong salaries tax purposes. However, following the Court of Final Appeal's decision in *Fuchs, Walter Alfred Heinz* case and the withdrawal of the appeal to the Court of Appeal by the taxpayers in the *Murad* case, payments in lieu of notice which are accrued to employees on or after 1 April 2012 would be regarded as employment income and hence subject to salaries tax.

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 Diggines* (10 TC 247)	A reward on passing an examination [*Ball v Johnson* (47 TC 155)
A suit (taxable at second 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)

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

The general commercial understanding of what constitutes a 'perquisite' is relatively wide, including any emolument or reward of value (i.e. benefits in kind) to a person in addition to salary and wages.

Following the decision of the Privy Council in *CIR* v David Hardy Glynn [(1990) 1 HKRC 90-032], there was a change to the IRO in 1991 to limit the scope of charge on taxable emoluments.

Benefits-in-kind (i.e. a reward in a form other than money) will not be subject to salaries tax if they are:

- not convertible into cash;
- provided by the employer in such a way that the employer has a sole and primary liability to pay for that benefit (with the exception of education benefits for children of employees – see s.9(2A)(b) below);
- a settlement of the employer's liability not guaranteed by any other person (not discharging the employee's personal liability);
- not benefits specifically chargeable to tax (e.g. Under s.9(2A)).

3.2 Items specifically chargeable to salaries tax

The following items are specifically chargeable to salaries tax:

Section	Benefits
9(1)(aa)	Lump sum payments (representing the employer's contributions) 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 (representing such part of the employer's contributions in respect of the employee that exceeds the proportionate benefit) from a recognised retirement scheme by reason of termination of service
9(1)(ac)	Lump sum payments (as attributable to the employer's contributions) received by an employee pursuant to a judgement given under s.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 (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)(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
9(2A)(b)	Educational benefits
9(2A)(c)	Holiday journey benefits

3.3 Retirement benefits

Key terms

Pursuant to s.2 of the IRO, '**recognised retirement scheme**' means:

- a recognised occupational retirement scheme; or
- a mandatory provident fund (MPF) scheme.

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

- is registered under s.18 of the Occupational Retirement Schemes Ordinance (ORSO);
- is exempt from registration by virtue of s.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 Hong Kong Ordinance.

An occupational retirement scheme is a scheme, comprised in one or more instruments or agreements, which provides (or is capable of providing) benefits in the form of pensions, allowances, gratuities or other payments on the termination of service, death or retirement of employees. Insurance contracts under which benefits are only payable upon the death or disability of an insured do not qualify as occupational retirement schemes.

DIPN No. 23 (Revised) provides guidance on recognised occupational retirement schemes.

A mandatory provident fund scheme is a scheme governed by the Mandatory Provident Fund Schemes Ordinance (Cap. 485).

With effect from 1 December 2000, employees (full time or part time), other than those exempted under the Mandatory Provident Fund Schemes Ordinance, are required to participate in MPF schemes. Existing ORSO schemes will need to comply with certain requirements (e.g. portability and preservation for new members) for getting an exemption under the MPF legislation. A general comparison of MPF and ORSO is as follows:

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 (eg 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

ORSO	MPF
No requirement on preservation of accrued benefits	Accrued benefits must be preserved until one of the following events: • 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 judgment given under s.57(3)(b) of ORSO is taxable	N/A

On 22 October 1999, 27 July 2000 and 5 October 2000, the Commissioner of Inland Revenue issued the first, second and the third MPF circular letters respectively. These letters set out the Department's position on the relevant questions raised on MPF. The IRD also issued a leaflet 'Deductibility of contributions for employees and self-employed persons'. See the homepage of the IRD (**http://www.ird.gov.hk/eng/pdf/pam38e.pdf**) for details.

3.3.1 Lump sum payments for retirement schemes

Lump sum payment (as represents the employer's contributions) from an unrecognised occupational retirement scheme

Notwithstanding its capital nature, such payment from an unrecognised occupational retirement scheme is chargeable to tax.

Lump sum payment (as represents the employer's contributions) from a recognised occupational retirement scheme by reason other than termination of service, death, incapacity or retirement of the employee

To discourage early withdrawal from a recognised occupational retirement scheme, payments from a recognised occupational retirement scheme by reason other than termination of service, death, incapacity or retirement of the employee are chargeable to tax.

Lump sum payment (as represents such part of the employer's contributions in respect of the employee that exceeds the proportionate benefit) from a recognised occupational retirement scheme by reason of termination of service

A lump sum payment (as represents such part of the employer's contributions in respect of the employee that exceeds the proportionate benefit) from a recognised occupational retirement scheme by reason of termination of service is specifically chargeable to tax.

Formula to learn

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

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

If the period of service is ten years or more (i.e. ≥120 months), the lump sum payment is exempt from salaries tax. Otherwise, the amount in excess of the proportionate benefit which is calculated using the above formula would be taxable.

Example: Proportionate benefit

Mr X has a period of service of five 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 (s.8(5)) is:

Proportionate benefit = $100,000 × 60/120 months = $50,000 (tax free)

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

The accrued benefit is the maximum benefit that the person would have been entitled to receive from a ROR scheme in respect of his recognised service as if he had retired on the date of termination of employment.

Lump sum payment (as attributable to the employer's contributions) received by an employee pursuant to a judgment given under s.57(3)(b) of the Occupational Retirement Schemes Ordinance (ORSO)

Any occupational retirement scheme may be wound up following the cancellation of its registration and a court order may be made to the employer requiring him to make up the shortfall in the funding of the employee's vesting benefit by making payment directly to the employee or former employee. Such payment and distribution from the fund of the retirement scheme as represent the employer's contributions are specifically chargeable to tax.

Lump sum payment (as attributable to the employer's contributions) received by an employee from a mandatory provident fund scheme by reason other than retirement, death, incapacity or termination of service of the employee

Accrued benefits that have been received, or are taken to have received by an employee from a mandatory provident fund scheme by reason other than retirement, death, incapacity or termination of service of the employee are chargeable to tax.

When payments are made on permanent departure from Hong Kong but without termination of service, the accrued benefits attributable to the employer's mandatory contributions are not taxable, but those attributable to the employer's voluntary contributions are fully taxable.

3.4 Accommodation benefits

Accommodation benefits for a place of residence provided rent-free by the employer or an associated company of the employer

Under s.9(1A)(b), a place of residence for which an employer or its associated corporation has paid or refunded all the rent is deemed to be provided rent-free by the employer or associated corporation. 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 as described in s.9(1)(a) derived from the employer for the period during which a place of residence is provided

after deducting the outgoings, expenses (provided in s.12(1)(a)) and depreciation allowances (provided in s.12(1)(b)).

Taxable stock option gains and lump sum gratuity are not included as income for the purposes of calculating the rental value. On the other hand, share award is included as income in calculating the rental value. Self-education expenses cannot be deducted from the income in calculating the rental value.

Alternatively, the rateable value of the accommodation may be elected as the rental value under s.9(2)(b) .

Rateable value is the estimated annual rental value of a property at a particular date which is used to calculate the amount of rates payable by the Rating and Valuation Department in Hong Kong.

If the 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%

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

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

Key terms

Under s.9(6) of the IRO, '**associated corporation**' means:

(a) a corporation over which the employer has control;

(b) if the employer is a corporation –

(i) a corporation which has control over the employer; or

(ii) a corporation which is under the control of the same person as is the employer.

'**Control**', in relation to a corporation, means the power of a person to secure –

(a) by means of the holding of shares or the possession of voting power in or in relation to that or any other corporation; or

(b) by virtue of any powers conferred by the articles of association or other document regulating that or any other corporation,

that the affairs of the first-mentioned corporation are conducted in accordance with the wishes of that person.

Example: Rental value

Mrs. W was provided with rent-free accommodation by her employer for 2012/13. Her annual salary was $320,000 and she was entitled to deductions under s.12(1)(a) 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)	31,000
Total income	341,000

Example: Subsidised accommodation

Mr X had a salary of $400,000 for 2012/13 and his employer also provided him with accommodation. However, Mr X contributed $850 per month towards the cost of the accommodation.

Mr X's income for the year would include the following:

	$	$
Salary		400,000
Add: Rental value ($400,000 × 10%)	40,000	
Less: Rent suffered ($850 × 12 months)	(10,200)	
Excess rental value over rent suffered		29,800
Total income		429,800

The IRD has issued a leaflet 'How to tax the provision of a place of residence to the employee' which can be downloaded from the website of the IRD: **http://www.ird.gov.hk/eng/pdf/pam44e.pdf**.

In this leaflet, the IRD indicates that there are special circumstances under which the assessor will examine the cases critically before accepting/rejecting the arrangement as akin to a place of residence provided by the employer:

- The employee lets his own property to himself or rents the property from some connected person (such as spouse) and then claims rental reimbursements from his employer; or
- The employee lets his own property or connected person's property to his employer and the employer provides that property to him for use as his place of residence.

The assessor will request the employee and/or the employer to provide information and evidence to show that there exists a genuine landlord and tenant relationship between the contracting parties. The assessor will take into account the following factors before making his decision:

- Whether the rent is at the market rent;
- Whether the normal letting formalities (such as stamping of tenancy agreement and periodic issue of rental receipts) have been executed; and
- Whether the rights and obligations between ordinary landlord and tenant have been observed.

3.5 Share-based benefits

3.5.1 Stock option gain

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 is chargeable to tax. The tax liability arises when the option is exercised, assigned or released, notwithstanding that no actual gain is made at that time or a loss may be suffered when the shares are being disposed of later.

Formula to learn

The notional gain chargeable to tax is computed as follows:

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

Share options have become very popular in recent years. The IRD issued DIPN No. 38 (Revised), which provides helpful guidance on employee share option benefits. The following are some of the main points:

- The date of grant governs the source of gain to be taxed. Other factors include the period of services in Hong Kong, the vesting period of the option, etc. (**Note**: The IRD considers that apportionment of gain from share options is only applicable to non-HK employment. In cases where services are partly performed in Hong Kong and partly outside Hong Kong and the employment is a Hong Kong employment, the IRD will, in general, not take into account the period of services performed outside Hong Kong in determining the taxable gain. However, one may argue that the period of services and the vesting period are also important in determining the amount of taxable gain under Hong Kong employment and apportion the gain as indicated in the example below);
- 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 Hong Kong will not extinguish the tax liability; furthermore, the gain should be assessed in the year of exercise and not treated as a gain in the last year of employment;
- There will be no tax on the grant of stock options;
- Gains from unconditional stock options granted before providing Hong Kong services are not taxable even when the options are exercised when rendering services in Hong Kong;
- Gains from conditional stock options granted for non-Hong Kong employment will be pro-rated if partially sourced in Hong Kong;
- Notional expenses (e.g. brokerage, stamp duty) can be claimed as a deduction from the notional gain.

Example: Share option gains

An example of the chargeability of an employee's option gain of $100,000 arising from the exercise of a stock option granted conditionally in three different situations is as follows:

Situation	Non-HK Employment	Non-HK Employment	HK Employment
Employment date in Hong Kong	1 April 2007	1 April 2007	1 April 2007
Granting date	1 April 2007	1 April 2007	1 April 2007
Vesting date	31 March 2008	31 March 2009	31 March 2009
Exercising date	30 April 2009	30 April 2009	30 April 2009
Number of days rendering services in Hong Kong in 2007/08	203 days	56 days	56 days
Number of days rendering services in Hong Kong in 2008/09	170 days	235 days	235 days
Number of days rendering services in Hong Kong in 2009/10	168 days	250 days	250 days

Situation	Non-HK Employment	Non-HK Employment	HK Employment
Taxable amount in 2009/10	Option gain will be taxed in 2009/10 using the 2007/08 time factor. $100,000 × 203/366 = $55,464 This amount will be included in the tax return for 2009/10 and will not be subject to further apportionment. Other income from the employment for 2009/10 will be subject to the time factor of 168/365 applicable to 2009/10.	Since the employee visited Hong Kong for not more than 60 days in 2007/08, no salaries tax is payable for 2007/08. The portion of option gain to be assessed in 2009/10 will be: $100,000 × 235/731 = $32,148 Other income from the employment for 2009/10 will be subject to the time factor of 250/365 applicable to 2009/10.	Since the employee visited Hong Kong for not more than 60 days in 2007/08, no salaries tax is payable for 2007/08. However, as the employee spent more than 60 days in Hong Kong in 2008/09, all his/her income will be subject to salaries tax in 2008/09. In accordance with DIPN 38, apportionment is not applicable for Hong Kong employment. Thus, the whole option gain should be taxed in 2009/10 when the option was exercised. Other income from the employment for 2009/10 will be fully taxable.

The IRD has issued a leaflet 'How to tax benefits related to stock awards and share options' which can be downloaded from the website of the IRD: **http://www.ird.gov.hk/eng/pdf/pam47e.pdf**.

As stock option gains form part of the income from employment, both the employer and employee are obliged to report the amount of gain, with details of calculations, in their annual returns.

The employer is required to report the full amount of the gain irrespective of whether the full gain is sourced in Hong Kong. DIPN No. 38 (Revised) also provides that the employer has the same obligation to report gains on stock options exercised by employees who have left their employment or have left Hong Kong. However, reporting is not required where the gain is less than the basic allowance and it is known during the relevant year that the individual did not derive any other income chargeable to salaries tax in Hong Kong.

It is the employee's responsibility to calculate the gain that is sourced in Hong Kong in his/her tax return. Individuals who exercise options after leaving Hong Kong are required to notify the Commissioner within four months after the end of the basis period for the year of assessment concerned.

For example, an individual, who left Hong Kong on 31 March 2010 and exercised share options on 1 January 2011, should notify the Commissioner in writing not later than 31 July 2011 of his/her chargeability to tax for 2010/11. A taxpayer planning to leave Hong Kong permanently may elect to have the notional share option gain assessed before his departure or within three months from the date of departure. In this case, the share option is deemed to be exercised on the notional exercise date, which is any day within seven days prior to the election, or the departure date if the election

was made after the departure. If the gain from subsequent exercise results in a lower gain, the IRD is prepared to revise the assessment to reduce the notional gain previously assessed.

3.5.2 Share award

The IRD issued the revised DIPN 38 in March 2008 to include the tax treatments on share award benefits. Essentially, Part 1 of the revised DIPN covers the share option benefits. Part 2 of the DIPN identifies share award benefits in two categories: 'upfront' and 'back end'.

It has been accepted that share awards are taxable as perquisites received by an employee during his or her employment. The essential element is to determine the timing of receipt of such perquisite, ie the timing when the employee would be fully entitled to the ownership of the shares and hence, the value attached to the perquisite. The characteristics of the two categories can be identified as follows:

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

Similar to the share option benefits, share award benefits can be determined by the locality of employment, i.e. Hong Kong vs used earlier non-Hong Kong employment. In addition, taxpayers leaving Hong Kong permanently can make a deemed vesting election relating to the 'back end' approach share award benefits.

DIPN No. 16 (Revised) provides guidance on the taxation of fringe benefits. Specific comments on the tax implications on some of the fringe benefits are included in paragraphs 23 to 36 which are summarised as follows.

3.6 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 irrespective of whether the employee or the employer is the party liable for the relevant expense (see the case of *David Hardy Glynn* [(1990) 1 HKRC 90-032]).

Taxable payments include tuition fees, incidental education expenses such as boarding fees and cost of school outings. Payments made on or after 1 April 2003 in respect of passage in connection with the education of the employee's children are chargeable to tax as explained in DIPN No. 16 (Revised).

One form of education benefit that is exempt from tax is the payment of education costs through a formally established education trust (e.g. an educational trust for the children of policemen/ policewomen).

3.7 Holiday warrants or passages

Prior to 1 April 2003, any holiday warrant or passage granted by an employer or allowance paid to the employee for the purchase of such a holiday warrant or passage or for the transportation of personal effects was not taxable, insofar as the holiday warrant or passage was used for travel and the allowance was expended for the purchase of the holiday warrant or passage or for the transportation of personal effects in such a journey related to the holiday warrant or passage.

With effect from 1 April 2003, ss.9(1)(a)(i), (ii) & (iii) have been repealed by the enactment of the Revenue (No. 2) Ordinance 2003 and the exemption is no longer available. Under s.9(2A)(c), any amount paid by an employer in connection with a holiday journey for the benefits of the employee will be assessable to tax.

The IRD issued DIPN No. 41 Taxation of Holiday Journey Benefits in August 2003 which provides guidance to the taxation of holiday journey benefits and the basis of assessment. According to DIPN No. 41, all payments made by an employer will be subject to tax regardless of whether the benefit is convertible into cash or whether the primary liability for the benefit is the employee's own and the assessable amount is based on the actual amount paid by the employer.

In case a trip is taken partly for business and partly for holiday purposes, the benefit will be tax exempt if it can be established that the holiday is merely incidental to a business trip. However, in the case that an identifiable part of the journey is taken for holiday purposes, the expenses relating to that part of the journey will be chargeable to tax.

If the expenses are not distinct and separable, they may have to be apportioned, generally on a holiday-days basis, to ascertain the amount attributable to the part of the journey taken for holiday purposes. The cost of travel to the destination would usually not be apportioned as that cost would be incurred regardless of the holiday element.

Where a business trip spans a weekend, the weekend does not necessarily comprise a holiday. However, where a weekend comes at the start or end of the business trip, such days would be regarded as a holiday, with costs apportioned to determine a taxable benefit.

Where an employee is required to travel to many locations in a single business trip, and whether due to routing or other reasons, stopovers are made, the stopovers will be regarded as incidental to the business journey if they are considered reasonable.

Where an employer organises a holiday journey for its employees on a group basis and costs are not distinct and separable, apportionment should be made on a head count basis.

Home leave will be specifically caught as a taxable benefit whether the employee travels home or elsewhere.

Where it can be established that a trip is not for holiday purposes, such as relocation of an employee and his family at the beginning or end of an assignment, relevant costs borne would fall outside the scope of the legislation and no taxable benefit would arise. As a concession, any visits to other destinations en route to or from Hong Kong would be disregarded.

3.8 Other fringe benefits

Car (or boat) made available by an employer for the private use of an employee

The IRD would not normally consider the private use of a car owned by his employer as chargeable benefit, provided that the employee is not in any way able to convert the benefit into money. However, if ownership of the car is transferred to the employee, the benefit is chargeable to salaries tax at its convertible value at the time of receipt. A chargeable benefit will also arise if the employer discharges an expense relating to private use for which the employee is liable. The assessable amount will be the sum paid by the employer to discharge the expense.

Recreational facilities/holiday homes provides for the use of employees

Such benefits are not chargeable to salaries tax on the basis that the employee is not in any way able to convert the benefit into money.

Payment of utilities by the employer

Where an employer is the only party liable to pay the cost of utilities provided to an employee's residence and the account rendered by the utility company is in the name of the employer, the IRD will accept that no chargeable benefit arises.

Similar tax treatment will apply to other benefits provided an employee's residence, e.g. furniture and domestic servants.

Loans provided to employees at less than market interest rates

Interest-free and low interest loans provided by employers to employees are not chargeable benefits where the cost involved in providing the benefit is the sole liability of the employer. This acceptance is based on the understanding that the benefit received by the employee (i.e. paying less that market rates) is not of itself convertible into money.

Credit cards

If the employer provides credit cards to employees under arrangements where expenses charged using the card are billed to and paid for the employer, the private expenses incurred by the employee will be considered as chargeable benefit under salaries tax. This is because in ordinary usage the holder of the card (i.e. the employee) has a liability to pay for the goods or services received which is effectively discharged by the employer when the card is used.

Club benefits

There would not be any chargeable benefit arises in respect of the cost of acquisition of corporate membership of a club since the entitlement to corporate membership benefits may be transferred from one employee to another.

However, where an employer makes a payment in respect of an individual membership fee or other club expense for which an employee is personally liable, the payment will constitute chargeable income of the employee.

4 Benefits specifically excluded from tax

Topic highlights

S.8(2) provides a list of items not chargeable for tax. S.9 also excludes a few items from the charge to salaries tax such as rent refunds and lump sum payments from retirement schemes under certain conditions.

The following items are of particular importance:

Section	Benefits
9(1A)(a)	Payment (or refund) of rent by an employer or its associated company. (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

4.1 Payment (or refund) of rent

A 'refund' of rent connotes a repayment or reimbursement, not a mere cash payment.

First of all, the intention of the employer and the employee on the nature and use of the payment would have to be clear. Furthermore, sufficient control would have to be exercised by the employer

over the payment so that the payment is effectively a refund of rent and not just an additional emolument to be spent in any way that an employee may desire.

If no system of employer control exists to verify that a payment made to an employee was a refund of rent, the payment from the employer is likely to be a cash allowance, which is fully chargeable to salaries tax.

A cash allowance (though labelled as a housing allowance) provided to an employee (with no control over its actual use) would likely be regarded as additional emolument of the staff, which is fully taxable, notwithstanding that the staff did spend the allowance on housing.

On the other hand, the payment (or refund) of rent by the employer or an associated company of the employer to the employee is not chargeable to tax, as the accommodation benefit provided to the employee is taxed on the notional rental value (or the rateable value) of that accommodation discussed in section 3.4 above.

4.2 Lump sum payment from a recognised occupational retirement scheme/mandatory provident fund (MPF) scheme

A lump sum payment received from a recognised occupational retirement scheme upon termination of service, death, incapacity or retirement of the employee is exempt from salaries tax.

Accrued benefits received from the approved trustee of a mandatory provident fund scheme on a person's retirement from employment, death or incapacity or permanent departure from Hong Kong as is attributable to mandatory contributions are exempt from salaries tax.

If the employee's period of service is less than ten years, the lump sum payment received from a recognised occupational retirement scheme on termination of service is exempt from tax if the amount does not exceed the proportionate benefit computed under s.8(4)(b) . Otherwise, the excess over the proportionate benefit is taxable. Accrued benefits received (or taken to have received) by a person from a mandatory provident fund scheme on termination of service as attributable to the employer's voluntary contributions are also subject to the proportionate benefit rule.

If the employer is not subject to profits tax, the exemption is limited to 15% of the employee's income for the year preceding the date of withdrawal multiplied by the number of completed years of service with that employer.

With the implementation of the provisions of the Mandatory Provident Fund Schemes Ordinance (i.e. with effect from December 2000), the accrued benefits withdrawn by scheme members of ORSO and MPF are now subject to the same treatment under salaries tax as follows:

	ORSO		MPF		
	Accrued Benefits Attributable to		Accrued Benefits Attributable to		
	Employee's Contributions	Employer's Contributions	Employee's Contributions (Mandatory and Voluntary)	Employer's Mandatory Contributions	Employer's Voluntary Contributions
Retirement	Exempt	Exempt	Exempt	Exempt	Exempt
Death	Exempt	Exempt	Exempt	Exempt	Exempt
Incapacity	Exempt	Exempt	Exempt	Exempt	Exempt
Termination of service (with or without permanent departure from Hong Kong)	Exempt	Exempt but 'Proportionate Benefit Rule' applies	Exempt	Exempt	Exempt but 'Proportionate Benefit Rule' applies

	ORSO		MPF		
	Accrued Benefits Attributable to		Accrued Benefits Attributable to		
	Employee's Contributions	Employer's Contributions	Employee's Contributions (Mandatory and Voluntary)	Employer's Mandatory Contributions	Employer's Voluntary Contributions
Permanent departure from Hong Kong without terminating service	Exempt	Assessable	Exempt	Exempt	Assessable
Any circumstances other than listed above	Exempt	Assessable	Exempt	Assessable	Assessable

4.3 Share option rights

The notional gain on exercise or release of the share option rights is chargeable to tax pursuant to s.9(1)(d) (refer to section 3.5.1), while the grant of a right to acquire shares is not subject to salaries tax. See explanations in DIPN 38.

5 Allowable deductions

Topic highlights

DIPN 9 provides detailed guidance on allowable deductions under salaries tax.

The following deductions are allowable under salaries tax:

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)	Excess allowable deductions under ss.12(1)(a), (b) and (c) of a spouse under joint assessment
12(1)(e)	Self-education expenses
Concessionary Deductions	
26C	Approved charitable donations
26D	Elderly residential care expenses
26E	Home loan interest
26G	Contributions to recognised retirement schemes

5.1 Outgoings and expenses

The test for deductibility is much stricter in salaries tax than in profits tax. In order to be qualified for deduction, the expenditure must satisfy each of the following tests in addition to not being expenditure of a domestic, private or capital nature:

- It must have been 'incurred';
- It must have arisen 'wholly and exclusively' in the production of the income; and
- It must have been 'necessary' in the production of the income.

The test of necessity is stringent. In DIPN No. 9 (Revised), the basic test is stated by the IRD as 'whether the expenditure is vital to the employment to the extent that it would not be possible for the taxpayer to produce the income from the employment without incurring that expenditure'.

On the other hand, the IRD has indicated that it would not interpret the words of 'wholly' and 'exclusively' too narrowly. Apportionment could be allowed on an expenditure incurred for dual purposes and the part attributable to the employment would be allowed for deduction, provided the other tests are satisfied.

The following are examples of non-deductible outgoings and expenses:

Non-deductible Expenses	Decided Case [Ref.]
Travelling expenses from home to office	*CIR v Humphrey* [HKTC 451]
Legal expenses incurred in an appeal against disqualification	*CIR v Robert P Burns* [HKTC 1181]
Payment in lieu of notice	*CIR v Sin Chun Wah* [2 HKTC 364]

DIPN No. 9 (Revised) provides detailed guidance on allowable deductions under salaries tax.

5.2 Depreciation allowances on machinery or plant

Depreciation allowances on machinery or plant essentially used by a taxpayer in the production of assessable income are allowable.

In practice, the IRD holds the view that it is the employer's obligation to provide all facilities essential to the performance of the services of the employee. If the employee acquires plant or machinery for his own convenience, no depreciation allowances will be granted.

5.3 Loss brought forward

In rare situations, a loss will be suffered when the allowable deductions exceed the assessable income. Such loss will be carried forward to offset future assessable income.

5.4 Excess allowable deductions of a spouse under joint assessment

The excess allowable deductions of a spouse under ss.12(a)(a), (b) and (c) not fully utilised by that person can be deducted from the assessable income of the other spouse under joint assessment.

5.5 Self-education expenses

The maximum amount allowable for self-education expenses is $60,000 with effect from the year of assessment 2007/08 ($40,000 for the years of assessment 2001/02 to 2006/07), as specified in Schedule 3A of the IRO.

It was proposed in the 2013/14 Budget, the maximum deduction of self-education expenses will be increased to $80,000 from 2013/14 (enacted on 5 July 2013).

Key terms

Expenses of self-education mean expenses paid by the taxpayer as:

(i) fees, including tuition and examination fees, in connection with a prescribed course of education undertaken by the taxpayer; or

(ii) fees in respect of an examination set by education provider, or by a trade, professional or business association for its members, and undertaken by the taxpayer to gain or maintain qualifications for use in any employment,

but does not include:

(i) expenses for which a deduction is allowable or has been allowed to the taxpayer in any year of assessment under any other provision of the IRO; or

(ii) expenses to the extent to which they have been reimbursed or are reimbursable to the taxpayer by his employer or any other person unless the reimbursement has been or will be included in the assessable income of the taxpayer.

Prescribed course of education means a course undertaken to gain or maintain qualifications for use in any employment and being:

(i) a course of education provided by an education provider;

(ii) a training or development course provided by a trade, professional or business association; or

(iii) a training or development course accredited or recognised by an institution specified in Schedule 13 of the IRO (commencing from 1 April 2004).

Education provider means:

(i) a university, university college or technical college;

(ii) a place of education to which the Education Ordinance (Cap. 279) does not apply by virtue of s.2 of that Ordinance;

(iii) a school registered under s.13(a) of the Education Ordinance (Cap. 279);

(iv) a school exempted from registration under s.9(1) of the Education Ordinance (Cap.279);

(v) an institution approved by the Commissioner for the purposes of s.16C; or

(vi) an institution approved by the Commissioner.

The Commissioner may in writing approve an institution as an education provider and the approval may operate from a date, whether before or after the date of approval, specified in the instrument of approval and may be withdrawn at any time.

The Secretary for Financial Services and the Treasury may by order amend Schedule 13 of the IRO.

5.6 Approved charitable donations

Approved charitable donations made by the taxpayer or his/her spouse 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 allowable as a deduction under profits tax.

*10% for years of assessment prior to 2003/04. 25% for 2003/04 to 2007/08, and 35% for 2008/09 onwards.

The donated organisations must be charitable institutions approved by the IRD and exempt under s.88 of the IRO. Otherwise, the donations made would not be deductible. Furthermore, the basic criteria governing the granting of the deduction are:

- the payment must be a donation
- the donation must be a donation of money
- the donation must be for charitable purposes
- a deduction in respect of the same donation cannot be granted to more than one person

The term 'donation' is not defined in the IRO. However, the IRD has taken the view that the ordinary meaning of 'donation' is 'gift' (*CIR v Sanford Yung* (1977) 1 HKTC 959). To constitute a 'gift', property must have been transferred voluntarily and no material advantages or benefits should have been received by the transferor.

DIPN No. 37 (Revised) provides guidance on Approved Charitable Donations.

5.7 Elderly residential care expenses

Any residential care expenses paid by a person or his/her spouse in respect of a parent or a grandparent of his/her spouse 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.

The maximum allowable deduction in respect of the residential care expenses of each parent or grandparent was $60,000 before the year of assessment 2011/12, as specified in Schedule 3C of the IRO. For the year of assessment 2011/12, the deduction ceiling for elderly residential care expenses is $72,000. For the year of assessment 2012/13, the deduction ceiling for elderly residential care expenses is $76,000. However, the person claiming for the deduction of residential care expenses should not be entitled to a dependent parent/grandparent allowance in respect of the same parent or grandparent. The deduction is only allowable to one person in respect of each parent or grandparent of the person.

Taxpayers chargeable to tax at the standard rate are also allowed to claim a deduction for residential care expenses in computing their incomes chargeable to tax.

Parent and grandparent of the person or his or her spouse are defined as follows:

Parent or Parent of his or her Spouse	Grandparent or Grandparent of his or her Spouse
• A parent of whose marriage the person or his or her spouse is the child;	• N/A
• The natural father or mother of the person or his or her spouse;	• A natural grandfather or grandmother of the person or his or her spouse;
• A parent by whom the person or his or her spouse was adopted;	• An adoptive grandparent of the person or his or her spouse (whether an adoptive parent of a natural parent, adoptive parent or step parent of the person or his or her spouse; or a natural parent of an adoptive parent of the person or his or her spouse);

Parent or Parent of his or her Spouse	Grandparent or Grandparent of his or her Spouse
• A step parent of the person or his or her spouse; or	• A step grandparent of the person or his or her spouse (whether a step parent of a natural parent, adoptive parent or step parent of the person or his or her spouse; or a natural parent of a step parent of the person or his or her spouse); or
• In the case of a deceased spouse, a person who would have been the parent of the person's spouse by reason of any of the above provisions if the spouse had not died.	• In the case of a deceased spouse, a person who would have been the grandparent of the person's spouse by reason of any of the above provisions if the spouse had not died.

Residential care expenses mean any expenses payable in respect of the residential care received at a residential care home and paid to that residential care home or any other person acting on its behalf.

DIPN No. 36 provides guidance on Elderly Residential Care Expenses.

5.8 Home loan interest

A person may be able to claim deduction of home loan interest paid during any year of assessment in respect of a dwelling, which is used at any time in that year of assessment by the person exclusively or partly as his place of residence.

Pursuant to s.26F, if the person entitled to the deduction has no income, property or profits chargeable to tax for that year of assessment, his/her spouse may be nominated to claim the deduction for that year of assessment.

The deduction period for home loan interest is extended from seven years to ten years (whether continuous or not), subject to the maximum annual deduction of $100,000, with effect from the year of assessment 2005/06. The maximum amount allowable in each year of assessment is $100,000, as specified in Schedule 3D of the IRO. For the years of assessment of 2001/02 and 2002/03, the maximum allowable amount is $150,000.

Starting from the year of assessment 2012/13, the deduction period for home loan interest is extended to 15 years.

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 by the person exclusively as his 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.

Key terms

Place of residence in relation to a person who has more than one place of residence, means his principal place of residence.

Dwelling means any building or any part of a building:

- that is designed and constructed for use exclusively or partly for residential purposes; and
- the rateable value of which is separately estimated under s.10 of the Rating Ordinance.

Home loan in relation to a person claiming a deduction of home loan interest in any year of assessment, means a loan of money which is:

(a) applied wholly or partly for the acquisition of a dwelling that:

  (i) during any period of time in that year of assessment is held by the person as a sole owner, or as a joint tenant or tenant in common; and

  (ii) during that period of time is used by the person exclusively or partly as his place of residence; and

(b) secured during that period of time by a mortgage or charge over that dwelling or any other property in Hong Kong.

Home loan interest, in relation to a person claiming a deduction in respect of a dwelling, means interest paid by the person as a sole owner, or as a joint tenant or tenant in common of the dwelling for the purposes of a home loan to:

(a) the Government;
(b) a financial institution;
(c) a credit union registered under the Credit Unions Ordinance (Cap. 119);
(d) a money lender licensed under the Money Lenders Ordinance (Cap. 163);
(e) the Hong Kong Housing Society;
(f) an employer of the person; or
(g) any recognised organisation or association.

Recognised organisation or association means any organisation or association approved as such by the Commissioner.

In D11/07 and D12/07, it was held that the taxpayers were not registered owners of the property, but were licensees instead. Also, as the loan was not secured by a mortgage or charge, they do not qualify for home loan interest deduction.

However, in D38/08, it was held that, due to unusual circumstance, interest paid for a bridging loan may be deductible even though the bridging loan did not meet all the criteria in s.26E(9).

The IRD's FAQ on Home Loan Interest contains the following example in relation to loans from developers:

The claimant, in addition to obtaining a bank mortgage loan on 70% if the cost of his dwelling, is further granted a second mortgage loan by the developer of the property, the developer being one approved by the Commissioner of Inland Revenue under s.26E(9) of the IRO. In such case, subject to the maximum limit under ss.26E(2)(a)(ii) and 26E(2)(c), interest paid on both loans are deductible for tax purposes.

Where a person pays any home loan interest for the purposes of a home loan obtained in respect of a dwelling which is used by that person exclusively or partly as his place of residence and the home loan was applied also for the acquisition of a car parking space, the car parking space shall be deemed-

- to be part and parcel of the dwelling; and
- to be used by that person in the same manner and to the same extent as the dwelling is used as his place of residence.

DIPN No. 35 (Revised) provides guidance on home loan interest.

5.9 Contributions to recognised retirement schemes

With effect from December 2000, 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 under salaries tax.

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 3B 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 while an employee during the year of assessment in question he had contributed as a participant in a MPF scheme.

The maximum annual tax deduction for mandatory contributions to Mandatory Provident Fund schemes is increased from $12,000 to $14,500 for the year of assessment 2012/13, and to $15,000 for the year of assessment 2013/14 onwards. This change is made in the light of the increase of the maximum relevant income level under the Mandatory Provident Fund Schemes Ordinance to $25,000, which will be effective from June 2012.

Under the MPF, employees (earning more than $5,000 per month) are required to contribute 5% of their relevant income (cash equivalent items excluding housing), subject to an income ceiling of $20,000 per month. They may contribute more than the statutory amount of 5% if they wish. The allowable deduction of $12,000 under Schedule 3B of the IRO is based on 5% × $20,000 × 12 = $12,000. An employee with no fixed monthly salary will also be entitled to the same amount of allowable deduction.

Employers also need to contribute 5% of the employees' relevant income to the MPF. Such mandatory contributions are allowable under profits tax. For further details of allowable deductions under profits tax, please refer to section 8.

* Although MPF took effect on 1 December 2000, employees were only required to make contributions after 30 days from the effective date. With effect from 1 February 2003, the Mandatory Provident Fund Schemes Ordinance was amended, and employees were not required to make contributions for the period between commencement of employment and the calendar month in which the 30th day of employment falls. For instance, for an employee who commenced work on 15 April 2009; he will not be required to make any mandatory contribution for April and May 2009. The obligation for mandatory contribution commences from 1 June 2009.

In this regard, the maximum allowable deduction of mandatory contributions to MPF scheme for the year of assessment 2009/10 is computed as follows:

	2009			*2010*	*Total*
	Apr 15-30	*May*	*Jun-Dec*	*Jan-Mar*	
	$	$	$	$	$
Salary ($20,000 per month)	10,000	20,000	140,000	60,000	240,000
MPF – mandatory contribution (5% or $1,000 per month, whichever is the lower)	Nil	Nil	7,000	3,000	10,000

Self-test question 2

Mr. Tong was employed by ACL as a Research Analyst. ACL filed an Employer's Return in respect of Mr. Tong for the period 6 June 2012 to 31 March 2013, which showed the following income particulars:

	$
Salary	752,500
Payment made to BCL (Note 1)	65,000
Others (Note 2)	210,378
	1,027,878

Note 1

Mr. Tong was previously employed by BCL before joining ACL. It was provided in the employment contract that either party may terminate the employment by giving one month's notice or payment in lieu of notice to the other party. To access Mr. Tong's services earlier, ACL agreed to pay $65,000 to BCL to release him immediately. Mr. Tong considers that this amount should not be subject to tax as the payment was made directly by ACL to BCL and he did not receive this amount from ACL.

Note 2

The following represent the expenses paid by ACL in respect of Mr. Tong's quarters in Kowloon. ACL leased the property from the landlord and provided it rent free to Mr. Tong as his place of residence. The sum of $210,378 was comprised of the following:

	$
Rent ($15,000 × 12)	180,000
Electricity, water and gas	8,730
Residents' club expenses	21,648
	210,378

The electricity, water and gas were billed in the name of the landlord of the property. ACL made the payment directly to the landlord.

The residents' club expenses were billed in the name of Mr. Tong. Mr. Tong paid the expenses first and was later reimbursed by ACL.

Required

(a) Discuss whether the payment in lieu of notice made by ACL to BCL is part of Mr .Tong's income chargeable to Hong Kong salaries tax.

(b) If the payment in lieu of notice was made by Mr. Tong himself rather than ACL, advise whether the payment made by Mr. Tong is deductible in computing his salaries tax liabilities.

(c) For the item 'Others – $210,378' reported in the employer's return by ACL, discuss whether the rent, electricity, water and gas; and residents' club expenses are chargeable to Hong Kong salaries tax.

(The answer is at the end of the chapter)

6 Personal allowances

Topic highlights

Part V of the IRO prescribes the allowances which shall be granted to persons chargeable to tax under Parts III (Salaries Tax) and VII (Personal Assessment) and the circumstances in which such allowances are grantable. An allowance claimed under Part V must be made in the specified form and an allowance will be granted only if the claim contains the relevant information supported by such documentary evidence as the Commissioner may require.

The following are the personal allowances:

Year(s) of Assessment		2005/06 & 2006/07	2007/08	2008/09 to 2010/11	2011/12	2012/13	2013/14#
Section	Allowance	$	$	$	$	$	$
28	Basic allowance	100,000	100,000	108,000	108,000	120,000	120,000
29	Married person's allowance	200,000	200,000	216,000	216,000	240,000	240,000
31	Child allowance - 1st to 9th (each)	40,000	50,000	50,000	60,000	63,000	70,000
	New born child (each)		50,000	50,000	60,000	63,000	70,000
30/30A	Dependent parent/grandparent allowance - for parent aged 60 or more* (each)	30,000	30,000	30,000	36,000	38,000	38,000
30/30A	Dependent parent/grandparent allowance - for parent aged between 55 and 59 (each)	15,000	15,000	15,000	18,000	19,000	19,000
30/30A	Additional dependent parent/grandparent allowance – for parent aged 60 or more* (each)	30,000	30,000	30,000	36,000	38,000	38,000
30/30A	Additional dependent parent/grandparent allowance – for parent aged between 55 and 59 (each)	15,000	15,000	15,000	18,000	19,000	19,000
30B	Dependent brother/sister allowance (each)	30,000	30,000	30,000	30,000	33,000	33,000
31A	Disabled dependant allowance (each)	60,000	60,000	60,000	60,000	66,000	66,000
32	Single parent allowance (irrespective of the number of children being maintained)	100,000	100,000	108,000	108,000	120,000	120,000

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

Proposed changes from the 2013-14 Budget enacted on 5 July 2013.

The following is a brief guidance on the conditions for claiming the personal allowances for your general information:

Allowance	Scope	Conditions
Basic allowance	Single person/married person not electing for joint assessment or personal assessment	N/A
Married person's allowance	Married person/person maintaining his or her spouse living apart	Taxpayer legally married; and Spouse has no assessable income; or Election for joint assessment or personal assessment has been made.

Allowance	Scope	Conditions
Child allowance	Own child (legitimate or illegitimate), step child, adopted child of the taxpayer or his/her spouse.	Child not married; Age of child ≤18 or ≤25 in full time education or >18 but incapacitated for work; Child is maintained by the taxpayer; Allowances in respect of all of the children are to be claimed either by the taxpayer or his or her spouse if no election for joint assessment or personal assessment has been made. [**Note**: If more than a person is entitled to the child allowance of the same child, the allowance will be apportioned.]
Dependent parent allowance	A parent of a marriage under which the taxpayer or his or her spouse is the child; the natural parents, adopted parents, step parents of the taxpayer or his or her spouse or deceased spouse(s) maintained by the taxpayer or his or her spouse	Parent is ordinarily resident in Hong Kong; Under s.30(1), age of parent ≥60 or <60 but eligible for Government's Disability Allowance (See the amount of allowance in the table above); Under s.30(1A), age of parent ≥55 and <60; and was not eligible for Government's Disability Allowance (See the amount of allowance in the table above); Parent either resides with the taxpayer for a continuous period of not less than six months in the year of assessment for less than full valuable consideration; or not less than $12,000 has been made for the maintenance of that parent in the year of assessment; The allowance in respect of a parent can only be granted to one taxpayer although more than one taxpayer may be eligible for the allowance; and The taxpayer cannot claim dependent parent allowance if deduction of elderly residential care expenses has been allowed to him/her or other person in respect of the same person.
Additional dependent parent allowance	Same as above	Same as above; and Parent resides with the taxpayer for less than full valuable consideration continuously throughout the year of assessment.
Dependent grandparent allowance	Natural/adopted/step grandparents of the taxpayer or his/her spouse or deceased spouse(s) maintained by the taxpayer or his or her spouse	Grandparent is ordinarily resident in Hong Kong; Under s.30A(1), age of grandparent ≥60 or <60 but eligible for Government's Disability Allowance (See the amount of allowance in the table above); Under s.30A(1A) , age of parent ≥55 and <60; and was not eligible for Government's Disability Allowance (See the amount of allowance in the table above);

Allowance	Scope	Conditions
		Grandparent either resides with the taxpayer for a continuous period of not less than six months in the year of assessment for less than full valuable consideration; or not less than $12,000 has been made for the maintenance of that grandparent in the year of assessment; The allowance in respect of a grandparent can only be granted to one taxpayer although more than one taxpayer may be eligible for the allowance; and The taxpayer cannot claim deduction of dependent grandparent allowance if deduction of elderly residential care expenses has been allowed to him/her or another person in respect of the same person.
Additional dependent grandparent allowance	Same as above	Same as above; and Grandparent resides with the taxpayer for less than full valuable consideration continuously throughout the year of assessment.
Dependent brother/ sister allowance	Natural/adopted/step brother or sister of the taxpayer or his or her spouse or any deceased spouse(s) of the taxpayer	Brother/sister not married; Age of brother/sister ≤18 or ≤25 in full time education or >18 but incapacitated for work; Taxpayer or the spouse of the taxpayer has sole or predominant care of the brother or sister at any time during the year of assessment; and No child allowance has been claimed by any person in respect of the brother or sister in the same year of assessment; and The allowance in respect of a brother or sister can only be granted to one taxpayer although more than one taxpayer may be eligible for the allowance.
Disabled dependant allowance	Spouse of the taxpayer, child, parent, grandparent or brother/sister of the taxpayer or his or her spouse	Taxpayer is eligible for married person's allowance, child allowance, dependent parent/grandparent allowance or dependent brother/sister allowance in respect of the dependant or entitled for deduction of elderly residential care expenses; and The dependant of the taxpayer is eligible for Government's Disability Allowance.

7 Computation of salaries tax

Topic highlights

DIPN 18 provides guidance on the assessment of individuals under salaries tax and personal assessment.

7.1 Ascertainment of assessable income

S.11B provides that the assessable income of a person for a year of assessment shall be the total amount of income accruing to that person from all sources in that year (i.e. the accruals basis).

Pursuant to s.11D, income accrues to a person when he becomes entitled to claim payment thereof. However, s.11D(a) also provides that an assessment on income accrued but not received is to be deferred until the income is received.

Income is treated as received when it has been made available to the taxpayer or has been dealt with according to his instructions.

Pursuant to s.11D(b), payments received after the cessation of an employment are deemed to have accrued on the last day of that employment. Noted that s.11D(b) is not applicable to share option gains, which is only a notional gain, rather than an actual payment of cash.

7.2 Lump sum payment on cessation of employment or deferred pay

S.11D(b)(i) provides that, within two years after the end of the year of assessment in which a lump sum payment on cessation of office/employment, termination of employment contract or deferred pay was received, application in writing can be made to have that lump sum payment related back for a period of:

- 36 months; or
- actual period of employment;

whichever is the shorter.

The lump sum payment should be related back from:

- the last date of employment; or
- the date on which the person became entitled to claim payment;

whichever is the earlier.

The lump sum payments that may be related back are as follows:

- lump sum payment or gratuity granted upon retirement or termination of office/employment or contract of employment; or
- lump sum payment of deferred pay or arrears of pay.

There are numerous Court cases and Board of Review decisions on the topic of lump sum payments received by individuals which provide interesting insights on the taxability of such income (refer to the Appendix).

7.3 Salaries tax computation

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.

The standard tax rates are as follows:

2003/04	2004/05 to 2007/08	2008/09 onwards
15.5%	16.0%	15.0%

The progressive tax rates are as follows:

2003/04		2004/05	
First $32,500	2.0%	First $30,000	2.0%
Next $32,500	7.5%	Next $30,000	8.0%
Next $32,500	13.0%	Next $30,000	14.0%
Balance	18.5%	Balance	20.0%

2006/07		2007/08		2008/09 & onwards	
First $30,000	2.0%	First $35,000	2.0%	First $40,000	2.0%
Next $30,000	7.0%	Next $35,000	7.0%	Next $40,000	7.0%
Next $30,000	13.0%	Next $35,000	12.0%	Next $40,000	12.0%
Balance	19.0%	Balance	17.0%	Balance	17.0%

A salaries tax computation schedule is as follows:

Assessable income		A
Less:		
Allowable outgoings and expenses [S.12(1)(a)]	B	
Depreciation allowances [S.12(1)(b)]	C	
Losses brought forward [S.12(1)(c)]	D	
Allowable outgoings and expenses/depreciation allowances/losses of a spouse not fully utilised [S.12(1)(d)] *	E	
Self-education expenses [S.12(1)(e)]	F	
		G
Net assessable income		H
Less:		
Concessionary deductions:		
Approved charitable donations [S.26C] **	K	
Elderly residential care expenses [S.26D] ***	L	
Home loan interest [S.26E] ****	M	
Contribution to recognised retirement schemes [S.26G]	N	
		P
Personal allowances	R	
		S
Net chargeable income		T
Tax thereon:		
Lower of:		
Standard rate × [H - P]; and		
T at progressive tax 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 to 15 years starting from the year of assessment 2012/13 (Enacted on 20 July 2012).

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

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13*
% of final tax reduction	75%	100%	75%	75%	75%	75%
Maximum limit	$25,000	$8,000	$6,000	$6,000	$12,000	10,000

* *Enacted on 5 July 2013*

7.4 Husband and wife

For a husband and wife, unless a valid election for joint assessment under s.10(2) is made, salaries tax will be payable on the net chargeable income of each spouse. Concerning the child allowances, one spouse would have to be nominated to claim the child allowances in respect of all the children.

An election under s.10(2) may be made if:

- either the husband or wife is entitled to concessionary deductions under Part IVA and personal allowances under Part V which, in aggregate, are in excess of his or her net assessable income; or
- lower tax will be payable on their aggregate income under joint assessment.

The election has to be made in a specified form jointly by the husband and wife. Such election has to be made:

- within that year of assessment or the following year of assessment;
- before the expiration of a period of one month following the time when the assessment for the year of assessment becomes final and conclusive under s.70, whichever is the later; or
- within such further time as the Commissioner considers reasonable in the circumstances.

When an election under s.10(2) is made, the spouse who would have been chargeable to tax in the absence of an election will be liable for tax. In any other case, a spouse nominated by the husband or wife will be liable for tax.

If the husband and wife have withdrawn an election for joint assessment jointly, they may not make an election for the same year of assessment again.

Self-test question 3

Mr and Mrs X would like to know whether they should elect for joint assessment for 2012/13.

Background information for year of assessment 2012/13:

	Assessable income $	*Allowable outgoings* $	*Charitable donations* $
Husband	200,000	2,000	20,000
Wife	100,000	–	20,000
Total	300,000	2,000	40,000

Required

(a) Compute the salaries tax payable by the couple if **no election** for joint assessment is made for 2012/13. (Ignore contributions to recognised retirement schemes)

(b) Compute the salaries tax payable by the couple if an election for joint assessment is made for 2012/13. (Ignore contributions to recognised retirement schemes)

(The answer is at the end of the chapter)

Self-test question 4

The following is the assessable income of a couple for year of assessment 2011/12.

	Assessable income $
Husband	400,000
Wife	300,000
Total	700,000

The couple is entitled to child allowances in respect of their two children (one born before 2011/12 and one born during 2011/12). They do not want to elect for joint assessment as it would result in a higher tax charge.

Required

(a) Compute the salaries tax payable by the couple for the year of assessment 2011/12 if the child allowances are to be claimed **by the husband.** (Ignore contributions to recognised retirement schemes)

(b) Compute the salaries tax payable by the couple for the year of assessment 2011/12 if the child allowances were to be claimed **by the wife.** (Ignore contributions to recognised retirement schemes)

(The answer is at the end of the chapter)

8 Tax efficient strategies under salaries tax

Topic highlights

Tax efficient strategies under salaries tax include:

- strategies on structuring the *source* of employment; and
- strategies on structuring the employment package.

8.1 Strategies on structuring the source of employment

Expatriates who are going to render services both in and outside Hong Kong should consider the source of their employment and the following tax implications.

Example: Source of employment – Hong Kong employment vs non-Hong Kong employment

There is an opportunity for Mr. T, an international sales executive, to work for a multinational group of companies with regional duties in the Far East. As a tax planning measure, Mr. T may refer to the criteria as outlined in DIPN No. 10 (Revised) to structure the location of his employment to either Hong Kong or a place outside Hong Kong. (**Note**: An artificial arrangement or an arrangement entered into with a 'sole or dominant' purpose to obtain a tax benefit will be subject to challenge from the IRD by invoking s.61 or s.61A.)

If Mr. T is has a Hong Kong employment, all his income will be subject to tax in Hong Kong. He may be exempted from HK salaries tax if he qualifies for the exemption under s.8(1A)(b) that all his services in connection with his employment are rendered outside Hong Kong. He may be entitled to exemption under s.8(1A)(c) if tax (of substantially the same nature as that of salaries tax) is paid on his income elsewhere. He may also claim tax credit under the Double Taxation Arrangement between HKSAR and the Mainland if he renders services in HK and the PRC.

On the other hand, if the employment of Mr. T is located at a place outside Hong Kong, the exposure of Mr. T to HK salaries tax will depend on the number of days that he visits Hong Kong during a year of assessment. If he visits Hong Kong for more than 60 days in a year of assessment, his income will be subject to tax in Hong Kong, usually based on a time-in-time-out apportionment basis. If he visits Hong Kong for no more than sixty days during a year of assessment, no salaries tax will be payable.

If circumstances warrant, Mr. T may have more than one employment (in different capacities) with the multinational group of companies. However, such "dual contract" arrangement is likely to be scrutinised by the IRD with suspicion and challenged under s.61 and s.61A.

It should be noted that a person's presence in Hong Kong for performing services may not be regarded as 'visits'. Besides, as the tax system in each jurisdiction differs, the overseas tax implications need to be taken into account for a person rendering services in Hong Kong and overseas who intends to structure the source of his/her employment from a tax perspective.

It is also worth noting that an employee, who is a Hong Kong resident, pays tax in the HKSAR and the PRC on his income will be better off by claiming the exemption under s.8(1A)(c) instead of the foreign tax credit under the Double Taxation Arrangement between HKSAR and the Mainland.

An example is as follows:

Example: Mr. Y

Mr. Y (a single person not entitled to any concessionary deductions) is under a Hong Kong employment. He is entitled to a monthly salary of $30,000 (i.e. annual salary $360,000).

During the year ended 31 March 2012 (i.e. the year of assessment 2011/12), he spent 8 months (from 1 April 2011 to 30 November 2011) in the Mainland.

In the absence of any tax relief, the salaries tax payable in Hong Kong will be computed as follows:

(($360,000 – $108,000) – $120,000) × 17% + $8,400 – $12,000 (tax deduction for 2011/12) = $18,840

Effective tax rate in Hong Kong: 18,840/360,000 = 5.23%

The income tax paid by Mr. Y in the PRC is computed as follows:

Assume the exchange rate is $1 = RMB0.8

$30,000 × 0.8 = RMB24,000

RMB24,000 – RMB4,800 = RMB19,200

Monthly PRC Individual Income Tax paid

= RMB[1,500 × 3% + 3,000 × 10% + 4,500 × 20% + (19,200 – 9,000) × 25%]

= RMB3,795

Total PRC IIT paid = RMB3,795 × 8 = RMB30,360

Tax paid for the 8 months' service in the PRC = RMB30,360 ÷ 0.8 = $37,950Net income after tax from the PRC = $240,000 – $37,950 = $202,050

Tax credit limit for tax paid in the PRC:

($202,050 × 1/(1 – 5.23%)) – $202,050 = $213,203 – $202,050

= $11,153

Tax paid in PRC not allowed as tax credit = $37,950 – $11,153 = $26,797

With tax relief under s.8(1A)(c)

Y/A 2011/12

	$
Assessable income	360,000
Less:	
Income that had been charged to tax in the PRC	(240,000)
	120,000
Personal allowance	(108,000)
Net chargeable income	12,000
Tax thereon ($12,000 × 2%)	240
Less: 2011/12 tax reduction	(180)
Total	60

With tax relief under the Double Taxation Arrangement between HKSAR and the Mainland

Y/A 2011/12

	$
Assessable income	360,000
Less:	
Amount not allowed as tax credit	(26,797
	333,203
Less:	
Personal allowance	(108,000)
Net chargeable income	225,203
Tax thereon	
First $40,000 @ 2%	800
Next $40,000 @ 7%	2,800
Next $40,000 @ 12%	4,800
Balance $105,203 @ 17%	17,884
	26,284
Less: 2011/12 tax reduction	(12,000)
Less: Tax credit	(11,153)
Tax payable	3,131

8.2 Strategies on structuring the employment package

A tax efficient employment package is one that provides the employee with as many tax-free benefits as possible, without increasing the financial cost or administrative work to the employer. For example, free medical treatment provided to the employee by the employer will be exempt from salaries tax, provided the liability to pay the medication fee lies with the employer, not the employee.

Refund of rent paid will also provide a tax saving for the employee as the accommodation benefit will only be computed at a notional rate of 10% of the employee's assessable income after deduction of allowable outgoings and expenses and depreciation allowances. It should be noted that the refund needs to be genuine. If the employer exercises no control on the refund of rent paid, the payment will be fully taxable as a cash allowance.

There is no restriction on the relationship between the taxpayer and the landlord. A taxpayer may enter into a tenancy agreement with his or her parent or a close relative. To avoid challenges from the IRD, there should be a genuine landlord and tenant relationship and the parties involved should be fully conversant with their rights and obligations. The rent agreed by the parties should be reasonable and the tenancy agreement should also be stamped. Please refer to the 'special circumstances' outlined in the leaflet 'How to tax the provision of a place of residence to the employee' issued by the IRD.

The following is an example of the salaries tax payable by a single taxpayer under alternative remuneration packages (Y/A 2011/12).

Example: Employment packages

Package 1

Annual salary $2,000,000, no fringe benefits.

Salaries tax payable = $288,000 (i.e. (15% × $2,000,000) – $12,000)

(**Note:** Tax computed based on progressive tax rates on net chargeable income (i.e. after deduction of personal allowance for single person) is $297,640 (after the deduction of $12,000 for 2011/12), which is higher than the tax computed at 15% on the net assessable income before the deduction of personal allowance for single person.)

Package 2

Annual salary $1,500,000 and refund of rent paid $500,000 for a flat.

Salaries Tax Computation

With progressive tax rates:

	$
Salary	1,500,000
Rental value (10%)	150,000
Assessable income	1,650,000
Less:	
Personal allowance (basic)	(108,000)
Net chargeable income	1,542,000
Tax thereon	
First $40,000 @ 2%	800
Next $40,000 @ 7%	2,800
Next $40,000 @ 12%	4,800
Balance $1,422,000 @ 17%	241,740
	250,140
Less: 2011/12 tax reduction	(12,000)
Total	238,140
With standard tax rate:	
$1,650,000 × 15%- $12,000	235,500
Total	235,500
Tax thereon	235,500
Tax savings = $288,000 – $235,500 =	52,500

Package 3

Annual salary $1,000,000 and refund of rent paid $1,000,000 for a flat.

Salaries Tax Computation

	HK$
Annual salary	1,000,000
Rental value (10%)	100,000
Assessable income	1,100,000
Less:	
Personal allowance (basic)	(108,000)
Net chargeable income	992,000
Tax thereon	
First $40,000 @ 2%	800
Next $40,000 @ 7%	2,800
Next $40,000 @ 12%	4,800
Balance $872,000 @ 17%	148,240
Total	156,640
Less: 2011/12 tax reduction	(12,000)
Total	144,640
Tax savings = $288,000 – $144,640 =	143,360

The IRD has not provided any guidance on the proper amount or proportion of the accommodation benefits in a remuneration package. For a relatively small amount of salary as compared with the amount of rent paid, it may be challenged by the IRD.

Appendix

Summary of salaries tax cases

The following is for general information only.

Taxpayer [Ref.]	Subject matter	Extract of facts and determination
D R Humphrey [(1970) HKTC 451]	Expenses of travelling from home to office	The taxpayer, a government employee, used his own car to travel from home to office. The Government reimbursed $559.30 of the travelling expenses of the taxpayer. The reimbursements were assessed for salaries tax with no deductions allowed for the travelling expenses. The Board of Review decided in favour of the taxpayer as they found that the taxpayer was requested by his employer to use his own car for travelling. On appeal, the High Court upheld the decision of the Board of Review. However, the Court of Appeal was of the view that the taxpayer was not on duty when he travelled from his home to office. The reimbursements of his private expenses were assessable and that the travelling expenses were non-deductible.
Robert P Burns [(1980) HKTC 1181]	Legal expenses on appeal against disqualification as a racehorse trainer	The taxpayer was a racehorse trainer employed by the Royal Hong Kong Jockey Club. In an appeal against the Club's decision of disqualifying the taxpayer for six months, the taxpayer incurred legal expenses of $40,000. The IRD disallowed the deduction of the legal expenses. With the view that the taxpayer's appeal was necessary for the production of his assessable income and that the legal fees were wholly, exclusively and necessarily incurred in the production of assessable income, the Board of Review decided in favour of the taxpayer. The Commissioner appealed against the Board's decision direct to the Court of Appeal. The Court of Appeal decided in favour of the Commissioner on the grounds that the legal expenses were not incurred in the production of assessable income but for the purposes of enabling the taxpayer not to be precluded from earning his assessable income.
Robert P Williamson [(1981) HKTC 1215]	Computation of rental value over rent paid	Time basis apportionment was allowed to the taxpayer. During the year of assessment 1977/78, the taxpayer rendered services in Hong Kong for 251 days. The taxpayer's employer provided quarters to the taxpayer at a rent of US$4,200. In computing the excess of the rental value over the rent paid by the taxpayer, the IRD was of the view that only 251/365 of the rent paid by the taxpayer was deductible. The Board of Review decided in favour of the taxpayer that the whole year's rent was deductible as there was no requirement for apportionment in s.9(1)(c). The High

Taxpayer [Ref.]	Subject matter	Extract of facts and determination
		Court also decided in favour of the taxpayer on the grounds that the rent was solely for the taxpayer's residence in Hong Kong and that there was no requirement for apportionment in s.9(1)(c).
Henry J Walton Masters [(1984) 2 HKTC 22]	Hotel service charge	The taxpayer was provided with rooms in a hotel by his employer as quarters. 7.5% of his basic salary was paid to his employer as rent for the quarters. As the taxpayer had to bear 50% of the service charge levied by the hotel, he claimed that the service charge should be treated as rent paid for the quarters in computing the excess of rental value over rent paid. The Board of Review decided in favour of the taxpayer as they were of the view that the service charge formed part of the rent for the hotel room. On appeal, the High Court decided in favour of the Commissioner that the service charged by the hotel was not 'rent' for the quarters provided.
So Chak Kwong, Jack [(1986) 2 HKTC 174]	Visits not exceeding a total of 60 days	The taxpayer was employed by a Hong Kong company but seconded to the United Kingdom. During the year of assessment 1981/82, he visited Hong Kong for 108 days of which 28 days were spent on rendering services in connection with his employment. The taxpayer's total emoluments were assessed to salaries tax. The Board of Review decided in favour of the taxpayer that his income should be exempt from tax as he had not rendered services in Hong Kong for more than 60 days. The High Court decided in favour of the Commissioner on the grounds that the words 'not exceeding a total of 60 days' qualified the word 'visits' rather than the words 'services rendered'. All the taxpayer's emoluments were taxable as he visited Hong Kong for more than 60 days.
Sin Chun Wah [(1988) 2 HKTC 364]	Payment in lieu of notice	The taxpayer was a government employee. He paid one month's salary to his employer as payment in lieu of three months' notice for resignation so as to take up another employment. The IRD disallowed the payment in lieu of notice. The Board of Review decided in favour of the taxpayer that the payment was allowable as the taxpayer could not have lawfully obtained his new employment without paying the one month's salary. On appeal, the High Court decided in favour of the Commissioner that the payment in lieu of notice was not expenditure incurred in the production of income from the taxpayer's new employer and was not allowable.

Taxpayer [Ref.]	Subject matter	Extract of facts and determination
George Andrew Goepfert [(1989) 1 HKRC 90-003]	Situs of employment	The taxpayer was employed by a US company, with salary paid in the US in US currency. The taxpayer was seconded to a company in Hong Kong to provide services to affiliated companies in the Far East. During the year of assessment 1981/82, the taxpayer rendered service outside Hong Kong for 42 days. In view of the fact that most of the taxpayer's services were performed in Hong Kong, the IRD assessed all the taxpayer's income to salaries tax. The Board of Review decided in favour of the taxpayer that he should be entitled to time basis apportionment on his income. The High Court upheld the Board's decision on the grounds that the place where services were rendered was not relevant in determining the situs of the taxpayer's employment. The taxpayer did not fall within the basic charge of s.8(1). He was liable for salaries tax under s.8(1A) and was entitled to time basis apportionment.
David Hardy Glynn [(1990) 1 HKRC 90-032]	Educational benefits	The employer of the taxpayer had entered into an arrangement with the school of the taxpayer's daughter that the primary liability for the payment of the school fee should be borne by the employer and that the taxpayer would only be liable to pay if his employer defaulted. The IRD assessed the school fees paid by the taxpayer's employer for salaries tax. The Board of Review decided in favour of the Commissioner that the school fees were taxable. On appeal, the High Court decided that the school fees were not taxable as they were neither convertible into cash nor being a discharge of a debt of the taxpayer. However, the Court of Appeal restored the Board's decision that the school fees were taxable as a perquisite. The Privy Council also decided that the school fees were within the definition of perquisite and chargeable to tax.
Sit Kwok Keung	Married person's allowance and single parent allowance	The marriage of the taxpayer and a Madam Yim was dissolved by a court decree on 13 November 1997. Custody of two sons was given to Madam Yim. The taxpayer was required to pay $15,000 per month to Madam Yim ($5,000 to Madam Yim and $10,000 to their two sons). The taxpayer claimed for 'Married Person's Allowance' and 'Single Parent Allowance' in his tax return for 1998/99. The Commissioner refused to allow the allowances, as the taxpayer was divorced and did not have 'the sole or predominant care' of his sons. The Board of Review also upheld the Commissioner's determination. On appeal, the Court and Court of Appeal also decided in favour of the Commissioner that the taxpayer was not entitled to the allowances.

Peter Leslie Page [(2003) 1 HKRC 90-123]	Rental allowance	The taxpayer's contract of employment provided housing benefit in the form of a monthly payment of a fixed sum subject to a cap. The employment contract provided that the employee should submit evidence of payment to the employer. The taxpayer rented a property and incurred rental expenses. However he did not provide a tenancy agreement and rental receipts to the employer for the monthly payments. The IRD was of the view that the monthly payments received by the taxpayer were cash allowances. The Board of Review, by majority, allowed the taxpayer's appeal. However, the Court of First Instance decided in favour of the Commissioner that the payments were taxable allowances.
Yung Tse Kwong [(2004) HKRC 90-136]	Payment upon termination of employment	The taxpayer's employment contract provided for reassignment or a 12-month severance payment 'Sum A' in accordance with the company's Career Transition Plan if his employment was terminated. The Commissioner took the view that the provision of Sum A was an inducement to secure the taxpayer's services throughout the whole period of employment. The taxpayer claimed that Sum A was compensatory in nature because it was paid as consideration for the restrictive covenants set out in the Severance Agreement which he had to sign in accordance with the Career Transition Plan before he was paid the sum. The Board of Review, by majority, held that Sum A was attributable to the giving of the restrictive covenants. On appeal by the Commissioner, the Court decided to apportion 10% of Sum A as inducement to enter into employment having regard to the circumstances of the case. The remaining 90% was attributable to the giving of restrictive covenants and non-taxable.
S. C. Sawhney [HCIA 1/2006]	Share option gains	On 1 September 1988, the taxpayer commenced employment in Hong Kong. The taxpayer was granted options at various times. On 30 September 1994, the taxpayer's employment was terminated and on 30 October 1994, he left Hong Kong. The taxpayer subsequently exercised two of the remaining stock options in the year of assessment 1996/97, one in the year of assessment 1998/99, and one in the year of assessment 2000/01. On each occasion, he made a gain. The Commissioner assessed these gains to tax in the relevant years of assessment. The taxpayer objected to the assessments. The Board of Review's decision was in favour of the taxpayer. On appeal by the Commissioner, the Court of First Instance decided in favour of the Commissioner. The taxpayer has filed an appeal to the Court of Appeal.

Elliott, S.W.G. [CACV 286/2006]	Payment received upon termination of employment	Pursuant to an employment agreement dated 30 October 1996, the taxpayer was to serve for a term of 5 years. His compensation package included, *inter alia*, a component described as Incentive Compensation Plan ('ICP'). Under the ICP, the taxpayer was to be awarded 5 million ICP units ('the Existing Units') upon the commencement of the employment and 500,000 additional ICP units each ('Future Units') upon the declared commercial operation of the company's next 6 electric power generating units. Each block of 500,000 ICP units would entitle the taxpayer to an annual payment equivalent to a certain % of the company's net income ('the Relevant Income'). Less than 5 months into his employment, the taxpayer was requested to resign and the company paid him, *inter alia*, a sum of US$11 million ('the Sum') for his agreement to the cancellation of his ICP units. The Board of Review ruled that the Existing Units constituted an inducement to the taxpayer to enter into the employment agreement and hence the portion of the Sum attributable to these Units was taxable. By adopting a 'rough and ready' method, the Board apportioned 50% of the Sum to tax. Both parties appealed to the Court of First Instance, the Deputy High Court Judge remitted the case back to the Board to reconsider the apportionment. Both parties appealed to the Court of Appeal which held that no part of the Sum was paid 'in return for acting as or being an employee' and no part of the Sum attracted tax. The whole of the Sum was to compensate the taxpayer for his loss of the ICP units.
Robertshaw, R Jesse [HCIA 3/2006]	Rent refund or cash allowance	In October 1999, the taxpayer purchased a boat through a service company owned by him and his wife and applied for housing assistance for his employer. In March 2001, the employer notified relevant employees that with effect of 1 April 2001 the housing allowance payable to employees who were owner-occupiers, irrespective of whether they had service companies or not, would be reported for tax purpose as cash allowance. The assessor treated the whole of the housing allowance declared by the employer as part of the income of the taxpayer chargeable to salaries tax. The taxpayer objected to the salaries tax assessments and claimed that the housing allowance was a rental subsidiary. The Board concluded that the payments were not exempted from tax under s.9(1A)(a) and dismissed the taxpayer's appeal. The Court of First Instance held that as the taxpayer was not challenging any finding of fact by the Board, he was thus bound by the Board's findings of fact. There was a clear finding of fact by the Board that the nature of the amounts in dispute determined at the time the payments were made was financial assistance to purchase a boat and not rental refund. The taxpayer's appeal was dismissed.

Yau Wah Yau [D53/04][(2006) 3 HKLRD 586] [HCIA 9/2005] [CACV 97/2006]	Rent refund or cash allowance	The taxpayer's employer provided quarters to him. The taxpayer purchased an apartment through a limited company which was 50% owned by him. The apartment was then rented to the taxpayer but without a tenancy agreement. Instead, an internal memo and memorandum of leases were signed between the Company and the taxpayer. His employer also issued a letter to the taxpayer confirming the provision of the apartment to him as his quarters. The taxpayer, his employer and the Company filed returns regarding the provision of these quarters and the corresponding rental income. The assessor assessed the rent refunded as cash allowance, to which the taxpayer objected. The Board held that since there is no stamped tenancy agreement, the parties involved did not have any intention to enter into a landlord and tenant relationship; and dismissed the appeal. The Court of First Instance overruled the Board's decision stating that the absence of stamped tenancy agreement did not deny the existence of a landlord and tenant relationship, and the parties involved had correctly reported this quarter provided and the rental income. The Court of Appeal overruled the above decision and initially ordered the case to be re-heard by a different Board, having considered the findings by the Board to be unsatisfactory. It later set aside this order as it did not have any jurisdiction for such an order, and based on the facts found by the Board, decided in favour of the Commissioner.

Franco Tong Siu Lun [21 BORD 947] [HCIA 2/2006]	Deductibility of contingent debts	The taxpayer was employed as a dealer's representative of Kingsway SW Securities Limited, in which the taxpayer agreed to indemnify the employer of any debts not received from the clients. In the Employer's Return, the Company reported the income without reducing the contingent debts, and the taxpayer's income tax assessment was issued based on the information supplied by the Company, also without reducing contingent debts. The Board allowed the taxpayer's appeal and stated that it would be illogical to tax high level of commissions but refuse any deductions when such risk materialised, thereby allowing the deduction for such debts. The Court of First Instance, however, overruled the Board's decision and decided in favour of the IRD, recognising that the deduction rule under salaries tax is more stringent and such debts could not be said as wholly, exclusively and necessarily incurred in the production of assessment income. However, the Judge observed that the taxpayer's employment could have been considered as a contract for services and taxed under profits tax. The taxpayer's appeal to the Court of Appeal was dismissed by way of consent.
Tsai Ge Wah [20 BORD 933] [D68/05] [HCIA 1/2007]	Gratuity, severance payment or long service payment	The taxpayer was employed by Mott MacDonald as Senior Resident Engineer from 15 May 1997 to 31 March 2004. According to Clause 10 of the last renewed contract, the taxpayer was entitled to a gratuity equals to 25% of the total basic salary drawn for the contracted period; and costs borne by the Company, such as severance pay or long service pay, would be deducted from the said gratuity. On 31 March 2004, the taxpayer ceased employment with the Company, and the Company reported that a gratuity was paid to the taxpayer. The taxpayer claimed that this gratuity was in fact severance pay and long service payment, which should not be subject to salaries tax. The assessor, relying on a reply from the Company, which calculated the gratuity as 25% of basic salary minus MPF contributions and denied any actual payment of severance or long service payment (but stated that the taxpayer was entitled to severance and long service payment), assessed the gratuity to salaries tax in full. The Board rejected the IRD's submission that any severance or long service payment would have been reduced to nil by virtue of s.31Y of the Employment Ordinance ('EO'). The Board ruled in favour of the taxpayer stating that he was entitled to long service pay and part of the gratuity was in fact long service payment and not subject to salaries tax. The reason was that the logical operation of Clause 10 of the contract should mean that the severance or long service payment must have been paid before the actual amount of gratuity could be determined, thus s.31YAA, instead of 31Y, of EO should

		apply to reduce the gratuity by the amount of severance or long service payment. The Court of First Instance upheld the Board's decision and rejected all the IRD's arguments; including its reliance of the Company's reply (both the Board and the Court found that such reply was contradictory in itself and the Company's intention could not undermine the statutory operation of the EO). The CIR's appeal to the Court of Appeal was heard on September 25, 2008. The COA ruled in majority in favour of the CIR and overturned the previous decision. The COA considered that the previous gratuities should be considered as part of the long service leave entitlement of the taxpayer and hence, the last gratuity received on termination of the employment should be wholly taxable. The decision stamped out from the interpretation of ss.31I or 31Y of the Employment Ordinance rather than over a provision of the IRO.
Fuchs, Walter Alfred Heinz [HCIA 1/2008] [CACV 196/2008] [FACV 22/2009]	Lump sum received on termination of employment	This case was directly appealed to the Court of First Instance, bypassing the Inland Revenue Board of Review. The taxpayer was employed by an overseas bank for many years and transferred to the Hong Kong branch under a 3-year contract as the "Head of Asia Region". He was terminated after two years due to a bank take-over. According to his employment contract, he was entitled to 'damages' equivalent to two annual salaries ('Sum B') and an average amount of the three previous years' bonus received from the Bank ('Sum C'). In addition, he received a sum equal to the salaries of the remaining period of his contract ('Sum A'). The IRD charged Salaries Tax on Sum B and C only as they were paid in accordance with his employment contract as inducement. The Court agreed that Sum A contained inducement, but it was not conclusive of its nature. The Court held that Sum C, which was calculated by reference to average bonus, was intended as a substitute of the bonus he would have been received had his employment continued, thus a return for his service and taxable. For 'Sum B', the Court held that this was paid for compensation of his loss of office because of his seniority within the Company and that this sum would not have been received had his employment continued, it was not referable to his work done, it was calculated by reference to his annual salary, and that all his rights and obligations were terminated. The Court of Appeal overturned the CFI's decision and held that Sum B and Sum C were taxable on the basis that both Sum B and Sum C were provided in the employment contract and that it was for being or acting as an employee or as an inducement to enter into such contract. The taxpayer's appeal was dismissed by the Court of Final Appeal.

Ahn Sang-gyun [D32/2007] [HCIA 4/2008]	Source of employment	The taxpayer was a security dealer employed by an overseas company registered and carried on business in Hong Kong. Most of the employment interviews were conducted in Hong Kong. His employment contract was sent from Hong Kong bearing the company letterhead showing the Hong Kong business address. Although the taxpayer signed his contract outside of Hong Kong and returned it to his employer, its contract stated that the employment offer was conditional of the grant of his Hong Kong employment visa and SFC licence. The taxpayer did not hold any security dealer licence elsewhere. His remuneration was paid in Hong Kong. In carrying out his duties, the taxpayer is required to travel extensively outside of Hong Kong. His position was offered to fit an expansion of the Hong Kong team, operated as an integral part of the Hong Kong team, and he reported to supervisors based in Hong Kong. The Board of Review held that his employment contract was only executed and concluded once those conditions were satisfied, which happened in Hong Kong; and that his position was for the benefit of the Hong Kong team and was offered from Hong Kong. The place of where the services were performed is irrelevant. His employer did not have any place of business other than in Hong Kong. By its constitution, the central management and control were vested in its directors, most of which were based in Hong Kong. In the declaration made in various forms filed with the SFC, the Company declared that no other person has control of the Company other than its directors and shareholders. Although the Company was regulated by its group's committee based overseas, initial proposals were put forth from the directors for the committee's deliberation. The Board held that the Company was resident in Hong Kong and that the overseas committee merely supervised but did not by-pass or usurp the Board of Directors of the Company. The taxpayer's appeal to the Court of First Instance was dismissed by a consent order dated 25 March 2009 as the taxpayer withdrew his appeal.

Mrs Murad, Barbara Ellen, Mrs Ward, Mona Frances, Mr Murad, Mark Basiem and Mr Strickroot, John Carl, the executors of the estate of the late Mr Murad, Mike M (formerly known as Mr Murad, Mohammad Mutaz) [HCIA 1/2009]	Lump sum received on termination of employment	This case was directly appealed to the Court of First Instance. The taxpayer was employed by a Bank. The employment contract provided that a sum equals to his annual basic salary, bonus and housing allowance until 30 September 2006, plus the cost for relocation to the US would be paid to the taxpayer if the Bank requested the taxpayer to resign prior to the end date on 30 July 2004. A separation agreement was signed confirming the payment of the aforesaid sum. It was held that the sum was paid in accordance with the employment contract for acting as an employee of the Bank, and not for breach of contract, thus taxable. The appeal was dismissed. The taxpayer filed an appeal to the Court of Appeal. On 18 April 2011 and 3 May 2011, the Appellant's solicitors offered settlement proposals and requested to submit the appeal for mediation. By letters dated 20 April 2011 and 9 May 2011, their requests were rejected. The case was pending further response from the Appellant's solicitors.

With regard to the costs involved in pursuing a case in the Courts, there are not many decided tax cases relating to salaries tax. However, there are a large number of BoR cases which offer views from different perspectives on salaries tax issues.

The following are some of the BoR cases which may be of interest.

Ref.	Issues considered
D2/86	Whether reimbursement of the cost of medical and dental treatment provided to an employee constitutes a 'perquisite'
D5/87	Whether utility and telephone charges paid by an employer on behalf of the employee are assessable
D9/87	Whether a government employee should be assessed on the allowances he received under the Government's Home Purchase Scheme
D46/87	Whether quarters provided are 'places of residence'
D11/88	Taxpayer obliged by his contract of employment to change residence. Whether expenses incurred in moving were deductible. Whether moving allowance was taxable
D24/88	Taxpayer received a lump sum payment paid upon termination of employment. Whether the payment represented a taxable gratuity or a tax-free severance payment
D106/89	Whether the reimbursement of salaries tax should be apportioned on 'time-in-time-out' basis
D54/90	Whether the taxpayer was an employee or carrying on business
D72/90	Whether the membership fee paid by the taxpayer to a professional body was deductible
D77/90	Whether the taxpayer was an employee or carrying on business
D78/90	Computation of value of quarters occupied jointly by two persons

Ref.	Issues considered
D4/91	Whether compensation paid for loss suffered from not exercising stock option earlier was taxable
D17/91	Whether the membership fee paid by the taxpayer to a professional body was deductible
D16/92	Whether subscription to a professional journal was deductible
D24/92	Whether hotel subsistence allowance was taxable
D30/92	Taxpayer required to occupy quarters under terms of employment. Whether value of quarters was taxable
D37/92	Whether travelling and entertainment expenses were deductible
D41/92	Whether solicitor can claim cost of clothing as expense
D43/92	Whether payment in lieu of leave was assessable
D54/92	Taxpayer required to occupy quarters under terms of employment. Whether value of quarters was taxable
D24/93	Whether the taxpayer was an employee or carrying on business
D65/93	Whether the taxpayer was an employee or carrying on business
D12/94	Whether part of a day comprises a day for tax purposes
D18/94	Whether motor car expenses were deductible
D33/94	Whether medical expenses were deductible
D43/94	Whether there was continuous employment or a new contract
D49/94	Method of computing income arising in Hong Kong
D66/94	Method of computing the value of share option
D78/94	Whether the taxpayer was an employee or carrying on business
D19/95	Whether housing assistance paid constituted rental refund or cash allowance
D40/95	Whether income from study leave was taxable
D46/95	Method of computing the value of a share option
D92/95	Whether housing assistance paid constituted rental refund or cash allowance
D15/96	Whether the taxpayer was an employee or carrying on business
D34/96	Whether part of the commission labelled reimbursement for rental is taxable
D53/96	Whether the taxpayer rendered part of his services in Hong Kong
D103/96	Whether the taxpayer was an employee or carrying on business
D3/97	Whether lump sum paid on termination of service was a taxable gratuity or non-taxable compensation for loss of office
D33/97	Whether housing assistance paid constituted a rental refund or cash allowance
D54/97	Whether all services of the taxpayer were rendered outside Hong Kong
D121/97	Whether the taxpayer was an employee or carrying on business
D76/98	Whether an 'out of court' settlement payment constitutes income from employment
D178/98	Whether an artist's income should be chargeable to profits tax or salaries tax
D35/99	Dual employment contracts and source of income
D43/99	Share option gains

Ref.	Issues considered
D88/99	Deductibility of self-education expenses paid in prior year
D20/00	Definition of 'a total of 60 days'
D21/00	Whether holiday allowance is exempt from salaries tax as being 'holiday warrant or passage'
D76/00	Taxpayer employed by Hong Kong and overseas companies – both contracts co-existed. Whether income sourced in Hong Kong
D138/00	Deductibility of fees incurred for Chinese opera course by a police constable
D20/01	Home loan interest deduction
D51/01	Gratuity or severance pay
D67/01	Income from two-contract arrangement
D87/01	Severance payment
D93/01	Housing allowance
D94/01	Home loan interest deduction
D123/01	Home loan interest deduction (Considered too restrictive by Board in D3/08)
D133/01	Gratuity for early retirement
D5/02	Home loan interest deduction
D6/02	Home loan interest deduction
D18/02	Home loan interest deduction
D25/02	Location and source of employment
D35/02	Secondment to Mainland
D72/02	Medical expenses
D89/02	Provident fund scheme contribution
D108/02	Home loan interest deduction
D120/02	Notional gain on exercise of right to acquire shares at a discount
D123/02	Director's fee – whether sourced outside Hong Kong
D12/03	Lump sum payment on completion of contact
D35/03	Rental refund or salary
D38/03	Lump sum payment upon termination of service. The Board was of the view that this case was a mixed purpose case, a fair order was to apportion the sum between difference elements of the payment
D37/03	Income arising from employment with constituent members of multi-national group of companies
D59/03	Location and source of employment
D90/03	Location and source of employment (Attending meeting constitutes services rendered)
D10/04	Whether a payment upon early termination of employment represented a taxable gratuity or a tax-free severance payment
D17/04	Whether sum received by appellant was excluded from salaries tax under s.8(1A)(c) of the IRO

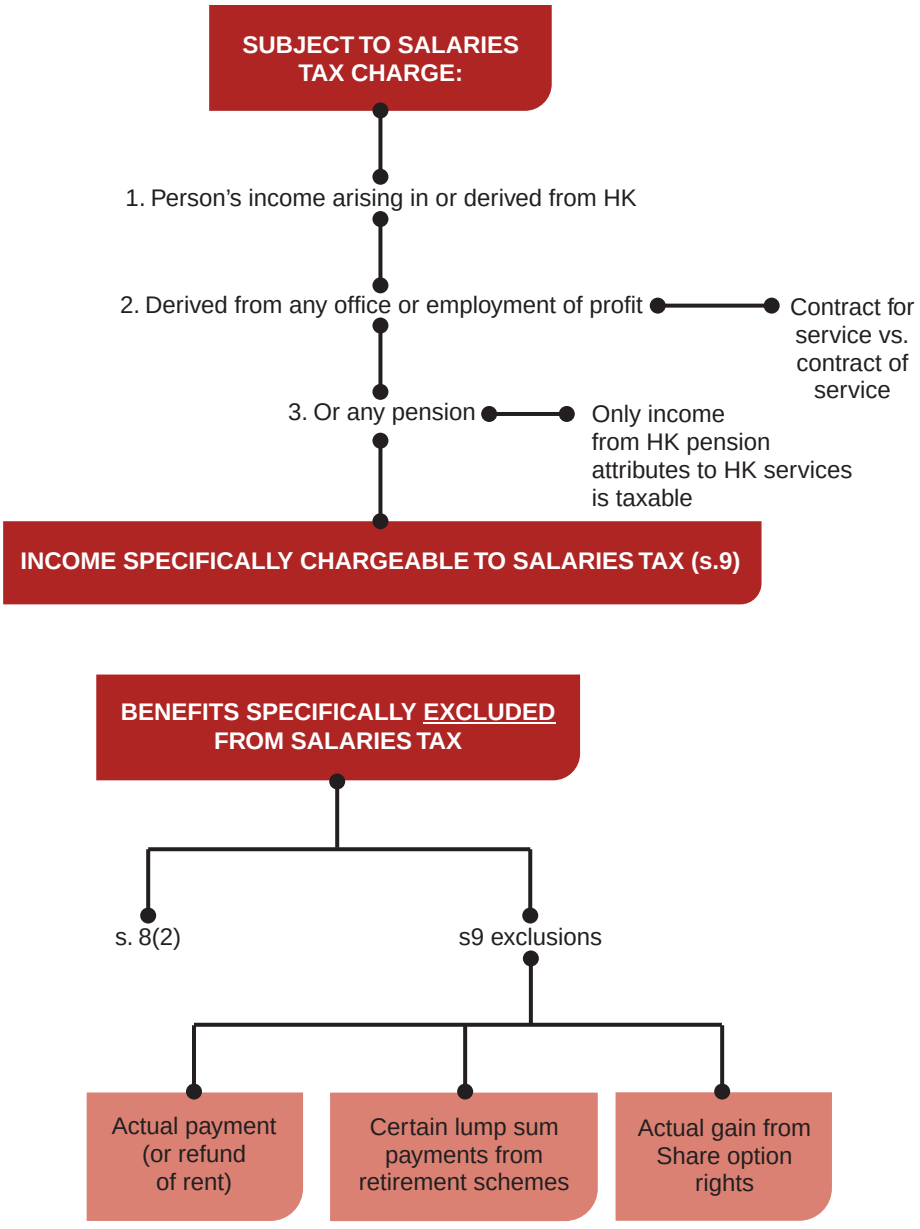
Ref.	Issues considered
D22/04	Home loan interest deduction
D28/04	Apportionment of income
D30/04	Rental refunds
D32/04	Gain on share option
D33/04	Home loan interest
D37/04	Severance payment and special notice payment income from employment
D38/04	Tenancy agreement between employer and employee
D39/04	Source of income
D43/04	Payment upon termination in addition to payment in lieu
D45/04	Whether the item of expenditure qualified as deductible expense
D53/04	Whether the sums are cash allowance chargeable to tax or refunds of rent
D60/04	Whether a new contract of employment exists and whether all services rendered outside Hong Kong
D68/04	Losses arising from the sale of share warrants
D69/04	Housing allowance
D73/04	Whether or not the sums in question constituted income arising in or derived from Hong Kong from employment of profit
D75/04	Bonus received after termination of employment
D83/04	Sum received under recognised provident fund scheme
D87/04	Whether compensation for wrongful termination of an employment contract is income from employment
D4/05	Whether a payment induced taxpayer to continue in employment or payment was compensation for loss of employment
D11/05	Time apportionment for employment outside Hong Kong and double taxation
D16/05	Rent received from employer
D17/05	Whether or not the payment was in the nature of compensation for loss of rights
D23/05	Whether or not the housing assistance received was a refund of rent and not fully assessable to salaries tax
D28/05	Gratuity payment or severance payment
D31/05	Dependent parent allowance
D34/05	Share options
D35/05	Source of income
D37/05	Special retention bonus – payment on top of severance payment
D38/05	Rental value
D46/05	Bonus from employment
D49/05	Income from employment
D57/05	Contingent liability under the indemnity in respect of potential non-payment by the clients
D63/05	Home loan interest deduction

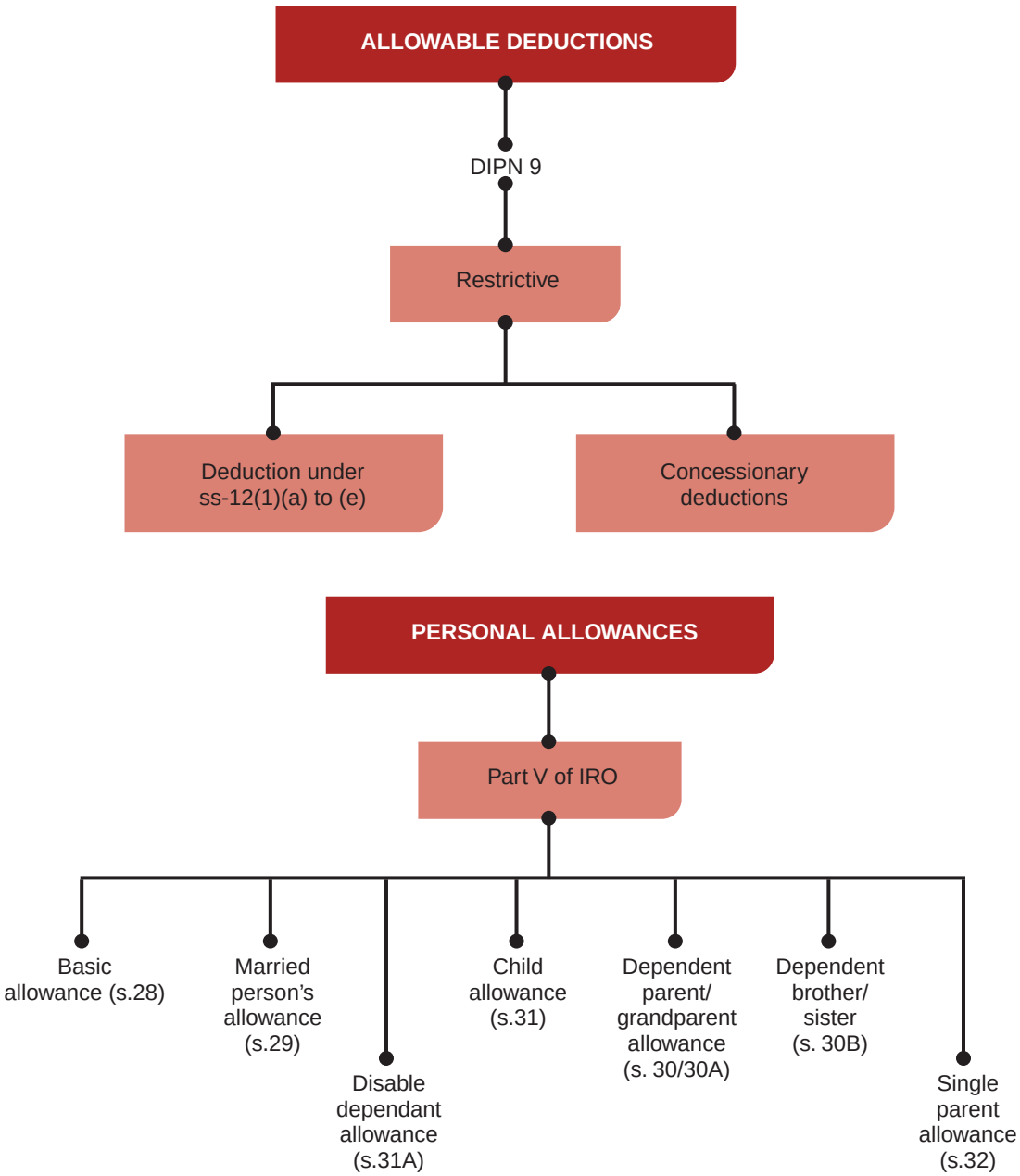
Ref.	Issues considered
D67/05	Married person's allowance and single parent allowance
D68/05	Whether gratuity or long service payment
D70/05	Home loan interest
D72/05	Whether or not the sum of money is severance payment and whether or not live difficulties can be a reason to have exemption from salaries tax
D76/05	Home loan interest
D77/05	Home loan interest
D79/05	Income from an employment of profit in Hong Kong – exclusion where services all rendered and performed outside Hong Kong
D80/05	Home loan interest
D2/06	Services rendered ordinarily outside Hong Kong except on one occasion – whether exempt
D3/06	Refund of rent or financial assistance
D5/06	Cash allowance or refund of rent
D6/06	Time apportionment for employment outside Hong Kong – double taxation
D8/06	Home loan interest
D9/06	Home loan interest
D11/06	Home loan interest
D13/06	S.9A of the IRO
D16/06	Whether or not the gratuity was remuneration and reward paid to the taxpayer under the contract of employment
D17/06	Whether package payment upon demotion and salary reduction is compensation or employment income
D19/06	Gratuity payment or severance payment
D27/06	Whether cash allowance or rental refund
D29/06	Deductions of business investment and outgoings
D34/06	Severance pay or special retention bonus
D39/06	The test whether a payment constitutes an inducement – whether or not the sum of money is a compensation for loss of employment
D48/06	Whether or not the nature of the sum of money is income from the employment or a compensation
D49/06	Whether or not the sum of money has been deducted from the director's remuneration
D52/06	Housing reimbursement or cash allowance
D55/06	Deductibility of travelling, queue jumping expenses and expenses of traffic accident
D60/06	Source of employment
D61/06	Whether reference books and CDs purchased by teacher for self study, improving own teaching quality and for lending to students constitute deductible ‘expenses'

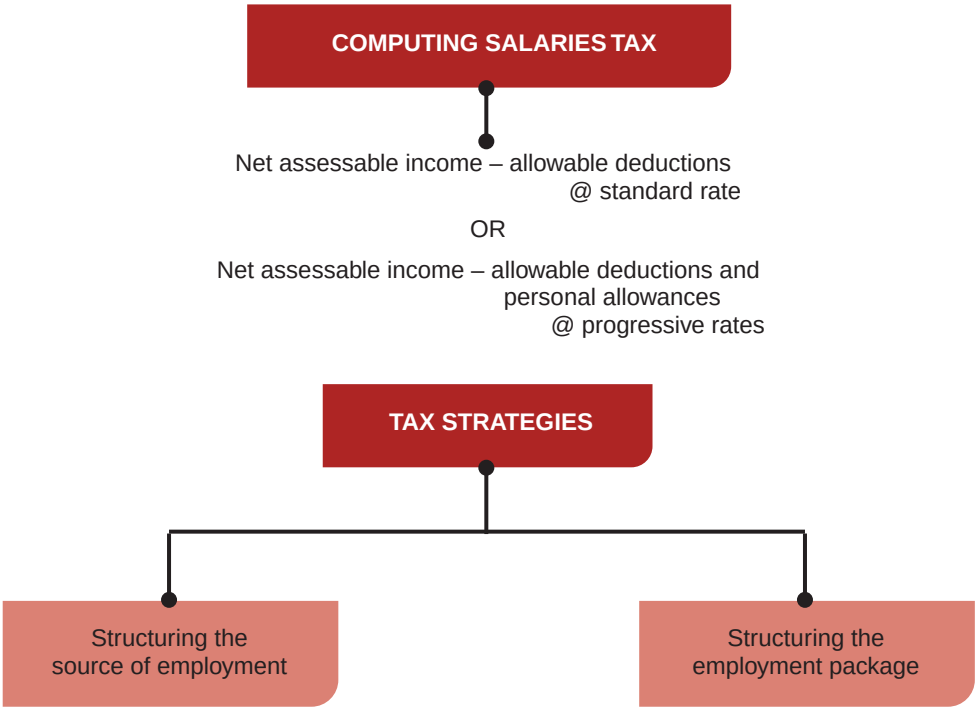
Ref.	Issues considered
D62/06	Share options
D65/06	Value of shares granted
D66/06	Share options
D67/06	Home loan interest
D68/06	Source of employment
D69/06	Consideration of termination of employment
D71/06	Consideration of termination of employment agreement
D74/06	Home loan interest
D78/06	Disguised employment, artificial transactions
D82/06	Dependent parent allowance, professional indemnity insurance and self-education expenses
D88/06	Spouse and child allowance
D8/07	Whether or not the rent and the holiday expenses paid by the employer be subject to taxable income
D11/07 & D12/07	Home loan interest – Licensee of property rather than registered owner and loan from developer not secured by mortgage or charge
D23/07	Deductibility of bad debts, facilities expenses, cleaning expenses and agent license fee
D26/07	Taxability of conditional sign-on bonus and setting-in allowance on commencement of employment
D27/07	Home loan interest – Cannot claim back-years deduction once final and conclusive
D28/07	Re-opened finalised assessment
D29/07	Dependent parent allowance
D30/07	Additional dependent parent allowance
D31/07	Dependent parent allowance
D32/07	Source of employment
D33/07	Appeal out of time – whether there was any reasonable excuse
D38/07	Freelance artiste – service of contract or service for contract, deduction of outgoing and expenses
D40/07	Source of employment, 60-day rule
D41/07	Appeal out of time (absence from Hong Kong), termination payment – whether compensation for loss of employment
D42/07	Termination payment – whether compensation for loss of employment
D46/07	Whether home loan interest – Loan not for place of residence
D50/07	Deduction of expenses

Ref.	Issues considered
D1/08	Source of employment
D2/08	Deductibility of expenses for professional indemnity
D4/08	Whether disguised employment
D9/08	Whether holiday benefit artificial or fictitious
D10/08	Valuation of share award with moratorium period
D11/08	Deductibility of contributions to overseas recognised retirement scheme
D19/08	Whether the appeal was out of time
D22/08	Whether assessable income for the relevant tax years are too high
D25/08	Whether or not payment in lieu of notice reimbursed from the employer is taxable income
D28/08	Source of employment income and deductibility of rental expenses
D38/08	Deductibility of home loan interest (Bridging loan held in substance to qualify as a home loan)
D43/08	Deductibility of maintenance payments and married person's allowance
D55/08	Source of employment
D58/08	Termination payment
D59/08	Absence from hearing, application for adjournment
D5/09	Married person's allowance
D6/09	Appeal out of time
D9/09	Absence from hearing
D16/09	Termination payment
D20/09	Housing allowance or refund of rents
D21/09	Termination payment
D26/09	Appeal out of time

Topic recap


SUBJECT TO SALARIES TAX CHARGE:
1. Person's income arising in or derived from HK
2. Derived from any office or employment of profit
Contract for service vs. contract of service
3. Or any pension
Only income from HK pension attributes to HK services is taxable
INCOME SPECIFICALLY CHARGEABLE TO SALARIES TAX (s.9)
BENEFITS SPECIFICALLY EXCLUDED FROM SALARIES TAX
s. 8(2)
s9 exclusions
Actual payment (or refund of rent)
Certain lump sum payments from retirement schemes
Actual gain from Share option rights


ALLOWABLE DEDUCTIONS
DIPN 9
Restrictive
Deduction under ss-12(1)(a) to (e)
Concessionary deductions
PERSONAL ALLOWANCES
Part V of IRO
Basic allowance (s.28)
Married person's allowance (s.29)
Disable dependant allowance (s.31A)
Child allowance (s.31)
Dependent parent/ grandparent allowance (s. 30/30A)
Dependent brother/ sister (s. 30B)
Single parent allowance (s.32)


COMPUTING SALARIES TAX
Net assessable income – allowable deductions
@ standard rate
OR
Net assessable income – allowable deductions and
personal allowances
@ progressive rates
TAX STRATEGIES
Structuring the
source of employment
Structuring the
employment package

Answers to self-test questions

Answer 1

Betty's employment is obviously a non-Hong Kong employment. However, she would still be subject to Hong Kong salaries tax in respect of any remuneration for her services rendered in Hong Kong, including leave pay attributable to such services.

In ascertaining whether Betty renders services in Hong Kong or not, the law provides that if she only renders services in Hong Kong during 'visits' which in aggregate amount to no more than 60 days during the basis period for the year of assessment, such services would be disregarded and the income received for that year of assessment would be exempt from HK salaries tax: ss.8(1A)(b)(ii) and 8(1B). In Betty's case, since she is a US resident and the question does not seem to indicate that she has any work base or family ties in Hong Kong, she would be regarded as a 'visitor' when she stays in Hong Kong. If she stays in Hong Kong for an aggregate of not more than 60 days, she will be exempt from Hong Kong salaries tax. In calculating the number of days of 'visits' in Hong Kong, the Board of Review case *D29/89* held that both the day of arrival and the day of departure are included.

In Betty's case, for the year of assessment 2010/11:

10 Dec 2010 to 31 Dec 2010	22
1 Jan 2011 to 20 Jan 2011	20
1 Feb 2011 to 18 Feb 2011	18
Total	60 days

As Betty's visits in Hong Kong for the year of assessment 2010/11 are not more than 60 days, she is not subject to Hong Kong salaries tax for that year.

For the year of assessment 2011/12:

1 Apr 2011 to 21 Apr 2011	21
1 May 2011 to 30 July 2011	91
8 Aug 2011 to 31 Aug 2011	24
1 Oct 2011 to 21 Oct 2011	21
15 Nov 2011 to 20 Dec 2011	36
Total	193 days

As Betty's total number of days of visits in Hong Kong for the year of assessment 2011/12 is more than 60 days, she would be subject to Hong Kong salaries tax.

The basis of taxing the employment income of visitors is usually by reference to the proportionate number of days spent in Hong Kong in the assessment year to the total number of days in that year. This is the so-called 'time-in-time-out' basis.

Time apportionment basis for Betty for the year of assessment 2011/12 is:

1 Apr 2011 to 21 Apr 2011	20	
1 May 2011 to 30 Jul 2011	90	(including 10 leave days)
8 Aug 2011 to 31 Aug 2011	23	
1 Oct 2011to 21 Oct 2011	20	
15 Nov 2011 to 20 Dec 2011	35	
Total days spent in Hong Kong	188	
Less: leave days in Hong Kong	10	
Total business days spent in Hong Kong	178	A
Total business days in the year	356	
Leave days attributable to HK service	5	B (10 × (178/(366-10))
Total days in Hong Kong	183	(A + B)
Time apportionment basis	183/	366

Note that in calculating the number of days for time apportionment purposes, either the day of arrival or day of departure is included, but not both. This is different from calculating the number of days in Hong Kong for the '60 days' rule purposes.

Answer 2

(a) ACL paid the sum after Mr. Tong had accepted the employment with the company. The sum was clearly sourced from the employment with ACL. It is chargeable under s.8(1).

The liability to make the payment in lieu of notice arose from the employment contract with BCL. It was Mr. Tong's own liability.

The payment made by ACL in discharge of Mr. Tong's (an employee's) own liability is a perquisite assessable to tax under s.9(1)(a).

Though Mr. Tong did not receive the payment from ACL, it was deemed to have been received by him by virtue of the proviso to s.11D(a).

(b) S.12(1)(a) allows for the deduction under salaries tax of all outgoings and expenses wholly, exclusively and necessarily incurred in the production of assessable income.

"In the production of assessable income" has the same meaning as "in the performance of duties" (*CIR v Humphrey*).

The payment in lieu of notice was not made while Mr. Tong was on duty. Therefore, it was not the expense incurred in the production of assessable income.

It is not deductible under salaries tax (*CIR v Sin Chun Wah*).

(c) *Rent payment*

As ACL is the tenant of the property, the rent payment made to the landlord was its own liability.

Under the exclusion under s.9(1)(a)(iv), the rent payment made by ACL in discharge of its own liability would not impose a salaries tax charge on Mr. Tong.

As the property was provided by ACL to Mr. Tong as a place of residence, a rental value computed as 10% of Mr. Tong's net assessable income should be included as his assessable income.

Electricity, water and gas

Although the payment was made for the benefit of Mr. Tong, Mr. Tong was not liable for the relevant expenses. ACL, as the tenant of the property, was liable for the expenses.

Under the exclusion under s.9(1)(a)(iv) , the payment made by ACL in discharge of its own liability would not impose a salaries tax charge on Mr. Tong.

Also, the benefit would not be convertible into cash by Mr. Tong.

Therefore, the benefit received by Mr. Tong would not be chargeable to tax.

Residents' club expenses

S.9(1)(a) provides that income from employment includes, among others, perquisites.

The bills for the residents' club were issued to Mr. Tong and the expenses were his own liabilities.

The disbursements of these personal liabilities by ACL are perquisites assessable to tax.

Answer 3

(a) **Year of assessment 2012/13**

	Husband	*Wife*
	$	$
Assessable income	200,000	100,000
Less:		
Allowable outgoings	(2,000)	–
Net assessable income	198,000	100,000
Less:		
Approved charitable donations	(20,000)	(20,000)
	178,000	80,000
Less:		
Personal allowance (basic)	(120,000)	(120,000)
Net chargeable income	58,000	Nil
Tax thereon		
First $40,000 @ 2%	800	
Balance $18,000 @ 7%	1,260	
	2,060	Nil
Less: 2012/13 tax reduction (Note)	(1,545)	–
Total	515	Nil

(Note) Assumed the 75% tax deduction proposed in 2013/14 Budget is approved

(b) **Year of assessment 2012/13**

	Husband	*Wife*	*Total*
	$	$	$
Assessable income	200,000	100,000	300,000
Less:			
Allowable outgoings	(2,000)	–	(2,000)
Net assessable income	198,000	100,000	298,000
Less:			
Approved charitable donations			(40,000)
			258,000
Less:			
Married person's allowance			(240,000)
Net chargeable income			18,000
Tax thereon			
First $18,000 @ 2%			360
Less: 2012/13 tax reduction			(270)
Total			90

Answer 4

(a) **Year of assessment 2011/12**

	Husband	*Wife*
	$	$
Assessable income	400,000	300,000
Less:		
Personal allowance	(108,000)	(108,000)
Child allowances	(180,000)	–
Net chargeable income	112,000	192,000
Tax thereon		
First $40,000 @ 2%	800	800
Next $40,000 @ 7%	2,800	2,800
32,000 @ 12%	3,840	4,800
Balance @ 17%	-	12,240
	7,440	20,640
Less: 2011/12 tax reduction	(5,580)	(12,000)
Total	1,860	8,640
Total salaries tax payable = $1,860 + $8,640 =	$10,500	

(b) **Year of assessment 2011/12**

	Husband	*Wife*
	$	$
Assessable income	400,000	300,000
Less:		
Personal allowance	(108,000)	(108,000)
Child allowances	–	(180,000)
Net chargeable income	292,000	12,000
Tax thereon		
First $40,000 @ 2%	800	240
Next $40,000 @ 7%	2,800	-
Next $40,000 @ 12%	4,800	
Balance @ 17%	29,240	–
	37,640	240
Less: 2011/12 tax reduction	(12,000)	(180)
Total	25,640	60
Total salaries tax payable = $(25,640 + 60) = $25,700		

From the above calculations, the couple will be better off if the child allowances were to be claimed by the husband.

Exam practice

George

36 minutes

George is an American. On 1 April 2009, he entered into an employment contract with A Limited in New York, under which he was employed as a legal advisor. A Limited is a company incorporated in the State of Delaware. Being a leading investment advisor in the United States (US), A Limited required a team of qualified solicitors as its legal advisors.

Having worked in New York for two months, George was seconded by A Limited to manage its Hong Kong branch from 5 June 2009. During the period from 5 June 2009 to 31 March 2010, George stayed in Hong Kong for 200 days. His remuneration for the period comprised a salary of HK$1,200,000 plus an apartment in Mid-levels, for which he paid rent of HK$50,000 in total. George declared all the relevant income in his 2009/10 tax return and, against which, he claimed deduction of the subscription of HK$3,000 and a professional indemnity fee of HK$10,000 paid to the US Law Society.

In addition to his employment income, George also acquired a residential flat in Hong Kong ('the Property') with tenancy on 1 February 2010. In his 2009/10 tax return, George declared rental income of HK$45,000 and claimed deduction of his payments for various expenses, including rates of HK$5,000, management fees of HK$24,000 and mortgage interest of HK$35,000. He also elected for Personal Assessment (PA).

George is married with no children. As his wife, Mary, did not come with him to Hong Kong, half of George's salary was paid in the US to maintain Mary's living expenses. Mary did not have any income chargeable to tax in Hong Kong.

Required

(a) Advise George on the following:

(i) the source of his employment with A Limited; and **(3 marks)**

(ii) the deductibility of the payments made to the US Law Society. **(3 marks)**

(b) Determine the deductibility of the expenses claimed by George in respect of the Property. **(3 marks)**

(c) Discuss whether George is eligible to elect for PA for the year of assessment 2009/10. **(2 marks)**

(d) Assuming that George is eligible for PA election, compute the Net Chargeable Income of George under PA for the year of assessment *2009/10*. **(9 marks)**

(Total = 20 marks)

HKICPA Module D (December 2010 session)

Carol Smith

32 minutes

Carol Smith is employed by ABC Co. as sales and marketing manager. Her remuneration package consists of a base salary of HK$20,000 per month plus commission. If her sales exceed the quarterly target of HK$1M ("Target Sales"), she will be paid commission computed as follows: 1% × (Sales less Target Sales). Commission is paid on a quarterly basis, namely, on the following dates – 31 March, 30 June, 30 September and 31 December.

Last year, Carol's annual chargeable income was HK$500,000. Provisional salaries tax was computed by reference to the aforementioned amount. For the current year of assessment, her bank statements revealed the following:

Salaries for the months of April to June HK$60,000

June commission HK$20,000

Salaries for the months of July to September HK$60,000

Carol informed you that she failed to meet her sales target for the quarter ending September. However, December is usually a good month and she should be able to exceed her target.

Carol will be taking 8 weeks leave from early January to travel round the world. This is because she is able to utilise her accumulated leave entitlement for the past three years.

She noted that the due date for her provisional salaries tax is 30 January.

Required:

(a) Carol asked you if there is any way to defer or minimise her tax payment on 30 January so she could have more surplus funds for her round-the-world trip. Please advise Carol (with computation to illustrate if required). **(11 marks)**

(b) During ABC Co.'s annual party held on 15 December, Carol won a cash prize of HK$10,000. The next day, she also won HK$20,000 at the lucky draw held at her friend's wedding party. In appreciation of her contribution, ABC Co. awarded her a travel allowance of HK$8,000 for her round-the-world trip. Please advise if the above are taxable.

(3 marks)

(c) ABC Co. reimbursed Carol for the parking fees and fines incurred during her visits to clients' offices in the past year. Comment on the tax implications for Carol and for ABC Co.

(4 marks)

(Total = 18 marks)

HKICPA Module D (June 2011 session)

John Chan

18 minutes

John Chan acquired Property A in January 2002 just before his wedding. The funds for financing the purchase were provided by his father as a wedding gift to his son.

John and his wife moved into Property A after they returned from their honeymoon.

John's wife, Mary, gave birth to a baby boy on 10 October 2009. They moved into a larger apartment, Property B. They used the proceeds from the sale of Property A and a mortgage loan obtained from a local bank to finance the purchase of Property B.

Required:

(a) Is the gain on Property A taxable? **(3 marks)**

(b) John is preparing his salaries tax return for the year of assessment 2010/11 and called you to inquire what allowances/deductions are available to him? **(7 marks)**

(Total = 10 marks)

HKICPA Module D (June 2011 session)

Barry Fisher

36 minutes

Barry Fisher is a US resident. He graduated as an MBA in 2009. Just before his graduation, Barry was invited by A Inc., a fund house incorporated in the US, to discuss an employment offer in its New York office. The employment was concluded on that occasion with the following terms: (a) Barry's annual salary was US$100,000 payable into his bank account in the US; (b) he would be granted an option to purchase 100,000 shares in A Inc. at US$0.10 upon the commencement of his employment, subject to a vesting period of one year; and (c) he would be paid a sum equivalent to his annual salary ("Sum A") if his employment was terminated within two years.

Barry's employment commenced on 1 September 2009. During the first half year, Barry was required to work at the New York office. With effect from 1 April 2010, A Inc. assigned Barry to work for its subsidiary in Hong Kong, A-HK Ltd. His terms of employment with A Inc. remained unchanged during the assignment. Barry came to Hong Kong on 1 April 2010, whilst his wife stayed in the US to look after their two-year-old son. During the year of assessment 2010/11, Barry stayed in Hong Kong for 20 days each month.

As a result of group restructuring, A Inc. terminated Barry's employment on 31 March 2011 and paid him Sum A pursuant to his terms of employment. Barry also exercised his share option on that day, when the relevant share closed at US$0.60.

A-HK Ltd. filed an employer's return reporting the full amount of Barry's remuneration for the year of assessment 2010/11 (comprising salary, Sum A and the share option gain) in May 2011. Failing to receive any tax return from Barry, the Assessor raised an estimated salaries tax assessment on Barry without granting any personal allowances in accordance with the employer's return on 14 September 2011.

Required

(a) Determine the source of Barry's income from employment for the year of assessment 2010/11. **(3 marks)**

(b) Evaluate whether Sum A should be chargeable to salaries tax. Cite the relevant authorities to support your analysis. **(3 marks)**

(c) Advise whether and if so, when and how the share option gain realised by Barry should be assessed to salaries tax (Note: (i) Computation of the share option gain is required; and (ii) Exchange rate: US$1 = HK$7.8). **(8 marks)**

(d) Barry engaged C Ltd. as his tax representative and decided to object to the 2010/11 estimated salaries tax assessment. Assuming that you are the tax manager of C Ltd. who has been assigned to this engagement, draft a notice of objection for Barry. **(6 marks)**

(Total = 20 marks)

HKICPA June 2012 session

Further reading

Suggested References

When studying this topic we suggest the following references:

Primary References

Advanced Taxation in Hong Kong, Pearson (Chapter 2 – Salaries Tax: Scope of Charge, Chapter 3 – Salaries Tax: Income from Office or Employment, Chapter 4 – Salaries Tax: Expenses and Deductions, Personal Allowances and Tax Computation, Chapter 5 – Salaries Tax: Husband and Wife)

Hong Kong Master Tax Guide, CCH Hong Kong Ltd (Chapter 2 – Salaries Tax)

Hong Kong Taxation – Law and Practice, The Chinese University Press (Chapter 3 – Salaries Tax)

Hong Kong Taxation and Tax Planning, Pilot Publishing Co Ltd (Chapters 8 to 12)

Inland Revenue Ordinance (Part III, Part IVA, Part V)

DIPN 9 (Revised) Major deductible items under salaries tax

DIPN 10 (Revised) The charge to salaries tax

DIPN 16 (Revised) Salaries tax - Taxation of fringe benefits

DIPN 18 (Revised) Assessment of individuals under salaries tax and personal assessment

DIPN 23 (Revised) Recognized retirement schemes

DIPN 25 (Revised) Service company "Type I" arrangements - Salaries tax

DIPN 32 (Revised) Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the avoidance of double taxation on income

DIPN 33 (Revised) Insurance agents

DIPN 35 (Revised) Concessionary deductions : Sections 26E and 26F Home loan interest

DIPN 36 Concessionary deductions : Section 26D

Elderly residential care expenses

DIPN 37 (Revised) Concessionary deductions : Section 26C

Approved charitable donations

DIPN 38 (Revised) Salaries tax – Employee share-based benefits

DIPN 41 Salaries tax – Taxation of holiday journey benefits

DIPN 44 (Revised) Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income

Supplementary Reference

Hong Kong Tax Manual, CCH Hong Kong Ltd (Para 10 – Salaries Tax, Personal Allowances)

chapter 6

Hong Kong property tax

Topic list

Learning focus

Property tax is charged on owners of land and/or buildings situated in Hong Kong under s.5 of IRO. Taxpayers should know the computation of net assessable value as well as the tax payable. The treatment of interest expense should be noted since interest is often incurred by a typical property owner. The responsibility of joint owners or co-owners under s.56A should be properly understood.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Tax on property income		
2.01	**Scope of property tax charge**	2
2.01.01	Identify the scope of the property tax charge	
2.01.02	Evaluate whether property letting amounts to a business	
2.01.03	Describe the relief and exemptions available under property tax	
2.01.04	Explain and apply DIPN 14	
2.02	**Chargeable property and owners of land and/or buildings**	2
2.02.01	Describe the 'owner' of a property as defined under the IRO	
2.02.02	Describe the obligations of property owners under the IRO	
2.02.03	Explain and apply DIPN 14	
2.03	**Ascertainment of assessable value and property tax liability**	3
2.03.01	Ascertain the assessable value of a property	
2.03.02	Identify allowable deductions under property tax	
2.03.03	Compute net assessable value and property tax payable	
2.03.04	Explain and apply DIPN 4 and DIPN 14	

1 Scope of property tax charge

Topic highlights

Under s.5 of the IRO, property tax is charged for each year of assessment on the owners of any land or buildings or both situated in Hong Kong at the standard rate on the net assessable value.

The standard rate is as follows:

Year of Assessment	2003/04	2004/05 to 2007/08	2008/09 onwards
Standard rate	15.5%	16%	15%

If the owner of any land or buildings or land and buildings ('the property') is a corporation, it should apply to the Commissioner in writing for an exemption from property tax under s.5(2)(a) of the IRO if its rental income is chargeable to profits tax or the property is used or occupied for the purpose of producing chargeable profits. Once the exemption is granted, the corporation is obliged to inform the Commissioner of any change in ownership or use of the property within thirty days after the change pursuant to s.5(2)(c) of the IRO.

Key term

The definition of '**owner**' as defined in s.2 of the IRO is:

'**Owner**', in respect of land or buildings or land and buildings, includes:

a person holding the land or buildings or land and buildings directly from the Government (i.e. the Government lessee);

(a) a beneficial owner;

(b) a tenant for life;

(c) a mortgagor;

(d) a mortgagee in possession;

(e) a person with adverse title to land who is receiving rent from buildings or other structures erected on the land;

(f) a person who is making payments to a co-operative society registered under the Co-operative Societies Ordinance for the purpose of the purchase of the land or buildings or land and buildings;

(g) a person who holds land or buildings or land and buildings subject to a ground rent or other annual charge; and

(h) (in so far as common parts are concerned) a corporation registered under s.8 of the Building Management Ordinance (Cap. 344) or a person who, on the person's own behalf or on behalf of another person, receives any consideration, in money or money's worth, in respect of the right of use of any common parts solely or with another; and

(i) an executor of the estate of an owner.

In BoR case D27/98, Incorporated Owners formed by the owners of a building under the Buildings Ordinance has been ruled as the owner of the common parts of the building (Refer also to DIPN No. 14 (Revised), paragraphs 41 to 43).

Key term

'**Common part**', in relation to any land or buildings or land and buildings is further defined as

(a) the whole of the land or buildings or land and buildings, except such parts as have been specified or designated in an instrument registered in the Land Registry as being for the exclusive use, occupation or enjoyment of an owner; and

(b) includes, unless so specified or designated in the instrument mentioned in paragraph (a), those parts of a building specified in Schedule 1 to the Building Management Ordinance (Cap. 344).

The following owners of property are exempt from property tax:

- The HKSAR government;
- Consulars (for property used for consular purposes or residence of consular employee);
- Charitable bodies;
- Corporations carrying on business in Hong Kong (with rental income chargeable to profits tax); and
- Those with exemptions granted by the Chief Executive in Council.

1.1 Property letting amounting to a business

S.2 of the IRO states that the letting and sub-letting by a corporation and sub-letting by any person other than a corporation would constitute to a business. The rental income so derived is therefore chargeable to Profits Tax under s.14 of the IRO. While it is a question of fact to be determined in each case, the IRD would consider the following circumstances as strong indication of the existence of a business:

(a) The number of properties let is substantial and the owner has engaged some staff to handle the tenancies matters;

(b) The properties are of special purpose use such as ballrooms, cinemas or restaurants, and additional services are provided by the landlord (see *Louis Kwan-nang KWONG & Carlos Kwok-nang KWONG v. CIR,* 2 HKTC 541);

(c) Letting by a property dealer: the rents are regarded as income of the property dealing business; or

(d) The letting is incidental to and is therefore part of the trade or business such as in the situation where the owner uses the property partly for his trade and letting out the remaining surplus part.

2 Assessable value of land or buildings or land and buildings

Topic highlights

Under s.5B(2) of the IRO, the assessable value of land and/or building is the amount of consideration which is payable to the owner for the right of use of property in a year of assessment. Any consideration payable for the provision of services or benefits connected with the right of use of the land and/or buildings is included in the computation.

Key term

'**Consideration**' includes any consideration payable in respect of the provision of any services or benefits connected with or related to the right of use (e.g. management or service fees payable to the owner).

A deposit with the landlord which is refundable upon the termination of a lease is not a consideration chargeable to property tax.

Any consideration previously deducted as irrecoverable and recovered during any year of assessment (i.e. bad debt recovery) shall be treated as consideration payable in that year of assessment (i.e. taxable in the year of recovery).

Other than the payment of a rental deposit, it is common that a tenant is also required to pay a lump sum payment (i.e. a premium) in addition to the monthly rent in order to obtain a lease of property in Hong Kong. Unlike the rental deposit, the premium is not refundable to the tenant upon the termination of the lease. This amount is taxable in calculating the property tax liability (see below).

Key term

'**Premium**' refers to the consideration payable in respect of a period of the right of use that is not contained within any one year of assessment.

Under s.5B(4), the 'premium' shall be deemed to be payable in equal monthly instalments, either:

- during the period of the right of use, or
- during a period of three years commencing at the start of the period of the right of use to which the consideration relates,

whichever is the shorter.

The following example in DIPN 4 demonstrates the tax treatment on premium received:

Example: Tax treatment on premium received

Company H carries on a property letting business. While retaining substantially all the risks and rewards incidental to its ownership, it leased one of its properties for a term of two years at a premium of $1,200,000 at the beginning of Year 1.

According to **Hong Kong Accounting Standard 17 – Leases, issued by the Hong Kong Institute of Certified Public Accountants** (paragraphs 4 and 8), the lease will be an operating lease and hence the lease premium 'shall be recognised in income on a straight line basis over the lease term' (paragraph 50), i.e. over the two-year period. Therefore, half of the premium will be assessed to profits tax in Year 1 and half in Year 2.

Property tax assessments may be issued to Company H. Pursuant to s.5B(4) , half of the premium will be charged to property tax in Year 1 and half in Year 2. Company H is entitled to set off the property taxes paid against its profits taxes payable on the premium for these two years and have the balance refunded, if any (s.25). Alternatively, Company H can apply for property tax exemption under s.5(2)(a) of the IRO, leaving the premium to be assessed to profits tax.

Self-test question 1

Mr Lam let his flat for five years from 1 August 2011. The monthly rent was $12,000 and the tenant paid a lease premium of $200,000 on 1 August 2011.

Required

Show, with brief explanations, Mr Lam's property tax liabilities for 2011/12 and 2012/13.

(The answer is at the end of the chapter)

3 Allowable deductions under property tax

Topic highlights

Deductions for rates, bad debts and statutory outgoings are allowable under property tax.

The following deductions are allowable under property tax:

Allowable deduction	Conditions
Rates	If the owner agrees to pay the rates in respect of the land or buildings or land and buildings, the rates paid by him are deductible from the assessable value.
Bad debts	Any consideration proved to the satisfaction of an assessor to have become irrecoverable during the year of assessment is deductible in ascertaining the assessable value. If there is no or insufficient assessable value for the deduction of the bad debts, 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	There is a notional 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 incurred on repairs and maintenance are ignored for tax purposes.

4 Property tax computation

Topic highlights

Property tax is computed using a standard formula as highlighted below.

S.5(1A)(b)(i) of the IRO provides that rates are a deductible item whereas s.5(1A)(b)(ii) only allows a deduction of a statutory allowance for repairs and outgoings of 20% of the property's assessable value after deduction of any rates paid by the owner.

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 normally, by concession, allow the rates, as long as the taxpayer was actively looking for tenants and the property was rented out during the year.

The following is a general format of a property tax computation:

Note: Actual expenses incurred by the property owner are ignored by statute. Only a notional amount (20% on assessable value less rates) of statutory outgoings is allowable

	$
Consideration receivable	A
Premium (related to that year of assessment)	B
Bad debt recovery	C
	D
Less:	
Bad debts	E
Unrelieved bad debts (brought forward from subsequent year(s) of assessment)	F
Assessable value	G
Less:	
Rates paid by the owner	H
	J
Less:	
Statutory outgoings (20% of J)	K
Net assessable value	L
Tax thereon at standard rate (L × tax rate)	M

Example: Computation of Property Tax Payable

Mr X let a flat to Ms Y at a monthly rent of HK$20,000 from 1 April 2010 to 30 September 2011. Mr X would like to know his liability for property tax.

Required

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

Solution

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

	2010/11 HK$		2011/12 HK$
Rent	240,000		120,000
Less: Statutory outgoings (20%)	(48,000)		(24,000)
Net assessable value	192,000		96,000
Tax thereon @15%	28,800	=	14,400

Example: Treatment of bad debts in calculating property tax payable

Based on the background information provided in Example 1 and assuming that Ms Y failed to pay the rent to Mr X from 1 February 2012 and was subsequently declared bankrupt on 1 October 2012, Mr X would have a bad debt of $160,000 ($20,000 × 8 months = $160,000) while the assessable value for 2012/13 amounts to $120,000 ($20,000 × 6 months).

Required

(a) Advise Mr X on the treatment of the bad debts.
(b) Compute the property tax payable by Mr.X. (Ignore provisional tax).

Solution

(a) Part of the bad debt is to be deducted from the assessable value of $120,000 in 2012/13.

While there is no tax payable for 2012/13, there will still be an unrelieved amount of bad debt of $40,000 ($160,000 – $120,000) which is deductible in the previous year (i.e. 2011/12).

Notwithstanding s.70 of the IRO, Mr. X can apply to the IRD to reopen the assessment for 2011/12.

(b) The property tax payable by Mr. X is computed as follows:

	2012/13 $
Rent (from 1 April 2012 to 30 September 2012)	120,000
Less: Bad debt	(120,000)
Statutory outgoings (20%)	Nil
Net assessable value	Nil
Tax thereon	Nil

	2011/12 (Revised) $
Rent (from 1 April 2011 to 31 March 2012)	240,000
Less: Unrelieved bad debt brought backward from 2012/13	(40,000)
	200,000
Less: Statutory outgoings (20%)	(40,000)
Net assessable value	160,000
Tax thereon ($160,000 × 15%)	24,000
Less: Tax paid for 2011/12	(28,800)*
Refund of tax overpaid	(4,800)

* $240,000 × (1 – 20%) × 15% = $28,800

Self-test question 2

Mr A let a flat to Ms B at a monthly rent of $25,000 from 1 April 2012 to 31 March 2013. Ms B was required to pay $50,000 to Mr A as a refundable rental deposit. Mr A was responsible for payment of the following expenses during the year of assessment 2012/13:

	$
Property management fees ($2,000 × 12)	24,000
Rates	13,500
Sundry repairs	10,000
Total	47,500

Required

Compute the property tax payable by Mr A for Year 2012/13. (Ignore provisional tax.)

(The answer is at the end of the chapter)

4.1 Deduction of property tax from profits tax

The consideration from any land or buildings or land and buildings may be within the scope of charge to property tax and also the scope of charge to profits tax.

The consideration from any land or buildings or land and buildings may be within the scope of charge to property tax and also the scope of charge to profits tax. To avoid double tax on such

consideration, there is a provision for set-off of the property tax payable from the profits tax payable of the owner of the property pursuant to s.25 of the IRO.

5 Obligations of property owners

Topic highlights

In recent years, the IRD has stepped up its efforts to ensure that property owners are fulfilling their obligations under the IRO. The obligations of property owners are summarised in DIPN 14.

The obligations of property owners are summarised in DIPN 14 as outlined below:

1 *Filing of Returns – s.51(1)*

Property owners must complete the tax returns issued to them under s.51(1) and return them to the IRD within the time limit stipulated in the tax returns (which is normally one month from the date of issuing the return).This should be done even if the property is occupied by the owner or any other person without consideration.

2 *Notification of Chargeability to Tax – s.51(2)*

Every person who is chargeable to Property Tax for any year of assessment but has not received a return form should notify the CIR in writing that he is so chargeable within four months after the end of that year of assessment (e.g. on or before 31 July 2011 for the year of assessment 2010/11).

3 *Notification of Cessation of Ownership – s.51(6)*

Where the property has been sold or transferred, the vendor or the transferor must notify the IRD of the change in writing within one month after the sale or transfer is effected.

4 *Notification of Change of Address – s.51(8)*

A person chargeable to Property Tax who changes his address should, within one month, inform the CIR in writing of the particulars of the change.

5 *Keeping of Sufficient Rental Records – s.51D*

Property owners must keep sufficient records of not less than seven years of rent received, such as lease agreements and duplicates of rent receipts, to enable their tax liability to be readily ascertained.

6 *Notification of Change in Exemption Status – s.5(2)(c)*

Where the owner is a corporation exempted from Property Tax under s.5(2)(a), the owner should notify the CIR in writing within 30 days of any change in the ownership or use of the property or any other circumstances affecting the exemption previously granted.

7 *Responsibility of Joint Owners or Co-owners – s.56A*

Where two or more persons are joint owners or owners in common of any property, each and every owner is fully responsible in fulfilling the obligations of a property owner as if he is the sole owner, including the filing of tax returns and paying the tax [s.56A(1)]. It should be noted that this section does not relieve any person of any obligation under the IRO or affect any right or obligation of the joint owners or owners in common as between themselves [s.56A(2)]. Further, if any person has paid Property Tax for which he would not have been liable except for the provisions of s.56A(1), he may recover such tax from the person who is liable to pay it [s.56A(3)].

[**Note**: in D80/02, an individual owner of a residential unit in a building complex was held to be a co-owner of the car parking spaces in the building. S.56A would apply to him. It is not necessary to have an instrument naming all co-owners, past or present.]

8 *Letting of Common Areas of a Building*

Where any part of the common areas of a building is let out, the rental income derived is chargeable to Property Tax. The owners collectively are responsible for reporting the rental income and paying the tax. If the owners have not received the Property Tax return relating to the common areas let, they are required to notify the CIR in writing. If an owners' corporation is formed, s.16 of the Building Management Ordinance (Cap. 344) provides that the rights and duties of the owners relating to the common parts of the building shall be exercised and performed by the incorporated owners of the building. Therefore, the incorporated owner is required, on behalf of all the owners of the building, to report the income and pay the tax.

6 Decided tax cases: Property tax

Topic highlights

The following tax cases are related to property tax.

Taxpayer	Subject matter	Reference
Louis Kwan Nang Kwong & Anor	Rental income from letting a cinema as a going concern	(1989) 1 HKRC 90-017
Harley Development Inc & Anor	Premiums received by corporations from letting a property	(1996) 1 HKRC 90-079

Louis Kwan Nang Kwong & Anor [(1989) 1 HKRC 90-017]

The facts: The taxpayers were brothers. They inherited a cinema from their late father and received rental income from letting the premises. The tenant was required to use the same name for the cinema and maintain the goodwill of the cinema. The IRD assessed the taxpayers' rental income to profits tax.

Decision: The Board of Review decided in favour of the CIR that the taxpayers had been engaged in the business of letting a cinema as a going concern.

On appeal, the High Court also decided in favour of the CIR on the grounds that the transaction between the taxpayers and the tenant had amounted to more than a simple tenancy.

The Court of Appeal upheld the decision of the High Court on the grounds that the taxpayers' activities were within the definition of 'business' and their rental income from letting the cinema was subject to profits tax.

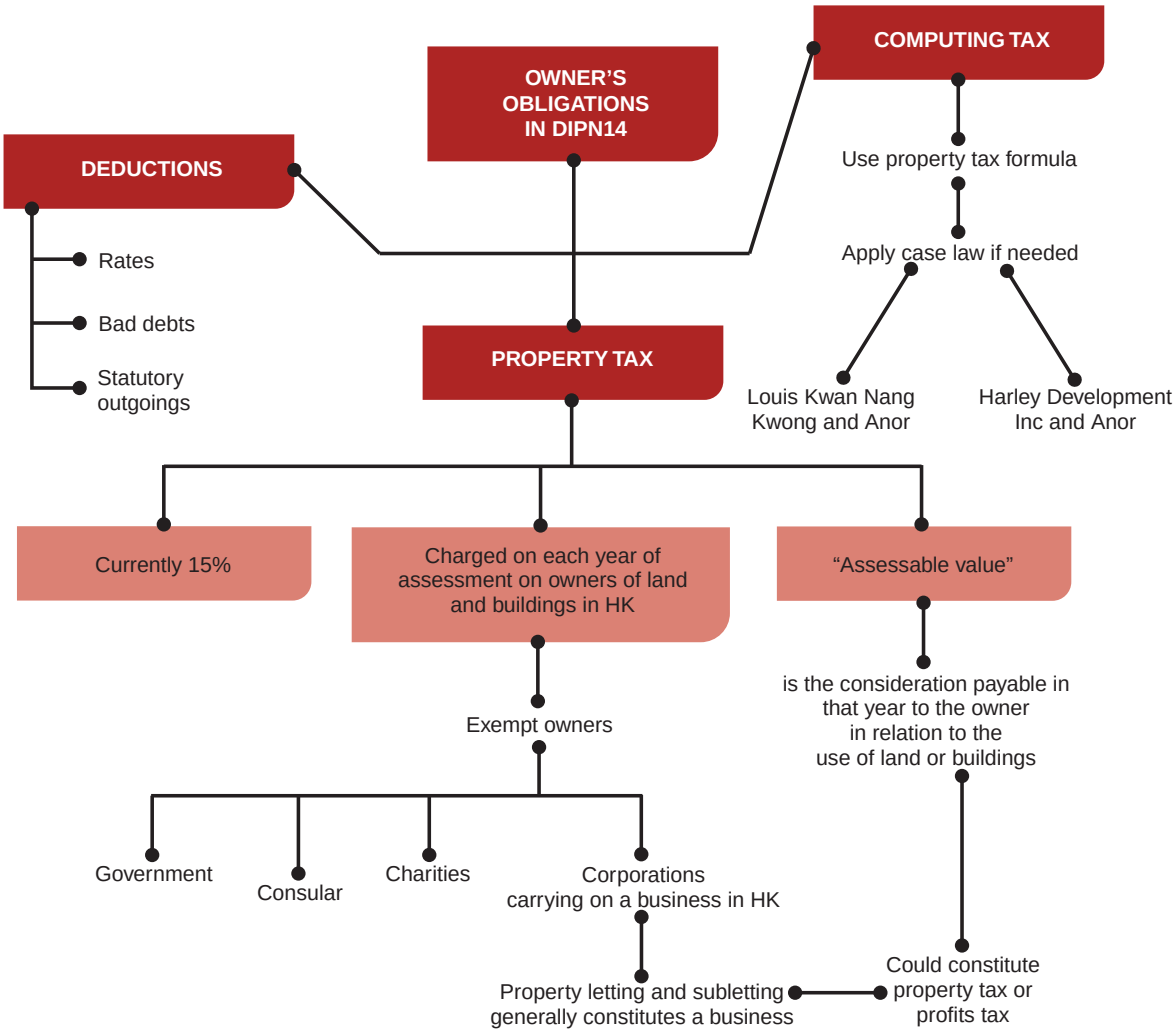
Harley Development Inc & Anor [(1996) 1 HKRC 90-079]

The facts: The taxpayers were property owners. In 1985, each of the taxpayers granted a 30-year under-lease to the Hong Kong and Shanghai Banking Corporation for a premium of $119,875,000 and $55,125,000 respectively.

Both taxpayers submitted nil profits tax returns. Profits tax assessment was raised on the premium received by one of the taxpayers but that assessment was subsequently annulled. Property tax assessments were then raised on the premiums received by the taxpayers. The taxpayers applied for judicial review as they were of the view that they had been entitled to exemption from property tax under s.5(2) of the IRO and that the property tax assessments were *ultra vires*.

Decision: The High Court, Court of Appeal and the Privy Council all decided in favour of the CIR. The Privy Council was of the view that the IRD had done nothing to justify the taxpayers' belief that exemption from property tax had been granted. The property tax assessments were not *ultra vires*.

Topic recap


COMPUTING TAX
OWNER'S OBLIGATIONS IN DIPN14
DEDUCTIONS
Use property tax formula
Apply case law if needed
Rates
Bad debts
Statutory outgoings
PROPERTY TAX
Louis Kwan Nang Kwong and Anor
Harley Development Inc and Anor
Currently 15%
Charged on each year of assessment on owners of land and buildings in HK
"Assessable value"
is the consideration payable in that year to the owner in relation to the use of land or buildings
Exempt owners
Government
Consular
Charities
Corporations carrying on a business in HK
Property letting and subletting generally constitutes a business
Could constitute property tax or profits tax

Answers to self-test questions

Answer 1

Property tax liabilities for Mr Lam are as follows:

2011/12	$
Rental income – $12,000 × 8	96,000
Premiums – 8/36 × $200,000	44,444
Assessable value	140,444
Statutory deduction @20%	(28,089)
Net assessable value	112,355
Property tax @ 15%	$16,853
2012/13	
Rental income - $12,000 × 12	144,000
Premiums – 12/36 × $200,000	66,667
Assessable value	210,667
Statutory deduction @20%	(42,133)
Net assessable value	168,534
Property tax @ 15%	$25,280

Answer 2

Year of Assessment 2012/13

	$
Consideration ($25,000 × 12)	300,000
Less: Rates	13,500
	286,500
Less: Statutory outgoings (20%)	(57,300)
Net assessable value	229,200
Tax thereon ($229,200 × 15%)	34,380

Exam practice

Mr. Wong

36 minutes

Mr. Simon Wong acquired two shops (Shop A and Shop B) at $8 million in Hong Kong by obtaining an advance of $3 million from his brother, Mr. Patrick Wong, who is a retired businessman living in Hong Kong.

Shop A is held for rental purposes while Shop B is used as a retail shop of Simon's trading business (unincorporated).

The following is a summary of the income and expenses relating to the two shops for the year of assessment 2010/11:

	Shop A	*Shop B*
	$	$
Rental income	500,000	–
Trading income	–	1,000,000
Trading expenses	–	(500,000)
Repairs and maintenance to the property	(50,000)	(50,000)
Rates	(20,000)	(20,000)
Interest paid to Patrick Wong	(150,000)	(150,000)
Net profit	280,000	280,000

Mr. Simon Wong is single. As a reorganisation of his business affairs, he plans to transfer the two shops to a limited company incorporated in Hong Kong that is to be owned by him and his brother.

Required

(a) Advise Mr. Simon Wong of the tax treatment on the interest expenses paid to his brother.

(6 marks)

(b) Based on information provided, compute the total tax payable by Mr. Simon Wong on income derived from the two shops (assuming no personal assessment is elected).

(8 marks)

(c) Advise Mr. Simon Wong of the tax implications on transferring the two shops to a limited company.

(6 marks)

(Total = 20 marks)

Ms. Poon

31 minutes

Ms. Poon was a Hong Kong resident and migrated to Canada for more than a decade ago. She returns to Hong Kong to visit her relatives and friends three to four times each year spending about ten days each time. In the year 2009, Ms. Poon acquired a local residential property during her stay in Hong Kong. The purchase consideration was partially settled by her personal savings and partially settled by a mortgage loan from a bank in Hong Kong.

The property was then leased to a tenant, Mr. Chan, under the following terms:

(1) Term of lease : 4 years from 1 July 2009
(2) Monthly rental : HK$18,000 payable in advance on the first day of each month
(3) Rent free period : 1.5 months from 1 July 2009
(4) Premium : HK$36,000 payable on 1 July 2009
(5) Deposit : HK$35,000 payable on 1 July 2009
(6) Rates : HK$3,000 net payment per quarter (after the Rates Concession), payable by Ms. Poon
(7) Management fee : HK$1,500 per month, payable by Ms. Poon

Due to financial difficulties, Mr. Chan has only paid HK$11,000 per month as rental since January 2010 and from April 2010, Mr. Chan did not pay any rent to Ms. Poon at all. Finally, Mr. Chan moved out from the property on 31 July 2010 and cannot be traced anymore (the IRD agreed with Ms. Poon on the irrecoverable rent as bad debt on the same date).

Ms. Poon has become more cautious in the property leasing market and finally she leased the property to another tenant Mr. Cheng for a one year leasing term, with annual rental amount of HK$120,000 fully payable in advance. Rates (after the Rates Concession) and management fee, both in the same amount as last year, are fully payable by Ms. Poon. The new lease was effective on 1 September 2010.

Ms. Poon has incurred HK$55,000 and HK$86,000 mortgage loan interest for the years ended 31 March 2010 and 2011 respectively.

Required:

Calculate the property tax liability of Ms. Poon for the years of assessment 2009/10 and 2010/11.

(12 marks)

HKICPA December 2011 (Extract)

Further reading

Suggested References

When studying this topic we suggest the following references:

Primary References

Advanced Taxation in Hong Kong, Pearson (Chapter 6 - Property Tax)

Hong Kong Master Tax Guide, CCH Hong Kong Ltd (Chapter 5 - Property Tax)

Hong Kong Taxation - Law and Practice, The Chinese University Press (Chapter 2 - Property Tax)

Hong Kong Taxation and Tax Planning, Pilot Publishing Co Ltd (Chapters 6 and 7)

Inland Revenue Ordinance (Part II)

DIPN 4 (Revised) Lease premiums / Non-returnable deposits / Key or tea money / Construction fees etc.

DIPN 14 (Revised) Property tax

Supplementary Reference

Hong Kong Tax Manual, CCH Hong Kong Ltd (Para 5 - Property Tax)

chapter 7

Personal assessment

Topic list

Learning focus

Tax advisers should understand the possible benefits of personal assessment and advise the taxpayers when it is beneficial to them. Computation of the tax payable under personal assessment should also be mastered. It must be noted that personal assessment is not a separate charge of tax. The procedure for its election and its time limit should also be noted.

Learning outcomes

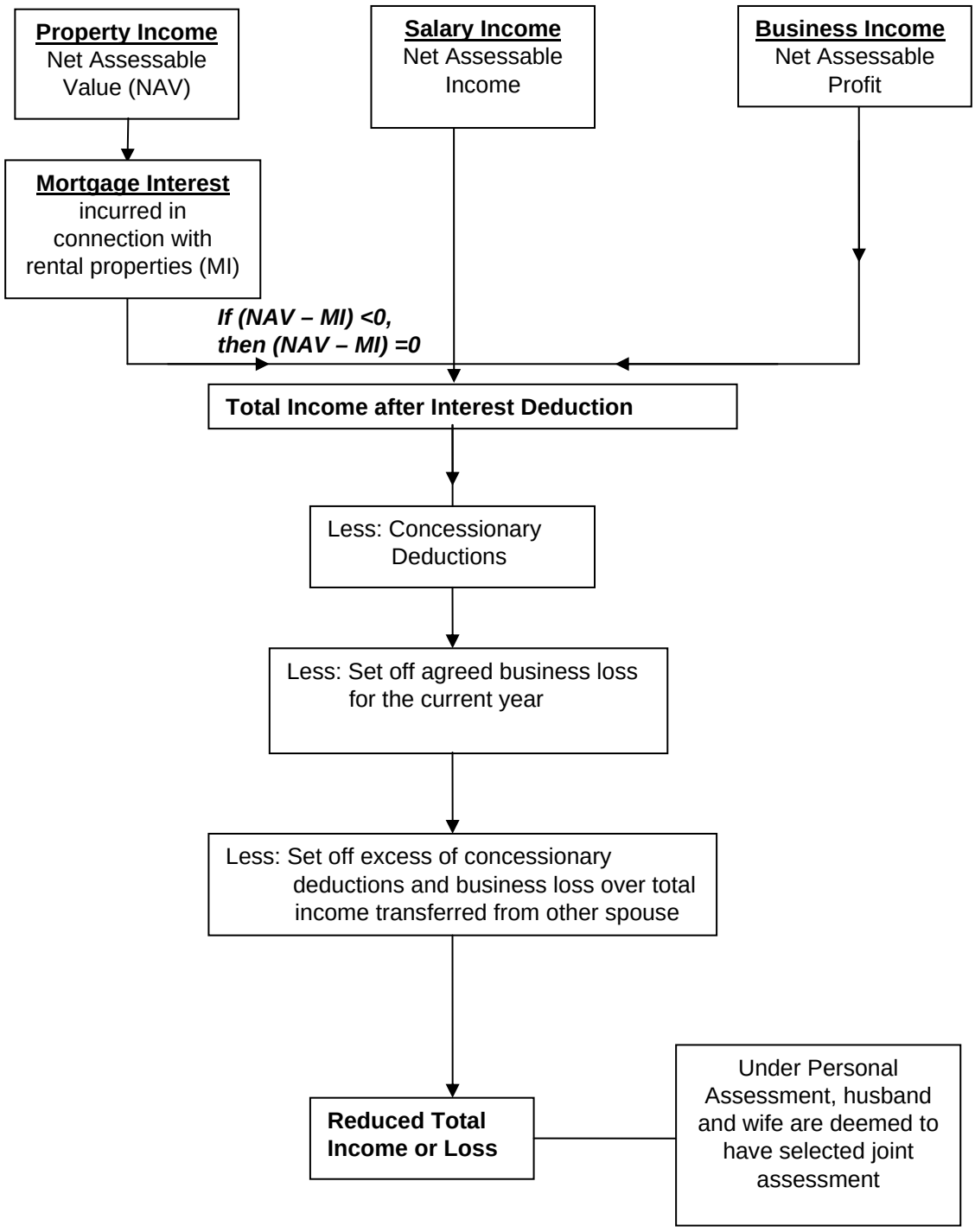
In this chapter you will cover the following learning outcomes:

		Competency level
Personal assessment		
2.12	**Election for personal assessment**	2
2.12.01	Identify the issues, including eligibility and application procedures, relating to personal assessment election	
2.12.02	Demonstrate how a taxpayer can benefit from a personal assessment election	
2.12.03	Explain and apply DIPN 18	
2.13	**Computation of total income and tax payable**	2

1 Defining personal assessment

Topic highlights

Personal assessment is not a separate charge of tax. It only provides an alternative method of computing the tax liability of an individual (and his or her spouse) by aggregating that individual's (and the spouse's) taxable income under property tax, salaries tax and profits tax.



By electing for personal assessment, the business loss (or losses) suffered by the individual (and his or her spouse) can be used to set-off against other taxable income (eg assessable income under salaries tax, net assessable value under property tax) and therefore reduce the tax burden of the individual (and his or her spouse).

The interest payable on money borrowed for producing rental income of property owned by the individual (and his or her spouse) will also be allowed under personal assessment (the amount of interest deduction is limited to the net assessable value of the property).

For individuals who do not have income chargeable to salaries tax, they will be entitled to concessionary deductions (ie approved charitable donations, elderly residential care expenses, home loan interest, and contributions to recognised retirement schemes), personal allowances and progressive tax rates by electing to be assessed under personal assessment.

Depending on the individual's (and his or her spouse's) circumstances, personal assessment may not always be beneficial.

It should be noted that, unlike salaries tax, there is no separate assessment for husband and wife under personal assessment. The tax liability of a married couple is calculated based on the aggregate of their respective taxable income.

The couple will have two separate demand notes for payment of their total tax liability (i.e. by apportionment on the total tax payable on their joint income).

It should also be noted that an election for personal assessment does not extend the objection period under separate taxes or affect the finality of income or profits included in the total income.

DIPN No. 18 (Revised) provides guidance on the assessment of individuals under salaries tax and personal assessment.

2 Persons who may elect for personal assessment

Topic highlights

Individuals satisfying certain criteria may elect for personal assessment. For married individuals, they may not make elections for personal assessment unless their spouses do as well.

2.1 Eligibility criteria

Personal assessment may be elected by a person who is:

- an individual;
- aged eighteen or above, or under that age if both his or her parents are dead; and
- either a permanent or temporary resident in Hong Kong or, if he or she is married, whose spouse is either a permanent or temporary resident.

'Permanent resident' means an individual who ordinarily resides in Hong Kong.

'Temporary resident' refers to an individual who stays in Hong Kong for more than:

- 180 days during the year of assessment in respect of which the election is made, or
- 300 days in two consecutive years of assessment, one of which is the year of assessment in respect of which he or she elects for personal assessment.

2.2 Husband and wife

Where an individual is married and not living apart from his or her spouse and both that individual and his or her spouse:

- have income assessable under the IRO; and
- are eligible to make an election for personal assessment,

then that individual may not make an election for personal assessment unless his or her spouse does as well.

For a couple who got married during a year of assessment to which the election for personal assessment relates, they shall be deemed to be married at the commencement of that year.

2.3 Deceased taxpayer

For a deceased taxpayer who was eligible to elect for personal assessment, his or her executor shall have the same right to elect for personal assessment on the total income of the deceased as the deceased would have had if he or she were alive.

3 Time limit for election for personal assessment

Topic highlights

Elections for personal assessment must be in writing and lodged with the Commissioner within the prescribed timeframes.

Elections for personal assessment must be made in writing and lodged with the Commissioner within:

- two years after the end of the year of assessment in respect of which the election is made; or
- one month after an assessment of income or profits forming part of the individual's total income for such year of assessment becomes final and conclusive under s.70 (ie two months after the issue of the assessment), or
- such further period, if any, as the Commissioner may allow as being reasonable in the particular circumstances,

whichever is the later.

4 Personal assessment computation

Topic highlights

An individual taxpayer's liability is often less than the aggregate tax liabilities if assessed separately under the individual heads of taxation.

The benefits from electing for personal assessment are likely derived from the following deductions (some of which are not available under profits tax or property tax):

- interest incurred on money borrowed for the purpose of producing property income, (the amount of interest deductible should not exceed the net assessable value of each individual property);
- approved charitable donations;
- elderly residential care expenses (from the year of assessment 1998/99 onwards);
- home loan interest (from the year of assessment 1998/99 onwards);

- business losses incurred in the year of assessment;
- losses brought forward from previous years under personal assessment; and
- personal allowances.

However, as the net chargeable income (i.e., after deduction of personal allowances) is chargeable to tax at the progressive tax rates, the aggregation of all income of an individual (and his/her spouse) may cause more income to be subject to the higher marginal tax rate than the standard rate. In general, it may not be advantageous for high income taxpayers to elect for personal assessment.

DIPN No. 18 (Revised) provides guidance on personal assessment computations.

Examples of personal assessment computation are as follows:

Example: Mr. A

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)

Required

Compute the tax payable by Mr. A for the year of assessment 2012/13 (with no personal assessment elected).

Solution

Without the election of personal assessment, the tax payable by Mr. A for the year of assessment 2012/13 is as follows:

Profits Tax – Business X

	$
Assessable profits from Business X	300,000
Tax rate	15%
Tax thereon	45,000

Property Tax – Property Y

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

Total tax payable = 69,000 (ie $45,000 + $24,000)

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

Example: Mr. A continued

Based on the information provided above, compute the tax payable by Mr. A for the year of assessment 2010/11 (with personal assessment elected).

Solution

With personal assessment elected, the tax payable by Mr. A for 2012/13 is as follows:

	$
Assessable profits from Business X	300,000
Add: Donation already allowed	100,000
	400,000
Net assessable value – Property A	160,000
	560,000
Less: Allowable charitable donations (limited to 35%)	(150,000)
	410,000
Less: Home loan interest	(100,000)
	310,000
Less: Personal allowance	(120,000)
Net chargeable income	190,000
Tax thereon	
First $40,000 @ 2%	800
Second $40,000 @ 7%	2,800
Third $40,000 @ 12%	4,800
Balance $70,000 @ 17%	11,900
	20,300
Less: 2012/13 tax reduction (assumed 2013/14 Budget is approved)	(10,000)
	10,300
Less: Tax paid ($45,000 + $24,000)	(69,000)
Refund of tax overpaid	(58,700)

A breakdown of the tax savings is computed as follows:

	$
Tax saving from additional charitable donation: 50,000 × 15%	7,500
Tax saving from personal allowance: 120,000 × 15%	18,000
Tax saving from home loan interest deduction: 100,000 × 15%	15,000
Tax saving from 2012/13 tax reduction	10,000
Tax saving from the first three brackets of progressive tax rates: 120,000 × 15% – 8,400	9,600
Increase in tax liability from the balance of the net chargeable income that is chargeable at 17% 70,000 × (17% – 15%)	(1,400)
	58,700

Self-test question 1

Background Information

	$
Husband	
Net assessable income	450,000
Charitable donations	(100,000)
Allowable losses from Business Y	(50,000)
Interest on mortgage loan used to acquire Property B *	(50,000)
Contribution to MPF	(12,000)
Wife	
Net assessable value of Property A	200,000
Interest on mortgage loan used to acquire Property A	(300,000)
Interest on mortgage loan used to acquire Property B *	(50,000)
Assessable profits from Business X	100,000
Contribution to MPF as a self-employed person	(12,000)

* Jointly owned and occupied by the couple as their matrimonial home

Required

(a) Compute the tax payable for 2011/12 by the couple under personal assessment.

(b) Assume the couple make all possible claims and compute the tax payable by the couple with no election for personal assessment based on the background information provided. (Ignore provisional tax.)

(The answer is at the end of the chapter)

Self-test question 2

Background Information

	$
Husband	
Net assessable income	400,000
Wife	
Net assessable value of Property A	200,000
Assessable profits from Business X	200,000

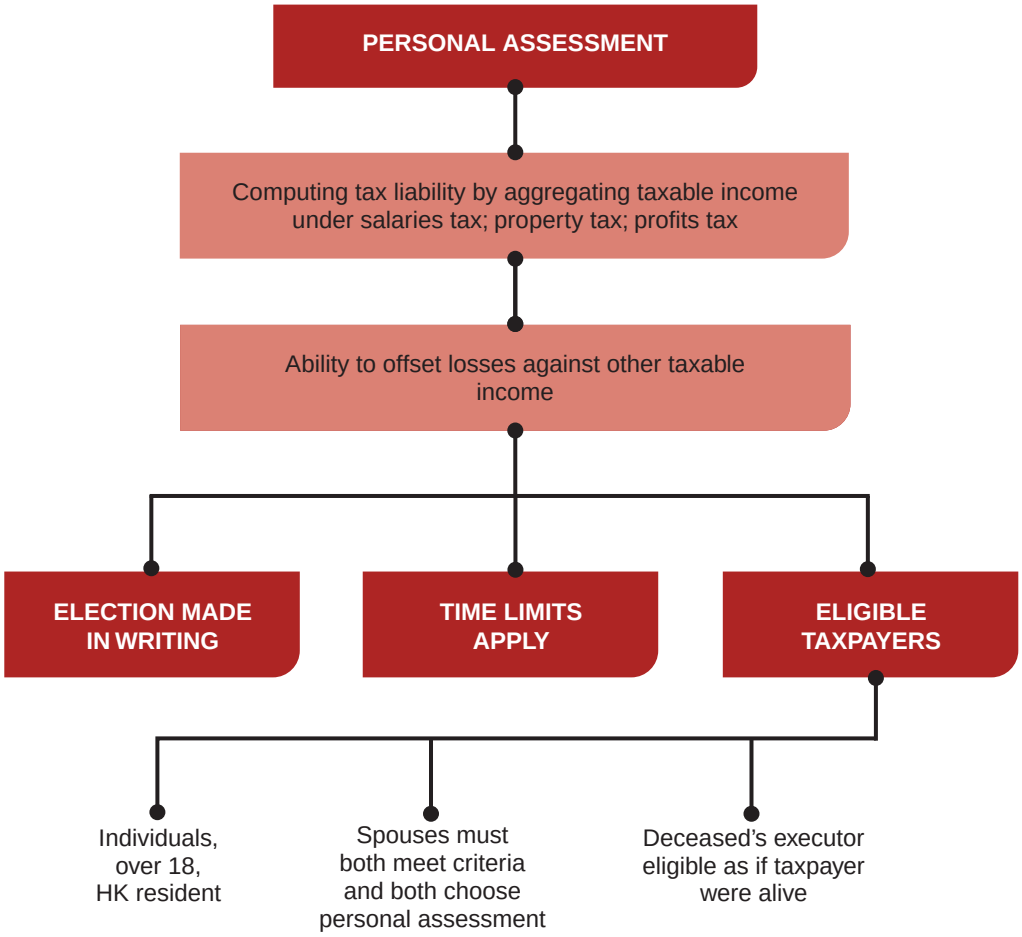
Required

(a) Compute the tax payable by the couple under personal assessment for the year of assessment 2011/12.

(b) Compute the tax payable by the couple with no election for personal assessment for the year of assessment 2011/12.

(The answer is at the end of the chapter)

Topic recap


PERSONAL ASSESSMENT
Computing tax liability by aggregating taxable income under salaries tax; property tax; profits tax
Ability to offset losses against other taxable income
ELECTION MADE IN WRITING
TIME LIMITS APPLY
ELIGIBLE TAXPAYERS
Individuals, over 18, HK resident
Spouses must both meet criteria and both choose personal assessment
Deceased's executor eligible as if taxpayer were alive

Answers to self-test questions

Answer 1

(a) **Assessment Computation – Y/A 2011/12**
Husband and wife

	Note	*Husband*	*Wife*	*Total*
		$	$	$
Net assessable value of Property A		–	200,000	200,000
Net assessable income		450,000	–	450,000
Assessable profits from Business X		–	100,000	100,000
		450,000	300,000	750,000
Less interest on mortgage loan re Property A	1	–	(200,000)	(200,000)
		450,000	100,000	550,000
Less:				
Charitable donations		(100,000)	–	(100,000)
Home loan interest		(50,000)	(50,000)	(100,000)
Allowable losses from Business Y		(50,000)	–	(50,000)
MPF contribution		(12,000)	(12,000)	(24,000)
		238,000	38,000	276,000
Less: Personal allowances				(216,000)
Net chargeable income				60,000
Tax thereon:				
First $40,000 @ 2%				800
Remaining $20,000 @ 7%				1,400
Tax thereon				2,200
Less: 2011/12 tax reduction				(1,650)
				550

Note:

1 Allowable mortgage loan interest is limited to the net assessable value of Property A

The total tax payable will be shared by the couple as follows:

Husband's share of the total tax liability:	$
$550 × 238,000/276,000	474
Wife's share of the total tax liability:	
$550 × 38,000/276,000	76
Total	550

(b) If there is no election for personal assessment, tax payable by the couple for the year of assessment 2011/12 will be computed as follows:

Salaries Tax

Husband

	$
Net assessable income	450,000
Less:	
Charitable donations	(100,000)
Home loan interest (see note below)	(50,000)
MPF Contribution	(12,000)
	288,000
Less: Personal allowances	(216,000)
Net chargeable income	72,000
Tax thereon:	
First $40,000 @ 2%	800
Remaining $32,000 @ 7%	2,240
Tax thereon	3,040
Less: 2011/12 tax reduction	(2,280)
	760

Note: Normally the wife can nominate the husband to claim the mortgage loan interest that she paid. Otherwise the mortgage interest paid by the wife would be wasted. However, as the wife has other business income, s.26F denies her nomination. The amount of deduction is restricted to those paid by the husband.

Property Tax

Wife

Property A:

	$
Net assessable value	200,000
Tax thereon @ 15%	30,000

Profits Tax

Wife

Business X:

	$
Assessable profits	100,000
Less: MPF Contribution	(12,000)
	88,000
Tax thereon @ 15%	13,200

Husband

Business Y:

Allowable losses	(50,000)
Tax thereon	Nil

Total tax liability

$760 + 30,000 + 13,200	43,960

Tax savings from electing for personal assessment

($43,960 – 550)	43,410

Answer 2

(a) **Personal Assessment Computation for the year of assessment 2011/12**

Husband and Wife

	Husband	*Wife*	*Total*
	$	$	$
Net assessable income	400,000	–	400,000
Net assessable value of Property A	–	200,000	200,000
Assessable profits from Business X	–	200,000	200,000
	400,000	400,000	800,000
Less:			
MPF contributions	(12,000)	(12,000)	(24,000)
	388,000	388,000	776,000
Less: Personal allowances			(216,000)
Net chargeable income			560,000
Tax thereon:			
First $40,000 @ 2%			800
Second $40,000 @ 7%			2,800
Third $40,000 @ 12%			4,800
Balance $440,000 @ 17%			74,800
Tax thereon			83,200
Less: 2011/12 tax reduction			(12,000)
			71,200
Husband's share of the total tax liability:			
$71,200 × 388,000/776,000			35,600
Wife's share of the total tax liability:			
$71,200 × 388,000/776,000			35,600
Total			71,200

(b) If there is no election for personal assessment, tax payable by the couple for the year of assessment 2011/12 will be computed as follows:

Salaries Tax

Husband:	$
Net assessable income	400,000
Less: MPF contributions	(12,000)
Less: Personal allowances	(216,000)
Net chargeable income	172,000
Tax thereon	
First $40,000 @ 2%	800
Second $40,000 @ 7%	2,800
Third $40,000 @ 12%	4,800
Balance $52,000 @ 17%	8,840
Tax thereon	17,240
Less: 2011/12 tax reduction	(12,000)
	5,240

Property Tax

Wife

Property A:	
Net assessable value	200,000
Tax thereon @ 15%	30,000

Profits Tax

Wife

Business X:	$
Assessable profits	200,000
Less: MPF contributions	(12,000)
	188,000
Tax thereon @ 15%	28,200

Total tax liability:

$5,240 + 30,000 + 28,200	63,440

Additional tax liability from electing for personal assessment:

$71,200 – 63,440	7,760

The additional tax liability of $7,760 is computed as follows:

	$
Additional tax liability from higher progressive tax rate	
$388,000 × (17% – 15%)	7,760

Based on the above calculations, the couple should not elect for personal assessment as that will result in a higher tax charge on their total income.

Exam practice

Emma Wong — 36 minutes

Emma Wong is a famous pianist in the Mainland. She has immigrated to Hong Kong and would like to set up her music studio providing music lessons to young talents in Hong Kong.

She rented two apartments in Kowloon: one as her family accommodation and the other one as her studio. As she is a famous pianist, many students have signed up for her classes.

For the year of assessment 2008/09, her records revealed the following:

	$
Tuition fees	1,000,000
Rent for apartment	360,000
Rent for studio	600,000
Utilities – studio	10,000
Utilities – apartment	8,000
Travelling – personal	8,000
Domestic helper	3,000
Other personal expenses	200,000
Office expenses – studio	200,000

Required

(a) Explain whether Emma is liable to pay salaries tax or profits tax. **(3 marks)**

(b) Assuming Emma is liable to pay tax in part (a), compute her assessable income / profits for the year of assessment 2010/11. **(3 marks)**

(c) State which of the items (if any) are not deductible and explain. **(2 marks)**

(d) Give suggestions, if any, for Emma to reduce her tax payable (assume Emma needs to pay tax in part (a)). **(2 marks)**

(e) If Emma was invited to perform in London's Albert Hall and received a gratuity for her performance, explain whether such a gratuity would be taxable. Advise whether the cost of travel to the UK, hotel accommodation and miscellaneous expenses would be deductible.

What would be the tax position if Emma recorded her performance in her studio in Hong Kong and the recording was then broadcast in London? **(10 marks)**

(Total = 20 marks)

(HKICPA May 2010 Session)

Ms. Poon 30 minutes

Ms. Poon was a Hong Kong resident and migrated to Canada for more than a decade ago. She returns to Hong Kong to visit her relatives and friends three to four times each year spending about ten days each time. In the year 2009, Ms. Poon acquired a local residential property during her stay in Hong Kong. The purchase consideration was partially settled by her personal savings and partially settled by a mortgage loan from a bank in Hong Kong.

The property was then leased to a tenant, Mr. Chan, under the following terms:

(1) Term of lease : 4 years from 1 July 2009

(2) Monthly rental : HK$18,000 payable in advance on the first day of each month

(3) Rent free period : 1.5 months from 1 July 2009

(4) Premium : HK$36,000 payable on 1 July 2009

(5) Deposit : HK$35,000 payable on 1 July 2009

(6) Rates : HK$3,000 net payment per quarter (after the Rates Concession), payable by Ms. Poon

(7) Management fee : HK$1,500 per month, payable by Ms. Poon

Due to financial difficulties, Mr. Chan has only paid HK$11,000 per month as rental since January 2010 and from April 2010, Mr. Chan did not pay any rent to Ms. Poon at all. Finally, Mr. Chan moved out from the property on 31 July 2010 and cannot be traced anymore (the IRD agreed with Ms. Poon on the irrecoverable rent as bad debt on the same date).

Ms. Poon has become more cautious in the property leasing market and finally she leased the property to another tenant Mr. Cheng for a one year leasing term, with annual rental amount of HK$120,000 fully payable in advance. Rates (after the Rates Concession) and management fee, both in the same amount as last year, are fully payable by Ms. Poon. The new lease was effective on 1 September 2010.

Ms. Poon has incurred HK$55,000 and HK$86,000 mortgage loan interest for the years ended 31 March 2010 and 2011 respectively.

Required:

Discuss under what circumstances an individual deriving taxable rental income can deduct mortgage interest expenses under the IRO, and advise if the circumstances are applicable to Ms. Poon. **(5 marks)**

HKICPA December 2011 (Extract)

Mr. and Mrs. Lip — 32 minutes

Mr. and Mrs. Lip married on 1 October 2011. The following information is provided by them for the year ended 31 March 2012.

(a) Mr. Lip was the Finance Director of a company listed on the Hong Kong Stock Exchange. His total remuneration for the year was $1,350,000. He made a contribution of $12,000 to his Mandatory Provident Fund Scheme.

(b) Mr. Lip resided in a residential flat provided rent free by his employer. The flat was leased directly by his employer at a monthly rent of $45,000.

(c) Mr. Lip had been granted an option to subscribe for 30,000 shares of his employer's shares on 1 May 2011 at the option cost of $6,000 payable to his employer. On 1 August 2011 he assigned one third of the share option to his colleague at the consideration of $20,000, subsequent to the approval obtained from his employer on the assignment. He exercised another one third of the option on 1 December 2011 at the option exercise price of $2 per share, whilst on the same day the remaining one third of the share option right was released back to his employer at the consideration of $100,000. He sold all the shares obtained from exercising the option on 1 March 2012. The market value of the share was $5 on 1 May 2011, $6 on 1 August 2011, $7 on 1 December 2011 and $8 on 1 March 2012.

(d) Mrs. Lip did not have any full-time or part-time employment during the year. Instead, she carried on a beauty salon business with her sister in the form of a partnership with profit or loss to be shared on an equal basis. The tax loss sustained by the partnership and attributable to Mrs. Lip for the year and agreed by the IRD was $150,000.

(e) Mrs. Lip has acquired a residential property and has leased it out to generate rental income for a number of years. A new tenancy agreement was entered into and commenced on 1 April 2011 at $12,000 per month with one month rent free period in April 2011. Rates of $1,800 per quarter were paid by Mrs. Lip. During the year Mrs. Lip incurred $165,000 mortgage loan interest for the abovesaid property.

(f) Mrs. Lip donated $10,000 to the Community Chest during the year, and enrolled in an MBA course at a local university and paid $65,000 in school fees for the year. Mr. Lip had been constantly living with his mother for many years. Unfortunately, his mother passed away on 1 February 2012 at the age of 75. Mr. Lip's father was 78 years old and lived in an elderly residential care home. Mr. Lip incurred $86,000 residential care expenses for the year.

Required

(a) Calculate the net assessable income of Mr. Lip for the year of assessment 2011/12.

(5 marks)

(b) Calculate the net assessable value of the property owned by Mrs. Lip for the year of assessment 2011/12. **(3 marks)**

(c) Calculate the Hong Kong tax liabilities of Mr. and Mrs. Lip under personal assessment for the year of assessment 2011/12. Ignore the 2011/12 tax reduction and 2012/13 provisional tax in your calculation. **(9 marks)**

(Total = 17 marks)

HKICPA December 2012

Further reading

Suggested References

When studying this topic we suggest the following references:

Primary References

Advanced Taxation in Hong Kong, Pearson (Chapter 19 – Personal Assessment)

Hong Kong Master Tax Guide, CCH Hong Kong Ltd (Chapter 4 – Personal Assessment)

Hong Kong Taxation – Law and Practice, The Chinese University Press (Chapter 6 – Personal Assessment)

Hong Kong Taxation and Tax Planning, Pilot Publishing Co Ltd (Chapters 32 and 33)

Inland Revenue Ordinance (Part VII, IVA)

DIPN 18 (Revised) Assessment of individuals under salaries tax and personal assessment

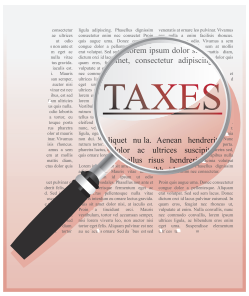
Supplementary Reference

Hong Kong Tax Manual, CCH Hong Kong Ltd (Para 28 – Personal Assessment)

Part D

Stamp duty

Stamp duty is levied under the Stamp Duty Ordinance. While the other three taxes charge on different incomes, stamp duty is a document tax. It is important to be familiar with all the heads of charge, including the sub-heads. The recent hefty increase in property prices in Hong Kong makes stamp duty an increasingly important source of revenue for the Hong Kong government. In fact, stamp duty is sometimes used as an instrument to curb speculation in real property, although with doubtful effect.



chapter 8

Hong Kong stamp duty

Topic list

Learning focus

You should understand thoroughly the scope of the stamp duty charge and the exemptions and reliefs available. In particular, you should be familiar with the various sub-heads of the stamp duty charge on instruments in relation to both immovable property in Hong Kong and Hong Kong stock. It is also important to know when adjudication is required and the treatment of voluntary disposition *inter vivos*. The important group relief under s.45 of the Stamp Duty Ordinance and its conditions should be well understood.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Describe the key aspects of the tax system in Hong Kong		
1.05	**Duties and liabilities of a taxpayer or his agent or an executor**	2
1.05.01	Explain the duties and liabilities of a taxpayer, his agent or an executor under the IRO and the SDO	
Stamp duty		
2.30	**Scope of charge**	2
2.30.01	Identify relevant heads of stamp duty charge	
2.31	**Conveyance on sale of immovable property**	3
2.31.01	Explain the stamping requirements and practices in relation to conveyance on sale of immovable property in Hong Kong and compute the relevant stamp duty payable	
2.32	**Agreement for sale of residential immovable property**	3
2.32.01	Explain the stamping requirements and practices in relation to agreement for sale of residential immovable property and compute the relevant stamp duty payable	
2.32.02	Explain and apply SOIPN 1, 3, 4 and 5	
2.33	**Lease of immovable property**	3
2.33.01	Explain the stamping requirements and practices in relation to lease of immovable property in Hong Kong and compute the relevant stamp duty payable	
2.34	**Hong Kong stock**	3
2.34.01	Explain the stamping requirements and practices in relation to Hong Kong stock and compute the relevant stamp duty payable	
2.35	**Voluntary disposition inter vivos**	3
2.35.01	Explain the stamp duty implication for voluntary disposition *inter vivos*	
2.36	**Exemptions and reliefs**	3
2.36.01	Explain the exemptions and reliefs available under the SDO	
2.36.02	Outline the *Arrowtown* case and explain its significance	
2.37	**Adjudication, assessment and administration**	2
2.37.01	Describe the administration issues concerning stamp duty	
2.37.02	Explain the adjudication and appeal procedures for stamp duty assessment	
2.37.03	Describe stamp duty offence and related penalty provisions under the SDO	
2.38	**Stamp duty planning**	3
2.38.01	Identify stamp duty planning opportunities	

1 Overview of stamp duty

Topic highlights

Stamp duty is a tax on **instruments** or **documents** levied under the **Stamp Duty Ordinance (Chapter 117) ('SDO')**. The SDO is made up of nine parts with ss.1 to 68 and five schedules. In this chapter, all references to statutory provisions are references to the SDO unless otherwise stated. The SDO is administered by the Stamp Office which is a part of the IRD, and the officer in charge is the Collector of Stamp Revenue ('the Collector') who is also the Commissioner. With the growth of e-commerce, the Government has also introduced an alternative way of stamping certain instruments in the form of an electronic record.

An 'instrument' is defined in s.2 as including 'every written document'. Provided that an instrument falls within one of the following Heads of charge, it will be stampable, whether or not that instrument was executed in or outside Hong Kong:

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

Theoretically, stamp duty is levied on instruments or documents, not on transactions. If a transaction can be effected verbally or by conduct, no stamp duty is chargeable. However, for some of the transactions which are not effected by an instrument or a document, there are provisions under the SDO or other Ordinances requiring a document to be made for stamping. For example,

(a) all conveyance of land/buildings must be by way of deed;

(b) a sale and purchase agreement of immovable property must be evidenced in writing.

(c) a lease of immovable property for a period exceeding three years must be in writing.

(d) in the case of sale and purchase of Hong Kong stock, the buyer and the seller or their brokers are required under s.19 to execute contract notes (sold note for the seller, bought note for the buyer) for stamping.

Section 19 also deems a verbal agreement to transfer the beneficial interest in Hong Kong stock, other than by sale and purchase, to be a sale and purchase of Hong Kong stock and the parties to the transaction are required to execute contract notes, which are chargeable to stamp duty. Even if the required document is not made, liability to stamp duty is still recoverable by the Collector.

Stamp duty may either be fixed (e.g. $5 for a duplicate under Head 4) or *ad valorem* (e.g. 0.2% on contract notes, based on the value of stock transferred under Head 2).

The Stamp Office is not responsible for ascertaining the legality of any document or instrument before stamping. An illegal document (e.g. a lease agreement for subletting a flat owned by the Housing Authority) may still be stamped. On the other hand, instruments not properly stamped will not be acted upon, filed or registered by any public officer or body corporate.

To deter speculations in the residential property market, the stamp duty rate for property transactions valued more than $20 million was increased to 4.25%. In addition, no deferred payment of stamp duty will be granted for chargeable agreement for sale ('AFS') of residential property with a consideration exceeding $20 million (both amendments are effective from 1 April 2010). With effect from 30 June 2011, this anti-speculation measure is further extended to all residential properties. This is further discussed in **section 3.2** on 'Agreement for sale'.

To further discourage speculation in residential properties, a special stamp duty ('SSD') was proposed by the Financial Secretary in November 2010 and the Stamp Duty (Amendment) Ordinance 2011 was enacted on 30 June 2011 to give effect to the proposal. This is discussed in **section 3.3** on 'Special stamp duty'.

2 Scope of charge

Topic highlights

Stamp duty is charged on instruments specified in the First Schedule under the four Heads of charges:

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

An instrument must be stamped for its leading and principal object. If a chargeable instrument contains separate and distinct matters, such matters will be separately stamped as if they were separate instruments under more than one Head.

The place of execution of the instruments does not affect the chargeability to stamp duty. It only affects the time of stamping: s.10(2).

2.1 Chargeable instruments

The following instruments are chargeable:

Head	Instrument	Stamp duty
1 (1)	Conveyance on sale	$100 or 0.75 – 4.25% on the higher of consideration and market value
1 (1AA)	Conveyance on sale chargeable with SSD	5% – 15% on the higher of consideration and market value
1 (1A)	AFS of residential property	$100 or 0.75 – 4.25% on the higher of consideration and market value
1 (1B)	AFS chargeable with SSD	5% – 15% on the higher of consideration and market value
1(2)	Lease of immovable property:	
	With premium only	Same as conveyance on sale ($100 or 0.75 – 4.25% on the higher of consideration and market price)
	With premium and/or rent	4.25% on premium and/or
	Lease term not specified	0.25 % on average yearly rent, or
	Lease term ≤ 1 year	0.25 % on total rent payable, or
	Lease term > 1 year but ≤ 3 years	0.5% on average yearly rent, or
	Lease term > 3 years	1% on average yearly rent
	An agreement for lease executed in pursuance of a duly stamped AFS	$3
2(1)	Contract note, not jobbing business	0.2% (0.1% on bought note, 0.1% on sold note)
2(2)	Contract note, jobbing business	$5
2(3)	Instrument of transfer for voluntary disposition *inter vivos*	$5 + 0.2% on value of stock

Head	Instrument	Stamp duty
2(4)	Instrument of transfer of any other kind	$5
3(1)	Hong Kong bearer instrument	3% on market value
3(2)	Instrument in substitution for duly stamped instrument under Head 3(1)	$5
4	Duplicates and counterparts of any chargeable instrument	$5

2.2 Substance over form

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

For example, both a lease and a license give the tenant and licensee a right to occupy an immovable property. However, a lease provides the tenant an exclusive right of possession while a license agreement provides the licensee a right of occupation which may be revoked by the licensor at will (e.g. the right of a hotel guest). As a lease is a stampable instrument under Head 1(2) but a licence agreement is not, to avoid stamp duty, a duty-payer may label an agreement which grants an exclusive right of possession as a license. In such circumstances, the Collector will ignore the label and stamp the agreement as a lease.

2.3 Stampable consideration

Stamp duty is levied on the value of consideration which may be made up of money, money's worth, debts assigned or waived, securities, commodities or services performed. If stated consideration is less than the market value of the immovable property or stock transferred, stamp duty is chargeable on the market value. Hence, the stampable value of

(a) immovable property is based on the market value of the property free from any encumbrance;

(b) stock is based on the net asset value of the stock determined with reference to the latest accounts of the company and market value of the assets at the time of transfer.

If there is no stated consideration, the instrument is regarded as a voluntary disposition *inter vivos* (i.e. a gift made during lifetime); and stamp duty is chargeable on the market value of the immovable property or stock transferred (see **section 7** on Voluntary disposition *inter vivos*).

2.3.1 Consideration consisting of stock

Pursuant to s.22(1), where the consideration or any part of the consideration for a conveyance on sale consists of any stock, stamp duty is chargeable by reference to the value of the stock on the date of conveyance or transfer.

2.3.2 Consideration consisting of security not being stock

Pursuant to s.22(2), where the consideration or any part of the consideration for a conveyance on sale consists of any security not being stock, stamp duty is chargeable by reference to the amount due on the date of conveyance or transfer for the principal and interest upon the security.

2.3.3 Consideration consisting of debts payable by the transferee

Section 24(1) provides that debts, including contingent ones, payable by the transferee are treated as part of the consideration for a conveyance of immovable property or transfer of stock that is chargeable to stamp duty.

2.3.4 Consideration in the form of debts waived

Under s.24(1), debts waived by the transferee are treated as part of the consideration for a conveyance of immovable property or transfer of stock. If the debt consideration exceeds the value of the property conveyed or stock transferred, stamp duty is chargeable based on the higher amount of the debt to be settled by the immovable property or stock. However, pursuant to s.24(2), the person liable for the stamp duty may apply to have the stamp duty payable based on the lower value of the immovable property or stock. In such case, the chargeable instrument (the conveyance or contract note) has to be adjudicated (see **section 9.3** on 'Adjudication').

Example 1

A owes B $5 million and is in financial difficulties. The parties agree that A will assign to B his immovable property with a value of $4.5 million as full settlement of the debt.

Stamp duty payable on the conveyance will be based on $5 million. However, the duty-payer may apply to the Collector to have the stamp duty payable based on the value of the property of $4.5 million.

2.3.5 Consideration in the form of debts assigned

Pursuant to s.24(3), when there is a transfer of a beneficial interest in a body corporate and the transferee will incur liability in respect of any indebtedness of the body corporate, the amount of the indebtedness will form part of the consideration for the transfer.

Example 2

C owns a property with a market value of $5 million and an outstanding mortgage of $2 million. D agrees to acquire the property by paying C $3 million and settling the $2 million liability.

Stamp duty payable on the conveyance will be based on $5 million, being cash plus value of the debt.

SOIPN 3 (para 21) provides guidance on deemed consideration under s.24 and examples as to the practical application of s.24.

2.3.6 Consideration consisting of periodic payments

If consideration consists of periodic payments, stamp duty is charged under s.23 as follows:

Consideration consisting of periodic payments	Stamp duty
Payable for a definite period not exceeding 20 years	Stamp duty chargeable by reference to the total amount payable
Payable for a definite period exceeding 20 years or in perpetuity or for any indefinite period not terminable with life	Stamp duty chargeable by reference to an amount equal to the total amount which will or may, according to the terms of sale, be payable during the period of 20 years after the date of the conveyance or contract note
Payable periodically for a life or lives	Stamp duty chargeable by reference to an amount equal to the total amount which will or may, according to the terms of sale, be payable during the period of 12 years after the date of the conveyance or contract note

2.3.7 Consideration expressed in foreign currency

For the purpose of calculating the stampable value, the consideration is translated into Hong Kong dollars at the rate of exchange prevailing on the date of the instrument. As defined in s.18(2), the 'rate of exchange' means the buying rate for the currency in question, as determined by the Monetary Authority, for telegraphic transfers at the commencement of business on the date of the instrument or, if that date is a Sunday or a general holiday, on the business day immediately preceding that date.

2.3.8 Contingency principle

Stamp duty is assessed on the basis of the circumstances prevailing at the time an instrument is executed. Liability to stamp duty cannot be altered or affected by events subsequent to the execution. The so-called 'contingency principle' applies as follows:

(a) If the consideration under an instrument is unascertainable at the time of execution, no stamp duty can be assessed.

(b) If the consideration is uncertain but the instrument contains a clause on the amounts of maximum and minimum consideration payable, stamp duty is assessed on the **maximum** amount payable. Any duty paid will not be refunded even though the consideration payable at a later date is less than the maximum amount stated.

(c) If the consideration is uncertain but the instrument contains a clause on the amount of minimum consideration payable, stamp duty is assessed on the **minimum** amount payable. Further duty cannot be assessed even though the consideration payable at a later date is more than the minimum amount stated.

Example 3

E lets a shop to a boutique owner under a lease for a term of three years, for a monthly rental of $10,000 plus 10% of the monthly turnover of the boutique.

(a) If there is no agreed maximum or minimum rental, stamp duty is assessed on the amount that is ascertainable at the time of execution, i.e. monthly rental of $10,000. Stamp duty payable is therefore 0.5% of average yearly rent, i.e. $600 ($10,000 × 12 × 0.5%) (see **section 3.4.2** on 'Lease with premium and/or rent').

(b) If there are agreed maximum monthly rental of $60,000 and minimum monthly rental of $30,000, stamp duty is assessed on the maximum amount payable, i.e. monthly rental of $60,000. Stamp duty payable is therefore 0.5% of average yearly rent, i.e. $3,600 ($60,000 × 12 × 0.5%).

(c) If there is no maximum monthly rental but a minimum monthly rental of $30,000, stamp duty is assessed on the minimum amount payable, i.e. monthly rental of $30,000. Stamp duty payable is therefore 0.5% of average yearly rent, i.e. $1,800 ($30,000 × 12 × 0.5%).

3 Immovable property in Hong Kong (Head 1)

Topic highlights

The stamping of immovable property is governed by Head 1 in the First Schedule:

Head 1	Immovable property in Hong Kong
1(1)	Conveyance on sale
1(1AA)	Conveyance on sale chargeable with SSD
1(1A)	Agreement for sale
1(1B)	Agreement for sale chargeable with SSD
1(2)	Lease

In accordance with s.3 of the Interpretation and General Clauses Ordinance, 'immovable property' means:

(a) land, whether covered by water or not;

(b) any estate, right, interest or easement in or over land; and

(c) things attached to land or permanently fastened to anything attached to land.

The definition includes both tangible land and buildings and intangible rights in or over any land and buildings.

There are normally three instruments involved in the sale of immovable property, namely a provisional (temporary) AFS, a formal AFS and a conveyance on sale. Typically the provisional AFS (or the formal AFS if it is executed within 14 days of signing the provisional AFS) of a residential property is subject to ad valorem rates of stamp duty while the conveyance on sale (if it is executed in conformity with the duly stamped AFS) is subject to stamp duty of $100. On the other hand, for non-residential property, it is the conveyance on sale which is subject to ad valorem rates of stamp duty.

3.1 Conveyance on sale (Head 1(1))

'Conveyance' is defined in s.2(1) to mean 'every instrument (including a surrender) and every decree or order of any court whereby any immovable property is transferred to or vested in any person'.

'Conveyance on sale' is also defined in s.2(1) to mean 'every conveyance whereby any immovable property, upon the sale thereof, is transferred to or vested in a purchaser or any other person on his behalf or by his direction, and includes a foreclosure order'. This definition is considered to be wide enough to cover release and renunciations relating to immovable property. However, not every conveyance is a conveyance on sale, e.g. a mortgage document or other legal charge over immovable property; and no stamp duty is payable if it is not.

The following instruments are chargeable under Head 1(1):

(a) **Deed of assignment** for the sale and purchase of immovable property.

(b) **Deed of gift** of immovable property or conveyance operating as a voluntary disposition *inter vivos*. Stamp duty is chargeable on the market value of the property: s.27(1).

(c) **Foreclosure order** relating to immovable property whereby the mortgaged property is conveyed to the mortgagee (the lender which is usually the bank) as the mortgagor (the borrower) is unable to repay the debt. Foreclosure is the process by which the right of a mortgagor to redeem the mortgaged property is terminated, and the mortgagee becomes the owner of the mortgaged property at law and at equity. A foreclosure order must be granted by court decree.

(d) **Deed of exchange** for the exchange of immovable property. By virtue of ss.25(7) and 27, stamp duty is chargeable on any consideration paid or given for equality (i.e. equality money paid by one owner to the other owner) or the difference between the values of the exchanged properties, whichever is the higher.

(e) **Deed of partition** in relation to immovable property. By virtue of ss.25(7) and 27, stamp duty is chargeable on any consideration paid or given for equality or the difference between the values of the partitioned properties, whichever is the higher.

(f) **Deed of family arrangement** whereby a beneficiary takes immovable property in satisfaction of his pecuniary legacy.

The ad valorem rates of stamp duty on conveyance on sale of immovable property are as follows:

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 plus 10% of the excess over $3,000,000
$3,290,321 – $4,000,000	2.25%
$4,000,001 – $4,428,570	$90,000 plus 10% of the excess over $4,000,000
$4,428,571 – $6,000,000	3%
$6,000,001 – $6,720,000	$180,000 plus 10% of the excess over $6,000,000
$6,720,001 – $20,000,000	3.75%
$20,000,001 – $21,739,120	$750,000 plus 10% of the excess over $20,000,000
Over $21,739,120	4.25%

As an anti-avoidance measure, if a duty-payer wishes to enjoy the progressive rates rather than the maximum rate of 4.25%, he or she must include in the conveyance on sale a s.29 certificate stating that the transaction does not form part of a larger transaction or a series of transactions, in respect of which the aggregate consideration or value exceeds the amount for that progressive rate.

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, and no provisional AFS was entered into before that date (see **section 3.3** for details on SSD).

Example 4

F executed a deed of gift to transfer an immovable property to his son. The market value of the property on the date of transfer to the son was $5.3 million.

The deed of gift is the chargeable instrument. Stamp duty payable will be based on the market value on the date of transfer, $5.3 million at 3%, i.e. $159,000.

Example 5

F died on 31 January 2013. By his will he bequested cash of $3 million to his daughter, who preferred to take F's residence in lieu of the pecuniary legacy. The market values of the residential property on the date of F's death and the date of transfer to the daughter were $2.7 million and $2.8 million, respectively.

The deed of family arrangement is the chargeable instrument. Stamp duty payable will be based on the market value on the date of transfer, $2.8 million at 1.5%, i.e. $42,000.

Example 6

G and H agree to exchange their flats. G's flat is valued at $10 million and H's flat is valued at $8 million. H agrees to pay G $1.8 million to effect the exchange.

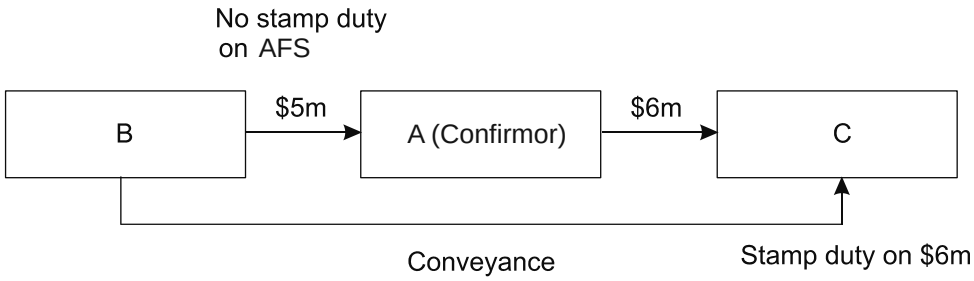
The deed of exchange is the chargeable instrument. Stamp duty payable will be based on the higher of the equality money and the difference between the values of the exchanged properties, i.e. $2 million ($10m - $8m). Stamp duty payable is therefore $100.

3.2 Agreement for sale (Head 1(1A))

Before the introduction of stamp duty on an AFS of residential property, property speculators were able to obtain large and mostly untaxed profits from the residential property market by acting as confirmors.

Example 7

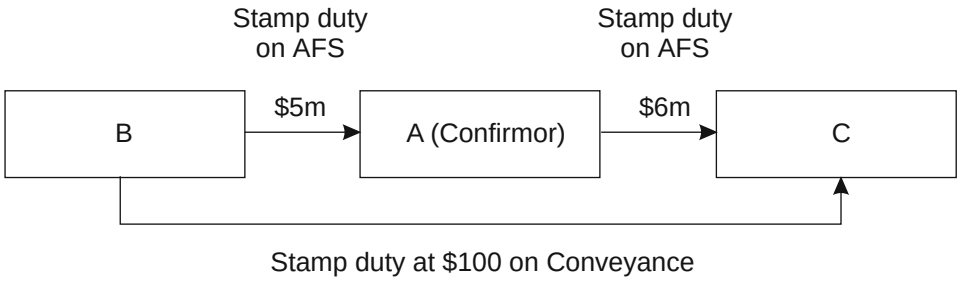
A acquired a property from B at $5 million and sold it to C for $6 million before conveyance. Stamp duty at 3% would only be imposed on $6 million, being the consideration paid by C when the property was conveyed to him from B. A was able to earn $1 million free of encumbrances.



To deter speculations in the residential property market, provisions were introduced to the SDO with effect from 31 January 1992 to impose stamp duty on AFS of residential property.

Example 8

A agreed to purchase a residential property from B at $5 million and sold it to C for $6 million before conveyance. A needs to pay stamp duty at 3% on $5 million on the AFS; and C needs to pay stamp duty at 3% on $6 million on the AFS. Stamp duty payable on the conveyance on sale between B and C executed in conformity with the duly stamped AFS will be $100.



3.2.1 Stamp duty on AFS of residential property

In accordance with the provisions in Part IIIA, each purchaser and vendor who enters into an agreement (written or unwritten) for the sale and purchase of immovable property (residential and non-residential) is required to execute an AFS containing a variety of specified matters. The matters which must be set out in the AFS are (s.29B(5)):

(a) the names and addresses of the vendor and purchaser;

(b) the Certificate of Identity or passport numbers of the vendor and purchaser, where applicable;

(c) the business registration numbers of the vendor and purchaser, where applicable;

(d) the description and location of the property;

(e) a statement as to whether the property is a residential or non-residential property;

(f) the date on which the AFS was made;

(g) if the AFS was preceded by an unwritten sale agreement or an AFS made between the same parties and on the same terms, the date on which the first such agreement was made;

(h) a statement as to whether or not a date for conveyance has been fixed and if so, the date;

(i) a statement as to whether or not the consideration has been agreed to and if so, the amount of consideration;

(j) the amount or value of any other consideration paid or given to any other person, together with the identification details of that person and a description of the benefit to which the consideration relates; and

(k) if the purchaser has not executed the AFS, a statement as to whether or not the purchaser knew that the AFS affected him.

The terms 'residential property' and 'non-residential property' are defined in s.29A(1) as follows:

(a) **Residential property** means immovable property other than non-residential property.

(b) **Non-residential property** means immovable property which may not be used at any time for residential purposes under the existing conditions of:

(i) a Government lease or an agreement for a Government lease;

(ii) a deed of mutual covenant, within the meaning of s.2 of the Building Management Ordinance;

(iii) an occupation permit issued under s.21 of the Buildings Ordinance; or

(iv) any other instrument which, the Collector is satisfied, effectively restricts the permitted use of the property.

It should be noted that the classification of the property (residential or non-residential) is by reference to the permitted use rather than the actual use.

'Agreement for sale' is defined in s.29A(1) to mean:

(a) an instrument in which a person contracts to sell or purchase immovable property;

(b) an instrument conferring an option or a right to purchase immovable property, or a right of pre-emption in respect of immovable property, other than a specified option or right;

(c) an instrument, other than a mortgage or charge made in favour of a FI, that:

(i) gives a person a power of attorney, with authority to dispose of any interest of the donor in immovable property; or

(ii) grants to a person an authority to sell or dispose of any interest of the grantor in immovable property;

(d) an instrument in which a declaration of trust in respect of immovable property is made, other than where no beneficial interest is to pass under the trust;

(e) an instrument that would be implemented by a conveyance on sale;

(f) an instrument constituting a memorandum, note, or other evidence of an unwritten sale agreement;

(g) an instrument in which a purchaser under another instrument assigns rights in respect of immovable property under the other instrument; and

(h) an instrument in which a purchaser under another instrument makes a nomination or gives a direction that:

(i) transfers any benefit in respect of immovable property of the purchaser under the other instrument; or