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## **QP Module D - Taxation**

# **Module Preparation Seminar (Part II)**

## **Seminar Handout**

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## Topic 1.1: Capital Receipt vs Revenue Receipt

| Fixed Capital  | Circulation Capital   |
|--|---|
| When a person keeps it for his possession, he makes profits.<br><i>e.g. plant and machinery</i>                          | When a person parts with it, he earns profits.<br><i>e.g. trading stock</i>                                   |
| Sale of capital assets – Not taxable<br><i>e.g. sale of motor car by a restaurant owner (motor car is capital asset)</i> | Sale of revenue assets – Taxable<br><i>e.g. sale of motor car by a car dealer (motor car = trading stock)</i> |

### Examples on Receipts:

|     | Capital Nature (i.e. not taxable)   | Revenue Nature (i.e. taxable)  |
|-----|---|--|
| (1) | Sums received for permanent loss or destruction of a fixed asset<br><i>e.g. Insurance compensation for loss of a business-use motor car in an accident</i>  | Sum received for the temporary loss of use of a capital asset and payment for loss of profit<br><i>e.g. Insurance compensation for rental of a motor car while the delivery van damaged in an accident is under repairs.</i> |
| (2) | Sums received for repairable damaged to a fixed asset<br><i>(Note: But the sums should be used to set off against actual cost of repair)</i><br><i>e.g. Insurance compensation for the repair cost of a business-use motor car damaged in an accident</i> |  |
| (3) |   | Sums received from loss of trading stock<br><i>e.g. Insurance compensation to a car dealer for loss of a motor car in transit</i>  |
| (4) | Sums received from cancellation of contract which leads to the failure of the whole business  | Sums received from cancellation of a trade contract/ agency contract   |
| (5) | Sums received from compensation for restrictions which the recipient would otherwise be entitled to do  |  |
| (6) | Sums received for exchange difference arising from capital assets<br><i>e.g. exchange gain on conversion of bank accounts</i>   | Sums received for exchange difference arising from revenue (circulating) assets<br><i>e.g. exchange gain arising upon settlement of trade debts</i>  |

## Topic 1.2: Capital Expenditure vs Revenue Expenditure

| Fixed Capital   | Circulation Capital   |
|---|---|
| When a person keeps it for his possession, he makes profits.<br><b>e.g. plant and machinery</b>                                   | When a person parts with it, he earns profits.<br><b>e.g. trading stock</b>   |
| Purchase of capital assets – Not deductible<br><b>e.g. purchase cost of motor car by a restaurant (motor car = capital asset)</b> | Purchase of revenue assets – Deductible<br><b>e.g. purchase cost of motor car by a car dealer (motor car = trading stock)</b> |

### Examples on Expenditures:

|     | Capital Nature (i.e. not deductible)  | Revenue Nature (i.e. deductible)   |
|-----|---|--|
| (1) | Lump sum payment (once and for all) that bringing into existence an asset or advantage for the enduring benefit of the trade<br><b>e.g. acquisition of a trade mark</b>   | Lump sum payment to dispense with a continuing revenue expense (which does not create any new tangible asset)<br><b>e.g. license fee for use of a trade mark</b> |
| (2) | Cost of acquiring raw material in its natural state<br><b>e.g. acquisition of a forest</b>  | Cost of acquiring raw material as trading stock<br><b>e.g. acquisition of wood as trading stock</b>  |
| (3) | Cost of replacing by an entire new asset and the cost of construction of an alternative or improved part of an asset<br><i>(Note: Where an expenditure includes both repair and improvement, no allowance should be made for the hypothetical repair)</i> | Cost of replacing part of an asset   |
| (4) | Compensation to director / employee if it creates new benefits<br><b>e.g. compensation for not to compete</b>   | Payment to get rid of an unsatisfactory director / employee<br><b>e.g. payment in lieu of notice</b>   |
| (5) | Sums paid for cancellation of contract which is of capital nature   | Sums received from cancellation of a trade contract/ agency contract   |
| (6) | Sums paid for exchange difference arising from capital assets<br><b>e.g. exchange loss on conversion of bank accounts</b>   | Sums paid for exchange difference arising from revenue (circulating) assets<br><b>e.g. exchange loss arising upon settlement of trade debts</b>                  |

## Topic 2: Common profits tax deduction items

### General Deductions

|                    |  |
|--------------------|--|
| <b>s.16(1)</b>     | All outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by person in the production of profits chargeable to profits tax for any period.   |
| <b>s.16(1)(a)</b>  | Interest on any money borrowed for the purpose of producing such profits, and sums payable by such person by way of legal fees, procurator fees, stamp duties and other expenses in connection with such borrowing.  |
| <b>s.16(1)(b)</b>  | Rent paid of land or buildings occupied for the purpose of producing such profits.   |
| <b>s.16(1)(c)</b>  | Tax of substantially the same nature as HK profits tax been paid in respect of profits chargeable to tax by virtue of section 15(1)(f), (g), (i), (ia), (j), (k), (l) or (la).   |
| <b>s.16(1)(d)</b>  | (1) Bad debts incurred, proved to the satisfaction of the assessor to have become bad during the basis period,<br>(2) Doubtful debts to the extent that they are respectively estimated to the satisfaction of the assessor to have become bad during the basis period, limited to debts which were included as a trading receipt in ascertaining the profits chargeable to profits tax,<br>or<br>(3) Debts in respect of money lent, in the ordinary course of the business of the lending of money within Hong Kong, by a person who carries on that business. |
| <b>s.16(1)(e)</b>  | Expenditure incurred in the repair of any premises, plant, machinery, implement, utensil or article employed in the production of such profits.  |
| <b>s.16(1)(f)</b>  | Expenditure incurred in the replacement of any implement, utensil or article employed in the production of such profits.   |
| <b>s.16(1)(g)</b>  | Notwithstanding section 17, a sum expended for the registration of a trade mark or design, or the registration or grant of a patent, used in the trade, profession or business which produces such profits.  |
| <b>s.16(1)(ga)</b> | The payments and expenditure specified in s.16AA, s.16B, s.16C, s.16E, s.16EA, s.16F, s.16G and s.16I.   |
| <b>s.16(1)(h)</b>  | such other deductions as may be prescribed by any rule made under this Ordinance   |

**Special Deductions**

|                         |   |
|-------------------------|---|
| <b>s.16A &amp; 16AA</b> | Special Payment on MPF/ORSO; MPF(MC) on self-employment case        |
| <b>s.16B</b>            | Expenditure on Research & Development                               |
| <b>s.16C</b>            | Payment for Technical Education                                     |
| <b>s.16D</b>            | Approved Charitable Donation  |
| <b>s.16E</b>            | Expenditure on Patent / Know-how right                              |
| <b>s.16EA-16EC</b>      | Expenditure on Copyright / Registered design / Registered trademark |
| <b>s.16F</b>            | Expenditure on Building Refurbishment                               |
| <b>s.16G</b>            | Expenditure on Prescribed Fixed Assets                              |
| <b>s.16H-K</b>          | Expenditure on Environmental Protection Facilities                  |

**Capital Allowance**

|                      |   |
|----------------------|---|
| <b>s.36 to39</b>     | Depreciation Allowance (Pooling system) |
| <b>s.34 &amp; 35</b> | Industrial Building Allowance           |
| <b>s.33 &amp; 35</b> | Commercial Building Allowance           |

## Topic 3: Loss Relief

### S.19C(1) – Loss Relief for Sole Proprietorship

Where in any year of assessment an individual sustains a loss in any trade, profession or business and the individual does not elect for personal assessment, the amount of that loss shall be carried forward and set off against the amount of his assessable profits from that trade, profession or business for subsequent years of assessment.

### S.19C(2) – Loss Relief for Partnership

Where in any year of assessment an individual incurs a share of a loss of a partnership in any trade, profession or business and the individual does not elect for personal assessment, the amount of that share of the loss shall be carried forward and set off against the amount of his share of assessable profits of the partnership from that trade, profession or business for subsequent years of assessment.

### s.19C(3) – if Personal Assessment is elected

Where in any year of assessment an individual has sustained a loss or has incurred a share of a loss of a partnership and is personally assessed, the amount of the loss or share of the loss shall be dealt with under Personal Assessment.

### s.19C(4) – Loss Relief for Corporation

Where in any year of assessment a corporation or persons (who is not an individual, a partnership or a corporation, carrying on a trade, profession or business) sustains a loss in that trade, profession or business, the amount of that loss shall be set off against the assessable profits of the corporation or person (including its share of the assessable profits of a partnership in which it is a partner) for that year of assessment.

And to the extent not so set off, shall be carried forward and set off against the corporation's or the person's assessable profits and its share of assessable profits of such a partnership for subsequent years of assessment.

### S.19C(5) – Loss Relief for a Corporate Partner

Where a corporation or a person (who is not an individual, a partnership or a corporation) is a partner of a partnership and in any year of assessment a loss is incurred in that trade, profession or business, then the corporation's or the person's share of that loss shall be set off against the assessable profits of the corporation or the person for the year of assessment in which the loss was incurred.

And to the extent not so set off, shall be carried forward and, for subsequent years of assessment, be set off first against the corporation's or the person's share of the assessable profits of such partnership and, to the extent not so set off, then against the assessable profits of the corporation or the person.

**s.19C(6) – Conditions for Loss Relief**

- (a) the amount of any loss set off in computing the assessable profits for any year of assessment shall not be set off in computing the assessable profits for any other year of assessment;
- (b) the amount of any loss carried forward to any year of assessment to be set off against the assessable profits for that year shall not be set off more than once in that year of assessment;
- (c) the total amount set off against assessable profits shall not exceed the amount of the loss;
- (d) the amount of any loss to be set off under this section shall be the loss attributable to activities in Hong Kong;
- (e) the amount of any loss sustained in any trade, profession or business carried on for the benefit of a trust by a person in his capacity as trustee shall not be available for set off except against the assessable profits of that trust from that trade, profession or business for subsequent years of assessment.



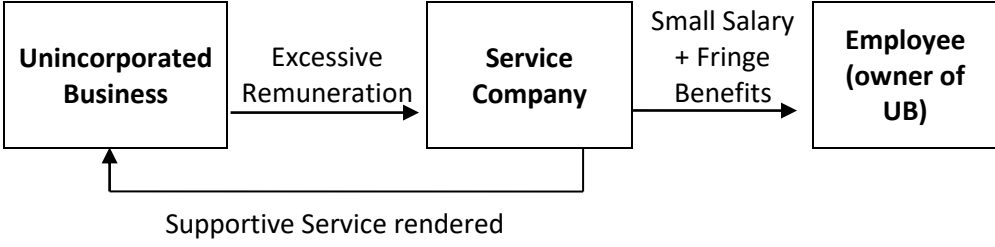
## **Topic 4: Profits Tax implication on transaction with non-resident persons**

| IRO /<br>DIPN |   |
|---------------|---|
| <b>s.20</b>   | <p>Where a non-resident person (NR)</p> <ul style="list-style-type: none"> <li>- carries on business with a resident person (R) who is <b><u>closely connected</u></b>; and</li> <li>- the <b><u>business is so arranged</u></b> that it produces to the resident person (R) <ul style="list-style-type: none"> <li>o <u>either no profits</u> which arise in or derive from Hong Kong <u>or</u></li> <li>o <u>less than the ordinary profits</u> which might be expected to arise in or derive from Hong Kong</li> </ul> </li> </ul> <div style="border: 1px solid black; padding: 5px; margin: 10px 0;"> <p><b>Closely connected</b> = if CIR considers that such persons are <u>substantially identical</u> or that the <u>ultimate controlling interest</u> of each is owned or deemed under this section to be <u>owned by the same person or persons</u> (<i>see notes below</i>).</p> <p>Notes:<br/><i>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</i></p> </div> <p><b><u>Consequence:</u></b></p> <ol style="list-style-type: none"> <li>1. The business done by the <u>non-resident</u> person shall be <u>deemed to be carried on in Hong Kong</u>.</li> <li>2. Such non-resident person shall be assessable in respect of his profits from such business <u>in the name of the resident person</u> as if the resident person were his agent.</li> </ol> |

### Topic 5: Anti-avoidance provision under IRO

| IRO / DIPN |  |
|------------|--|
| s.61       | <p>Where an assessor is of the opinion that any transaction which</p> <ul style="list-style-type: none"> <li>- reduces or would reduce the amount of tax payable by any person</li> <li>- is <b>artificial</b> or <b>fictitious</b> or that any disposition is not in fact given effect to,</li> </ul> <p><b>Consequence:</b><br/>He may disregard any such transaction or disposition and the person concerned shall be assessable accordingly.</p>   |
| s.61A      | <p>Where an assessor is of the opinion that any transaction which is of a <b>sole or dominant purpose of obtaining a tax benefit</b></p> <div style="border: 1px solid black; padding: 5px; margin: 10px 0;"> <p><b>Tax benefit</b> = avoidance / postponement / reduction of tax liability</p> </div> <div style="border: 1px solid black; padding: 10px; margin: 10px 0;"> <p><b>Seven matters</b> to consider if a transaction has the <b>sole or dominant purpose</b> for obtaining a tax benefit:</p> <ol style="list-style-type: none"> <li>(1) the manner in which the transaction was entered into or carried out;</li> <li>(2) the form and substance of the transactions;</li> <li>(3) the anticipated objective and result of the transaction that would have been really achieved by the transaction;</li> <li>(4) any change in the financial position of the relevant person that has resulted, or may reasonably be expected to result, from the transaction;</li> <li>(5) any change in the financial position of any person who has, or has had, any connection with the relevant person, has resulted, or may reasonably be expected to result, from the transaction;</li> <li>(6) whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm's length under a transaction of the kind in question; and</li> <li>(7) the participation in the transaction of a corporation resident or carrying on business outside Hong Kong.</li> </ol> </div> <p><b>Consequence:</b><br/>An assessment may be made by an Assistant Commissioner either:</p> <ul style="list-style-type: none"> <li>- as if the transaction/any part thereof had NOT been entered into; or</li> <li>- in such other manner as the assistant commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained.</li> </ul> |
| s.61B      | <p>Where the Commissioner is satisfied that-</p> <ul style="list-style-type: none"> <li>- any <b>change in the shareholding</b> in any corporation;</li> <li>- as a direct or indirect result, profits have been received by or accrued to that corporation during any year of assessment; and</li> <li>- the <b>sole or dominant purpose</b> of the change was <b>to utilize any loss</b> in a trade, profession or business carried on by the corporation in order <b>to avoid / reduce tax liability</b> of that corporation or any other person</li> </ul> <p><b>Consequence:</b><br/>CIR may disallow the set off of loss against any such profits of that corporation.</p>   |

| IRO / DIPN |  |
|------------|--|
| s.9A       | <p><b>Service Companies - Type I Arrangement</b><br/>                     Arrangement to disguise employer / employee relationships where the remuneration for services rendered by a person under employment-like conditions is paid not as salary to that person, but as a consultancy fee to an employee controlled Service Company.</p> <p><u>Prima Facie Liability</u></p> <ol style="list-style-type: none"> <li>(1) There is an agreement;</li> <li>(2) A person (relevant person, RP) carrying on a trade, profession or business in Hong Kong is a party to the agreement;</li> <li>(3) Services have been carried out under the agreement by an individual (relevant individual, RI) for the relevant person or any other person;</li> <li>(4) Remuneration for the services is paid/credited to a corporation/trustee controlled by the RI/its associates/together with its associates of/the trustee.</li> </ol> <p><u>Consequence:</u></p> <ol style="list-style-type: none"> <li>1. The RI shall be treated as having an employment with the RP;</li> <li>2. The RI shall be treated as an employee of the RP;</li> <li>3. The RP shall be treated as the employer of the RI;</li> <li>4. Any such remuneration shall be treated as being income derived by the RI from an employment with the RP.</li> </ol> <div style="text-align: center; margin: 10px 0;"> <pre>                     graph LR                         RP[Employer (RP)] -- "Remuneration (Ignored)" --&gt; SC[Service Company]                         SC -- "Small Salary + Fringe Benefits (Ignored)" --&gt; RI[Employee (RI)]                         RP -- "Service rendered (Employer-Employee relation -&gt; subject to Salaries Tax)" --&gt; RI                     </pre> </div> <p><b>Escape Provisions</b><br/>                     s9A shall not apply (i.e. not treated as an employment) where <b>ALL</b> the key features of an employment relationship do not exist:</p> <ol style="list-style-type: none"> <li>(1) Neither the agreement nor any undertaking for services provides for any remuneration with <b>employment type benefits</b>.<br/>                     (e.g. annual leave / sick leave, passage allowance, pension entitlements, medical payments, accommodation, etc)</li> <li>(2) The <b>RI</b>, whenever required to carry out any services personally for the RP, <b>carries out the same or similar services for other persons</b>.</li> <li>(3) The services provided by the <b>RI</b> are <b>not subject to any control or supervision commonly exercised by an employer</b> by any person other than “the corporation or trustee” to whom remuneration is paid.</li> <li>(4) <b>Remuneration is not paid or credited periodically</b> and calculated on a basis commonly used to calculate remuneration under a contract of employment.</li> <li>(5) The <b>RP has no employment type of right to dismiss the RI</b>.</li> <li>(6) The <b>RI is not held out to the public to be an officer or employee of the RP</b>.</li> </ol> |

| IRO / DIPN |  |
|------------|--|
| DIPN 24    | <p><b>Service Companies - Type II Arrangement</b><br/>                     Arrangement to make management fees by an unincorporated business to a service company controlled by the proprietor or partners of the business.</p>  <pre>                     graph LR                         UB[Unincorporated Business] -- Excessive Remuneration --&gt; SC[Service Company]                         SC -- Small Salary + Fringe Benefits --&gt; EOUB[Employee owner of UB]                         SC -- Supportive Service rendered --&gt; UB                     </pre> <p><b>DIPN24 stated that:</b><br/>                     If the service company</p> <ul style="list-style-type: none"> <li>- functions as a separate business entity &amp;</li> <li>- charge management fee on an arm’s length basis &amp;</li> <li>- complete documentation available</li> </ul> <p>→ <b>Such arrangements would be tolerated by the IRD within limit (DIPN 24)</b></p> <p><b>Deduction of the management fee</b> (for the unincorporated business) is limited to:</p> <p>(1) Qualifying services (mark-up of 12.5% will generally be accepted); and</p> <div style="border: 1px solid black; padding: 5px; margin: 5px 0;"> <p><b>Qualifying services</b> are services that are required to provide the infrastructure for the firm operates and to cater for its day to day operations;<br/>                     [e.g. provision of premises, staff (administrative, secretarial, clerical and cleaning staff), plant and equipment and miscellaneous supplies (i.e. stationery, photocopying, etc.)]<br/>                     But <b>DO NOT INCLUDE:</b></p> <ol style="list-style-type: none"> <li>1) Professional services performed by proprietor or partners as employees of a service company.</li> <li>2) Services performed by other professional “fee earners” who have a contract of employment with a service company.</li> <li>3) Any expenses not relating to provision of services to the unincorporated business (e.g. audit fee for service company)</li> </ol> </div> <p>(2) Other professional services performed by “fee earners” (with no mark-up is accepted)</p> <div style="border: 1px solid black; padding: 5px; margin: 5px 0;"> <p>Professional services performed by proprietor/partners are not allowed.</p> </div> <p><b>Consequence:</b></p> <ul style="list-style-type: none"> <li>❖ <b>To the unincorporated business</b><br/>                     The excessive management fee would be considered as NOT incurred in the production of chargeable profits and thus not be allowable.</li> <li>❖ <b>To the service company</b><br/>                     100% of the management fee be taxable if services are rendered in HK (even if part of the management fee is not deductible by the unincorporated business).</li> </ul> |

## Notes on Examination Technique:

**1. *Read the question carefully***

It is important to identify the issue or issues that the question is referring to. Plan ahead before you start writing. A well-structured answer would enable you to capture more relevant issues.

**2. *Be relevant***

Use your time wisely. You won't score by rote-copying irrelevant materials. In an open book examination like QP, marks would be allocated to the theoretical part but there must be more marks on the discussion part. So it is important to explain and apply the theory or rules that is relevant in the scenario given.

**3. *Time management***

On top of the 1.8 minutes per mark guideline stated in the question, do plan your "productive" and "non-productive" time in advance and **MUST** attempt all the questions.

**4. *Avoid unnecessary panics***

Questions in section B are usually independent to each other. A good strategy is to answer the questions in accordance with your confidence level.

**5. *Produce a marker-friendly answer script***

Markers would not demand for some elegant English and/or handwriting, but something readable would suffice. Start a new page for every question and write in short paragraphs with lines between paragraphs would facilitate the markers' marking. It is also good for yourself when you want to add something to your answer.