Qualification Programme

Module D: Taxation

FOURTH EDITION

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

Hong Kong's
CPA Qualification
香港會計師專業資格

LEARNING PACK

Qualification Programme

Module D
Taxation

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

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Director's message

Welcome to the Qualification Programme (QP) of the Hong Kong Institute of Certified Public Accountants (HKICPA).

You have made the decision to complete the HKICPA's QP which entails completing the training programme, passing professional examinations and acquiring practical experience under an authorized employer or supervisor. This marks a further step on your pathway to a successful business career as a CPA and becoming a valued member of the HKICPA.

The QP comprising four core modules and a final examination will provide you with a foundation for life-long learning and assist you in developing your technical, intellectual, interpersonal and communication skills. You will find this programme challenging with great satisfaction that will open a wide variety of career opportunities bringing in attractive financial rewards.

A module of the QP involves approximately 120 hours of self-study over fourteen weeks, participation in two full-day workshops and a three-hour open-book module examination at the module end. We encourage you to read this Learning Pack which is a valuable resource to guide you through the QP.

The four core modules of the QP are as follows:

Module A: Financial Reporting
Module B: Corporate Financing
Module C: Business Assurance
Module D: Taxation

Should you require any assistance at any time, please feel free to contact us on (852) 2287 7228.

May I wish you every success in your QP!

Jonathan Ng

Executive Director
Hong Kong Institute of Certified Public Accountants

Introduction

This is the fourth edition of the Learning Pack for Module D Taxation of the HKICPA Qualification Programme.

The Institute is committed to updating the content of the Learning Pack on an annual basis to keep abreast of the latest developments. This edition has been developed after having consulted and taken on board the feedback received from different users of the previous edition. Some of the examples and self-test questions have been rewritten to better reflect current working practices in industry and facilitate the learning process for users of the Learning Pack.

The Learning Pack has been written specifically to provide a complete and comprehensive coverage of the learning outcomes devised by HKICPA, and has been reviewed and approved by the HKICPA Qualification and Examinations Board for use by those studying for the qualification.

The HKICPA Qualification Programme comprises two elements: the examinations and the workshops. The Learning Pack has been structured so that the order of the topics in which you study is the order in which you will encounter them in the workshops. There is a very close inter-relationship between the module structure, the Learning Pack and the workshops. It is important that you have studied the chapters of the Learning Pack relevant to the workshops before you attend the workshops, so that you can derive the maximum benefit from them.

On page (ix) you will see the HKICPA learning outcomes. Each learning outcome is mapped to the chapter in the Learning Pack in which the topic is covered. You will find that your diligent study of the Learning Pack chapters and your active participation in the workshops will prepare you to tackle the examination with confidence.

One of the key elements in examination success is practice. It is important that not only you fully understand the topics by reading carefully the information contained in the chapters of the Learning Pack, but it is also vital that you take the necessary steps to practise the techniques and apply the principles that you have learned.

In order to do this, you should:

- work through all the examples provided within the chapters and review the solutions, ensuring that you understand them;
- complete the self-test questions within each chapter, and then compare your answer with the solution provided at the end of the chapter; and
- attempt the exam practice questions that you will find at the end of the chapter. Many of these are HKICPA past examination questions, which will give an ideal indication of the standard and type of question that you are likely to encounter in the examination itself. You will find the solutions to exam practice questions at the end of the book.

In addition, you will find at the end of the Learning Pack a bank of past HKICPA case-study style questions. These are past ‘Section A' examination questions, which present a case study testing a number of different topics within the syllabus. These questions will provide you with excellent examination practice when you are in the revision phase of your studies, bringing together, as they do, the application of a variety of different topics to a scenario.

Please note that the Learning Pack is not intended to be a 'know-it-all' resource. You are required to undertake background reading including standards, legislations and recommended texts for the preparation for workshop and examination.

Module structure

Please refer to the QP Learning Centre for the six-month rule.

Overall Structure of Module D (Taxation)

Chapter features

Each chapter contains a number of helpful features to guide you through each topic.

Topic list

Tells you what you will be studying in the chapter. The topic items form the numbered headings within the chapter.

Learning focus

Puts the chapter topic into perspective and explains why it is important, both within your studies and within your practical working life.

Learning Outcomes

The list of Learning Outcomes issued for the Module by HKICPA, referenced to the chapter in the Learning Pack within which coverage will be found.

Topic highlights

Summarise the key content of the particular section that you are about to start. They are also found within sections, when an important issue is introduced other than at the start of the section.

Key terms

Definitions of important concepts. You really need to know and understand these before the examination, and understanding will be useful at the workshops too.

Examples

Illustrations of particular techniques or concepts with a worked solution or explanation provided immediately afterwards.

Case study

An example or illustration not requiring a solution, designed to enrich your understanding of a topic and add practical emphasis. Often based on real world scenarios and contemporary issues.

Self test questions

These are questions that enable **you** to practise a technique or test your understanding. You will find the answer at the end of the chapter.

Formula to learn

You may be required to apply financial management formulae in Module B, Corporate Financing.

Topic recap

Reviews and recaps on the key areas covered in the chapter.

Exam practice

A question at the end of the chapter to enable you to practise the techniques that you have learned. In most cases this will be a past HKICPA examination question, updated as appropriate. You will find the answers in a bank at the end of the Learning Pack entitled Answers to Exam Practice Questions.

Further reading

In Modules B and D you will find references to further reading that will help you to understand the topics and put them into the practical context. The reading suggested may be books, websites or technical articles.

Bold text

Throughout the Learning Pack you will see that some of the text is in bold type. This is to add emphasis and to help you to grasp the key elements within a sentence or paragraph.

Learning outcomes

HKICPA's learning outcomes for the Module are set out below. They are cross-referenced to the chapter in the Learning Pack where they are covered.

Fields of competency

The items listed in this section are shown with an indicator of the minimum acceptable level of competency, based on a three-point scale as follows:

1 Awareness

To have a general professional awareness of the field with a basic understanding of relevant knowledge and related concepts.

2 Knowledge

The ability to use knowledge to perform professional tasks competently without assistance in straightforward situations or applications.

3 Application

The ability to apply comprehensive knowledge and a broad range of professional skills in a practical setting to solve most problems generally encountered in practice.

Topics

		Competency	Chapter where covered
LO1. Overview of the taxation system and administration of taxes			
Describe the key aspects of the tax system in Hong Kong			
LO1.01	Principles of taxation	2	
	1.01.01 Describe the Hong Kong tax system		1
	1.01.02 Explain the territorial source principle		1
	1.01.03 Describe the roles of the taxpayer, tax advisor and the Inland Revenue Department (IRD)		1, 11
LO1.02	Types of tax	2	
	1.02.01 Describe the various types of taxes levied under the Inland Revenue Ordinance (IRO) and Stamp Duty Ordinance (SDO)		1
LO1.03	Structure and procedures of the IRD	2	
	1.03.01 Describe the structure of IRD		1
	1.03.02 Explain the procedures adopted by IRD		1
LO1.04	Duties and powers of officers of the IRD; official secrecy	2	
	1.04.01 Explain the duties and powers of IRD officers		2
	1.04.02 Explain the secrecy provisions under s4 of the IRO		1, 2
LO1.05	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		2, 8

		Competency	Chapter where covered
LO1.06	Sources of Hong Kong tax law – statute, case law, Board of Review decisions	3	
	1.06.01 Describe various sources of tax law		1
	1.06.02 Describe the doctrine of precedent in the context of taxation law		1
LO1.07	Interpretation of tax statutes	3	
	1.07.01 Explain the rules of interpretation of tax law and their applications		1
	1.07.02 Explain the purposive interpretation and the significance of the *Ramsay* principle		9
LO1.08	The Basic Law	2	
	1.08.01 Explain the tax relations between HKSAR and the Mainland of China		1
	1.08.02 Describe the major articles of the Basic Law relating to taxation		1
	1.08.03 Explain and apply DIPN 29		1
LO1.09	Departmental Interpretation and Practice Notes and Stamp Office Interpretation and Practice Notes	3	
	1.09.01 Describe the status and application of Departmental Interpretation and Practice Notes (DIPN) and Stamp Office Interpretation and Practice Notes (SOIPN)		1
LO1.10	Returns, offences and penalties	2	
	1.10.01 Describe the powers of IRD officers to require the furnishing of returns, statements and information		2
	1.10.02 Describe the powers of IRD officers to seize books, records and documents by way of search warrant		2
	1.10.03 Describe the obligations of a taxpayer in relation to business and rent records		2
	1.10.04 Describe the obligations and rights of an employer under the IRO		2
	1.10.05 Discuss the essential compliance and disclosure issues in relation to profits tax, salaries tax and property tax		2
	1.10.06 Describe the tax offences and the related penalty provisions under the IRO		2
LO1.11	Assessments, additional assessments and provisional assessments	3	
	1.11.01 Explain the provisions under the IRO which concern tax assessments		2
LO1.12	Payment, recovery, hold-over and refund of taxes	2	
	1.12.01 Describe the provisions under the IRO regarding payment of tax		2
	1.12.02 Describe the provisions under the IRO in relation to recovery, holdover and refund of taxes		2

		Competency	Chapter where covered
LO1.13	Objections and appeals	3	
	1.13.01 Describe the objection and appeal procedures under the IRO		2
	1.13.02 Explain and apply DIPN 6		2
LO1.14	Board of Review	2	
	1.14.01 Describe the role and formation of the Board of Review		11
LO1.15	Board of Inland Revenue	2	
	1.15.01 Describe the role and formation of the Board of Inland Revenue		1
	1.15.02 Describe the Inland Revenue Rules		1
LO1.16	Field audit and tax investigation	2	
	1.16.01 Identify the essential issues concerning tax investigation and field audit		10
	1.16.02 Identify the efficient ways to lead a tax investigation to an early settlement		10
	1.16.03 Explain the settlement methods used by the IRD in the quantification process		10
	1.16.04 Explain and apply DIPN 11		10
LO2. Taxes in Hong Kong			
Interpret and apply rules of major taxes as they impact and interact on transactions, individuals and organisations and ascertain related tax liabilities:			
Tax on property income			
LO2.01	Scope of property tax charge	2	
	2.01.01 Identify the scope of the property tax charge		6
	2.01.02 Evaluate whether property letting amounts to a business		6
	2.01.03 Describe the relief and exemptions available under property tax		6
	2.01.04 Explain and apply DIPN 14		6
LO2.02	Chargeable property and owners of land and/or buildings	2	
	2.02.01 Describe the 'owner' of a property as defined under the IRO		6
	2.02.02 Describe the obligations of property owners under the IRO		6
	2.02.03 Explain and apply DIPN 14		6
LO2.03	Ascertainment of assessable value and property tax liability	3	
	2.03.01 Ascertain the assessable value of a property		6
	2.03.02 Identify allowable deductions under property tax		6
	2.03.03 Compute net assessable value and property tax payable		6
	2.03.04 Explain and apply DIPN 4 and 14		6

		Competency	Chapter where covered
Salaries tax on employees and directors			
LO2.04	Scope of salaries tax charge	2	
	2.04.01 Identify the scope of salaries tax		5
	2.04.02 Discuss various exemptions available under salaries tax		5
	2.04.03 Describe the rules governing the source of income from office, employment and pension		5
	2.04.04 Compute the assessable income from an office, employment and pension		5
	2.04.05 Explain and apply DIPN 10		5
LO2.05	Expenses and deductions	3	
	2.05.01 Explain the rules governing the deduction of expenses and depreciation allowance allowable under salaries tax		5
	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		5
	2.05.03 Explain and apply DIPN 9, 23, 35, 36 and 37		5
LO2.06	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		5
	2.06.02 Explain and apply DIPN 10		5
LO2.07	Personal allowances	2	
	2.07.01 Describe the provisions under the IRO which govern the claims for various personal allowances		5
	2.07.02 Explain and apply DIPN 18		5
LO2.08	Benefits in kind, housing benefit, share options	3	
	2.08.01 Identify and explain the taxation of benefits in kind and housing benefit		5
	2.08.02 Explain the rules governing the taxation of employee share-based benefits		5
	2.08.03 Explain the rules governing the taxation of holiday journey benefits		5
	2.08.04 Explain and apply DIPN 16, 38 and 41		5
LO2.09	Treatment of lump sum receipts and losses	2	
	2.09.01 Explain the taxation of lump sum receipts		5
	2.09.02 Explain the taxation of retirement scheme benefits		5
	2.09.03 Explain the treatment of losses		5
	2.09.04 Explain and apply DIPN 23		5
LO2.10	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		5
	2.10.02 Explain and apply DIPN 18		5

		Competency	Chapter where covered
LO2.11	Ascertainment of salaries tax liability	3	
	2.11.01 Ascertain net assessable income		5
	2.11.02 Ascertain net chargeable income		5
	2.11.03 Ascertain allowable outgoings and expenses, deductions and allowances		5
	2.11.04 Compute salaries tax payable including provisional salaries tax under separate or joint assessment		5
Personal assessment			
LO2.12	Election for personal assessment	2	
	2.12.01 Identify the issues, including eligibility and application procedures, relating to personal assessment election		7
	2.12.02 Demonstrate how a taxpayer can benefit from a personal assessment election		7
	2.12.03 Explain and apply DIPN 18		7
LO2.13	Computation of total income and tax payable	2	7
Taxation of Businesses			
LO2.14	Scope of profits tax charge		
	2.14.01 Identify and explain the scope of charge to profits tax	3	3
	2.14.02 Identify the specific rules applicable to special classes of corporate entities including financial institutions, insurance companies, ship-owners, aircraft owners, clubs and associations	2	3
	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 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 30	3	4
LO2.15	Badges of trade	3	
	2.15.01 Explain the criteria for determining whether a person carried on a trade, business or profession in Hong Kong		3
	2.15.02 Apply badges of trade in the context of recent Board of Review decisions and tax cases		3
LO2.16	Source of business profits	3	
	2.16.01 Describe the rules governing the sources of profits for profits tax purposes (including the chargeability of e-commerce transactions)		3
	2.16.02 Describe the latest developments in tax cases on source issues		3
	2.16.03 Explain and apply DIPN 21 and 39		3

		Competency	Chapter where covered
LO2.17	Deemed trading receipts	3	
	2.17.01 Explain the rules governing the taxation of deemed trading receipts under s15 and s15A of the IRO		3
	2.17.02 Explain and apply DIPN 22 and 49		3
LO2.18	General deductions and specific deductions	3	
	2.18.01 Explain the rules governing allowable and non-allowable profits tax deductions under the IRO		3
	2.18.02 Explain and apply DIPN 3, 5, 13, 13A, 24, 28, 33 and 49		3
LO2.19	Distinction between capital and revenue items	2	
	2.19.01 Distinguish the capital and revenue items and explain its significance		3
LO2.20	Computation and treatment of losses	2	
	2.20.01 Explain the treatment of losses and its computation		3
	2.20.02 Explain and apply DIPN 8		3
LO2.21	Business cessation and post-cessation receipts and payments	2	
	2.21.01 Explain the tax issues in relation to the business cessation		3
	2.21.02 Explain the operation of s15D of the IRO		3
LO2.22	Sharkey v Wernher principle	2	
	2.22.01 Explain the Sharkey v Wernher principle and its application		3
LO2.23	Financial instruments	3	
	2.23.01 Explain the taxation of financial instruments and foreign exchange differences		3
	2.23.02 Explain and apply DIPN 42		3
LO2.24	Exemption for offshore funds	3	
	2.24.01 Explain the exemption for offshore funds		4
	2.24.02 Explain and apply DIPN 43		4
LO2.25	Ascertainment of profits tax liability	3	
	2.25.01 Identify assessable and non-assessable profits from a trade, profession and business		3
	2.25.02 Ascertain the basis period for computing assessable profits for the years in which the business commenced, ceased or there is a change in accounting date		3
	2.25.03 Prepare profits tax computations		3
	2.25.04 Recognise the relevance of accounting policies in the context of tax computations		3
	2.25.05 Explain and apply DIPN 1, 20, 34 and 40		3

		Competency	Chapter where covered
LO2.26	Partnerships and allocation of profit/loss	2	
	2.26.01 Identify the tax rules governing partnerships and joint ventures		3
	2.26.02 Apply the rules relating to partnerships and joint ventures in evaluating the choice of entity for business purposes and the tax reporting requirements		3
LO2.27	Depreciation allowances: plant and machinery	2	
	2.27.01 Explain the rules governing the grant of allowances on plant and machinery		3
	2.27.02 Compute the allowances on plant and machinery		3
	2.27.03 Explain and apply DIPN 7		3
LO2.28	Depreciation allowances: industrial buildings and commercial buildings	2	
	2.28.01 Explain the rules governing the grant of allowances on industrial buildings and commercial buildings		3
	2.28.02 Compute the allowances on industrial and commercial buildings		3
	2.28.03 Explain and apply DIPN 2		3
LO2.29	Arrangement between the Mainland of China and the HKSAR ('the Arrangement')	3	
	2.29.01 Explain the various articles and provisions under the Arrangement		12
	2.29.02 Explain the relationship between the Arrangement and the IRO		12
	2.29.03 Explain what constitutes a 'resident' in the context of the Arrangement		12
	2.29.04 Calculate the amount of tax paid and credits under the Arrangement		12
	2.29.05 Explain the article concerning exchange of information under the Arrangement and its significance		12
	2.29.06 Explain and apply DIPN 32, 44 and 47		12
Stamp duty			
LO2.30	Scope of charge	2	
	2.30.01 Identify relevant heads of stamp duty charge		8
LO2.31	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		8
LO2.32	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		8
	2.32.02 Explain and apply SOIPN 1, 3, 4 and 5		8

		Competency	Chapter where covered
LO2.33	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		8
LO2.34	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		8
LO2.35	Voluntary disposition inter vivos	3	
	2.35.01 Explain the stamp duty implication for voluntary disposition *inter vivos*		8
LO2.36	Exemptions and reliefs	3	
	2.36.01 Explain the exemptions and reliefs available under the SDO		8
	2.36.02 Outline the *Arrowtown* case and explain its significance		8
LO2.37	Adjudication, assessment and administration	2	
	2.37.01 Describe the administration issues concerning stamp duty		8
	2.37.02 Explain the adjudication and appeal procedures for stamp duty assessment		8
	2.37.03 Describe stamp duty offence and related penalty provisions under the SDO		8
LO2.38	Stamp duty planning	3	
	2.38.01 Identify stamp duty planning opportunities		8
Tax planning			
LO2.39	Anti-avoidance provisions in the Inland Revenue Ordinance	3	
	2.39.01 Explain the general and specific anti-avoidance provisions under the IRO		9
	2.39.02 Discuss the application of the general and specific anti-avoidance provisions under the IRO		9
	2.39.03 Discuss the tax implications and development of the tax avoidance cases		9
	2.39.04 Explain deemed employment income under service company 'Type I' arrangement		9
	2.39.05 Explain and apply DIPN 15 and 25		9
LO2.40	*Ramsay* principle	3	
	2.40.01 Explain the *Ramsay* principle		9
	2.40.02 Discuss the application of the *Ramsay* principle		9
	2.40.03 Explain and apply DIPN 15		9
LO2.41	Offences and penalties	3	
	2.41.01 Discuss the exposure to penalty action in tax planning		9, 10
	2.41.02 Explain and apply DIPN 15		9, 10
LO2.42	Advance ruling	2	
	2.42.01 Describe the advance ruling system		9
	2.42.02 Explain and apply DIPN 31		9

			Competency	Chapter where covered
LO2.43	Double taxation relief		1	
	2.43.01	Describe the general purpose and application of double taxation treaties		12
LO2.44	Hong Kong tax planning		3	
	2.44.01	Identify issues on tax planning opportunities for individuals, partnerships, unincorporated businesses and corporations and group restructuring		9
	2.44.02	Recognise tax-efficient ways to structure remuneration packages for employees and employment arrangements		9
	2.44.03	Identify tax planning opportunities for individuals under contracts of service or contracts for service		9
	2.44.04	Identify strategies to minimise or defer the tax liability of a group of companies by diverting income, increasing allowable deductions, and altering the period of income recognition		9
	2.44.05	Evaluate alternative business operations and transactions from a tax perspective		9
	2.44.06	Evaluate the tax implications of setting up a holding company, subsidiary or a branch in Hong Kong for international tax planning considerations		9
	2.44.07	Describe the role of OECD		12
	2.44.08	Discuss the use of transfer pricing arrangement in tax planning		12
	2.44.09	Identify the tax planning opportunities under the Arrangement		9, 12
	2.44.10	Explain and apply DIPN 24, 45, 46 and 48		9, 12
LO3. Tax and the Professional Accountant				
Describe the role of the Professional Accountant in tax management				
LO3.01	Professional and ethical standards		3	
	3.01.01	Identify and explain the importance of the ethical considerations in tax planning		11
LO3.02	Relationship with tax authority and the law		2	
	3.02.01	Explain the relevant issues in relation to: - Tax advice letter to a client - Reply to an IRD enquiry letter - Objection letter to IRD - Holdover application to IRD - Section 70A claim letter to IRD		11
LO4. Overview of China tax system				
Understand the key aspects of the tax system in China				
LO4.01	Overview of China tax system		1	
	4.01.01	Outline the China tax system		13
	4.01.02	Outline the regimes of VAT, consumption tax and business tax in China		13
	4.01.03	Outline the regime of Individual Income Tax		13
	4.01.04	Outline the regime of Corporate Income Tax		13

Tax Tables

Profits Tax

Tax Rates applicable to Corporations

Year of Assessment	Tax Rate
2008/09 onwards	16.5%
2003/04 to 2007/08*	17.5%
2002/03	16%

*75% of the 2007/08 profits tax is waived subject to a ceiling of $25,000 per case.

Tax Rates applicable to Unincorporated Businesses

Year of Assessment	Tax Rate
2008/09 onwards	15%
2004/05 to 2007/08*	16%
2003/04	15.5%
2002/03	15%

*75% of the 2007/08 profits tax is waived subject to a ceiling of $25,000 per case.

Retained Amounts applicable to Non-Resident Entertainers and Sportsmen

Below is the amount to be withheld by the Hong Kong taxpayer for tax payment for performances.

Performance procured directly with the non-resident entertainers or sportsmen

Year of Assessment	Tax Rate	Amount to Retained
2008/09 onwards	15%	10% of gross amount payable
2004/05 to 2007/08*	16%	10.67% of gross amount payable
2003/04	15.5%	10.33% of gross amount payable
2002/03	15%	10% of gross amount payable

Performance procured through a non-resident agent who is an individual person or partnership

Year of Assessment	Tax Rate	Amount to Retained
2008/09 onwards	15%	10% of gross amount payable
2004/05 to 2007/08*	16%	10.67% of gross amount payable
2003/04	15.5%	10.33% of gross amount payable
2002/03	15%	10% of gross amount payable

Performance procured through a non-resident agent who is a corporate agent or a corporation

Year of Assessment	Tax Rate	Amount to Retained
2008/09 onwards	16.5%	11% of gross amount payable
2003/04 to 2007/08*	17.5%	11.67% of gross amount payable
2002/03	16%	10.67% of gross amount payable

*75% of the 2007/08 profits tax is waived subject to a ceiling of $25,000 per case.

Salaries Tax and Personal Assessment

Year of Assessment 2008/09 onwards

	Net Chargeable Income ($)	Rate	Tax ($)
On the First	40,000	2%	800
On the Next	40,000	7%	2,800
	80,000		3,600
On the Next	40,000	12%	4,800
	120,000		8,400
Remainder		17%	

For 2011/12, 75% of the final tax payable under profits tax, salaries tax and tax under personal assessment would be waived, subject to a ceiling of $12,000 per case (Enacted on 20 July 2012).

For 2010/11, 75% of the final tax payable under salaries tax and tax under personal assessment would be waived, subject to a ceiling of $6,000 per case.

For 2009/10, 75% of the final tax payable under salaries tax and tax under personal assessment would be waived, subject to a ceiling of $6,000 per case.

For 2008/09, 100% of the final tax payable under salaries tax and tax under personal assessment would be waived, subject to a ceiling of $8,000 per case.

Year of Assessment 2007/08

	Net Chargeable Income ($)	Rate	Tax ($)
On the First	35,000	2%	700
On the Next	35,000	7%	2,450
	70,000		3,150
On the Next	35,000	12%	4,200
	105,000		7,350
Remainder		17%	

For 2007/08, 75% of the final tax payable under salaries tax and tax under personal assessment would be waived, subject to a ceiling of $25,000 per case.

Year of Assessment 2006/07

	Net Chargeable Income ($)	Rate	Tax ($)
On the First	30,000	2%	600
On the Next	30,000	7%	2,100
	60,000		2,700
On the Next	30,000	13%	3,900
	90,000		6,600
Remainder		19%	

For 2006/07, 50% of the final tax payable under salaries tax and tax under personal assessment would be waived, subject to a ceiling of $15,000 per case.

Years of Assessment 2004/05 and 2005/06

	Net Chargeable Income ($)	Rate	Tax ($)
On the First	30,000	2%	600
On the Next	30,000	8%	2,400
	60,000		3,000
On the Next	30,000	14%	4,200
	90,000		7,200
Remainder		20%	

Standard Rate

Year of Assessment	Tax Rate
2008/09 onwards (Note)	15%
2004/05 to 2007/08 (Note)	16%

Note

(1) For 2011/12, 75% of the final tax payable under profits tax, salaries tax and tax under personal assessment would be waived, subject to a ceiling of $12,000 per case (Enacted on 20 July 2012).

(2) For 2010/11, 75% of the final tax payable under salaries tax and tax under personal assessment would be waived, subject to a ceiling of $6,000 per case.

(3) For 2009/10, 75% of the final tax payable under salaries tax and tax under personal assessment would be waived, subject to a ceiling of $6,000 per case.

(4) For 2008/09, 100% of the final tax payable under salaries tax and tax under personal assessment would be waived, subject to a ceiling of $8,000 per case.

(5) For 2007/08, 75% of the final tax payable under salaries tax and tax under personal assessment would be waived, subject to a ceiling of $25,000 per case.

(6) For 2006/07, 50% of the final tax payable under salaries tax and tax under personal assessment would be waived, subject to a ceiling of $15,000 per case.

Annual Income Levels at which Salaries Taxpayers enter the Standard Rate Zone

	Year of Assessment 2006/07 ($)	Year of Assessment 2007/08 ($)	Year of Assessment 2008/09 to 2010/11 ($)	Year of Assessment 2011/12# ($)
Single	983,334	2,750,000	1,518,000	1,518,000
Married	1,616,667	4,450,000	2,436,000	2,436,000
Married + 1 child*	1,870,000	5,300,000	2,861,000	2,946,000
Married + 2 children*	2,123,334	6,150,000	3,286,000	3,456,000
Married + 3 children*	2,376,667	7,000,000	3,711,000	3,966,000

Including Two Dependent Parents or Grandparents Aged 60 or Above

	Year of Assessment 2006/07 ($)	Year of Assessment 2007/08 ($)	Years of Assessment 2008/09 to 2010/11 ($)	Year of Assessment 2011/12# ($)
Single	1,363,334	3,770,000	2,028,000	2,130,000
Married	1,996,667	5,470,000	2,946,000	3,048,000
Married + 1 child*	2,250,000	6,320,000	3,371,000	3,558,000
Married + 2 children*	2,503,334	7,170,000	3,796,000	4,068,000
Married + 3 children*	2,756,667	8,020,000	4,221,000	4,578,000

Including Two Dependent Parents or Grandparents Aged 60 or Above Living with You

	Year of Assessment 2006/07 ($)	Year of Assessment 2007/08 ($)	Year of Assessment 2008/09 to 2010/11 ($)	Year of Assessment 2011/12# ($)
Single	1,743,334	4,790,000	2,538,000	2,742,000
Married	2,376,667	6,490,000	3,456,000	3,660,000
Married + 1 child*	2,630,000	7,340,000	3,881,000	4,170,000
Married + 2 children*	2,883,334	8,190,000	4,306,000	4,680,000
Married + 3 children*	3,136,667	9,040,000	4,731,000	5,190,000

Including One Dependent Parent or Grandparent Aged 60 or Above and Living with You and One Disabled Dependant Brother or Sister

	Year of Assessment 2006/07 ($)	Year of Assessment 2007/08 ($)	Year of Assessment 2008/09 to 2010/11 ($)	Year of Assessment 2011/12# ($)
Single	1,933,334	5,300,000	2,793,000	2,895,000
Married	2,566,667	7,000,000	3,711,000	3,813,000
Married + 1 child*	2,820,000	7,850,000	4,136,000	4,323,000
Married + 2 children*	3,073,334	8,700,000	4,561,000	4,833,000
Married + 3 children*	3,326,667	9,550,000	4,986,000	5,343,000

Being a Single Parent with:

	Year of Assessment 2006/07 ($)	Year of Assessment 2007/08 ($)	Years of Assessment 2008/09 to 2010/11 ($)	Year of Assessment 2011/12# ($)
1 child*	1,870,000	5,300,000	2,861,000	2,946,000
2 children*	2,123,334	6,150,000	3,286,000	3,456,000
3 children*	2,376,667	7,000,000	3,711,000	3,966,000

Note. The effects of the various deductions are not included in the above tables.

*Not including new born child allowance

#Tax measures proposed by the Financial Secretary in the 2012-13 Budget and enacted on 20 July 2012 are included in the computation.

Personal allowances

Allowances	2009/2010 & 2010/11 $	2011/12 $	Enacted on 20 July 2012 2012/13
Basic allowance	108,000	108,000	120,000
Married person's allowance	216,000	216,000	240,000
Child allowance - 1st to 9th child (each)	50,000	60,000	63,000
New born child – additional allowance in the year of birth (each)	50,000	60,000	63,000
Single parent allowance	108,000	108,000	120,000
Dependent parent/grandparent allowance (each) (Age 55-59/≥60*)	15,000/30,000	18,000/36,000	38,000
Additional dependent parent/grandparent allowance (each) (Age 55-59/≥60*)	15,000/30,000	18,000/36,000	38,000
Dependent brother/sister allowance (each)	30,000	30,000	33,000
Disabled dependant allowance (each)	60,000	60,000	66,000
Deductions			
Self-education expenses (max.)	60,000	60,000	60,000
Elderly residential care expenses (max.)	60,000	72,000	76,000
Home loan interest (max.)	100,000	100,000	100,000 (#)
MPF (max.)	12,000	12,000	14,500
Approved charitable donations (max.) [@]	35%	35%	35%

[*] Can also claim the basic dependent parent or grandparent allowance if the dependent parent or grandparent is eligible to claim an allowance under the Government's Disability Scheme.

[#] The number of years of deduction for home loan interest increased from ten years of assessment to 15 years of assessment with effect from 2012/13 (Enacted on 20 July 2012).

[@] Calculated as follows:

(Income – allowable expenses – depreciation allowances) × Percentage

Tax rates

	2008/09 and onwards
Progressive tax rates	
First $40,000	2%
Next $40,000	7%
Next $40,000	12%
Remainder	17%
Standard rate (Individual or unincorporated)	15%
Profits tax rate for corporations	16.5%

Property Tax

Year of Assessment	Tax Rate
2008/09 onwards	15%
2004/05 to 2007/08*	16%
2003/04	15.5%
2002/03	15%

*75% of the 2007/08 property tax is waived subject to a ceiling of $25,000 per case.

Stamp Duty

On Sale or Transfer of Immovable Property in Hong Kong

With effect from 1 April 2010, stamp duty on sale of immovable property in Hong Kong is charged at rates which vary with the amount or value of the consideration as follows:

(Where the stamp duty calculated includes a fraction of $1, round-up the duty to the nearest $1)

Amount or value of the consideration		Rate
Exceeds	Does not Exceed	
	$2,000,000	$100
$2,000,000	$2,351,760	$100 +10% excess over $2,000,000
$2,351,760	$3,000,000	1.5%
$3,000,000	$3,290,320	$45,000 +10% excess over $3,000,000
$3,290,320	$4,000,000	2.25%
$4,000,000	$4,428,570	$90,000 +10% excess over $4,000,000
$4,428,570	$6,000,000	3%
$6,000,000	$6,720,000	$180,000 +10% excess over $6,000,000
$6,720,000	$20,000,000	3.75%
$20,000,000	$21,739,120	$750,000 +10% excess over $20,000,000
$21,739,120		4.25%

With effect from 20 November 2010, a special stamp duty (SSD) will be imposed (on top of the normal stamp duty currently payable on conveyance on sale of immovable properties) on disposal of residential properties which were acquired by the vendor on or after 20 November 2010 and resold within 24 months from the date of acquisition. The above was enacted on 30 June 2011.

SSD is calculated based on the stated consideration or market value (whichever is higher) of the resold property at the following regressive rates (higher rate for shorter holding periods):

Holding period	**Duty rate**
For residential properties held for six month or less	15%
For residential properties held for more than 6 months but for 12 months or less	10%
For residential properties held for more than 12 months but for 24 months or less	5%

Refer to chapter 8, section 3.3 for details.

From 28 February 2007 to 31 March 2010, stamp duty was charged as follows:

Amount or value of the consideration		Rate
Exceeds	Does not Exceed	
	$2,000,000	$100
$2,000,000	$2,351,760	$100 +10% excess over $2,000,000
$2,351,760	$3,000,000	1.5%
$3,000,000	$3,290,320	$45,000 +10% excess over $3,000,000
$3,290,320	$4,000,000	2.25%
$4,000,000	$4,428,570	$90,000 +10% excess over $4,000,000
$4,428,570	$6,000,000	3%
$6,000,000	$6,720,000	$180,000 +10% excess over $6,000,000
$6,720,000	$20,000,000	3.75%

With effect from 1 April 1999, the exact amount or value of the consideration will be used to compute the stamp duty for property transfers. That is, round-up of the value or consideration to the nearest $100 is no more required.

With effect from 31 January 1992, stamp duty at the same rates as conveyances of immovable property is chargeable on agreements for the sale and purchase of residential property. After the agreement has been so stamped, the related conveyance will be chargeable with a fixed stamp duty of $100 only.

On Lease of Immovable Property in Hong Kong

Stamp duty is calculated at rates which vary with the term of the lease as follows:

Term		Rate
Not defined or is uncertain		0.25% x of the yearly or average yearly rent*
Exceeds	Does not exceed	
	1 year	0.25% of the total rent payable over the term of the lease*
1 Year	3 years	0.5% x of the yearly or average yearly rent*
3 years		1% x of the yearly average yearly rent*
Key money, construction fee etc. mentioned in the lease		4.25% of the consideration if rent is also payable under the lease. Otherwise, same duty as for a sale of immovable property
Duplicate or counterpart		$5 each

*The yearly rent/average yearly rent/total rent has to be rounded-up to the nearest $100.

Please note that any deposit which may be mentioned in the lease will not be taken into account when assessing the stamp duty.

On Transfer of Hong Kong Stock

With effect from 1 September 2001, stamp duty on sale or purchase of any Hong Kong stock is charged at rates which vary with the amount or value of the consideration as follows:

Nature of Document	Rate
Contract Note for sale or purchase of any Hong Kong Stock	0.1% of the amount of the consideration or of its value on every sold note and every bought note
Transfer operating as a voluntary disposition inter vivos	$5 + 0.2% of the value of the stock
Transfer of any other kind	$5

Source of tables:

Hong Kong Inland Revenue Department

www.ird.gov.hk

Part A

Hong Kong taxation and administration

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

chapter 1

The tax system in Hong Kong

Topic list

1 **Principles of taxation**
- 1.1 Residence
- 1.2 Capital gains
- 1.3 Double taxation relief

2 **The Basic Law**

3 **The Inland Revenue Department (IRD)**
- 3.1 The Inland Revenue Department and the Tax Ordinances
- 3.2 The Board of Inland Revenue
- 3.3 The Board of Review

4 **Learning Hong Kong tax law**
- 4.1 Sources of information
- 4.2 Identifying relevant information
- 4.3 Interpreting the provisions in the Ordinances
- 4.4 Common keywords in the Ordinances
- 4.5 Reference to DIPNs
- 4.6 Reference to Board of Review Decisions and Court Cases

5 **Types of taxes**
- 5.1 Persons chargeable to taxation under the IRO
- 5.2 Tax rates
- 5.3 Tax positions: partnerships, trustees and agents
- 5.4 Trade, profession and business losses

6 **Double taxation arrangements**

7 **Current and future tax developments**
- 7.1 Comprehensive Tax System Review
- 7.2 The Budget
- 7.3 Amendments proposed by the 2013-14 Budget
- 7.4 Expanding the scope for deduction under s.16E
- 7.5 DIPN 48 – Advance Pricing Arrangement
- 7.6 Changes in stamp duty
- 7.7 DIPN No. 49 – Profits tax deduction of capital expenditure on relevant intellectual property rights and taxation of royalties derived from licensing of intellectual property rights

Appendix

Learning focus

The Hong Kong tax system sets the stage for raising revenues through all the tax laws in Hong Kong. The Basic Law establishes Hong Kong as a distinct tax system from that of the Mainland of China and preserves the Hong Kong tax system as it was before 1997 to the present day. This has great implications for the continuity of the tax system and preserves many distinct features like low tax system, territorial source concept and so on.

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		
1.01	**Principles of taxation**	2
1.01.01	Describe the Hong Kong tax system	
1.01.02	Explain the territorial source principle	
1.01.03	Describe the roles of the taxpayer, tax advisor and the Inland Revenue Department (IRD)	
1.02	**Types of tax**	2
1.02.01	Describe the various types of taxes levied under the Inland Revenue Ordinance (IRO) and Stamp Duty Ordinance (SDO)	
1.03	**Structure and procedures of the Inland Revenue Department**	2
1.03.01	Describe the structure of the IRD	
1.03.02	Explain the procedures adopted by IRD	
1.04	**Duties and powers of the Inland Revenue Department; official secrecy**	2
1.04.02	Explain the secrecy provisions under s4 of the IRO	
1.06	**Sources of HK tax law – statute, case law, Board of Review decisions**	3
1.06.01	Describe various sources of tax law	
1.06.02	Describe the doctrine of precedent in the context of taxation law	
1.07	**Interpretation of tax statutes**	3
1.07.01	Explain the rules of interpretation of tax law and their applications	
1.08	**The Basic Law**	2
1.08.01	Explain the tax relations between HKSAR and the Mainland of China	
1.08.02	Describe the major articles of the Basic Law relating to taxation	
1.08.03	Explain and apply DIPN 29	
1.09	**Departmental Interpretation and Practice Notes and Stamp Office Interpretation and Practice Notes**	3
1.09.01	Describe the status and application of Departmental Interpretation and Practice Notes (DIPN) and Stamp Office Interpretation and Practice Notes (SOIPN)	
1.15	**Board of Inland Revenue**	2
1.15.01	Describe the role and formation of the Board of Inland Revenue	
1.15.02	Describe the Inland Revenue Rules	

1 Principles of taxation

Topic highlights

Although Hong Kong is now a Special Administrative Region (SAR) of the PRC, it maintains its own tax system under the principle of 'one country, two systems'.

The tax system in Hong Kong is largely on a **territorial basis**. In general, only income arising in or derived from Hong Kong is chargeable to tax under the Inland Revenue Ordinance (IRO).

The Stamp Duty Ordinance (SDO) imposes a charge on instruments (including counterparts and duplicates) relating to immovable property in Hong Kong, Hong Kong stock and Hong Kong bearer instruments.

The Estate Duty Ordinance (EDO) only imposes a charge on the net principal value of the property (movable and immovable) situated in Hong Kong that passes on a person's death. By virtue of the Revenue (Abolition of Estate Duty) Ordinance 2005, which commenced with effect from 11 February 2006, estates of persons who passed away on or after this date will not be subject to estate duty.

1.1 Residence

The residence or nationality of a person is irrelevant in determining his or her chargeability for tax or duty. Foreign companies carrying on business in Hong Kong are charged to tax on the same basis and at the same rate of tax as local companies. Rule 5 of the Inland Revenue Rules provides for methods of ascertainment and determination of the profits of the Hong Kong branch of a person whose head office is situated elsewhere than Hong Kong.

Pursuant to Rule 5(1) of the Inland Revenue Rules, 'permanent establishment' 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 or has a stock of merchandise from which he regularly fulfils orders on his behalf.

1.2 Capital gains

Generally speaking, capital gains are outside the scope of charge for tax in Hong Kong.

1.3 Double taxation relief

Under the 'one country, two systems' concept, Hong Kong and China maintain two separate taxation systems.

As foreign income is generally not chargeable to tax in Hong Kong, there are only very limited provisions for granting double tax relief for foreign tax paid under the IRO.

Nevertheless, in order to enhance Hong Kong as an investment platform and a gateway for inbound and outbound investments, Hong Kong has accelerated its treaty negotiations with other jurisdictions. As of 1 June 2013, Hong Kong has concluded comprehensive double taxation agreements 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.

The agreements with Liechtenstein, France, Japan and New Zealand, and the Protocol to the Agreement with Luxembourg for the avoidance of double taxation and the prevention of fiscal evasion were gazetted on 13 May 2011. The agreements with Kuwait, Switzerland and Malta for the avoidance of double taxation were gazetted on 18 May 2012.

A summary of the status of the comprehensive double taxation agreements (CDTA) that have recently been gazetted or put into force is provided below:

Country	CDTA / Protocol	Gazetted	Came into force	Take effect
Liechtenstein	CDTA	13 May 2011	8 July 2011	Y/A 2012/13
France	CDTA	13 May 2011	1 December 2011	Y/A 2012/13
Japan	CDTA	13 May 2011	14 August 2011	Y/A 2012/13
New Zealand	CDTA	13 May 2011	9 November 2011	Y/A 2012/13
Luxembourg	Protocol	13 May 2011	17 August 2011	Y/A 2012/13
Switzerland	CDTA	18 May 2012	15 October 2012	Y/A 2013/14
Malta	CDTA	18 May 2012	18 July 2012	Y/A 2013/14
Malaysia	CDTA	19 October 2012	28 December 2012	Y/A 2013/14
Mexico	CDTA	19 October 2012	7 March 2013	Y/A 2014/15
Portugal	CDTA	12 January 2012	3 June 2012	Y/A 2013/14

In addition, there are 27 avoidance of double taxation agreements on airline income, six agreements on shipping income and two agreements on airline and shipping income.

For details, please refer to chapter 12 of the Learning Pack.

2 The Basic Law

Topic highlights

The Basic Law states the tax relationship between Hong Kong and the Mainland of China.

It is worth noting that none of the tax treaties entered into by the Mainland Government with the other countries is applicable to Hong Kong since Hong Kong and China maintain two separate taxation systems. DIPN 29 summarises the principle 'one country, two systems' and outlines the tax relations between Hong Kong and the Mainland. Under Article 151 of the Basic Law, the HKSAR has concluded comprehensive double taxation agreements with 29 jurisdictions under 'Hong Kong, China' as of 1 June 2013.

The following provisions in the Basic Law are considered relevant to the continuance of the tax system in Hong Kong:

Article	
5	Hong Kong's social and economic systems will remain unchanged.
8	The laws previously in force in Hong Kong will be maintained.
73	The Legislative Council of the HKSAR will have the power to approve taxation policies.
106	The SAR shall use its financial revenues exclusively for its own purposes, and they shall not be handed over to the Central People's Government. The Central People's Government will not levy taxes in the HKSAR.
108	The HKSAR will practise an independent taxation system. The HKSAR, taking the low tax policy previously pursued in Hong Kong as a

Article	
	reference, will enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation.
151	The HKSAR may on its own, use the name 'Hong Kong, China' to maintain and develop relations and conclude and implement agreements with foreign states and regions and relevant international organizations in the appropriate fields, including the economic, trade, financial and monetary, shipping, communications, tourism, cultural and sports fields.
153	The application to the HKSAR of international agreements to which the People's Republic of China (PRC) is or becomes a party shall be decided by the Central People's Government in accordance with the circumstances and needs of the Region, and after seeking the views of the government of the Region. International agreements to which the PRC is not a party but which are implemented in Hong Kong may continue to be implemented in the HKSAR. The Central People's Government shall, as necessary, authorise or assist the government of the Region to make appropriate arrangements for the application to the Region of other relevant international agreements.

Self-test question 1

World Inc is a USA company and intends to expand its business into Hong Kong and the Mainland of China. However, its finance manager, David Smith, is not sure whether the PRC tax authority would impose tax on businesses to be carried out in HK. In particular, he is not sure whether the tax treaty entered into between the Mainland and the USA will be applicable to the company's businesses to be carried on in Hong Kong.

Required

Explain using the description of Basic Law above the validity of concerns of a foreign investor like David Smith.

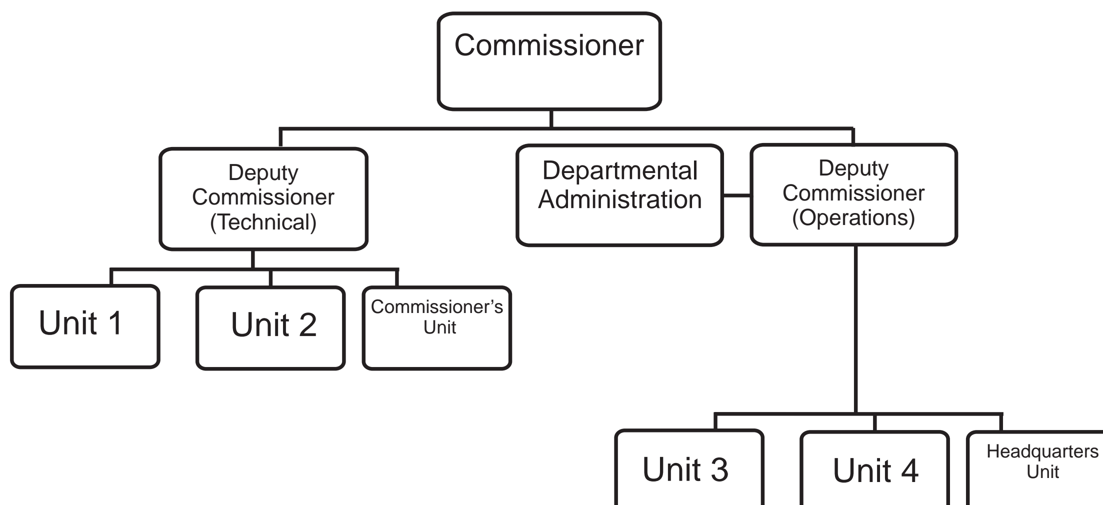
(The answer is at the end of the chapter)

3 The Inland Revenue Department (IRD)

Topic highlights

The IRD is headed by the Commissioner of Inland Revenue. There are six units within the IRD.

The Department is divided into various units and operating divisions as depicted below:



The Commissioner is assisted by the Deputy Commissioners and the other assistant commissioners and officers. Most times, the Commissioner will delegate certain statutory functions to the Deputy Commissioners or officers. However, there are circumstances where the Commissioner or the Deputy Commissioner is required to act personally as in the case of complying with Exchange of Information Article and to ensure that disclosure requests received are in order and that the information to be exchanged is proper in all respects before signing off the replies in their names.

The taxpayers would normally deal with the officers in one of the following Units within the IRD:

- Unit 1 – Profits Tax – Corporations and Partnerships Processing and Review
- Unit 2 – Salaries Tax, Profits Tax – Sole Proprietorships, Property Tax – Sole Owners and Personal Assessment
- Unit 3 – Collection, Inspection, Estate Duty, Stamp Duty, Business Registration
- Unit 4 – Field Audit and Investigation

3.1 The Inland Revenue Department and the Tax Ordinances

The Inland Revenue Department (IRD) is tasked to carry out the provisions of the following ordinances.

Ordinance	Scope of Charge
Inland Revenue	Property tax Salaries tax Profits tax
Estate Duty*	Estate duty
Stamp Duty	Stamp duty
Betting Duty	Betting duty
Hotel Accommodation Tax *	Hotel accommodation tax
Tax Reserve Certificates	Tax reserve certificates

* The Hotel Accommodation Tax was waived with effect from 1 July 2008. Estate Duty was abolished in respect of deaths occurring after 11 February 2006.

Other than the Ordinances, the Commissioner may from time to time issue Departmental Interpretation and Practice Notes (DIPNs) and Stamp Office Interpretation and Practice Notes (SOIPNs) to clarify the IRD's viewpoint and interpretation of certain situations.

At the very beginning of the IRO, there is a sentence:

'To impose a tax on property, earnings and profits.'

The income tax imposed in Hong Kong is charged under a schedular system (i.e. property tax on income from property, salaries tax on income from office, employment or pension, profits tax on profits from trade, profession or business), which is different from the total income concept in other jurisdictions.

It should be noted that personal assessment is not a separate charge of tax. It only provides an alternative basis for computing an individual's tax liability under the IRO.

There is a Business Registration Office in the IRD that carries out the provisions of the Business Registration Ordinance (BRO) for registration of businesses in Hong Kong.

The IRD uses the business registration number for profits tax file reference by assigning a two-digit prefix in accordance with the nature of the business. For example, file number 05/12345678 is for a corporation, with business number 12345678, engaged in trading.

For a taxpayer who does not have a business registration number, a dummy number may be assigned for identification purpose. For example, 40/90345678 is for an individual engaged in property speculation business without applying for a business registration certificate.

The legality of the income of a person is irrelevant in determining the chargeability of the income. In this regard, profits from illegal activities (e.g. smuggling) will be chargeable to profits tax, if the relevant charging conditions are satisfied.

For salaries tax and personal assessment purposes, the Hong Kong identity card number of an individual will be used for tax file reference.

For property tax purposes, the reference number used by the Rating and Valuation Department for rating purposes will be used for a tax file reference.

Except in the case of wilful tax evasion, the IRD has to raise an assessment or an additional assessment on a taxpayer within a year of assessment or within six years after the expiry of the year of assessment if the taxpayer has not been assessed or has been assessed at less than the proper amount. In wilful evasion cases, the period could be extended to 10 years. In the case of a deceased taxpayer who died before 11 February 2006, the IRD has to raise an assessment or an additional assessment in respect of a period prior to the date of the person's death within 1 year from the date of the death of the taxpayer, or 1 year from the date of filing any affidavit required under the EDO, whichever is the later. Where the person dies at any time on or after 11 February 2006, the IRD has to raise an assessment or an additional assessment in respect of a period prior to the date of the person's death within 3 years immediately after that year of assessment. Otherwise, the assessment will be time-barred.

There is a Tax Reserve Certificates Ordinance (TRCO), which governs the issue and redemption of Tax Reserve Certificates (TRCs). On 1 September 1999, a new electronic tax reserve certificate scheme was introduced to replace the paper tax reserve certificate. At present, there are two types of TRCs (i.e. the ordinary TRCs and the TRCs for 'Conditional Standover Order' issued under objection cases). Ordinary TRCs are now issued only in electronic form. On the other hand, TRCs for 'Conditional Standover Order' are issued only in paper form.

For offences committed by a person, a fine may be imposed by the courts based on the penalty levels prescribed in Schedule 8 of the Criminal Procedure Ordinance as follows:

Level	*Fine*
	$
1	2,000
2	5,000
3	10,000
4	25,000
5	50,000
6	100,000

Depending on the nature of the offence, other penalties (e.g. imprisonment) may also be imposed. For certain offences (e.g. failure to inform the Commissioner of chargeability for tax) where no legal

proceedings have been instituted, the Commissioner or a Deputy Commissioner may raise an additional tax assessment under s.82A as a penalty. For further details regarding offences and penalties, please refer to chapter 2, section 7, page 16.

3.2 The Board of Inland Revenue

The Board of Inland Revenue is constituted under s.3 of the IRO. It has the Financial Secretary as its Chairman and four other appointed members, of which only one can be a Government official. Its Secretary is a Deputy Commissioner of Inland Revenue. The Board operates independently of the IRD.

The Board has three major functions concerning the operation of the IRD as follows:

- To prescribe the returns to be used for property tax, salaries tax, profits tax and personal assessment or the form of the returns
- To prescribe the rates of annual allowance for depreciation on machinery and plant
- To prescribe the procedures relating to applications for refunds and relief, appeals procedures, and miscellaneous matters as authorised

The Board may from time to time make rules generally for carrying out the provisions of the IRO and for the ascertainment and determination of any class of *income* or profits. The Inland Revenue Rules (Cap: 112A) issued so far are as follows:

1 Rates of depreciation

  2A General apportionment of outgoings and expenses
  2B Interest on borrowed money used in purchase of shares
  2C Investment portfolios
  2D Rights of objection and appeal

2 Banks; Hong Kong branch offices

3 (Repealed)

4 Profit of Hong Kong branch offices

5 (Repealed)

3.3 The Board of Review

The Board of Review (Inland Revenue Ordinance) ('the Board') is an independent statutory body constituted since 1947 under s.65 of the IRO (Cap: 112) to determine tax appeals. The Board's members are appointed by the Chief Executive. The Chairman and Deputy Chairmen are persons with legal training and experience and other members from all walks of life. The Board shall comprise one Chairman and not more than ten Deputy Chairmen and 150 members. The Board is assisted by the Clerk to the Board.

The Board is responsible for conducting hearings on tax appeals lodged. A panel with at least three members, one of whom shall always be either the Chairman or a Deputy Chairman, is formed to hear and determine a tax appeal. Decision is made on the basis of a majority of votes and the member presiding has a casting vote in addition to his original vote.

After hearing an appeal, the presiding Chairman is responsible for delivering the decision of the Board usually in written form. Upon application by the Appellant or the Commissioner, the Board would state a case on a question of law for the opinion of the Court of First Instance of the High Court.

As from 12 February 2011,

- The Board can correct clerical mistakes in its written decisions on tax appeals.
- Members of the Board will be nominated by the Chairman of the Board, rather than by the Chief Secretary for Administration to hear appeals.

- Retired members may act on a case he/she handled previously.
- Presiding member can have the casting vote.

4 Learning Hong Kong tax law

Topic highlights

Tax statutes can be interpreted with reference to certain rules of construction, court decisions, and Board of Review cases.

4.1 Sources of information

To understand the tax law in Hong Kong, reference may be made to the following materials:

- Textbooks on taxation (e.g. Hong Kong Master Tax Guide, Hong Kong Taxation – Law and Practice, Advanced Taxation in Hong Kong)
- Tax Ordinances (Inland Revenue, Estate Duty, Stamp Duty)
- Inland Revenue Rules
- Case Law (Hong Kong tax cases (HKTC), cases in other jurisdictions)
- Board of Review (BoR) decisions
- Departmental Interpretation and Practice Notes (DIPNs)
- Other legislation (e.g. Interpretation and General Clauses, Mandatory Provident Fund (MPF))
- Reports of the Inland Revenue Ordinance Review Committee
- Other tax reports/seminars
- The Internet (e.g. website of the Inland Revenue Department (**http://www.ird.gov.hk/index.htm**), website of the Hong Kong Institute of Certified Public Accountants (**http://www.hkicpa.org.hk**)

In general, the IRD home page provides a lot of information with regard to the tax system in Hong Kong (including the DIPNs and BoR decisions). There are also standard forms (change of address, simple objection letter, etc.) which can be downloaded and software (Salaries Tax Computation program, software for the completion of Employer's Returns of Remuneration and Pensions), which may be accessed from the IRD home page.

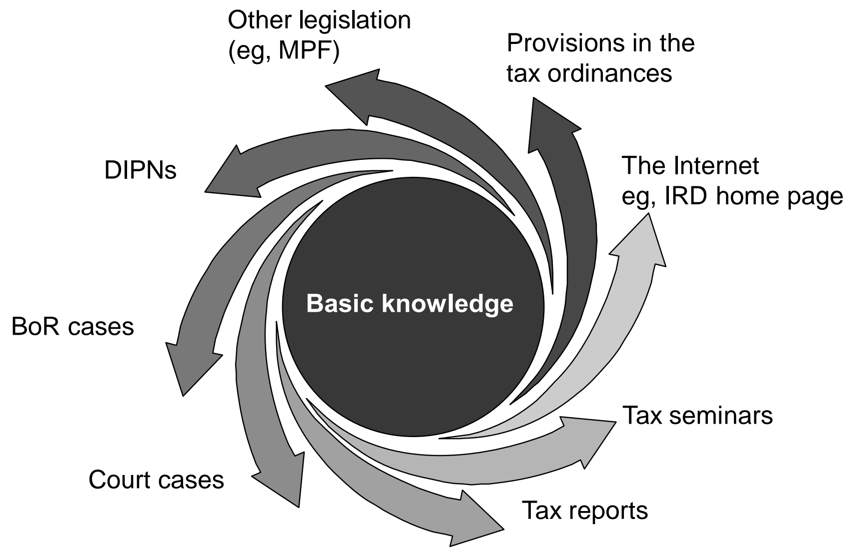
4.2 Identifying relevant information

Candidates should identify the relevant information with regard to their particular objectives.

For those who just wish to identify the basic tax principles and prepare simple tax computations, a textbook may be sufficient.

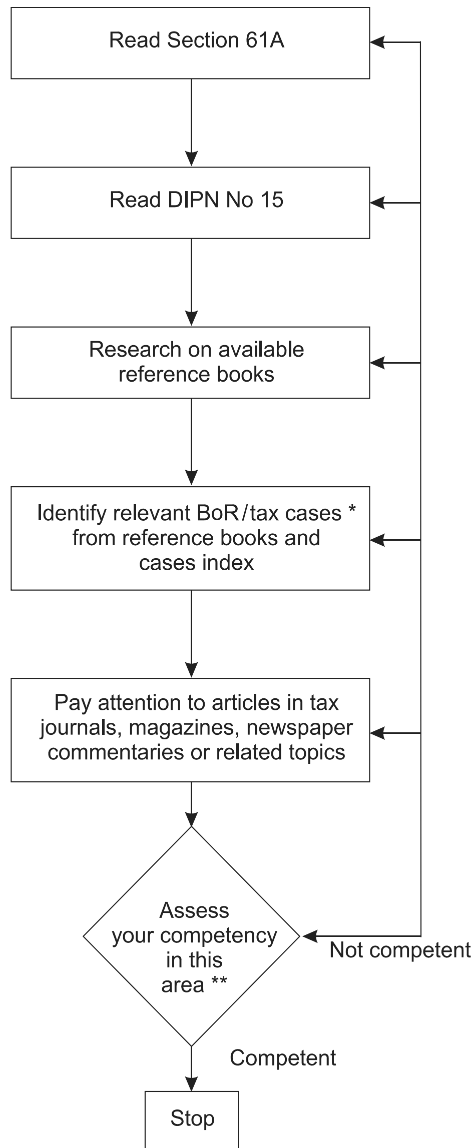
For those who wish to conduct research on the background of certain changes in the tax system in Hong Kong, the Reports of the Inland Revenue Ordinance Review Committee are necessary.

For those who aim to be tax practitioners in Hong Kong, continuing updating of knowledge and study with the aid of the following information is considered relevant.



Example: Learning the law

If a candidate would like to update their knowledge of the application of s.61A, they could adopt the following study method.



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* For example, D52/96, D44/97, *CIR v Yick Fung Estates Limited* [(1999) HKRC 90-096]
** Through discussions and practical application

4.3 Interpreting the provisions in the Ordinances

To read and understand the tax ordinances is a difficult task as the statutes are written in legal language that is not always readily understandable. Certain words may have very special meanings derived from court decisions. It is therefore necessary to have a grasp of certain interpretation rules and to know where to find information that will assist or guide interpretation.

In general, a **literal interpretation** must be followed unless the words taken in their natural sense could lead to an absurdity or an inconsistency with other provisions in the ordinance. For example, letting a property for rental purpose by a corporation is specifically within the meaning of 'business' under s.2 of the IRO.

There is also a general rule that, whenever a specific provision conflicts with a general provision, the **specific provision** prevails. For example, a club is chargeable to tax under s.24(1) of the IRO, as s.24(1) is a specific charging section for clubs rather than s.14, which is a general profits tax charging section.

According to s.19 of the Interpretation and General Clauses Ordinance (IGCO), where the meaning of words in a statute is unclear, an ordinance is deemed to be remedial and will receive such fair, large and liberal construction and interpretation as will best ensure the attainment of the object of the ordinance according to its true intent, meaning and spirit.

The IRD has also issued its DIPNs for guidance to taxpayers and tax practitioners. The DIPNs are not binding on either the tax authority or the taxpayers.

When a taxpayer and the tax authority cannot agree on the interpretation of a provision in an ordinance, the taxpayer or the IRD can use the appeal procedures laid down in the IRO and seek a ruling on a question of law from the courts. The courts have, in the past, clarified the interpretation of relevant provisions in ordinances. For example, the word 'incurred' in s.16(1) of the IRO was thoroughly discussed in the case of *Lo and Lo* [(1984) 2 HKTC 34].

As a judicial precedent, the decision of a higher court binds all lower courts. Thus, the decisions of the Court of Final Appeal and, prior to 1 July 1997, the Privy Council of the UK, are final on all parties.

Up to now, English has been the major language of the courts. Although the taxpayers have the right to litigate in Chinese, no tax case in Chinese has been put through the courts.

4.3.1 Steps to interpreting a tax provision

As a general guide to interpreting a tax provision, we should:

Step 1 Determine which words are defined in the ordinance. For example, most of the definitions in the IRO can be found in s.2 or other sections.

Step 2 Give the other words their usual literal or dictionary meaning.

Step 3 Check to see whether the tax authority has given its interpretation on the subject in the DIPNs.

Step 4 Check the case law to see if the courts have already been asked to rule on the subject.

Step 5 Look into the background of the enactment of the relevant provision to find out the legislative intention.

To correctly interpret the wording of an ordinance, special attention must be paid to words or expressions that occur frequently and have specific meanings.

4.4 Common keywords in the Ordinances

The following is a non-exhaustive list of such words or expressions together with examples that illustrate their meanings.

Keyword	Interpretation	Example
and/or	When a section contains a list, it is necessary to determine whether the series end with an 'and' or an 'or'. If there is an 'and' before the last item in the series, all the elements or conditions listed must be met or be present for the provision to apply. If there is an 'or', only one element in the series must exist in order for the provision to apply.	**S.41(1) of the IRO:** Subject to subsection (1A), an individual: (a) of or above the age of 18 years, or under that age if both his or her parents are dead; and (b) who is or, if he or she is married, whose spouse is either a permanent or temporary resident, may elect for personal assessment...
deemed	This word means that the legislation treats a form of income, a transaction or a relationship in a specific manner, regardless of the legal or ordinary reality.	**S.15(1) of the IRO:** For the purposes of this ordinance, the sums described in the following paragraphs shall be deemed to be receipts arising in or derived from Hong Kong…
except	This word means that the stated situation that follows "except" is to be excluded in applying the provision.	**S.2 of the IRO:** 'tax' except for the purposes of Parts XII and XIII, means any tax imposed by this Ordinance...
if	When the word 'if' is used in a provision, there is a condition to be met before applying the balance of the provision.	**S.9(2)(a) of the IRO:** If such place of residence be a hotel, hostel or boarding house the rental value shall be deemed to be 8%...
includes	The word 'includes' used in a definition indicates that the definition is not exhaustive and the elements listed are the extended meanings.	**S.2 of the IRO:** 'business' includes agricultural undertaking, poultry and pig rearing and...
means	The word 'means' used in a definition indicates that the definition is all inclusive. Nothing can be added.	**S.41(4) of the IRO:** Permanent resident means an individual who ordinarily resides in Hong Kong.
notwithstanding	This expression usually appears at the beginning of a provision. This means that the stated provisions will not be bound by or affected by another (possibly contradicting) provision.	**S.70A of the IRO:** Notwithstanding the provisions of s.70, if, upon application...

Keyword	Interpretation	Example
subject to	This expression usually appears at the beginning of a provision. This means that the interpretation of the relevant provision(s) depends on the condition(s) stated.	**S.51C of the IRO:** (1) Subject to subsection (2), every person carrying on a trade… (2) Subsection (1) shall not require the preservation of any records: (a) which the Commissioner has specified need not be preserved; or (b) of a corporation which has been dissolved.

4.5 Reference to DIPNs

A list of the DIPNs issued/revised by the IRD (as at 7 June 2011) is as follows:

Inland Revenue Ordinance (Chapter 112) – Departmental Interpretation & Practice Notes

No.	Subjects	Date of issue
1 (Revised)	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	Jul 2006
2 (Revised)	Profits Tax Part A: Industrial Buildings Allowances Part B: Commercial Buildings Allowances	Apr 1999
3 (Revised)	Profits Tax: Apportionment of Expenses	Jul 2008
4 (Revised)	Profits Tax: • Lease Premiums • Non-returnable Deposits • Key or Tea Money • Construction Fees etc.	Feb 2006
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) Environmental protection facilities	Jul 2012
6 (Revised)	Inland Revenue Ordinance – Provisions as to (A) Objections to the Commissioner (B) Appeals to the Board of Review (C) Appeals to the Courts	Nov 2006
7 (Revised)	Machinery or Plant – Depreciation Allowances	Aug 2009
8	Losses	Sep 2009

No.	Subjects	Date of issue
9 (Revised)	Major Deductible Items under Salaries Tax	Sep 2006
10 (Revised)	The Charge to Salaries Tax	Jun 2007
11 (Revised)	Field Audit and Investigation	Oct 2007
12 (Revised)	Commission, Rebates and Discounts	Sep 2001
13 (Revised)	Profits Tax: Taxation of Interest Received	Dec 2004
13A	Profits Tax: Deductibility of Interest Expense	Dec 2004
14 (Revised)	Property Tax	Mar 2011
15 (Revised)	(A) Limitation of Loss Relief (S.22B) (B) Leasing Arrangements (S.39E) (C) General Anti-Avoidance Provision (S.61) (D) General Anti-Avoidance Provision (S.61A) (E) Loss Companies (S.61B) (F) Ramsay Principle (G) Penalty on Tax Avoidance Cases (H) Guidelines on Lease Financing (I) Advance Rulings	Jan 2006
16 (Revised)	Salaries Tax – Taxation of Fringe Benefits	Oct 2003
17 (Revised)	The Taxation of Persons Chargeable to Profits Tax on behalf of Non-Residents	Jan 2005
18 (Revised)	Assessment of Individuals under Salaries Tax and Personal Assessment	Jan 2005
19	The Agreement between the United States of America and Hong Kong in respect of the Taxation of Shipping Profits	Sep 1989
20 (Revised)	Unit Trusts, Mutual Fund Corporations and Similar Collective Investment Schemes	Jun 2012
21 (Revised)	Locality of Profits	Jul 2012
22 (Revised)	Computation of Assessable Profits from cinematograph films, patents, trademarks, etc	Jan 2005
23 (Revised)	Recognised Retirement Schemes	Sep 2006
24 (Revised)	Service Company 'Type II' Arrangements – Profits Tax	Jul 2009
25 (Revised)	Service Company 'Type I' Arrangements – Salaries Tax	Nov 2011
26 (Revised)	Specified Securities for the purposes of s.15E of the Inland Revenue Ordinance	Jun 2009
27 (Revised)	Stock Borrowing and Lending	Jun 2010
28	Profits Tax: Deductibility of Foreign Taxes	Jul 1997
29	Tax Relations between The Hong Kong Special Administrative Region and The People's Republic of China	Aug 1997
30 (Revised)	Profits Tax: s.20AA – Persons not Treated as Agents	Sep 2009
31 (Revised)	Advance Rulings	Nov 2011

No.	Subjects	Date of issue
32 (Revised)	Arrangement between the Mainland of China and The Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income	Oct 2011
33 (Revised)	Insurance Agents	Oct 2009
34 (Revised)	Exemption From Profits Tax (Interest Income) Order 1998	Dec 2004
35 (Revised)	Concessionary Deductions: Sections 26E and 26F – Home Loan Interest	May 2007
36	Concessionary Deductions: s.26D – Elderly Residential Care Expenses	Jan 2000
37 (Revised)	Concessionary Deductions: s.26C – Approved Charitable Donations	Sep 2006
38 (Revised)	Salaries Tax – Employee Share-based Benefits	Mar 2008
39	Profits Tax – Treatment of Electronic Commerce	Jul 2001
40 (Revised)	Profits Tax – Prepaid or Deferred Revenue Expenses	Aug 2010
41	Salaries Tax – Taxation of Holiday Journey Benefits	Aug 2003
42	Profits Tax – Part A: Taxation of Financial Instruments; Part B: Taxation of Foreign Exchange Differences	Nov 2005
43 (Revised)	Profits Tax – Profits Tax Exemption for Offshore Funds	Feb 2010
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	Aug 2008
45	Relief from double taxation due to transfer pricing or profit reallocation adjustments	Apr 2009
46	Transfer pricing guidelines – Methodologies and related issues	Dec 2009
47	Exchange of Information under Comprehensive Double Taxation Agreements	Jun 2010
48	Advance Pricing Arrangement	Mar 2012
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	Jul 2012

Stamp Duty Ordinance (Chapter 117) – Stamp Office Interpretation & Practice Notes (SOIPN)

No.	Subjects	Date of Issue
1 (Revised)	Stamping of Agreements for Sale and Purchase of Residential Property	Aug 2006
2 (Revised)	Relief For Stock Borrowing and Lending Transactions	Feb 2011
3	Deemed Consideration under s.24 of the Stamp Duty Ordinance	Sept 1998
4	Deemed Sale and Purchase under s.19(1E) of the Stamp Duty Ordinance	Jan 2000
5 (Revised)	Special Stamp Duty	Oct 2011

Estate Duty Ordinance (Chapter 111) – Estate Duty Office Interpretation & Practices Notes (EDOIPN)

No.	Subjects	Date of Issue
1	Controlled Companies Provisions under the Estate Duty Ordinance	Dec 2000

The above Practice Notes can be found in the home page **http://www.ird.gov.hk/eng/ppr/dip.htm** of the IRD.

As stated above, the DIPNs issued by the IRD are neither binding on the tax authority nor the taxpayers. Some of the DIPNs have not been updated by the IRD for a long period of time. Some simply outline the administrative procedures while some are issued/revised by the IRD with regard to the decisions of the Courts.

Candidates should identify the relevant DIPNs with regard to their particular objective or the subject they are studying. With the relevant DIPN, they will be able to see how the IRD interprets a particular tax provision and/or what is the practice of the IRD in a given situation (eg source of profit as outlined in DIPN No. 21).

4.6 Reference to Board of Review Decisions and Court Cases

Each case has its own merits. Memorising the facts and decision of a particular case is not the correct way of learning tax law. The correct approach is to identify and analyse the relevant facts of a particular case with regard to the approach adopted by the Board of Review/Courts and to see how the relevant tax provisions are interpreted and applied in the circumstances. It is also important to distinguish the relevant facts in different cases on the same issue (eg capital v. revenue in nature).

The decision of the Board of Review is final with regard to the facts of a particular case. In an appeal to the Courts (Court of First Instance (formerly the High Court), Court of Appeal and Court of Final Appeal), the judges are required to decide the case by expressing their opinion in respect of questions of law. The principle on which the case was decided is called the *ratio decidendi*, which has binding force. Other things said by the judges in passing are called *obiter dicta*, which are only persuasive.

The decision of a Board of Review is not binding on other Boards of Review. On the other hand, the decision of a higher court (eg Court of Final Appeal) binds all lower courts. As each jurisdiction has its own statute, cases decided in other jurisdictions are not binding on local courts (they are often quoted for illustration of certain principles to assist the judges in making their decisions). Court cases are therefore more important than Board of Review decisions with regard to the doctrine of judicial precedent. As the tax rate in Hong Kong is low and the costs associated with an appeal to the courts in Hong Kong are often high, not many tax cases have been decided by the

courts in Hong Kong. Board of Review decisions, although without binding force, are regarded as important sources of information to those who have interest in the tax law in Hong Kong.

With regard to the doctrine of judicial precedent, the Court of First Instance (formerly the High Court) needs to follow the previous decisions of the Court of Appeal in similar cases. The Court of Appeal needs to follow the decision of the Court of Final Appeal and also its own previous decisions. However, a court may not follow the decision of a precedent case if it is able to:

- distinguish the case now before it from the previous case based on the facts;
- find the previous case to be *per incuriam* (i.e. where an important case or statue was not bought to the attention of the court when the previous decision was made);
- declare the previous case to be in conflict with a fundamental principle of law;
- declare the principle of the previous case to be obscure;
- declare the principle of the previous case to be too wide and regard some of it as persuasive and not binding;
- declare the previous case to be overruled by statute.

A full court (with five or more judges) may also overrule an earlier decision not heard by a full court of the same level.

5 Types of taxes

Topic highlights

HKSAR raises revenue through a number of taxes in Hong Kong.

5.1 Persons chargeable to taxation under the IRO

Key term

Under s.2 of the IRO, the definition of **person** includes a corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons.

Tax under the IRO may be charged on the 'person' as follows:

	Property Tax	Salaries Tax	Profits Tax
Individual	✓	✓	✓
Corporation	✓	×	✓
Partnership	×	×	✓
Trustee	✓	×	✓
Body of persons	✓	×	✓

5.2 Tax rates

The tax rates apply as follows:

Tax	Tax rate
Property tax	Standard rate on net assessable value
Salaries tax	The lower of (i) Standard rate on (assessable income after deductions of allowable outgoings, depreciation allowances, concessionary deductions and self-education expenses but before personal allowances) and (ii) progressive tax rates on (assessable income after deductions of allowable outgoings, depreciation allowances, concessionary deductions, self-education expenses and personal allowances).
Profits tax	
Corporation	16.5%
Partnership	16.5% on corporate partners' share of profit and standard rate on the balance
Unincorporated business	Standard rate

The standard rates are as follows:

Year of assessment	2003/04	2004/05 to 2007/08	2008/09 onwards
Unincorporated standard rate	15.5%	16%	15%

Year of assessment	2003/04	2004/05 to 2007/08	2008/09 onwards
Corporate profits tax rate	17.5%	17.5%	16.5%

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%

Note: There is a partial salaries tax reduction for 2006/07 as a relief measure. All taxpayers liable to salaries tax or personal assessment will receive a reduction of 50% of the 2006/07 final tax, subject to a ceiling of $15,000 per case.

There is a partial salaries tax reduction for 2007/08 as a relief measure. All taxpayers liable to salaries tax, profits tax or personal assessment will have a reduction of 75% of the 2007/08 final tax, subject to a ceiling of $25,000 per case.

There is a partial salaries tax reduction for 2008/09 as a relief measure. All taxpayers liable to salaries tax or personal assessment will have a reduction of 100% of the 2008/09 final tax, subject to a ceiling of $8,000 per case.

There is a partial salaries tax reduction for 2009/10 as a relief measure. All taxpayers liable to salaries tax or personal assessment will have a reduction of 75% of the 2009/10 final tax, subject to a ceiling of $6,000 per case.

There is a partial tax reduction for 2010/11 as a relief measure. All taxpayers liable to salaries tax or tax under personal assessment will have a reduction of 75% of the 2010/11 final tax, subject to a ceiling of $6,000 per case.

There is a partial tax reduction for 2011/12 as a relief measure. All taxpayers liable to profits tax, salaries tax or tax under personal assessment will have a reduction of 75% of the 2011/12 final tax, subject to a ceiling of $12,000 per case (Enacted on 20 July 2012).

There is a proposed partial tax reduction for 2012/13 as a relief measure as per the 2013-14 Budget. All taxpayers liable to profits tax, salaries tax or tax under personal assessment will have a reduction of 75% of the 2012/13 final tax, subject to a ceiling of $10,000 per case.

5.3 Tax positions: partnerships, trustees and agents

Although a partnership is not a legal person, it is taxed under the IRO as a chargeable entity.

The tax position of a trustee is not clear. A trustee may carry on a trade or business but the income derived from that trade or business does not belong to the trustee. The income actually belongs to the beneficiaries under the trust but such beneficiaries are not the persons carrying on the trade or business. If tax has been paid by a trustee, it is likely that no further tax would be payable on the distributions to beneficiaries.

A person may authorise another person in writing to act on his/her behalf with regard to his/her tax matters. At present, there is no qualification or experience requirement for a person to act as a tax representative. Any person may be appointed as a tax representative of a taxpayer. With regard to the role of a tax representative/advisor, refer to chapter 11.

5.4 Trade, profession and business losses

In Hong Kong, tax losses from a trade, profession or business can be carried forward indefinitely to offset against the future assessable profits of the same trade, profession or business (there is no time limit). For corporations, the share of tax losses from a partnership could be used to offset against the corporation's own assessable profits or vice versa.

A summary of the treatment of losses under profits tax is as follows:

Person	Treatment of losses
Individual	Allowable tax losses can only be carried forward to offset the future assessable profits from the same trade, profession or business unless personal assessment is validly elected for the year of assessment in which the loss was incurred.
Corporation	Allowable tax losses can be utilised to offset the assessable profits from other trade or business of the same corporation. The share of tax losses from a partnership can be used to offset the corporation's own assessable profits or vice versa. S.61B may deny the offset of tax losses of a company if there is a change in its shareholding with a sole or predominant purpose to obtain a tax benefit.
Partnership	The allowable tax losses of the partnership are allocated to each of the partners to offset that partner's future assessable profits from that trade or business. Any unused tax losses of a partner (other than a corporation) will lapse upon his withdrawal from the partnership. A corporate partner of a partnership may use its share of the tax loss from the partnership to offset its other assessable profits (or vice versa). ss.19C(4) and 19C(5) Pursuant to s.22B of the IRO, the tax loss shared by a limited partner of a partnership may not be fully allowed to offset the limited partner's other taxable profits. The allowable amount of the tax loss of a limited partner of a partnership is limited to the lesser of: – the amount of the loss; or – the amount of the limited partner's contribution to the partnership as at the end of the relevant year of assessment in which the loss is sustained (or by the time the person ceased to be a partner in the partnership).
Trustee	A trustee may carry on more than one trade or business. The allowable tax losses from a trade or business can only be utilised to offset against the future assessable profits from that trade or business.
Body of persons	Allowable tax losses can be carried forward to offset against the future assessable profits from the same trade or business. The share of tax losses from a partnership can be used to offset the body's own assessable profits or vice versa.

There is no group relief in Hong Kong. The tax losses suffered by a company in a group of companies cannot be used to offset against the assessable profits of the holding company or any company in the same group. It is therefore important for a group of companies to plan carefully for inter-company transactions and inter-company charges to mitigate the group's overall tax burden.

The absence of carry backward provisions in Hong Kong may cause a tax burden for those taxpayers who have earned profits in early years but suffered losses in subsequent years.

Example:

An example is as follows:

	Individual A	Individual B
Year 1 (commencement)	Profits $1,000	Losses $1,000
Year 2	Losses $500	Profits $500
Year 3 (cessation)	Losses $500	Profits $500
Total profits/(losses)	Nil	Nil
Profits tax paid (at tax rate of 15%)	$150	Nil

Note: Assume the profits are assessable and the losses are allowable.

Solution

Pursuant to the provisions under the IRO, individual A, if eligible, may elect for personal assessment to use his losses under profits tax to offset against his other taxable income.

6 Double taxation arrangements

Topic highlights

Hong Kong and the Mainland maintain two separate taxation systems. Hong Kong has its own network of double taxation agreements which is separate from that of the Mainland.

Hong Kong is a Special Administrative Region, which is neither subject to the Mainland's taxation (which imposes tax on its residents' income) nor covered by the Mainland's double tax treaty network.

Hong Kong maintains its own tax system under the principle of 'one country, two systems'. Candidates should be aware that there are significant differences between the tax system in Hong Kong and the tax system in the Mainland and the impact of the Double Taxation Arrangement entered into between the Mainland and the HKSAR.

Pursuant to s.49 of the IRO, the Chief Executive in Council may by order declare that arrangements specified in the order have been made with the Government of any territory outside Hong Kong with a view to affording relief from double taxation in relation to income tax and any tax of a similar character imposed by the laws of that territory, and that it is expedient that those arrangements should have effect, the arrangements shall have effect in relation to tax under the IRO notwithstanding anything in any enactment.

For more details on Double Taxation Arrangements, please refer to chapter 12, section 3.

7 Current and future tax developments

Topic highlights

Tax developments in Hong Kong include a comprehensive tax system review, the budget, amendments to the IRO, and expanding its tax treaty network.

7.1 Comprehensive Tax System Review

There have been fears that Hong Kong is facing major structural problems with its public finances. In 2000, an Advisory Committee on New Broad-based Taxes ('the Committee') was formed to conduct a comprehensive review on the tax system in Hong Kong.

The Committee has completed their review on the tax system in Hong Kong. They consider Hong Kong's tax system, when compared to international standards, to be narrow on two grounds. First, the scope of the taxes it imposes is narrow. Second, some of the taxes imposed are narrow in terms of the percentage of the population that are subject to them because of high allowance levels.

A consultation paper has been issued to seek views from the public on what types of broad-based taxes may be suitable for Hong Kong. The consultation paper sets out the following options to broaden the tax base in Hong Kong:

Raising the revenue productivity of certain key existing taxes by:

- increasing the tax rates
- reducing personal allowances and concessions
- extending the scope of their coverage

Introducing new taxes:

- Good and Services Tax
- Capital gains tax
- Tax on interest
- Tax on dividends
- Tax on worldwide income
- Land and sea departures tax
- Social security taxes
- Poll tax
- General consumption tax
- Tax on mobile phones and signboards

In 2006, the Government launched a public consultation on broadening the tax base including the recommendation on introducing Goods and Services Tax (GST) in Hong Kong. A final report on the public consultation in June 2007 was issued. In view of the fact that the public was strongly against GST, the Government considered there was insufficient public support nor were the conditions right for the introduction of GST. The Government, however, decided to continue to listen to public views on other options for broadening the tax base.

The consultation documents and other information concerning the Committee and broad-based taxes can be viewed or downloaded at the following websites:

http://www.fstb.gov.hk/tb/acnbt/engindex.html; and

http://www.taxreform.gov.hk/eng/doc_and_leaflet.htm.

It is hard to predict whether any of the options suggested in the 2006 consultation paper will be implemented in Hong Kong and the likely timing of such changes in the tax system in Hong Kong. It is expected that no new tax will be introduced in the near future.

7.2 The Budget

The Financial Secretary usually submits the Budget (which often involves changes in tax rates, allowances, etc.) to the Legislative Council in February or March each year. Relevant information could be obtained from the website of **http://www.budgetgov.hk/**.

The Budget is often prepared with regard to the submissions made by various focus groups, including the Hong Kong Institute of Certified Public Accountants. The proposals made by the Hong Kong Institute of Certified Public Accountants outline the relevant factors for reviewing and updating the tax system in Hong Kong in order to respond to the changing environment.

Candidates are recommended to visit the website of the Hong Kong Institute of Certified Public Accountants (**http://www.hkicpa.org.hk**) and the websites of other focus groups to identify the relevant information in connection with the future development of the tax system in Hong Kong.

7.3 Amendments proposed by the 2013-14 Budget

Tax measures proposed in the 2013-14 Budget which was enacted on 5 July 2013, include the following changes:

- Reduce profits tax, salaries tax and tax under personal assessment for 2012/13 by 75%, subject to a ceiling of $10,000 per case
- Increase child allowance and the additional one-off child allowance in the year of birth to $70,000 from 2013/14 onwards
- Increase the deduction of self-education expenses to $80,000 from 2013/14 onwards
- Waiver of business registration fee for 2013-14

7.4 Expanding the scope for deduction under s.16E

Inland Revenue (Amendment) (No. 3) Ordinance 2011. This amendment to the IRO was enacted on 16 December 2011 to expand the scope for deduction under s.16E by introducing s.16EA to allow deduction for capital expenditure incurred on the purchase of copyrights, registered designs and registered trademarks. The following conditions must be fulfilled:

- The registered designs or registered trademarks must have been registered on the date of acquisition, either in Hong Kong or overseas
- The taxpayer must have legal and economic ownership of the intellectual property rights
- The relevant intellectual property rights are used for the production of chargeable profits

The deduction is spread over five succeeding years on a straight-line basis. However, if the intellectual property right reaches the end of its maximum period of protection in less than five years, the deduction will be spread in equal amounts over the number of years of protection.

Where the intellectual property right is subsequently sold, the sales proceeds will be treated as trading receipts and chargeable to profits tax. However, the amount is capped at the amount which was previously allowed for deduction.

To guard against possible tax avoidance, deduction under ss.16E or 16EA will not be allowed in the following situations:

- The relevant intellectual property rights were purchased wholly or partly from an associated party
- If a taxpayer cancels a licence (that existed prior to 2011/12) to intellectual property rights before its expiry and purchases the relevant intellectual property rights at an unreasonable consideration
- The relevant intellectual property rights were under sale and leaseback or leveraged licensing arrangements
- The relevant intellectual property rights were used wholly or principally outside Hong Kong by a person other than the taxpayer

7.5 DIPN 48 – Advance Pricing Arrangement

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

The arm's length principle is the international transfer pricing standard that should be used for tax purposes and the behaviour of independent enterprises should be used as a benchmark to determine the arm's length consideration or profits in relation to controlled transactions.

Refer to chapter 12, section 4.4 for details.

7.6 Changes in stamp duty

(a) Increase in stamp duty rate on property transactions

Stamp duty rates on transactions of properties valued over HK$20 million would be increased from 3.75% to 4.25%. In addition, the deferred payment of stamp duty will no longer be applicable to a dutiable agreement for sale of residential properties valuing over HK$20 million. These measures became effective on 1 April 2010. See (d) below for Stamp Duty (Amendment) Bill 2013 for subsequent changes.

Refer to chapter 8, section 3.1 for more details.

(b) Introduction of Special Stamp Duty

The Stamp Duty (Amendment) Ordinance 2011 was enacted on 30 June 2011 to introduce a special stamp duty (SSD) which would be imposed on disposal of residential properties which were acquired by the vendor on or after 20 November 2010 and resold within 24 months from the date of acquisition. The SSD would be imposed on top of the normal stamp duty currently payable on conveyance on sale of immovable properties, with a few exemptions available.

The seller and the buyer are jointly and severally liable for paying the SSD which is calculated based on the stated consideration or market value, whichever is higher, of the resold property at the following regressive rates, with the higher rate for shorter holding periods:

Refer to chapter 8, section 3.3 for details.

Holding period	Duty rate
For residential properties held for six month or less	15%
For residential properties held for more than 6 months but for 12 months or less	10%
For residential properties held for more than 12 months but for 24 months or less	5%

In December 2012, the government introduced a Bill increasing **each** of the above existing 3 levels of SDD rates by 5%. In addition, it extends the coverage period from 24 months to 36 months. Once the amendment to the SDO is enacted, the proposed adjustments would have retrospective effect from 27 October 2012.

Refer to (d) below for more details.

(c) Buyer's stamp duty on acquisition of residential properties

Buyer's stamp duty (BSD) on acquisition of Hong Kong residential properties by any person (including Hong Kong and foreign companies) other than a Hong Kong permanent resident was also included in the Bill introduced in December 2012. Once the amendment to the SDO is enacted, the BSD would be charged at a flat rate of 15% of the stated consideration or the market value of the property acquired, whichever is higher.

The BSD would be imposed on top of the ad valorem stamp duty and the SSD, if applicable.

The proposed BSD, once enacted into law, would have retrospective effect from 27 October 2012.

(d) Stamp Duty (Amendment) Bill 2013

The Stamp Duty (Amendment) Bill 2013 was introduced in April 2013.

The Bill aims to implement the new measures that the Chief Executive in Council approved and the Government announced on 22 February 2013 to further address the overheated property market. The measures are:

(a) to increase the ad valorem stamp duty rates on transactions for residential and non-residential properties. Stamp duty rates applicable from 23 February 2013 on transfer of immovable properties range from 1.5% to 8.5%; and

(b) to advance the charging of ad valorem stamp duty on non-residential property transactions from the conveyance on sale to the agreement for sale.

Once the amendments to the SDO are enacted, the new measures are applicable to all persons except Hong Kong Permanent Residents buying residential properties on their own behalves but who do not own any residential property in Hong Kong on the date of acquisition.

7.7 DIPN No. 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

DIPN No. 49 was issued in July 2012 and sets out in detail the IRD's views and practice on the profits tax deduction relating to the purchase of patent rights, rights to know-how, copyrights, registered designs and registered trade marks following the enactment of the Inland Revenue (Amendment) (No.3) Ordinance 2011.

DIPN No. 49 also sets out the IRD's views and practice on the taxation of royalties derived from the licensing of intellectual property rights.

Refer to Chapter 3, section 8.5.6 for details.

Appendix

General Comparison of HKSAR and PRC Tax Systems

The following tables are for general information only.

	HKSAR	Mainland, PRC
Duty on commodities	Customs and excise duties on fuel, alcoholic beverages, tobacco and hydrocarbon oils	Import customs duty on a wide range of commodities and capital goods; Value-added tax on most locally consumed products and imported commodities; Consumption tax on 14 categories of items, mainly luxury items such as tobacco, alcoholic and non-alcoholic beverages, cosmetics, jewellery, motor vehicles, motor cycles, car tyres, gasoline, diesel, fireworks, golf balls and equipment, premium watches (selling price above RMB10,000), yachts, disposable wooden chopsticks and solid wood flooring; Refund of value-added tax and consumption tax on export goods. Export customs duty on a few goods.
Business tax	None	3%, 5% or 5% to 20% on revenue from provision of services, transfer of intangible assets and sale of immovable property situated in the PRC.
Land appreciation tax	None	Charge on appreciated value of PRC immovable property being transferred as follows: **Appreciated value** — **Tax rate** <50% of (cost + allowable deductions) — 30% Between 50 - 100% of (cost + allowable deductions) — 40% Between 100 - 200% of (cost + allowable deductions) — 50% >200 % of (cost + allowable deductions) — 60%

	HKSAR	Mainland, PRC
Rates and Government rent	Rates at 5% on rateable value of immovable property; Government rent at 3% on rateable value of certain immovable property after 1 July 1997	Property Tax on leasing property with no rental income. 1.2% on a percentage (70%-90%) of the rateable value of the property.
Estate duty	Charge on property in Hong Kong passing on death of people who died before 11 February 2006 Maximum duty rate is 15%	None
Stamp duty	Charge on instruments (including counterparts and duplicates) relating to Hong Kong immovable property, Hong Kong stock and Hong Kong bearer instruments Duty ranges from HK$3 to 8.5% on the higher of stated consideration and market value	Charge on legal and financial documents (including a wide range of contracts, business licences and books of account) executed or received in the PRC Duty ranges from RMB 5 to 0.1% on contract value
Capital duty	Charge at 0.1% of the authorised capital of a corporation (maximum $30,000). Capital duty levied on Hong Kong companies under the Hong Kong Companies Ordinances was abolished with effect from 1 June 2012	None

<table>
<tr><th>Income tax</th><th>HKSAR</th><th>Mainland, PRC</th></tr>
<tr><td>Fiscal year</td><td>From 1 April to 31 March</td><td>From 1 January to 31 December</td></tr>
<tr><td>Basic scope of charge</td><td>Territorial basis</td><td>Worldwide basis on residents.
PRC sourced income for non-residents with permanent establishment in the PRC
Withholding basis on passive income such as dividends, interest, royalties that is derived from the PRC for non-residents without permanent establishment in the PRC</td></tr>
<tr><td>Types of tax</td><td>• Property tax;
• Salaries tax; and
• Profits tax.</td><td>• Individual income tax on the following incomes:
– wages and salaries;
– production or business operation income to individual industrial and commercial entrepreneurs;
– income from contracting or leasing operations of enterprises or institutions;
– income from personal services;
– authors' remuneration;
– income from royalties;
– income from interest, dividends and bonuses;
– income from leasing of properties;
– income from transfer of properties;
– incidental income; and
– any other income.
• Corporate income tax</td></tr>
</table>

Income tax	Hong Kong	Mainland, PRC

Tax rates

Hong Kong

- Standard rate: 15.5% for 2003/04; 16% for 2004/05 to 2007/08; 15% for 2008/09 onwards
- Corporate profits tax rate: 17.5% for 2003/04 to 2007/08; 16.5% for 2008/09 onwards
- Progressive tax rates:

2003/04

Net chargeable income

(Annual amount)	Rate
First $32,500	2%
Next $32,500	7.5%
Next $32,500	13%
Remainder	18.5%

2004/05

Net chargeable income

(Annual amount)	Rate
First $30,000	2%
Next $30,000	8%
Next $30,000	14%
Remainder	20%

2006/07

Net chargeable income

(Annual amount)	Rate
First $30,000	2%
Next $30,000	7%
Next $30,000	13%
Remainder	19%

2007/08

Net chargeable income

(Annual amount)	Rate
First $35,000	2%
Next $35,000	7%
Next $35,000	12%
Remainder	17%

2008/09, 2009/10 & 2010/11

Net chargeable income

(Annual amount)	Rate
First $40,000	2%
Next $40,000	7%
Next $40,000	12%
Remainder	17%

Mainland, PRC

- Individual income tax rates starting from 1 Sept 2011 are as follows:
  - Progressive tax rates on taxable income from wages and salary:

Monthly amount	Rate
≤ RMB 1,500	3%
RMB 1,501 - 4,500	10%
RMB 4,501 – 9,000	20%
RMB 9,001 – 35,000	25%
RMB 35,001 – 55,000	30%
RMB 55,001 - 80,000	35%
RMB 80,001 or above	45%

  - Progressive tax rates on taxable income from production and business, contracting for, or leasing of business operations of enterprises starting from 1 Sept 2011:

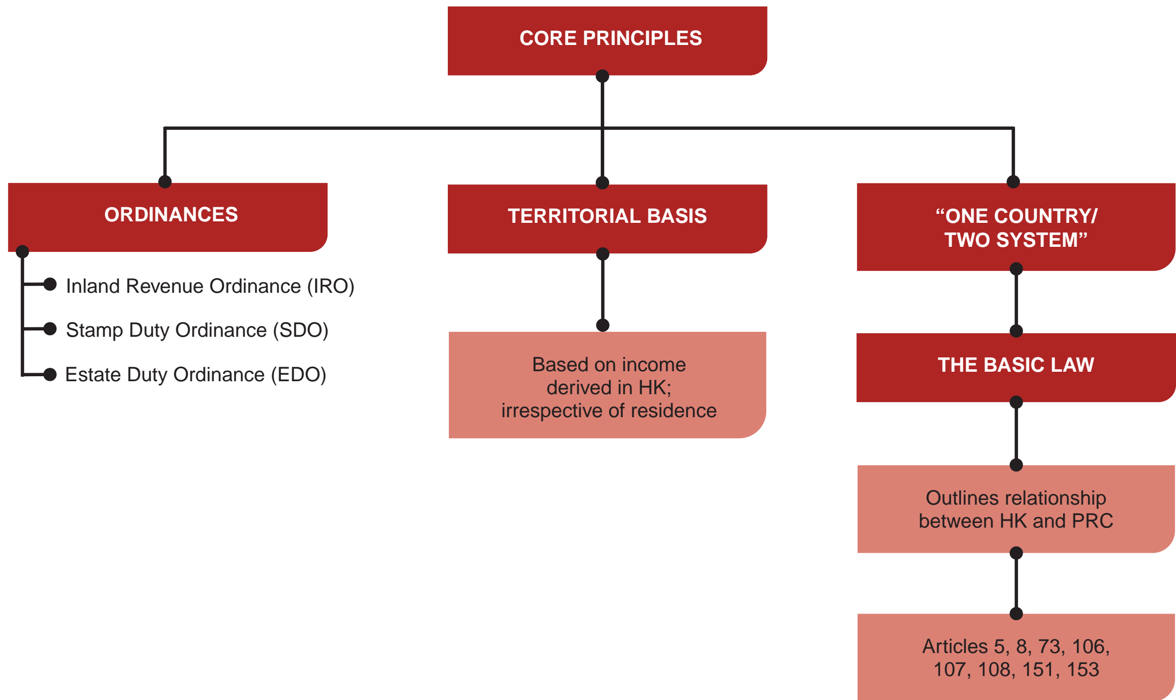
Annual amount	Rate
≤ RMB 15,000	5%
RMB 15,001 - 30,000	10%
RMB 30,001 - 60,000	20%
RMB 60,001 - 100,000	30%
> RMB 100,000	35%

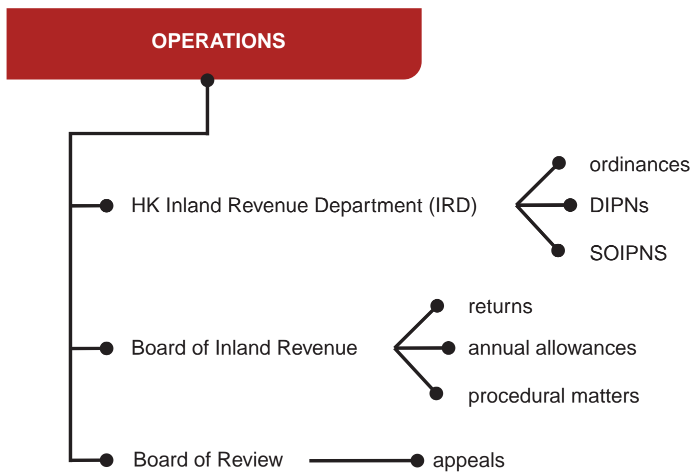
  - Progressive tax rates on taxable income from provision of personal services:

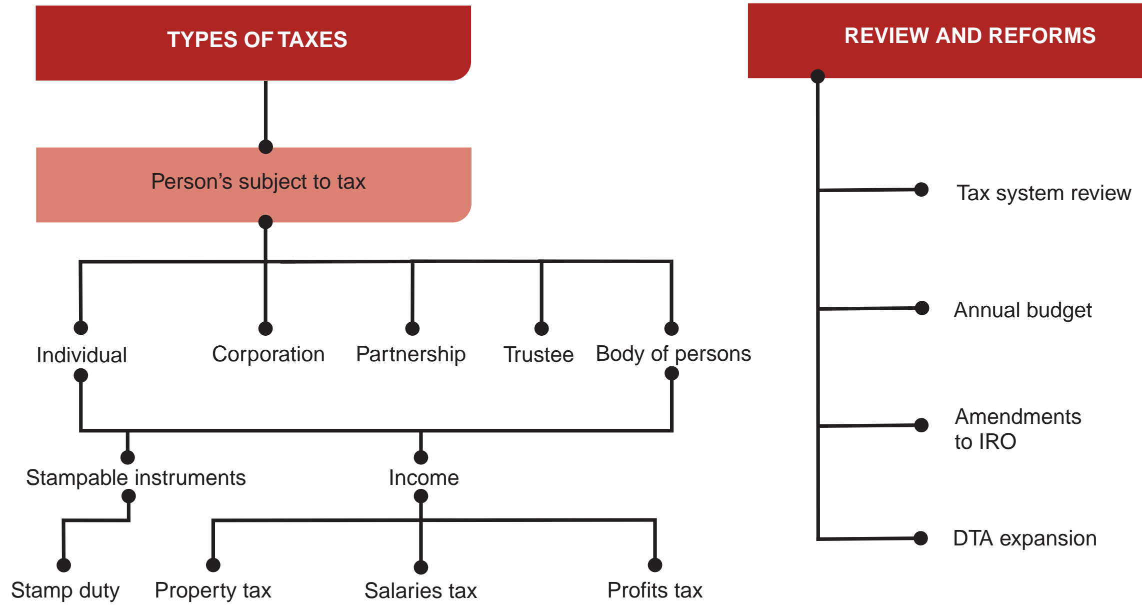
Each receipt	Rate
≤ RMB20,000	20%
RMB 20,001 - 50,000	30%
> RMB 50,000	40%

  - Income tax rate on individual's other taxable income = 20%
- Corporate income tax rate = 25% (with effect from 1 January 2008); 20% for qualified small and thin-profit companies; 15% for Advanced and New Technology Enterprises

Topic recap






TYPES OF TAXES
Person's subject to tax
Individual
Corporation
Partnership
Trustee
Body of persons
Stampable instruments
Income
Stamp duty
Property tax
Salaries tax
Profits tax
REVIEW AND REFORMS
Tax system review
Annual budget
Amendments to IRO
DTA expansion

Answer to self-test question

Answer 1

David Smith should be advised that according to Article 106 of the Basis Law, 'the HKSAR shall have independent finances. The Central People's Government of the PRC shall not levy taxes in the HKSAR.' In addition, by Article 108, 'the HKSAR shall practise an independent taxation system. The HKSAR shall, taking the low tax policy previously pursued in Hong Kong as a reference, enact laws on its own concerning types of taxes, tax rates, tax treaties, tax reductions, allowances and exemptions, and other matters of taxation.'

Furthermore, 'the HKSAR may on its own maintain and develop relations and conclude and implement agreements with foreign States and regions and relevant international organizations in the appropriate fields, including the economic, trade, financial and monetary, shipping, communications, tourism, cultural and sports fields (Article 151)'. Finally, by Article 153, 'the application to the HKSAR of international agreements to which the PRC is or becomes a party shall be decided by the Central People of Government in accordance with the circumstances and needs of the Region, and after seeking the views of the Government of the HKSAR.'

Exam practice

Basic Law

27 minutes

Describe the articles of Basic Law that are relevant to Hong Kong taxation.

(15 marks)

Further reading

Suggested References

When studying this topic we suggest the following references:

Primary References

Advanced Taxation in Hong Kong, Pearson (Chapter 1 – Introduction to the Hong Kong Taxation System)

Hong Kong Master Tax Guide, CCH Hong Kong Ltd (Chapter 1 – Introduction to Hong Kong Revenue Law)

Hong Kong Taxation – Law and Practice (Chapter 1 – General Scheme of Taxation in Hong Kong)

Hong Kong Tax Manual, CCH Hong Kong Ltd (Para 2 – Hong Kong Tax in Brief)

Hong Kong Taxation and Tax Planning, Pilot Publishing Co Ltd (Chapter 1)

Inland Revenue Ordinance

Inland Revenue (Disclosure of Information) Rules

Stamp Duty Ordinance

Supplementary References

Hong Kong Revenue Legislation, CCH Asia Pte Ltd (Introduction)

Brief Guide to Taxes issued by the Inland Revenue Department

chapter 2

Administration procedures under the Inland Revenue Ordinance

Topic list

1 **Overview**
2 **Returns and record keeping**
  2.1 Taxpayer's return
  2.2 Employer's return
3 **Assessments**
  3.1 Time limit for an assessor to raise an assessment or an additional assessment
  3.2 Assessments raised by an assessor
  3.3 Notice of assessment and demand for provisional tax payment
4 **Objection and holdover procedures**
  4.1 Objection
  4.2 Holdover of tax payment
5 **The tax appeal channel**
6 **Error or omission claim**
7 **Offences and penalties**
  7.1 Nature of an offence
  7.2 Taxpayer's obligations under the IRO
  7.3 Employer's obligations under the IRO
  7.4 Power of the IRD to obtain information from taxpayers and others
  7.5 Penalty provisions under the IRO
  7.6 Appeal against additional tax assessment
8 **Advance rulings system**
9 **Payment of taxes**
10 **Application to the Commissioner for a notice under s.88B**

Appendix
Summary of cases relating to administrative procedures under the IRO

Learning focus

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

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		
1.04	**Duties and powers of officers of the Inland Revenue Department; official secrecy**	2
1.04.01	Explain the duties and powers of IRD officers	
1.04.02	Explain the secrecy provisions under s.4 of the Inland Revenue Ordinance (IRO)	
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	
1.10	**Returns, offences and penalties**	2
1.10.01	Describe the powers of IRD officers to require the furnishing of returns, statements and information	
1.10.02	Describe the powers of IRD officers to seize books, records and documents by way of search warrant	
1.10.03	Describe the obligations of a taxpayer in relation to business and rent records	
1.10.04	Describe the obligations and rights of an employer under the IRO	
1.10.05	Discuss the essential compliance and disclosure issues in relation to profits tax, salaries tax and property tax	
1.10.06	Describe the tax offences and the related penalty provisions under the IRO	
1.11	**Assessments, additional assessments and provisional assessments**	3
1.11.01	Explain the provisions under the IRO which concern tax assessments	
1.12	**Payment, recovery, hold-over and refund of taxes**	2
1.12.01	Describe the provisions under the IRO regarding payment of tax	
1.12.02	Describe the provisions under the IRO in relation to recovery, holdover and refund of taxes	
1.13	**Objections and appeals**	3
1.13.01	Describe the objection and appeal procedures under the IRO	
1.13.02	Explain and apply DIPN 6	

1 Overview

Topic highlights

Any taxpayer who disagrees with the tax assessment raised by the IRD can lodge an objection with the Commissioner of Inland Revenue (the Commissioner).

The Commissioner is an important administrative officer charged with assessing tax and collecting revenue on behalf of the HKSAR Government.

The IRO gives the IRD wide powers to obtain not only the standard return of income from a taxpayer but also all kinds of information from a wide variety of persons including information which does not touch upon their own tax liability. In case of fraud and wilful default, the IRD's powers are even wider including, in appropriate circumstances, the power of entry and search.

Although vested with rights to obtain necessary records and information from any person, the taxes imposed under the IRO are, in general, assessed by direct assessments on the taxpayers. Taxpayers are requested to submit a return in a form specified by the Board of Inland Revenue (i.e. signified with BIR prefix) every year. An assessor will examine the tax returns and raise assessments on the taxpayers.

Returns are usually on printed forms. In recent years, some returns like IR 56B, Individual Tax Return (BIR60), Property Tax Return for jointly owned properties and Profits Tax Return meeting the pre-set requirements can be completed and submitted electronically following the launch of eTAX. See **http://www.gov.hk/en/residents/taxes/etax/index.htm** for details.

Notices of assessment are issued by the Commissioner on a computer-generated form. Under s.58(2) of the IRO, any notice given under the IRO may be served on a person either personally or by being delivered at, or sent by post to, his last known postal address, place of abode, business or employment or any place where he is, or was during the year to which the notice relates, employed or carried on business or the land and/or buildings in respect of which he is chargeable to property tax. Under eTAX, taxpayers can also choose to receive the notices electronically through their eTax accounts.

S.63 of the IRO states that no notice, assessment, certificate or other proceeding purporting to be in accordance with the provisions of the IRO shall be quashed, or deemed to be void or voidable, for want of form, or be affected by reason of a mistake, defect, or omission therein, if the same is in substance and effect in conformity with or according to the intent of the IRO, and if the person assessed or intended to be assessed or affected is designated therein according to common intent and understanding. Refer to *Hong Kong Flour Mills Ltd.*

Any person who disagrees with a notice of assessment may lodge an objection with the Commissioner within one month after the date of the notice of assessment. The Commissioner may hold over the tax in dispute either unconditionally or on condition that a Tax Reserve Certificate is purchased or a banker's undertaking is provided (i.e., Conditional Standover Order). If the objection cannot be settled with the Commissioner, the taxpayer may appeal to the Board of Review or the Court of First Instance against the Commissioner's determination. Further appeal may be made to the Court of Appeal and, ultimately, the Court of Final Appeal.

DIPN No. 6 (Revised 2006) provides guidance on the appeal and objection procedures.

The IRD has issued 'The Taxpayer's Charter', which outlines the rights and obligations of the taxpayers. The rights of the taxpayers include the following:

- payment of tax due under the law only,
- courteous treatment,
- timely professional service,
- privacy and confidentiality,
- access to information,
- bilingual service,
- complaints and appeals

On the other hand, taxpayers are obliged to be honest, lodge correct and timely returns, documents and information, make tax payments on time, keep records accurately and, keep the IRD informed of any changes such as change of address. See the IRD website at **http://www.ird.gov.hk** for details.

2 Returns and record keeping

Topic highlight

The taxpayer has duty to retain records in respect of businesses and other income-earning activities. The taxpayer may be required to furnish returns, provide information or documents within a reasonable time.

2.1 Taxpayer's return

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

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

In practice, returns are issued in the name of an assistant commissioner who can carry out the duties of an assessor under s.3 of the IRO.

All tax returns contain a declaration by the person who signs the return, that to the best of his/her knowledge and belief, all the statements contained in the return and enclosures are true, correct and complete. Submission of an incorrect return without a reasonable excuse is an offence under the IRO.

2.1.1 Profits tax returns

Taxpayers are required to complete the tax returns and provide information and documents as prescribed in the returns and the notes and instructions accompanying the returns.

The profits tax returns (Form BIR 51 and Form BIR 52) require the taxpayers to provide the taxpayer's particulars, its tax data and financial data, and details of the tax representatives etc. The return should be signed by the taxpayer's designated person. Except for a 'Small Corporation' or 'Small Business' (see note below), a profits tax return has to be filed with:

- a certified copy of the Statement of Financial Position, Auditor's Report (for a corporation) and Profit and Loss Account/Income Statement;
- a tax computation with supporting schedules showing how the Assessable Profits/Adjusted Loss is arrived at;
- other documents and information as specified in the Notes and Instructions enclosed with the return.

Audited accounts may not be required if:

- the company was incorporated in a country outside Hong Kong where no statutory audit is required and no audit has been carried out; or
- the company has applied to be dormant under s.344A(4) of the Companies Ordinance; or
- the company is in liquidation.

Note: If the total **gross** income (all types of income including sales and other ordinary business income, proceeds from sale of capital assets and other non-taxable income whether or not derived from the principal business activity) of a company for the basis period of a year of assessment does not exceed $2,000,000, then the company is a 'Small Corporation' or 'Small Business'. As a

'Small Corporation', the company needs not submit the supporting documents (i.e., the Statement of Financial Position, Profit and Loss Account/Income Statement, Auditor's Report and a Profits Tax computation) with the return and supplementary form. However, the taxpayer must prepare the supporting documents before the return is completed.

The time limit for the submission of the relevant tax return for the year of assessment 2010/11 is outlined as follows:

Type of return	Form	Normal time limit for submission	Code
Property tax return			
• Jointly owned property	BIR 57	One month from date of issue	
• Property owned by a corporation	BIR 58	One month from date of issue	
• Salaries tax	BIR 60	One month from date of issue or two months from date of issue for represented cases and lodgements through eTAX	
• Profits tax – sole proprietor business	BIR 60	Three months from date of issue, or four months from the date of issue for lodgements through eTAX, or five months from date of issue for represented cases	
• Corporation:			
– with year end date between 1 Dec and 31 Dec	BIR 51	15 August under block extension	D
– with year end date between 1 Jan and 31 Mar	BIR 51	15 November under block extension For loss cases, the usual practice is to allow an extension to 31 January of the following year	M
– with any other year end dates	BIR 51	One month from date of issue	N
• Business other than a corporation:			
– with year end date between 1 Dec and 31 Dec	BIR 52	15 August under block extension	D
– with year end date between 1 Jan and 31 Mar	BIR 52	15 November under block extension Usually, further extension to 31 January of the following year may be applied for loss cases	M
– with any other year end dates	BIR 52	One month from date of issue	N

The IRD provides information such as 'Frequently Asked Questions & Answers on Completion of Profits Tax Returns (BIR 51 & BIR 52)', 'Completion of Tax Return – Individuals (BIR 60)' and 'Completion of Other Tax Returns' in its website. See **http://www.ird.gov.hk** for details.

2.1.2 Introduction of eTAX

On January 19, 2008, the Inland Revenue Department (IRD) introduced eTAX, offering taxpayers an easy, secure and environment-friendly means to comply with the tax law. eTAX services are grouped under four categories, namely Individual, Property, Business and Payment.

Individual

- Viewing of eTAX Account, Tax Position and Messages
- Change of Personal Particulars, Profile and Password
- Tax Computation for Salaries Tax and Personal Assessment

- Filing of Tax Return − Individuals
- Request to Amend Tax Assessment and/or Provisional Tax
- Objection to Assessment
- Holdover of Provisional Tax
- Election for Personal Assessment

Property

- Stamping of Property Document
- Stamp Duty Computation
- Filing of Property Tax Return for Jointly Owned Properties (BIR 57)
- Viewing of Property Tax Return for Jointly Owned Properties (BIR 57)

Business

- Business Registration Number Enquiry
- Application for Supply of Information on the Business Register
- Application for Business or Branch Registration
- Change of Business Registration Particulars
- Block Extension Scheme for Lodgement of Tax Returns for the Current Year by Tax Representatives
- Completion of Profits Tax Return
- Submission of Profits Tax Return
- Viewing of Profits Tax Return

Payment

- Payment of Tax Bills, Business Registration Fee & Stamp Duty
- Purchase of Tax Reserve Certificate

Taxpayers may choose to receive notices and documents related to tax return filing, assessment and tax payment (including tax return and notice of assessment) in the form of electronic records instead of paper.

To gain access to the new services, a taxpayer has to open an eTAX Account by logging into eTAX at **www.gov.hk/etax** with his Taxpayer Identification Number and Password that he has registered with IRD, or by using his digital certificate issued by a recognised certification authority. Further details on eTAX are available on the website: **www.gov.hk/etax**

An eTAX Account holder can file his tax return through the Internet if he or she:

- does not claim exemption in respect of part or all of his/her salaries income;
- does not own any sole proprietorship business with gross annual income of more than $2,000,000 during the year;
- does not have any deemed assessable profits pursuant to s.20AE of the IRO during the year; and
- has not obtained an advance ruling on any of his/her tax matters in relation to the year.

With effect from 1 April 2010, a corporation or partnership meeting the following conditions can file its profits tax return through the Internet:

- Its gross income does not exceed $2,000,000;
- It does not have any deemed assessable profits pursuant to s.20AE of IRO;
- Its assessable profits/adjusted loss does not include any interest, profits/loss arising from medium term debt instruments as defined in s.14A(4) of the IRO;
- It does not claim a foreign tax credit;
- It has not obtained an advance ruling on any of its tax matter in relation to that year of assessment;

- It has not paid or accrued to a non-resident person any sum for the use of intellectual property specified in s.15(1)(*a*), (*b*) or (*ba*) of the IRO; and
- If it is a partnership business, it is carried on by a total of not more than 6 partners during the basis period for that year of assessment (including those partners who retired from the partnership) and that all of its partners are individuals.

2.2 Employer's return

Under s.52(2) of the IRO, an assessor may give notice in writing to any person who is an employer to furnish within a reasonable time stated in such notice a return containing the names and places of residence and the full amount of the remuneration for the period specified in the notice of:

- all persons employed by him in receipt of remuneration more than a figure specified by the assessor; and
- any other person employed by him named by the assessor.

The notice given by the assessor is the Form BIR 56A. The form with the particulars of the employee is IR 56B. Employer's returns are usually issued on 1 April with one month for filing.

An employer is also required to furnish a number of notifications to the Commissioner, that are outlined in s.7.3.

The IRD has extended its eTAX Internet filing service (**www.gov.hk/etax**) to enable employers to file annual employer's returns (BIR56A and IR56B) online for the year of assessment 2011/12.

Self-test question 1

Name five persons you know who have tax filing obligations under the IRO, by completing the following table.

Name	Relationship	Type of tax return to file with the IRD

(There is no sample answer provided for this question)

3 Assessments

Topic highlights

An assessor is authorised under Part X of the IRO to raise an assessment on any person who is liable to tax under the Ordinance.

3.1 Time limit for an assessor to raise an assessment or an additional assessment

Under s.59(1) of the IRO, an assessor shall assess every person (who is in the opinion of an assessor chargeable with tax under IRO) as soon as the time limited by the notice requiring him to furnish a return under s.51(1) has expired.

The assessor is not restricted by the above time limit and may assess any person at any time if the assessor is of the opinion that person is about to leave Hong Kong, or that for any other reason it is expedient to do so.

Under s.60(1) of the IRO, an assessor may raise an assessment or an additional assessment:

- within the year of assessment;
- within six years after the year of assessment; or
- within ten years after the year of assessment if the non-assessment or under-assessment is due to fraud or wilful evasion.

In the case of a deceased taxpayer, s.54(b) of the IRO provides that, when a person died before 11 February 2006, no assessment or additional assessment can be raised after:

- one year from the date of death; or
- one year from the date of filing any affidavit required under the Estate Duty Ordinance;

whichever is the later.

However, if the person dies on or after 11 February 2006 in any year of assessment, s.54(b) provides that no assessment or additional assessment can be made after the expiry of three years immediately after that year of assessment.

In normal circumstances, no assessment will be raised by the IRD under s.60 after it is time-barred. For example, no additional assessment for 2003/04 can be raised on an ordinary taxpayer after 31 March 2010. However, it should be noted that there is no such time limit for assessment raised under s.59.

3.2 Assessments raised by an assessor

An assessor may raise assessments as follows:

Section	Assessment
59(1)	An assessment can be raised after the expiration of the time limit for submission of the return. See note below.
59(1) proviso	An assessment can be raised at any time when it is expedient to do so.
59(2)(a)	An assessment raised in accordance with a return accepted by an assessor.
59(2)(b)	An estimated assessment raised in the case that the return is not accepted by an assessor.
59(3)	An estimated assessment raised in the absence of a return.
59(4)	An estimated assessment raised on the basis of the usual rate of profit on the turnover of that trade or business if the accounts have not been kept in a satisfactory form.
60	An assessment (or additional assessment) raised where it appears to an assessor that taxpayer has not been assessed (or has been assessed at less than the proper amount) within the year of assessment or within 6 years after the expiration thereof.

The IRD has implemented an assessing programme called 'Assess First Audit Later' (AFAL) for profits tax returns. Under the AFAL scheme, an assessor will not examine the taxpayer's returns. The profits tax assessment or statement of loss will be issued in the first instance as per the profits or loss stated in the tax returns provided certain pre-set conditions are satisfied. Some returns may, as a result of a computer-aided selection process, be selected for 'desk audit'. Additional assessments under s.60 of the IRO may be issued if adjustments are required as a result of the desk audit.

In order to run the AFAL system smoothly, the IRD relies heavily on full and frank disclosures by taxpayers in their tax returns.

Further, assessors often issue 'protective estimated assessments' before the time limit (i.e., the expiry of 6 years or 3 years in case of a deceased taxpayer) under s.60 of the IRO to protect tax revenue.

An additional assessment under s.60 can be raised following an assessment initially issued under deeming provisions such as those contained in ss.15(1)(a), (b) or (ba) : *Lam Soon Trademark Ltd v CIR [2006] 3 HKLRD 132*].

The Commissioner can raise alternative assessments upon a taxpayer in circumstances where information about the taxpayer's actual liability to tax is lacking. However, there can only be one final assessment to the same tax. If two or more assessments on the same income/profits co-exist, the latter assessments are invalid as cumulative assessments.

A statement of loss is just an administrative document and not an assessment *(Common Empire Ltd v CIR*.

An assessment becomes final and conclusive under s.70 of the IRO if no valid objection or appeal is lodged or the assessable profits or income are determined following an objection or appeal.

An assessment becomes final and conclusive by reason of s.70 notwithstanding that it is incorrect but is not appealed in time or that it provides for a greater liability for tax than would have been the case if a proper return had been available at the date of assessment and any such disparity does not constitute an arithmetical error within the meaning of s.70A(1).

S.70 does not prevent an estimated assessment for profits tax becoming final and conclusive even if a late return shows that an actual loss was made.

3.3 Notice of assessment and demand for provisional tax payment

After an assessment is raised by an assessor, the Commissioner will issue a Notice of Assessment under s.62 of the IRO to the taxpayer informing him of the amount assessed, the tax charged and the due date of payment.

The Notice of Assessment may be issued together with a demand of provisional tax that is usually computed based on the same amount of income assessed in the most recent year of assessment.

In some cases (eg, salaries tax), there are two due dates for the payment of the provisional tax. 75% of the provisional tax is payable (together with the balance of the final tax) on the first due date (usually in January of the coming year for salaries tax purposes) and the balance of the provisional tax is payable on the second due date (after 31 March of the coming year for salaries tax purposes). The purpose is not to request the taxpayer to pay tax on the income that he/she has not yet earned.

Example

A taxpayer, Ms. Cheung, is required to pay 75% of her provisional salaries tax for 2012/13 on 31 January 2013 and the balance of 25% on 30 April 2013. As at the first due date (31 January 2013), she should have earned 75% of her income for the year of assessment 2012/13 and by 30 April 2013, she should have earned all her income for 2012/13.

S.63 of the IRO states that no notice, assessment, certificate or other proceeding purporting to be in accordance with the provisions of the IRO shall be quashed, or deemed to be void or voidable, for want of form, or be affected by reason of a mistake, defect, or omission therein, if the same is in substance and effect in conformity with or according to the intent of the IRO, and if the person assessed or intended to be assessed or affected is designated therein according to common intent and understanding.

4 Objection and holdover procedures

Topic highlights

If a taxpayer disagrees with an assessment raised by the assessor, he may lodge an objection with the Commissioner.

4.1 Objection

If a taxpayer disagrees with an assessment raised by an assessor, he/she may lodge an objection with the Commissioner.

The notice of objection shall:

- be in writing;
- state precisely the grounds for the objection; and
- be received by the Commissioner within one month after the date of the notice of assessment.

The Commissioner may accept a late objection if the delay is caused by:

- sickness;
- absence from Hong Kong; or
- other reasonable grounds.

To object against an estimated assessment raised under s.59(3), a valid return has to be filed together with the notice of objection within the objection period of one month.

The onus of proof is on the taxpayer to show that the assessment is incorrect or excessive.

On receipt of a valid notice of objection, the Commissioner shall consider the same and within a reasonable time may confirm, reduce, increase or annul the assessment objected to.

It is interesting to note that while the taxpayers are obliged to adhere to the objection deadline and requirements, no deadline is imposed on the IRD to review the objections and/or for the Commissioner to issue a determination on the issues objected. This is reflected in the judicial review sought by the Yue Yuen Group. In this case, eight BVI indirect subsidiaries of Yue Yuen Industrial (Holdings) Limited had been issued with protective profits tax assessments for six years of assessment from 1997/98 to 2002/03. The assessments were issued from 2004 to 2009 before the statutory time limit expired. Objections were all made by the taxpayers within one month. Holdover of payment of profits tax was granted on the basis that Tax Reserve Certificates ('TRCs') were purchased. For the six years in question, the IRD has requested $432m TRCs to be

purchased, with $315m paid by the taxpayer, representing approximately 30% of the tax demanded.

The IRD claimed that the fault of delay lies in the taxpayer's slow response in providing documentation and that certain information required was still outstanding as of the date of the hearing. The CFI noted that the outstanding information was in relation to later years which were not relevant in determining the tax position of earlier years, as the tax audit was proceeded with the understanding that the operations of the taxpayer largely remains unchanged. CFI noted that at least, information regarding 1997/98 to 1999/00 has been provided prior to November 2008 and determination for such years should not have taken over a year.

The taxpayers claimed that all their manufacturing operations were offshore and should not be chargeable to tax and has requested the tax assessments be quashed on the grounds that the CIR abused her power in issuing the tax assessment and fail to determine the case within reasonable time. Judicial review was sought as the taxpayers were prevented from objecting further to the Board of Review or the Courts because no determination was ever issued.

The CFI stated that for a judicial review case, the Court would not determine any tax matters and as such no tax assessment is quashed. However, the CFI found that the IRD indeed processed the taxpayer's case with inordinate delay. An order of mandamus that the Commissioner determines the case within six months was issued by the CFI.

The CFI further added that inordinate delay would neither mean that the Commissioner's assessments become nullities nor that the Commissioner loses the power to determine an objection.

By a judgment dated 17 March 2010, the taxpayer's application to quash the relevant assessments and the Commissioner's holdover decision was refused. An order was made by the CFI that the Commissioner determines the Applicant's objections as soon as possible and at the latest within six months from the date of the judgment.

4.2 Holdover of tax payment

4.2.1 Holdover of tax in dispute under an objection

The Commissioner may holdover the tax in dispute under an objection as follows:

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

Under conditional holdover, the taxpayer has to purchase a Tax Reserve Certificate (TRC) or to provide a banker's undertaking. Purchasing a TRC will involve full payment of the tax in dispute (i.e. a cash outflow of the business). On the other hand, obtaining a bank guarantee will only require a fee to the bank, not the full amount of the tax in dispute.

In practice, obtaining a bank guarantee is difficult and the fees charged by banks are usually high. In most cases, the taxpayers have to purchase a TRC as they are unable to obtain a banker's undertaking, especially within the short period of time specified in the Conditional Standover Order.

It should be noted that the rate specified by the Chief Justice is much higher than the interest rate payable on the Tax Reserve Certificate. The interest rate payable on the TRC is reviewed every month based on the average of the prevailing six-month time deposit rates for $100,000 offered by the three note issuing banks in Hong Kong (with effect from 4 January 2010, the rate is 0.0433%

p.a.) while the rate specified by the Chief Justice is equivalent to the bank's prime rate plus a margin (with effect from 1 April 2009, the rate is 8.000%). This rate will apply to all certificates issued on or after the above date until further notice.

The interest rates on TRC and the rate specified by the Chief Justice can be found at the homepage of the IRD (**http://www.ird.gov.hk**).

4.2.2 Holdover of provisional tax payment

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

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

The application for holdover of provisional tax must be submitted to the Commissioner not later than:

- twenty-eight days before the payment due date of the provisional tax; or
- fourteen days after the date of the notice for payment of provisional tax;

whichever is the later.

It should be noted that the Commissioner has no discretionary power to extend the time limit for a holdover.

5 The tax appeal channel

Topic highlights

A tax appeal may be made to the Board of Review, the Court of First Instance, the Court of Appeal and, finally, the Court of Final Appeal

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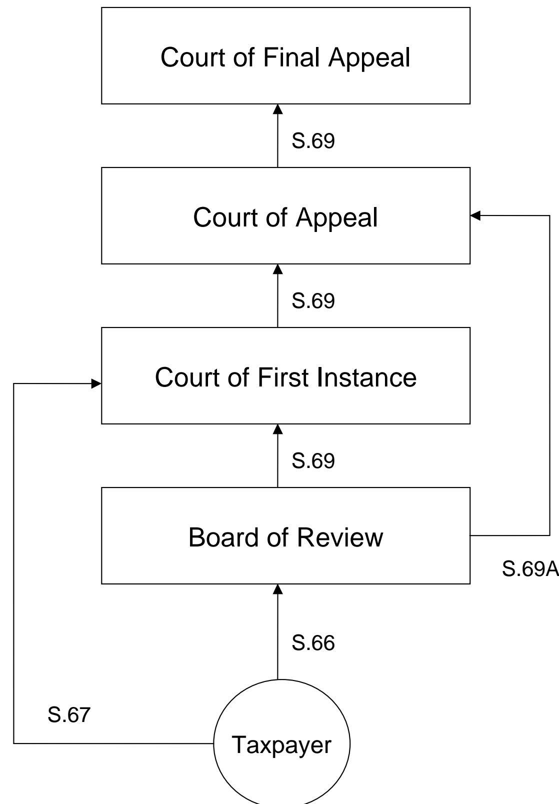
The tax appeal channel is summarised as follows.

Section	Hearing Body	Time Limit	Procedures
66	Board of Review	Within one month after the transmission of CIR's determination of the objection	Notice of appeal in writing to the Clerk to the Board of Review and copy of CIR's determination, reasons therefor and statements of facts and statement of grounds of appeal and copy of notice of appeal and statement of grounds of appeal to CIR.
67	Court of First Instance	Within twenty-one days after the receipt of the notice of appeal by the Clerk to the Board of Review or further time granted by the Board of Review	Either the taxpayer or the Commissioner may request to transfer the case to the Court of First Instance. Transfer will be made by the Board of Review with the consent of the other party.
69	Court of First Instance	Within one month after the decision of the Board of Review Within fourteen days after receiving the stated case	Written application to the Board of Review to state a case on question of law and a fee of $770. Transfer of the stated case to the Court of First Instance and notice of transfer and stated case to the other party.
69A	Court of Appeal	Within one month after the decision of the Board of Review Within fourteen days after receiving the stated case	Written application to the Board of Review to state a case to determine question of law and a fee of $770. Written application to the Court of Appeal for consent to the appeal.

The tax appeal



The hearing of the appeal in the Board of Review is an informal matter or at least lacks the strict formality of a court hearing.

At the hearing of the appeal, the onus of proof is on the taxpayer to prove that the assessment is excessive or incorrect. An appeal should be decided on the basis of balance of probabilities. Unless the appeal is transferred to the Court of First Instance under s.67(1) of the IRO, the Board of Review will ascertain the basic facts. The Board after hearing the appeal, the Board is entitled to confirm, reduce, increase or annul the assessment under appeal.

If either the taxpayer or the CIR disagrees with a decision of the Board of Review he may apply in writing to the Clerk of the Board requiring the Board to state a case for the opinion of the Court of First Instance.

If the Board of Review considers that there is little merit in an appeal, it may order the appellant to pay a sum not exceeding $5,000 as costs of the Board.

It is preferable for taxpayers to be legally represented in appeals to the courts, therefore the costs involved in appeals to the courts are likely to be substantial.

Leave has to be obtained before an appeal can be made to the Court of Appeal or the Court of Final Appeal. Consent or leave to appeal may be granted by the Court of Appeal and the Court of Final Appeal by reasons as follows:

- the amount of tax in dispute;
- the general or public importance of the matter;
- there are extraordinary difficulties; or
- any other reasons.

It may also be possible to apply for judicial review against the Commissioner or Board of Review. Judicial review is not an appeal but a means of challenging the correctness of an administrative decision and leave must be obtained.

6 Error or omission claim

Topic highlight

An assessment that has become final and conclusive may still be re-opened by an application under s.70A of the IRO.

The conditions under s.70A are as follows:

- it is established to the satisfaction of an assessor that the assessment is excessive due to an error or omission in a return or statement or that there is an arithmetical error or omission in the calculation of the assessable income or profits or tax charged; and
- an application is made within six years after the end of the year of assessment or within six months after the date on which the Notice of Assessment was served, whichever is the later.

However, no correction will be made under s.70A if the assessment was issued in accordance with the practice generally prevailing at the time the return or statement was made. Also, s.70A cannot be invoked to re-open an estimated assessment if it was issued in the absence of a return. Refer to *Sun Yau Investment Co. Ltd.*

What constitutes a prevailing practice is a question of fact. When there is a legal decision made in favour of a taxpayer, assessments which became final and conclusive before that legal decision should not be re-opened under s.70A.

If an assessor refuses to correct an assessment under s.70A, the taxpayer may object to such notice of refusal in the same manner as an objection against a Notice of Assessment.

Self-test question 2

On 1 June 2012, Mr. Au joined Hello Co Ltd (Hello Co) with an accounting year-end date 31 March, which is a private limited company incorporated in Hong Kong. Although Hello Co was a small manufacturing company, it held shares listed in Hong Kong for long-term investment purposes.

Mr. Au discovered that the IRD omitted to offset losses when assessing Hello Co's profits tax liabilities for the year of assessment 2009/10. The notice of assessment was issued in 2011. Apart from the loss set-off, Hello Co claimed initial and annual allowances in respect of moulds acquired for its own use in the tax year 2009/10.

In view of liquidity problems, Hello Co sold all its share investments (which it had held for five years) in the year of assessment 2010/11. The IRD assessed the gain and issued the 2010/11 notice of assessment last week.

Required

(a) Briefly discuss the actions that Mr. Au should take in respect of the notice of assessment for the year of assessment 2009/10.

(b) Briefly discuss the actions that Mr. Au should take in respect of the notice of assessment for the year of assessment 2010/11.

(c) In case Hello Co does not get a satisfactory result from the action in requirement (b), briefly discuss further action that can be taken.

(The answer is at the end of the chapter)

7 Offences and penalties

Topic highlights

An offence may be committed either by non-compliance without a reasonable excuse or by wilful wrongdoing. Penal actions may be imposed by the IRD for offence committed by taxpayers.

7.1 Nature of an offence

'Reasonable excuse' is not defined in the Ordinance.

Key term

In D13/85, the Board of Review described the concept of **'reasonable excuse'** as follows:

Reasonable excuse is what one would expect a reasonable person to do in all of the circumstances. A reasonable person is not a perfect person, but an average person using the reasonable skill and care in handling his tax affairs which one would expect to see from such an average person.

The following reasons have been rejected by the Board of Review as reasonable excuses.

Reason	Case Reference
Ignorance of law	D79/89
Limited education, illiteracy, linguistic difficulties with Chinese and English	D1/83, D24/84, D40/88, D46/89, D50/93
Domestic pressure	D15/83
Business pressure	D43/89, D67/90
Incompetent staff	D46/89, D47/90

For non-compliance offences not affecting the amount of tax charged, the Court may grant an order to instruct the defaulter to comply within a specified time together with a fine.

For offences affecting the amount of tax charged, the penalty may consist of a fine and/or up to 300% of the tax undercharged or the tax that would have been undercharged.

There are six levels of fine specified in Schedule 8 of the Criminal Procedure Ordinance as follows:

Level	Fine ($)
1	2,000
2	5,000
3	10,000
4	25,000
5	50,000
6	100,000

7.2 Taxpayer's obligations under the IRO

The following are the obligations of a taxpayer under the IRO.

Section	Obligation	Penalty that may be imposed by courts for non-compliance
51(1)	To complete returns within the time limit as requested in the notice from an assessor in writing.	A fine at level 3 and a further fine not exceeding 300% of tax undercharged or would have been undercharged. (If there is no prosecution, the Commissioner, or a Deputy Commissioner, may raise an additional tax assessment (not exceeding 300% of tax undercharged or would have been undercharged) under s.82A. Alternatively, the Commissioner may compound the offence.)
51(2)	To notify the Commissioner in writing, of his chargeability to tax, not later than four months after the end of the basis period in which the income was derived.	A fine at level 3 and a further fine not exceeding 300% of tax undercharged or would have been undercharged. (If there is no prosecution, the Commissioner, or a Deputy Commissioner, may raise an additional tax assessment (not exceeding 300% of tax undercharged or would have been undercharged) under s.82A. Alternatively, the Commissioner may compound the offence.)
51(3)	To furnish a fuller or further return as may be requested.	A fine at level 3 and Court order for compliance within the time specified in the order. (Alternatively, the Commissioner may compound the offence.)
51(6)	To notify the Commissioner in writing, of his cessation of income, within one month of such cessation.	A fine at level 3 and Court order for compliance within the time specified in the order. (Alternatively, the Commissioner may compound the offence.)
51(7)	To notify the Commissioner in writing, of his departure from Hong Kong for any period exceeding one month, not later than one month before the expected date of departure.	A fine at level 3 and Court order for compliance within the time specified in the order. (Alternatively, the Commissioner may compound the offence.)
51(8)	To notify the Commissioner in writing, of his change of address, within one month of such change.	A fine at level 3 and Court order for compliance within the time specified in the order. (Alternatively, the Commissioner may compound the offence.)

Section	Obligation	Penalty that may be imposed by courts for non-compliance
51C	To keep record of business income and expenditure for a period not less than seven years.	A fine at level 6 and Court order for compliance within the time specified in the order. (Alternatively, the Commissioner may compound the offence.)
51D	To keep record of property income for a period not less than seven years.	A fine at level 3 and Court order for compliance within the time specified in the order. (Alternatively, the Commissioner may compound the offence.)

7.3 Employer's obligations under the IRO

The following are the obligations of an employer under the IRO.

Section	Obligation	Penalty that may be imposed by courts for non-compliance
52(2)	To furnish an Employer's Return within the time limit as requested in the notice from an assessor in writing.	A fine at level 3 and Court order for compliance within the time specified in the order.
52(4)	To notify the Commissioner in writing, of the commencement of employment of an employee chargeable to tax, not later than three months after the date of commencement of employment.	Same as above.
52(5)	To notify the Commissioner in writing, of the cessation of employment of an employee chargeable to tax, not later than one month before the expected date of cessation of employment.	Same as above.
52(6)	To notify the Commissioner in writing, of the departure of an employee chargeable to tax from Hong Kong for more than one month, not later than one month before the expected date of departure.	Same as above.
52(7)	To withhold payment of money to the employee who is leaving Hong Kong for a period of one month from the date of serving a notice to the Commissioner under s.52(6).	Same as above.

The following are the forms provided by the IRD to enable the employer to furnish information requested.

Employer's Return	Form	Section
Employer's Return Of Remuneration And Pension	BIR 56A and IR 56B	52(2)
A Notification By Employer Of Employee Who Commences To Be Employed	IR 56E	52(4)
Notification By Employer Of Employee About To Cease To Be Employed	IR 56F	52(5)
Notification By Employer Of Employee About To Depart From HK	IR 56G	52(6)
Notification Of Remuneration Paid To Persons Other Than Employees	IR 56M	51(4)

7.4 Power of the IRD to obtain information from taxpayers and others

The IRD has power to obtain information from any person as follows:

Section	Power of the IRD	Exercised by
51(1)	To request returns (property tax, salaries tax, profits tax and composite tax return) from any person.	Assessor
51(2A)	To request a Personal Assessment Return from an individual who has elected for personal assessment.	Assessor
51(2B)	To request a Personal Assessment Return from an individual and his or her spouse who have elected for personal assessment.	Assessor
51(3)	To request fuller and further returns from any person.	Assessor
51(4)(a)	To request full information or documents in possession from any person (including third parties).	Assessor/ Inspector
51(4)(b)	To request any person to attend an interview and answer questions (including third parties).	Assistant Commissioner
51(4AA)	To exercise the same power under s.51(4) to collect information concerning tax of a foreign territory for the purpose of exchange of tax information under a double taxation arrangement.	Same as above for ss.51(4)(a) and (b)

Section	Power of the IRD	Exercised by
51(4A)	To request information from any person (including any person, or any employee of any person, who was party to the property transaction; any person, or any employee of any person, who has acted for any party to the property transaction; any person who either paid or received any consideration, brokerage, commission or fee; and any person, or any employee of any person, who was concerned in passing of any consideration, brokerage, commission or fee, or in the clearing or collection of any cheque or other instrument of exchange) relating to property transactions or to request any person to attend at a time and place and answer questions relating to property transactions. Privilege from disclosure* constitutes no excuse for non-disclosure.	Assessor/ Assistant Commissioner
51A	To request statement of assets and liabilities from any person for a period not earlier than seven years before the commencement of the year of assessment in which the request is given, with the consent of the Board of Review.	Commissioner or a Deputy Commissioner personally
51B	To apply for a search warrant from a magistrate to search for and take possession of any books, records, accounts or documents.	Chief Assessor or above/ Authorised by CIR in writing
51B(1AA)	To exercise the same power under s.51B to issue search warrants for information concerning tax of a foreign territory for the purpose of exchange of tax information under a double taxation arrangement.	Same as above for s.51B
52(1)	To request information from officials in the employment of the Government or of public body.	Commissioner
52(2)	To request returns from employers.	Assessor

* It is a practice under the common law that the information possessed by a legal practitioner in respect of his client is protected from disclosure to any third party without the client's consent.

7.5 Penalty provisions under the IRO

The following are the major penalty provisions under the IRO.

Section	Provision
80(1)	Any person who, without reasonable excuse:
	(a) fails to comply with the requirements of a notice given to him under the following sections: S.51(3) – fuller or further return; S.51A(1) – statement of assets and liabilities etc.; S.52(1) – information to be supplied by officials of the Government or of any public body; S.52(2) – employer's return; S.64(2) – further information or books or documents for CIR's determination of an objection; or
	(b) fails to attend in answer to a summons issued under the following sections: S.64(2) – summons to any person who, in the opinion of the Commissioner, is able to give evidence respecting the assessment under objection and be examined by the Commissioner on oath or otherwise; S.68(6) – summons to any person who, in the opinion of the Board of Review, is able to give evidence respecting the appeal and be examined by the Board of Review on oath or otherwise; or, having attended, fails to answer any questions put to him by the Commissioner or the Board of Review; or
	(c) fails to comply with the following sections:
	S.5(2)(c) – corporations exempted from property tax shall inform the Commissioner in writing of any change in the ownership or use of the land and/or buildings or in other circumstances affecting such exemption within thirty days after the event;
	S.51(6) – any person ceasing to derive chargeable income shall inform the Commissioner in writing within one month of such cessation;
	S.51(7) – any person chargeable to salaries tax, profits tax or personal assessment who is about to leave Hong Kong for any period exceeding one month shall give notice in writing to the Commissioner of his expected date of departure, and if he intends to return to Hong Kong, the approximate date of his return, not later than one month before the expected date of departure.
	S.51(8) – any person chargeable to tax who changes his address shall within one month inform the Commissioner in writing the particulars of the change;
	S.51D(1) – rent records to be kept for not less than seven years after the completion of the transactions, acts or operations to which they relate, unless the Commissioner directs otherwise or upon the dissolution of a corporation;
	S.52(4) – employer's return on commencement of employment not later than three months after the date of commencement of employment;
	S.52(5) – employer's return on cessation of employment not later than one month before the expected date of cessation of employment;

Section	Provision
	S.52(6) – employer's return on departure from Hong Kong for more than one month not later than one month before the expected date of departure;
	S. 52(7) – employer to withhold payment due to the employee who is about to leave Hong Kong for a period of one month from the date of servicing a notice to the Commissioner (i.e., the employer's return on departure from Hong Kong) under s.52(6) unless with the consent in writing of the Commissioner;
	S.76(3) – notification to the Commissioner in writing acquainting him with the facts that deduction of tax from payment due to the defaulter is not able to be complied with within fourteen days of the expiration of thirty days from the date of receipt of the Commissioner's notice;
	Commits an offence and is liable on conviction to a fine at level 3 and the Court may order the person convicted within a time specified in the order to perform the act which he has failed to do.
80(1A)	Any person who without reasonable excuse fails to comply with the requirements of s.51C (i.e. fails to keep records of business income and expenditure for a period not less than seven years) commits an offence and is liable on conviction to a fine at level 6 and the Court may order the person convicted within a time specified in the order to perform the act which he has failed to do.
80(1AA)	Without prejudice to the generality of the term 'reasonable excuse' under s.80(1) relating to the employer's obligations under ss.52(4), (5), (6) or (7), where a person deemed to be an employer by operation of s.9A may have a defence if he shows that:
	(a) he did not comply with those requirements because he relied upon a statement in writing (i) by that individual; and (ii) in the form specified under s.80(1AC); and
	(b) it was reasonable for him to rely upon the statement.
80(1AB)	A person who knowingly or recklessly makes a statement of the kind referred to in s.80(1AA)(a) that in a material respect is false or misleading commits an offence and is liable on conviction to a fine at level 3.
80(2)	Any person who, without reasonable excuse:
	(a) makes an incorrect return by omitting or understating anything in respect of which he is required to make a return;
	(b) makes an incorrect statement in connection with a claim for any deduction or allowance;
	(c) gives any incorrect information in relation to any matter or thing affecting his own liability for tax or the liability of any other person;
	(d) fails to comply with the requirements of a notice given to him under s.51(1) or s.51(2A) (i.e. fails to submit a return by the due date); or
	(e) fails to comply with s.51(2) (i.e. to inform the Commissioner of his chargeability to tax).
	commits an offence and is liable on conviction to a fine at level 3 and a fine of treble the amount of tax that has been undercharged or that would have been undercharged if such failure had not been detected.

Section	Provision
80(2A)	In the case of an offence under s.80(2)(d), the Court may order the person convicted to comply with the requirements of the notice given to him under s.51(1) or s.51(2A) within such time as may be specified in the order.
80(2B)	Any person who does not comply with an order of the Court under s.80(1) or s.80(2A) or s.51(4B)(b) commits an offence and is liable on conviction to a fine at level 4.
80(2C)	Any person who does not comply with an order of the Court under s.80(1A) commits an offence and is liable on conviction to a fine at level 6.
80(2D)	Any person who without reasonable excuse gives incorrect information in relation to any matter that affects his or another person's liability to a foreign tax covered by an exchange of information article under a double taxation arrangement commits an offence and is liable on conviction to a fine at level 3.
80(3)	No person shall be liable to any penalty under this section unless the complaint concerning such offence was made in the year of assessment in respect of or during which the offence was committed or within six years after the expiration thereof.
80(5)	The Commissioner may compound any offence under s.80 and may before judgment stay or compound any proceedings thereunder.
82(1) & (1A)	Any person who wilfully with intent to evade or to assist any other person to evade tax
	(a) omits from a return any sum which should be included;
	(b) makes any false statement or entry in any return;
	(c) makes any false statement in connection with a claim for any deduction or allowance;
	(d) signs any statement or return furnished without reasonable grounds for believing the same to be true;
	(e) gives any false answer whether verbally or in writing to any question or request for information asked or made;
	(f) prepares, maintains or authorises the preparation or maintenance of any false books of account or other records or falsifies or authorises the falsification of any books of account or records; or
	(g) makes use of or authorises the use of any fraud, art or contrivance, commits an offence.
	Penalty on summary conviction: • a fine at level 3 and • a further fine of three times the tax undercharged or the tax that would have been undercharged and • imprisonment for six months.
	Penalty on indictment: • a fine at level 5 and • a further fine of three times the tax undercharged or the tax that would have been undercharged and • imprisonment for three years

Section	Provision
82(2)	The Commissioner may compound any offence under s.82 and may before judgment stay or compound any proceedings thereunder.
82A(1)	Any person who, without reasonable excuse:
	(a) makes an incorrect return by omitting or understating anything in respect of which he is required to make a return;
	(b) makes an incorrect statement in connection with a claim for any deduction or allowance;
	(c) gives any incorrect information in relation to any matter or thing affecting his own liability to tax or the liability of any other person;
	(d) fails to comply with the requirements of a notice given to him under s.51(1) or s.51(2A) (i.e. fails to submit a return by the due date); or
	(e) fails to comply with s.51(2) (i.e. fails to inform the Commissioner of his chargeability for tax).
	provided that no prosecution under s.80(2) or s.82(1) has been instituted in respect of the same facts, shall be liable to be assessed under s.82A to additional tax of an amount not exceeding treble the amount of tax that:
	(i) has been undercharged in consequence of such incorrect return, statement or information, or would have been so undercharged if the return, statement or information had been accepted as correct; or
	(ii) has been undercharged in consequence of the failure to comply with a notice under s.51(1) (i.e. return of property tax, salaries tax, profits tax or Composite Tax Return) or s.51(2A) (i.e. personal assessment return) or failure to comply with s.51(2) (i.e. fails to notify the Commissioner his chargeability for tax), or which would have been undercharged if such failure had not been detected.
82A(2)	Additional tax shall be payable in addition to any amount of tax payable under an assessment or an additional assessment under s.60.
82A(3)	An assessment to additional tax may be made only by the Commissioner personally or a Deputy Commissioner personally.
82A(4)	Before making an assessment to additional tax, the Commissioner or a Deputy Commissioner, as the case may be, shall:
	(a) cause notice to be given to the person he proposes so to assess which shall:
	(i) inform such person of the alleged incorrect return, incorrect statement or incorrect information or alleged failure to comply with s.51(1) , s.51(2A) or s.51(2) ;
	(ii) inform the person that he has the right to submit written representations;
	(iii) specify the date, which shall not be earlier than twenty-one days from the date of service of the notice, by which representations of the person must be received;
	(b) consider and take into account any representations made from or on behalf of the person.

Section	Provision
82A(4A)	If the Commissioner or a Deputy Commissioner is of the opinion that the person is about to leave Hong Kong, additional tax may be raised without a s.82A(4) notice.
82A(5)	s.82A(4) notice and notice of additional tax shall be given in the same manner as is provided in s.58(2) in respect of a Notice of Assessment under s.62.
82A(6)	Where a person who is liable to be assessed to additional tax has died, an assessment to additional tax may be made on his executor, and the additional tax shall be recovered as a debt due from and payable out of the deceased person's estate.
82A(7)	A person who has been assessed to additional tax shall not be liable to be charged on the same facts with an offence under s.80(2) or s.82(1) .

7.5.1 Comparison of Penalty Provisions

The following is a general comparison of the penalty provisions under s.80(1), s.80(2), s.82(1) and s.82A.

S.80(1)	S.80(2)	S.82(1)	S.82A
For offences without a reasonable excuse.	For offences without a reasonable excuse.	For wilful evasion cases.	For offences without a reasonable excuse.
Covers most non-compliance offences not involving tax undercharged.	Covers non-compliance offences (no return/late return/incorrect return/failure to inform chargeability for tax) involving tax undercharged.	Covers incorrect return involving tax undercharged.	Covers non-compliance offences (no return/late return/incorrect return/failure to inform chargeability for tax) involving tax undercharged.
Civil proceeding.	Civil proceeding.	Criminal proceeding.	Administrative penalty. No legal proceeding either before or after the additional tax.
Taxpayer to prove, on balance of probability.	Taxpayer to prove, on balance of probability.	Prosecutor to prove, beyond reasonable doubt.	Taxpayer to prove, on balance of probability.
Penalty assessed by Court.	Penalty assessed by Court.	Penalty assessed by Court.	Additional tax raised by the Commissioner or a Deputy Commissioner personally.

S.80(1)	S.80(2)	S.82(1)	S.82A
Penalty: a fine at level 3.	Penalty: a fine at level 3 and ≤ 300% of tax undercharged or would have been undercharged.	Penalty: on summary conviction: a fine at level 3 and ≤ 300% of tax undercharged or would have been undercharged and six months' imprisonment; On indictment: a fine at level 5 and ≤ 300% of tax undercharged or would have been undercharged and three years' imprisonment.	Penalty: additional tax not exceeding 300% of tax undercharged or would have been undercharged.
Appeal to Court.	Appeal to Court.	Appeal to Court.	Appeal to Board of Review.

The IRD indicates that the objectives of imposing additional tax under s.82A are as follows:

- Restitution – recovering compensation for loss of use of revenue;
- Deterrence – discouraging recurrence of similar offence; and
- Rehabilitation – allowing the offender a chance to start afresh after settling the tax and penalty due

The IRD has prepared a penalty loading table by classifying the nature of the omission/understatement into three groups of culpability (i.e., 'intentionally disregard', 'recklessness' and 'absence of reasonable care') and the nature of co-operation into four categories of disclosure or co-operation (i.e., 'full voluntary disclosure', 'disclosure with full information promptly on challenge', 'incomplete or belated disclosure' and 'disclosure denied').

The IRD's policies on penalties under s.82A can be found on its website at **http://www.ird.gov.hk/eng/pol/ppo.htm**.

7.6 Appeal against additional tax assessment

Under s.82B of the IRO, a taxpayer may, within one month after the Notice of Assessment to additional tax, lodge an appeal in writing to the Clerk to the Board of Review together with copies of:

- the Notice of Assessment;
- the Commissioner's notice under s.82A(4) ;
- the taxpayer's representations under s.82A(4) ; and
- a statement of the grounds of appeal.

There are three grounds of appeal provided under s.82B(2) as follows:

- There is a reasonable excuse;
- The additional tax exceeds the maximum amount allowed under s.82A; and
- The additional tax is excessive having regard to the circumstances.

For any s.82A notice of assessment given on or after 25 June 2004, the Board of Review may extend the time limit for an appeal under s.82B as it thinks fit if it is satisfied that the appellant was prevented by illness or absence from Hong Kong or other reasonable cause from giving the notice of appeal within the one-month period.

The Board of Review has indicated that each case has to be determined on its own merits. However, the following factors have been considered relevant in determining whether the additional tax is excessive:

- Whether there was a criminal intent in a taxpayer's failure to comply with his obligations;
- Whether the IRD has to resort to an investigation or the preparation of an asset betterment statement;
- Whether the taxpayer's default has persisted for a number of years;
- Whether the delay in tax filing is substantial;
- Whether there has been an actual, as opposed to hypothetical, loss of revenue;
- Whether the taxpayer is co-operative;
- Whether the taxpayer has done something to mitigate the situation; and
- Special circumstances (although falling short of a reasonable excuse) that could explain the failure of the taxpayer.

The Board has indicated that 100% of the tax undercharged or the tax that would have been undercharged, should be considered as a norm in the absence of mitigating or aggravating factors. However, the starting point of 100% is not intended to apply to the run of the mill type of cases.

The starting point of 100% of tax undercharged is considered to be appropriate in the following circumstances:

- Where there has been no criminal intent and the taxpayer has totally failed in his or its obligation under the IRO; or
- Where the CIR has had to resort to investigations or the preparation of assets betterment statements or has otherwise had difficulty in assessing the tax; or
- Where the failure by the taxpayer to fulfil his or its obligation under the IRO has persisted for a number of years.

In general, as most of the late return cases do not fall within the above circumstances, the level of penalty is usually much lower than 100%.

Case study: *Koon Wing Yee v Insider Dealing Tribunal*

Recently, there was a Court of Final Appeal case on *Koon Wing Yee v. Insider Dealing Tribunal*. *Decision:* The decision upheld that the imposition of a penalty equal to a maximum of 300% of the insider trading profits was considered as 'criminal' in nature. In a criminal proceeding, no one should be forced to provide evidence that could be used to incriminate himself. In addition, the standard of proof for criminal charges would be 'proof beyond reasonable doubt' and the defendant should be entitled to a fair and independent hearing by an impartial, independent and competent tribunal. The decisions in this case could have a far reaching impact on many punitive sections provided in the Hong Kong Ordinances including s.82A of the IRO. Readers are encouraged to observe further legislative and judicial developments resulting from the decision of this case.

Board of Review Case D17/08

The Board provided its view on whether proceedings under s.82A involved the determination of a criminal charge as considered in *Koon Wing Yee v. Insider Dealing Tribunal.*

S.68(4) applied to an appeal against an additional tax assessment under s.82B and imposed on the taxpayer a reverse persuasive burden, derogating from the presumption of innocence under Article 87 of the Basic Law and Article 11(1) of the Hong Kong Bill of Rights. However, the Board was of the view that the derogation was justified. It considered that imposing an administrative penalty with a reverse onus on appeal was a rational means of enforcing compliance with the duties to submit timely and correct tax returns and information to the Commissioner.

8 Advance rulings system

Topic highlights

The IRD introduced advance rulings in 1986 after several anti-avoidance provisions (e.g. s.61A, s.61B, s.39E) were enacted. At that time, application for an advance ruling was free of charge. However, the ruling was neither binding on the taxpayer nor the IRD. S.88A was enacted in 1998 to formalise the advance rulings system.

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DIPN No. 15 provides guidance on the application for an advance ruling in connection with s.61A (including leveraged lease arrangement) and s.61B.

DIPN No. 22 (Revised) provides guidance on the application for an advance ruling in connection with s.21A.

DIPN No. 25 provides guidance on the application for an advance ruling in connection with s.9A.

S.88A was enacted in 1998 to formalise the advance rulings system. DIPN No. 31 provides guidance on application for an advance ruling on how any provision of the IRO applies to the applicant or to the arrangement described in the application. However, a ruling will not be provided if the matter on which a ruling is sought involves the imposition or remission of a penalty, the correctness of a return or other information supplied by any taxpayer, the prosecution of any taxpayer or the recovery of any debt owing by any taxpayer.

Any person who wishes to ascertain the tax position of a contemplated transaction or arrangement by obtaining an advance ruling from the Commissioner has to make an application in accordance with Part I of Schedule 10 of the IRO and pay a fee specified in Part II of Schedule 10.

A form (Application for Advance Ruling (Form IR 1297)) can be obtained from the IRD by writing to the Chief Assessor, Special Duty at GPO Box 11234 or by phone at 2594 5005 or 2594 5028. The form is also downloadable from the IRD website: **http://www.ird.gov.hk/eng/paf/for.htm#pf**

The following information has to be provided in applying for an advance ruling:

- Details of the applicant (name, address and tax file number);
- Details of other parties to the transaction (name, address and tax file number);
- Period(s) to which the ruling request relates;
- If the application is by a tax representative, written authorisation or notification of consent from the taxpayer to act on his or her behalf;
- The relevant facts of the applicant's case together with supporting documentation;
- The provision of the IRO upon which a ruling is sought;
- The proposition of law that relates to the issues raised in the ruling;
- Copies of any professional advice already received regarding the proposed transaction;
- Confirmation on whether a ruling request has been lodged about the arrangement for another period; and
- A draft of the requested ruling.

The completed Form IR 1297, together with requested supporting documents and specified application fee ($30,000 for source of income, $10,000 for other cases), should be mailed to the

Deputy Commissioner of Inland Revenue (Technical), 36/F., Revenue Tower, 5 Gloucester Road, Hong Kong.

If the time spent by the IRD in considering the application exceeds seven hours (or eleven hours in the case of s.9A or twenty three hours in case of s.14), the applicant will need to pay additional fees computed on an hourly basis ($1,000 - $1,330 per hour).

The Commissioner will not issue a ruling if the matter on which the ruling is sought is:

- not seriously contemplated by the applicant;
- frivolous or vexatious; or
- similar to an arrangement currently in place which is the subject of a tax audit.

The Commissioner may refuse to issue a ruling if the ruling:

- is the subject of a return which has been or is due to be lodged;
- is the subject to an objection or appeal (even if the objection or appeal is in relation to a person other than the applicant);
- requires the Commissioner to determine or establish any question of fact; or
- depends upon the Commissioner making an assumption in respect of a future event or other matter.

A ruling made by the Commissioner must state:

(a) the name of the person, the provision of the IRO, and the arrangement to which the ruling applies;

(b) the period for which the ruling applies; and

(c) any material assumptions in respect of a future event or any other matter made by the Commissioner.

Where the Commissioner has made a ruling for a person on the application of any provision of the IRO in relation to an arrangement and that person implements the arrangement in the way stated in the ruling, the Commissioner shall apply the provision in relation to the person and the arrangement in accordance with the ruling.

The person who has obtained a ruling should disclose in the return:

(a) the existence of the ruling and the reference number;
(b) whether or not the person has relied on the ruling in preparing and providing the return; and
(c) any material changes to the arrangement identified in the ruling.

A ruling issued by the Commissioner will be legally binding on the Commissioner on condition that the taxpayer adheres precisely to the facts as outlined in the ruling request. If the actual arrangement is materially different from that contained in the application or alternatively there was a material omission or misrepresentation in the application, the ruling will not be binding on the Commissioner.

The Commissioner has the power to withdraw any ruling at any time by notifying the applicant in writing of the withdrawal and the reasons for the withdrawal. The ruling will remain in force until the end of the period indicated in the initial ruling, provided that the arrangement has been entered into or effected on or before the date of the withdrawal of the ruling and that the taxpayer has disclosed in the tax return that he has relied on the ruling. In other cases, the ruling will cease to apply once it has been withdrawn.

The IRD has indicated in DIPN No. 31 (Revised) that a ruling will generally not be valid for more than two years of assessment from the year of issue of the ruling.

The IRD has selected some rulings of general interest for publication. They are now published in 'Publications and Press Releases' section of the IRD's website **http://www.ird.gov.hk**. The published rulings are for general reference only.

9 Payment of taxes

Topic highlights

Taxpayers can pay tax by various methods. To help taxpayers save sufficient money to meet their tax liabilities, the IRD encourages the use of Tax Reserve Certificates (TRCs)

Taxpayers can pay tax by cash or by cheque to the Collection Offices of the IRD or Post Offices on or before the tax due date. Cheque payments can also be made by post or by dropping into the cheque deposit boxes in the Collection Offices. Tone phones, the Internet (via the PPS system: **http://www.ppshk.com/**),certain bank automated teller machines (ATMs) and through eTAX accounts can also be used for payment of tax. To assist the taxpayers to save sufficient money for payment of tax, the IRD often encourages taxpayers to use Tax Reserve Certificate (TRC) for payment of tax.

At present, there are two types of TRCs (i.e., the ordinary TRCs and the TRCs for 'Conditional Standover Order' issued under objection cases). Ordinary TRCs are now issued only in electronic form. On the other hand, TRCs for 'Conditional Standover Order' are issued only in paper form.

Regarding ordinary TRCs, civil servants and civil service pensioners may use the 'Save-As-You-Earn' Scheme' while other taxpayers may join the Electronic TRCs Scheme. The Electronic TRCs Scheme provides various electronic purchase methods (monthly bank autopay, telephone, Internet and bank automated teller machine) and auto tax payment service to the participants.

Both the 'Electronic Tax Reserve Certificates Scheme' and 'Save-As-You-Earn' Scheme offer 'Auto Tax Payment Service' which ensures on-time tax payment. The TRCs held in the accounts with the IRD will be automatically redeemed on a First-In-First-Out basis for payment of the account holder's tax. A mid-year statement will be issued by the IRD to the TRC account holders in September every year showing the account balance of TRCs as at 31 August of the year. The TRC account holder may also check his or her account balance with the IRD at any time as he or she may wish. Around two weeks before the tax of the TRC account holder is due, a redemption statement will be issued by the IRD to the TRC account holder showing the details of the TRCs that will be redeemed for payment of tax and the balance of tax payable, if any.

S.71 of the IRO was amended under the Inland Revenue (Amendment) (No. 2) Ordinance 2010 to enable the Commissioner to refund to a taxpayer the balance remaining in the Tax Reserve Certificates account without requiring the taxpayer to return the Tax Reserve Certificate to the Commissioner. Consequential amendments were made to the Tax Reserve Certificates Ordinance and its subsidiary legislation.

Ordinary TRCs must be purchased in denominations of $300 or above and in multiples of $50. They will earn interest only when they are redeemed to pay the TRC account holder's tax. If they are redeemed for other purposes, no interest will be payable.

The interest rate of ordinary TRCs varies from time to time with regard to the latest market trend (it is reviewed every month based on the average of the prevailing 6-month time deposit rates for $100,000 offered by the three note issuing banks). With effect from 4 January 2010, the rate is 0.0433% p.a.

In general, interest payable on an ordinary TRC is governed by the following rules:

- The TRC will earn interest only when used for payment of the holder's tax.
- Once purchased, the TRC will bear the interest rate prevailing at the date of purchase.
- The TRC will bear simple interest, which is calculated from the date of purchase to the date of redemption.
- The TRC will earn interest for a maximum period of 36 months.

If the tax is not paid on the due date, the IRD may impose surcharge on the unpaid amount.

Pursuant to s.71(5) of the IRO, where any tax is in default, the Commissioner may in his discretion order a sum or sums not exceeding 5% in all of the amount in default which will be added to the tax and recovered accordingly. If the default is more than 6 months, the Commissioner may order a

further sum or sums not exceeding 10% in all of the unpaid amount (including the 5% surcharge and recovery costs), which will be added to the unpaid amount and recovered accordingly.

The IRD will recover the unpaid tax and surcharge as a civil debt through the District Court. Pursuant to s.75(4) of the IRO, the Court will not entertain any plea that the tax is excessive. The production of a certificate signed by the Commissioner stating the name and last known postal address of the defaulter and particulars of the tax due by him will be sufficient evidence of the amount of tax so due and sufficient authority for a District Court to give judgment for the said amount.

Case study: *Tak Wing Investment Co Ltd* [2001 HKRC 90-110]

The facts: In the case of *Tak Wing Investment Co Ltd* [2001 HKRC 90-110], the taxpayer lodged objections against two assessments but failed to pay the tax in dispute. The Commissioner sought to recover the unpaid tax and surcharge through the District Court. The taxpayer filed a defence in the District Court. In response, the Commissioner filed a summons to strike out the defence of the taxpayer. The taxpayer then filed a summons seeking stay or dismissal of the Commissioner's summons and applied to the Court of First Instance for leave to apply for judicial review of the Commissioner's decision to commence enforcement proceedings. The Court of First Instance refused the taxpayer's application for leave. The taxpayer then applied to the Court of Appeal. The Court of Appeal dismissed the taxpayer's application for leave to apply for judicial review of the Commissioner's decisions to:

- commence enforcement proceedings; and
- apply to strike out the taxpayer's defence in those proceedings.

Decision: However, the Court of Appeal granted leave to the taxpayer to apply for judicial review (by way of mandamus) of the Commissioner's alleged failure to consider the objections within a reasonable time.

Under s.76(1) of the IRO, the Commissioner may request a third party (who is the debtor of the taxpayer) to pay a sum that he owes to the taxpayer (not exceeding the amount of the tax in default) for payment of the tax in default.

Under s.71(6) of the IRO, the Commissioner may agree to accept payment of tax by instalments. In general, the taxpayer needs to have good reasons to apply for payment of tax by instalments. The IRD will usually request the taxpayer to pay the surcharge on the tax not paid on or before the due date.

Self-test question 3

Your client, Ms. Lim, is the sole proprietor of a garment business. She has recently received a query from the IRD regarding the source of funds she used to purchase two flats in late 2009. The IRD has found that Ms. Lim had not reported all the business' sales in her profits tax returns submitted for the years of assessment 2002/03 to 2009/10. The omitted sales represented about two-fifths of the total sales.

Ms. Lim told the IRD that she was illiterate and relied on her bookkeeper to handle all the accounting and tax matters. She claimed to have no knowledge of the omission. Although she now wants to disclose her true profits to the department, her accountant has not kept proper books and records from which you could prepare revised accounts.

Required

(a) Advise Ms Lim on the following matters:

(i) The obligations that are contained in the IRO in regard to the keeping of business records.

(ii) The penalty and prosecution action (if any) that could be taken against her by the Inland Revenue Department.

(b) You have decided to prepare an assets betterment statement for submission to the IRD. Make a brief list of the initial information and records you would require Ms Lim to produce to you.

(The answer is at the end of the chapter)

10 Application to the Commissioner for a notice under s.88B

Topic highlights

Upon an application under s.88B of the IRO (Form IR 1263) and payment of a fee specified in Schedule 11 of the IRO ($270), the Commissioner under certain conditions will issue the notice of no objection in respect of an application to deregister a private company under s.291AA of the Companies Ordinance.

A defunct, solvent private limited company in Hong Kong may either be liquidated or be deregistered from the Companies Registry under s.291AA of the Companies Ordinance.

To facilitate the deregistration of a company under s.291AA of the Companies Ordinance, a written notice from the Commissioner of Inland Revenue stating that he has no objection to the company being deregistered is required.

Upon an application under s.88B of the IRO (Form IR 1263) and payment of a fee specified in Schedule 11 of the IRO ($270), the Commissioner will issue the notice of no objection in respect of an application to deregister a private company under s.291AA of the Companies Ordinance, if:

- the company has never commenced operation, or has already ceased business;
- the company will not start / resume business in the future;
- the company has disposed of all trading stock, landed property and securities, if any;
- the company has no outstanding tax liabilities which include Profits Tax, Property Tax, Stamp Duty, Business Registration fee, fines and penalties in connection thereof and court fees;
- the company has no outstanding obligations under the Inland Revenue Ordinance. These include submission of return(s) which has (have) been issued by the IRD, liability to notify the Commissioner of Inland Revenue in writing that the company is chargeable to tax for any year of assessment in which a return has not been received;
- there are no unanswered enquiries from the IRD;
- there are no unsettled objections or appeals in respect of assessments already raised.

Appendix

Summary of cases relating to administrative procedures under the IRO

Taxpayer [Ref.]	Subject Matter	Extract of Facts and Determination
Mayland Woven Labels Factory Ltd [(1975) 1 HKTC 627]	Tax return without audited financial statements	The taxpayer submitted its Profits Tax Return without audited financial statements. The IRD rejected the tax return. On appeal, the High Court decided that the mere completion of a return form without the attachment of documents specifically required by the form was not sufficient compliance with s.51(1). This is because s.51(1) provides that any person, if required by the assessor, shall furnish a return containing such particulars as may be specified by the Board of Inland Revenue. The audited financial statements fall within the type of documents as specified by the Board of Inland Revenue.
Mui Y.F. or otherwise known as Moy Yick Fong [(1975) 1 HKTC 632]	Possession of information	The taxpayer was fined $2,000 for failure to provide information requested by the IRD under s.51(4)(a) in respect of shares transactions between 31.3.1971 and 31.3.1973. The taxpayer contended that the IRD's enquiry letter was *ultra vires* as it was a general request at large for information. The District Court decided that 'possession' should not be limited to physical possession of information or documents and that the taxpayer should produce the information as requested.
Lam Ying Bor Investment Co. Ltd [(1979) 1 HKTC 1098]	Late objection	The taxpayer had failed to lodge an objection within the one-month period. It claimed that as its sole active director was ill and that the other two directors were either too old or too busy, it had therefore been prevented from lodging the objection in time. The Commissioner refused to accept the taxpayer's late objection. The taxpayer applied for an order of *certiorari* or *mandamas* from the High Court. The High Court refused to grant any order and the taxpayer appealed to the Court of Appeal. The Court of Appeal decided that the delay in lodging the objection was caused by mismanagement by the directors and such grounds did not justify an extension of time for lodging an objection.

Taxpayer [Ref.]	Subject Matter	Extract of Facts and Determination
Chun Yuet Bun trading as Chong Hing Electrical Company [(1989) 2 HKTC 325]	Late objection	The taxpayer had failed to submit a Profits Tax Return and an estimated assessment was raised on him. The taxpayer lodged an objection after the issue of a Surcharge Notice and expiry of the one-month period claiming that he had not seen the Notice of Assessment. The Commissioner refused to accept the taxpayer's late objection. The High Court decided that there was no flaw in the decision-making process of the Commissioner and that his decision in refusing the taxpayer's objection was within his jurisdiction and not unreasonable. The judge further pointed out that the role of the Court in judicial review was of a limited nature. It was not for the Court to set standards or guidelines for the Commissioner to follow, nor to substitute its views of the facts for those of the Commissioner.
CIR v Shelcore Hong Kong Ltd [DCTC 5209/2009]	Reasonable basis to raise estimated assessment	It was held that if there are existing appeal mechanism on the correctness of an assessment, it is unlikely that claims for judicial review or defence against s.75 on recovery of tax will be entertained.
Lee Sap Pat [(1991) HKRC 90-055]	Estimated assessment	In March 1991, the taxpayer was prosecuted before a magistrate on a charge of possession of cash reasonably suspected of having been stolen or unlawfully obtained. Although the taxpayer was not convicted, the IRD raised an estimated assessment for 1984/85 and issued a Recovery Notice to the Commissioner of Police requiring the money be seized from the taxpayer to be paid for settlement of the tax. The taxpayer objected against the assessment and completed a tax return declaring that she had not carried on any business. However, she was advised by the Commissioner that tax should be paid in accordance with the demand notice. The taxpayer then applied for judicial review against the Commissioner of Inland Revenue and Commissioner of Police. The High Court dismissed the taxpayer's application on the grounds that the Commissioner of Inland Revenue had not exceeded his jurisdiction or acted illegally as the provisions under s.59(1) and s.59(3) clearly enabled an estimated assessment to be made in the absence of a return if it was expedient to do so and that the Commissioner of Police was obliged to transfer the money to the Commissioner of Inland Revenue in accordance with s.76.
Sun Yau Investment Co. Ltd. [(1984)2HKTC17]	S.70A and estimated assessment	An estimated assessment issued in the absence of a return, once finalised, cannot be re-opened by invoking s.70A.

Taxpayer [Ref.]	Subject Matter	Extract of Facts and Determination
Extramoney Limited [(1997) HKRC 90-083]	Meaning of 'error' under s.70A	The taxpayer was a company owned by subsidiaries and associated companies of Carrian Holdings Ltd. It filed a 1980/81 Profits Tax Return supported by unqualified audited financial statements. Carrian Holdings Ltd then went into liquidation. In 1987, the taxpayer and Carrian Holdings Ltd requested the IRD to reopen the 1980/81 profits tax assessment under s.70A on the grounds that the taxpayer had never made a profit. The auditors of the taxpayer were held to be negligent in another litigation and there was evidence that the taxpayer had not made the profit as disclosed in its financial statements. The Board of Review rejected the taxpayer's request on the grounds that there was no 'error' in its tax return. On appeal, the High Court, having regard to the meaning of 'error' given in the Oxford English Dictionary as 'something incorrectly done through ignorance or inadvertence, a mistake', decided that the taxpayer's deliberate declaration of the fictitious profits in its tax return was not an 'error' within the meaning of s.70A.
Dodge Knitting Co. Ltd, Dodge Trading Ltd [(1989) 1 HKRC 90-015]	Penalty under s.82A	The taxpayers had failed to submit Profits Tax Returns and notify the Commissioner of their chargeability for tax. The Commissioner imposed additional tax penalties on the taxpayers after raising profits tax assessments on the taxpayers. The taxpayers appealed to the Board of Review on the grounds that no tax had been 'undercharged' within the meaning of s.82A. The Board of Review dismissed the appeal and the taxpayers appealed to the High Court. The High Court confirmed the Board's decision on the grounds that s.82A(1)(ii) covered both factual undercharge and what would have been undercharged when a failure was left undetected. However, the Court also annulled an additional tax assessment on the grounds that the issue of a tax return from the IRD would have relieved the statutory duty of the first taxpayer to notify the Commissioner of its chargeability for tax.

Taxpayer [Ref.]	Subject Matter	Extract of Facts and Determination
Kwok Siu Tong [(1977) HKTC 1012]	Penalty under s.82A	The returns submitted by the taxpayer were not accepted by the assessor and estimated assessments were raised under s.59(2)(b). After further investigation, the original estimated assessments were found to be inadequate and additional assessments were raised on the taxpayer. The Commissioner then raised additional tax penalties based on the tax that would have been charged had the returns been accepted as correct and the tax that would have been charged had correct returns been made. The taxpayer disagreed and claimed that the additional tax should be based on the amount of tax charged by the original assessments. On appeal, the High Court decided in favour of the Commissioner. The wording in s.82A 'the amount of tax that has been undercharged in consequence of the incorrect return' means the difference between the tax on the ultimate reassessment and tax on the original incorrect return had it been accepted.
Charles C.Y. Cheng [(1979) HKTC 1087]	Service of s.82A(4) notice	The taxpayer had migrated to the USA after an investigation. The Commissioner issued a s.82A(4) notice to the taxpayer's last known address and then raised additional tax assessments for incorrect returns. The taxpayer claimed that it was an abuse of s.58(2) as he was not given a chance to make representations to the Commissioner. The Board of Review decided to reduce the additional tax assessments by half. On appeal, the High Court decided that there had not been any abuse of s.58 in the issue of the penalty assessments and reinstated the penalties imposed by the Commissioner.
Wong Wing Pui & Wong Wing Pui trading as Tai Yip Glass Company [(1985) 2 HKTC 134]	Late appeal against additional tax assessment [see note below]	The taxpayer had failed to lodge an appeal under s.82B within one month after the notice of assessment of additional tax. He applied to the Board of Review for an extension of time under s.66(1A). The Board refused to grant the extension as its power to extend the time limit for an appeal did not apply to additional tax assessment. On appeal, the High Court decided that the Board's decision was correct.
Wong Tung Kin [(1990) HKRC 90-043]	Commissioner's decision to prosecute	The taxpayer, after being investigated by the IRD, was prosecuted under s.82(1) for fraudulent evasion of tax. The Commissioner refused to impose additional tax under s.82A or to compound the offence under s.82(2) as alternatives to the prosecution. The taxpayer applied to the High Court for judicial review. The High Court decided that it could neither interfere in a criminal process nor interfere with the Commissioner's discretion entrusted by law.

Taxpayer [Ref.]	Subject Matter	Extract of Facts and Determination
Radofin Electronics (Far East) Ltd and another [(1982) HKTC 1252	Wilful intent to evade tax	The taxpayer manufactured electronic goods and sold them to customers in various countries. Two sets of invoices were kept for the transactions and a lower sales figure was recorded in its accounts. The taxpayer and its managing director were charged with offences of making false return, statement and declaration and of using fraud, art and contrivance with a wilful intent to evade tax contrary to ss.82(1)(b), (d) and (g). The Court found that the bookkeeping system adopted by the taxpayer was inappropriate and that its accounts and return were false. However, as the accounting system was disclosed to and endorsed by the auditor of the taxpayer, there was insufficient evidence to prove beyond reasonable doubt that the taxpayer and its director had a wilful intent to evade tax. The taxpayer and its director were therefore acquitted.
Chan Min Ching (Chan Min Ching trading as Chan Siu Wah Herbalist Clinic) [(1999) HKRC 90-100]	Late appeal against additional tax assessment [see note below]	The taxpayer had failed to lodge an appeal under s.82B within one month after the notice of assessment of additional tax. He applied to the Board of Review for an extension of time under s.66(1A). The Board refused to grant the extension as its power to extend the time limit for an appeal did not apply to additional tax assessment. On appeal, the High Court decided that the Board's decision was correct.
Loganathan Suresh Babu [(2000) 5 HKTC 191]	Validity of additional tax assessment under s.82A	An additional tax assessment under s.82A has to be raised by the Commissioner or a Deputy Commissioner personally. The taxpayer claimed that the additional tax assessment raised by Mrs. Sin Law Yuk Lin (a Deputy Commissioner) was invalid as the notice under s.82A(4) was issued by a different person, Mr. Lee Kwok Leung (an acting Deputy Commissioner). The Board of Review decided in favour of the taxpayer. On appeal, the Court of First Instance was of the view that when the Ordinance requires that the assessment of additional tax is to be made by the Commissioner or a Deputy Commissioner personally, all that it means is that the Commissioner or a Deputy Commissioner cannot delegate his task to someone else and the task has to be performed by a public officer holding the rank of the Commissioner or Deputy Commissioner for the time being. The Court also decided that it could not be the intent of the legislature that in the operation of the Ordinance, a single person should be responsible for assessing the additional tax. The additional tax

Taxpayer [Ref.]	Subject Matter	Extract of Facts and Determination
		assessment raised by Mrs. Sin was valid. The power to assess additional tax by the Commissioner or Deputy Commissioner is administrative, not judicial.
Tak Wing Investment Co Ltd [2001 HKRC 90-110]	Stay of enforcement proceedings	The taxpayer objected to the assessments for 1994/95 and 1995/96. The Commissioner did not determine the objections even though (i) over 11 months have elapsed since the taxpayer objected to the assessment for 1994/95 and (ii) over 20 months have elapsed since the taxpayer objected to the assessment for 1995/96. Pending the determination of the objections, the taxpayer did not pay the tax assessed, and surcharges have been levied in respect of the taxpayer's default. The Commissioner sought to recover the amount in default through the District Court. The taxpayer filed a defence and also applied for leave for judicial review of the Commissioner's decisions to commence enforcement proceedings. The Court of Appeal decided that the Commissioner was entitled to commence enforcement proceedings but granted leave to the taxpayer to apply for judicial review of the Commissioner's failure to determine the objections within a reasonable time.
Hong Kong Flour Mills Ltd [2002 HKRC 90-118]	Whether the notice of assessment is null and void due the absence of the word 'Limited' from the name of the taxpayer	Hong Kong Flour Mills Ltd requested for a tax refund from the IRD regarding the withholding tax paid on the royalties paid/payable to Lam Soon Trademark Limited as the notice of assessment was issued to 'Hong Kong Flour Mills Ltd for Lam Soon Trademark' instead of 'Hong Kong Flour Mills Ltd for Lam Soon Trademark Limited'. The Court decided that the omission of the word 'Limited' was an error of form only and the notice of assessment was valid by virtue of s.63 of the IRO.
Chia Tai Conti – Hong Kong Ltd [DCTC 9755/2006]	Payment of tax demanded under additional assessments under objections	The taxpayer objected to the assessments for 1997/98 to 1999/2000, and did not settle the profits tax demanded in the additional assessments. The Commissioner applied to the District Court for summary judgment for the tax overdue. The taxpayer claimed that the tax is excessive and that valid objections have been lodged. The taxpayer further claimed that there was an undue delay by the Commissioner in making her determination. The District Court ruled in favour of the Commissioner and stated that s.71 of the IRO clearly requires the tax to be paid when due notwithstanding that an objection has yet been settled and the taxpayer's plea is specifically covered by s.75(4). It further ruled that the taxpayer has not proved there was undue delay by the Commissioner and such claim would not be a valid ground for not settling the tax.

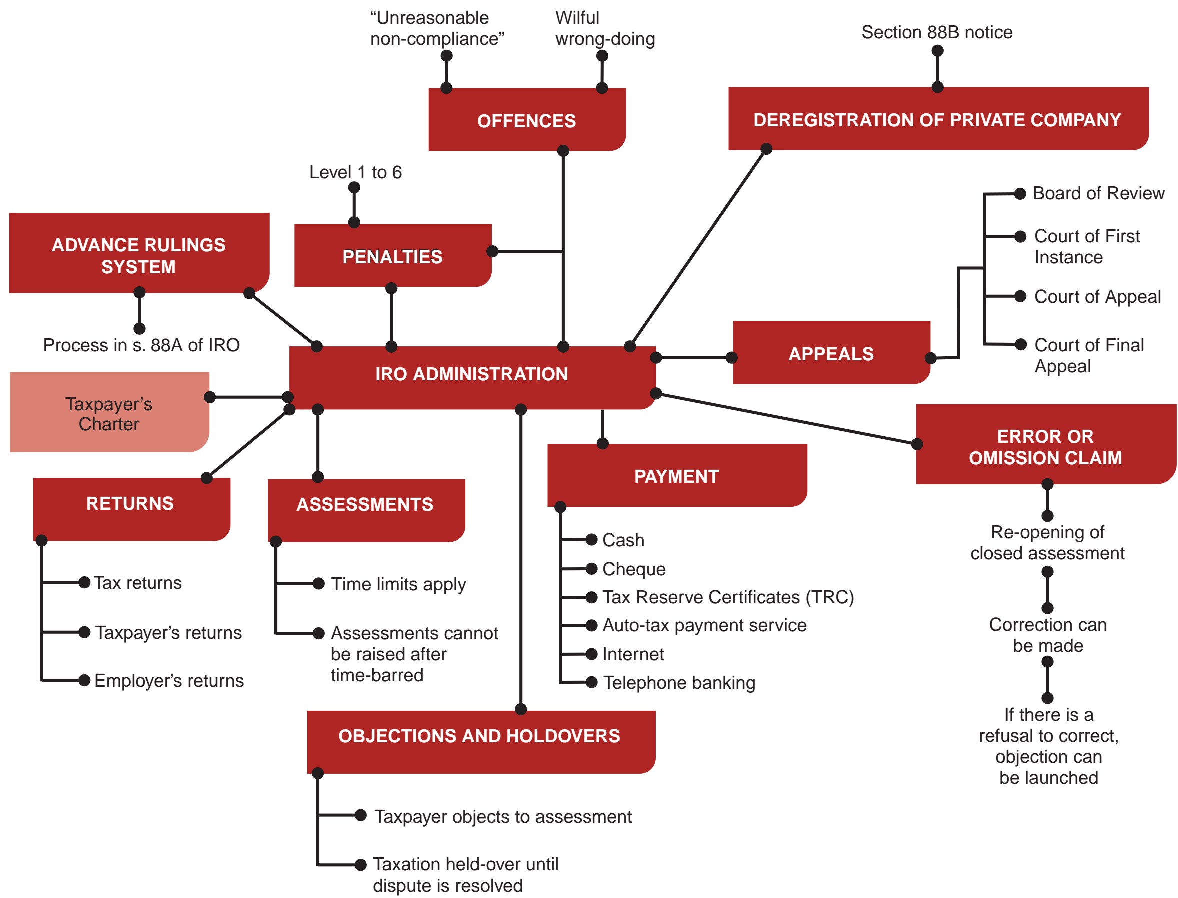
Taxpayer [Ref.]	Subject Matter	Extract of Facts and Determination
Harley Development Inc v CIR [1996] 1 HKC 703	Judicial review proceedings	Where a statute laid down a comprehensive system of appeals procedure against administrative decisions, then only in exceptional circumstances, typically involving an abuse of power, will the courts entertain an application for judicial review of a decision which had not been appealed against.
Indosuez W I Carr Securities Limited [CACV 57A/2006]	Judicial review proceedings	The taxpayer has previously appealed to the High Court regarding the source of its brokerage income. The case was remitted back to the Board of Review for determination on the basis of apportioning the commission income regarding the Company's Hong Kong clients. The Board made a new decision but declined to state a new case for the new decision stating that it would be an abuse of the process for the Commissioner to raise new questions. The Commissioner appealed the Board's decision to the Court of Instance and the Judge ruled that the Board should state a case, which was subsequently upheld by the Court of Appeal. In addition, the Court of Appeal refused to grant leave to appeal to the Court of Final Appeal, stating that a case should be stated because there were matters of law which arose in the Board's latest decision and which did not arise in the previous decision. The question of apportionment is clearly a question of law not a question of fact. By consent summons filed with the CFA, the parties agreed to the finalization of the case on the basis of the Board of Review decision handed down after the case had been remitted to the Board of Review with the opinion of the CFI by an order dated 30 January 2002 and a further order dated 24 April 2003.
Koon Wing Yee and Insider Dealing Tribunal The Financial Secretary [FACV No. 19 of 2007]	Potential implication on the imposition of a penalty under s.82A	The case stamped out from an Insider Dealing Tribunal case. The Court of Appeal ruled that a penalty equal to a maximum of 300% of the insider trading profits was criminal in nature. In addition, the company director should not be forced to give incriminating evidence against himself. For criminal charges, the defendant should be presumed innocent unless proven guilty beyond reasonable doubt. The Court of Final Appeal unanimously upheld the decisions of the Court of Appeal. The decisions in this case may have far reaching impacts on s.82A of the Inland Revenue Ordinance. Refer to Board of Review Case D17/08 in section 7.6.
Ahn Sang Gyun [HCIA 4/2008]	Application for amendment of case stated	Taxpayer has appealed to the Court of First Instance. Prior to the hearing, the taxpayer has applied for amendment to the case stated. The Court of First Instance stated that any proposed amendment to the Stated Case must constitute a question of law. As the proposed amendments were either not a question of law or mere extension of existing questions which will be dealt with by the Court with or without the amendments, the application was dismissed.

Taxpayer [Ref.]	Subject Matter	Extract of Facts and Determination
Chu R. Y. [HCIA 7/2007] [CACV 203/2008]	Penalty for omission of income	The taxpayer entered into a Type I service company arrangement with her employers which was challenged by the IRD. Additional salaries tax assessments were issued. The taxpayer objected to the Board without stating any grounds of appeal. The Board did not grant any extension to the taxpayer and dismissed the appeal. No further appeal was filed by the taxpayer. The CIR then imposed additional tax on the taxpayer. The taxpayer appealed to the Board against the additional tax. The grounds submitted were that no incorrect returns were made as she was an independent contractor instead of an employee; her honest belief of the aforesaid should constitute a reasonable excuse; and that improper administration was implemented by the IRD to handle her case after 6 years. The Board held that the additional salaries tax assessments were final and conclusive under s.70 of the IRO and the taxpayer was not allowed to re-open the issue; the taxpayer has a choice whether or not to use the Service Company, and should take up the risk of being challenged by the anti-avoidance provision if she chose to do so; and that personal belief is not a reasonable excuse. Accordingly, the Board dismissed the appeal. The taxpayer appealed to the Court of First Instance challenging whether all the assessments were 'final and conclusive'. The Court of First Instance and the Court of Appeal upheld the Board's decision and dismissed the appeal.
Lee Yee Shing, Jacky & Yeung Yuk Ching [HCAL 40/2008]	Judicial review on case stated procedure	The taxpayer's claim of deduction of loss from trading of shares was first dismissed by the BoR in Dec 2004, then by the CFI, CA and finally by the CFA in Jan 2008. The CFA judges noted that had the BoR made a finding on the trading or gambling nature of the case, the BoR would have found it as trading loss. Since no such finding was made, the CFA was bound to restrict itself to only the case stated in question of law and dismissed the appeal. The taxpayers applied for judicial review on the case stated procedure, which was opposed by the CIR on two grounds: (1) delay on application (2) abuse of legal process. Both grounds were dismissed by the CFI as the Judge noted that the limitation of case stated procedure did not come to the attention of the taxpayers nor their counsel but only after the judgment by the CFA. The application for leave of judicial review was submitted within 3 months from that judgment. Having considered the importance of the matter, the CFI granted leave to extend time for applying the judicial review and granted leave to move for judicial review. The Court of Appeal dismissed the taxpayer's appeal.

Taxpayer [Ref.]	Subject Matter	Extract of Facts and Determination
Yue Yuen Marketing Company Limited & Others vs. Commissioner of Inland Revenue (HCAL000049)	Judicial review on the objections raised and the time required for review	The Applicants seek judicial review of profits tax assessments raised by the Commissioner against them in relation to financial years 1997/98, 1998/99, 1999/2000, 2000/2001, 2001/2002 and 2002/2003. The assessment for 1997/98 was raised in 2004, just before the expiry of the 6 year limitation for making assessments in Inland Revenue Ordinance (Cap. 112) (IRO) s.60. Thereafter, between 2005 and 2009, assessments for financial years 1998/99 to 2002/2003 were routinely made just before the expiry of the 6 year limitation for each financial year. In every case, the Applicants objected within the 1 month period. It was noted that as at the date of hearing, the CIR has not issued any determination on the objections. It was ruled that the IRD has indeed processed the taxpayers' case with inordinate delay. An order of mandamus that the CIR determines the case within 6 months was issued by the CFI. The CFI further stated that inordinate delay would neither mean that the CIR's assessments become nullities nor that the CIR loses the power to determine an objection.
CIR v. Roderick John Sutton, Joint and Several Liquidator of Moulin Global Eyecare Trading Ltd [2010] 4 HKLRD 283	Tax assessment based on falsified accounts	A tax assessment is held to be final and conclusive under s.70, even if the liquidator considers that the accounts of the company were not real and did not disclose true profits
Moulin Global Eyecare Trading Limited (In Liquidation v CIR) HCAL 29/2010	Judicial review on CIR's refusal to accept taxpayer's accounts as falsified	It was held that the CIR should reconsider the Liquidator's application for an extension of time to lodge an objection under s.64 and for a revision of the taxpayer's return under s.70A. It was also held that the Liquidators are not prevented from challenging the assessments underlying the CIR's proof of debt by way of procedures laid out in the IRO or by way of judicial review.
Kinco Investment Holding Ltd v CIR HCAL 91/2009	Conditional Holdover	A Judicial Review application against the CIR's decision to require the taxpayer to purchase a tax reserve certificate for conditional holdover of tax and the CIR's refusal to grant an unconditional holdover. The taxpayer's application was dismissed.
Common Empire Ltd v CIR [2007] 1 HKLRD 679	Statement of loss	The Court of Appeal affirmed the decision of the Court of First Instance that a statement of loss is just an administrative document and not an assessment. Therefore the statement of loss cannot become final and conclusive.

Taxpayer [Ref.]	Subject Matter	Extract of Facts and Determination
Chan Chun Chuen v. CIR [2012] FAMV 23	Judicial review on CIR's refusal to extend time to lodge objection	The CFI held that the CIR did not properly consider the evidence submitted and have therefore acted unreasonably in refusing to grant an extension of time for the taxpayer to lodge an objection. The Court of Appeal allowed the CIR's appeal. On 15 April 2013, the taxpayer's application for leave to appeal to the CFA was dismissed.
CIR v Choon Nang Electrical Appliance Manufactory Limited (2011) DCTC 2456	Not paying profits tax	The taxpayer made various defences for not paying the profits tax when they fall due, including that the amount was excessive or incorrect as the matter was under objection. However, it was held that the taxpayer did not have a reasonable defence, which was struck out accordingly.
Kong Tai Shoes Manufacturing Company Limited v CIR [2011] HCAL 34	Objection	The CIR did not issue a determination on the taxpayer's objections for up to six and a half years. The court, although it refused the taxpayer's application to quash the assessments, ordered that the CIR issued a determination within two to six months. The taxpayer filed a notice of appeal to the Court of Appeal. The appeal is scheduled to be heard on 20 July 2012.
Nam Tai Group Management Limited v. CIR (2011) DCTC 458	Objection and holdover	The CIR claimed against the taxpayer for profits tax due and payable under s.75 of the IRO. The taxpayer's defence was that the CIR should have exercised his discretion properly when deciding whether to holdover the tax pending objection, and since he did not, the tax should not be payable. It was held that the taxpayer did not have a reasonable defence, which was struck out accordingly.
Tungtex Trading Company Limited v. CIR [2009] HCIA 7	Remitted the case to the Board of Review	The taxpayer sought to have the case stated remitted back to the Board of Review for amendment. The court considered the proposed amendments and decided that it was not justified. The taxpayer has withdrawn its appeal against the Board of Review decision.
Moulin Global Eyecare Trading Limited (In Liquidation) v. CIR [2011] CACV 64	Re-opening tax assessments in liquidation	The CIR's appeal to the Court of Appeal was heard on 2 and 3 February 2012. The judgement was made on 21 March 2012. The key issue in this appeal is whether the taxpayer, by its liquidators, may re-open its tax assessments years later on the grounds that its controlling directors at the time the tax returns were filed had fraudulently inflated its profits for the purpose of defrauding its bankers and other creditors. The Court of Appeal allows the Commissioner's appeal. The Court of Appeal allowed the CIR's appeal against the CFI's decision (HCAL 29/2010). The taxpayer has been granted leave to appeal to the CFA.

Topic recap



Answers to self-test questions

Answer 1

There is no sample answer provided to this question.

Answer 2

(a) In respect of the notice of assessment 2009/10, an s.70A claim could be submitted for the following reasons:

(1) Treatment of moulds

Pursuant to s.16G of the Inland Revenue Ordinance (IRO), a taxpayer who incurs specified capital expenditure on the provision of a prescribed fixed asset during the basis period for a year of assessment (year of assessment 1998/99 and onwards) is entitled to 100% deduction of the specified capital expenditure for that year of assessment.

As Hello Co used the moulds to manufacture goods, ie, tools for manufacturing operations, it should be eligible to claim 100% deduction for the acquisition costs.

(2) An assessment that has become final and conclusive can be re-opened under s.70A of the IRO if:

- an application is made within six years after the end of the year of assessment or within six months after the date on which the Notice of Assessment was served, whichever is the later; and
- it is established to the satisfaction of an assessor that the assessment is excessive due to an error or omission in a return or statement or that there is an arithmetical error or omission in the calculation of the assessable income or profits or tax charged.

However, no correction will be made under s.70A of the IRO if the assessment was issued in accordance with the practice generally prevailing at the time the return or statement was made.

Omission in loss set-off by the IRD should be regarded as an arithmetical omission in the ascertainment of assessable profits. At the same time, Hello Co made an error of fact in the 2009/10 profits tax return. It claimed initial and annual allowances (instead of 100% deduction) in relation to the moulds acquired in the tax year 2008/09. Under these circumstances, Hello Co should apply for re-opening the assessment under s.70A for the year of assessment 2009/10.

(b) If Hello Co disagrees with an assessment raised by an assessor, it can lodge an objection with the Commissioner of Inland Revenue (CIR).

The notice of objection shall:

- be in writing;
- state precisely the grounds for the objection; and
- be received by the CIR within one month after the issue date of the 2010/11 Notice of assessment.

Hello Co is required to prove that the assessment is incorrect or excessive.

(c) If the CIR rejects the argument submitted by Hello Co regarding the gain on disposal of listed shares, Hello Co can give notice of appeal to the Board of Review (BoR). The requirements for a valid appeal are outlined as follows:

– The notice must be in writing to the Clerk of the BoR.

– The notice must be given within one month after CIR's determination of the objection.

– The notice must be accompanied by a statement of the grounds of appeal and a copy of CIR's written determination together with copies of the reasons therefore and of the statement of facts.

– When Hello Co gave the notice of appeal to the BoR, it must, at the same time, send copies of it, and of the statement of the grounds of appeal, to the CIR.

Answer 3

(a) (i) The statutory obligation to keep business records is contained in s.51C which requires every person carrying on a trade, profession or business to keep sufficient records, either in English or Chinese, of income and expenditure to enable the assessable profits to be readily ascertained. Further, there is an obligation to retain such records for at least seven years after the transactions to which they relate, subject only to the following exceptions (neither of which is relevant to this case):

(1) When a corporation has been dissolved all records may be destroyed.

(2) Records may be destroyed in any other case where the Commissioner gives his consent.

'Records' include books of account (whether in legible form or by computer), receipts and payments, income and expenditure, together with vouchers, bank statements, invoices, receipts and other documents necessary to verify the entries in the accounts. It also includes records of assets and liabilities, goods purchased and sold, details of sellers and buyers, records of stocktakings and records of services provided.

(ii) With regard to the omission of sales, s.80(2)(a) provides, *inter alia*, that any person who without reasonable excuse makes an incorrect return by omitting or understating something is guilty of an offence. If prosecuted and convicted, the maximum punishment is a fine at level 3 ($10,000) for each charge and a further fine of treble the amount of tax that has or would have been undercharged as a result of the omission or understatement. The Commissioner may compound these offences and settle for a monetary penalty under s.80(5).

In cases of fraud and wilful evasion, action may be taken under s.82(1) which can lead to imprisonment in addition to the usual fines. In order for a prosecution under s.82 to succeed, fraud or wilful default to evade tax must be proved; and in practice this may be difficult. The following acts, if committed with the deliberate objective of evading tax, fall within the provisions of s.82(1):

(1) An omission from a return

(2) A false entry or statement in a return

(3) A false statement in a claim for a deduction or allowance

(4) Signing a statement or return without reasonable grounds for believing that it is true

In Ms. Lim's case, in view of the magnitude of the understatement, the recurrent omission over eight consecutive years, Ms. Lim's wilful intent to evade tax is likely to be established. Prosecution under s.82(1) may be instituted against Ms. Lim. The maximum punishment under s.82 is a fine at level 5 ($50,000) for each charge and a further fine of treble the amount of tax undercharged and imprisonment for three years. It should also be noted that multiple offences may be committed by Ms. Lim under

s.82(1), e.g. the omission of sales may amount to both an omission from the return as well as a false entry or statement in a return. The Commissioner may, however, compound these offences under s.82(2).

If no prosecution under ss.80(2) or 82(1) has been instituted, the Commissioner or Deputy Commissioner may penalize Ms Lim by way of assessment to additional tax under s.82A up to a maximum of treble the amount of tax undercharged. s.82B provides Ms. Lim with a right of appeal to the Board of Review against the imposition and/or quantum of any additional tax assessed.

The burden of proof for both ss.82 and 80 offences is on the prosecution to prove beyond reasonable doubt. The burden of proof for an appeal against a s.82A assessment is on Ms. Lim to prove on a balance of probability.

Illiteracy and reliance on bookkeepers may not be sufficient defences in a prosecution which is a criminal proceeding, nor are they reasonable excuses in terms of ss.80 or 82A. Ms. Lim's co-operation and full voluntary disclosure might be considered as mitigating factors when passing sentence or imposing monetary penalties. The time span and magnitude of the understatement, however, are aggravating factors.

With regard to the failure to keep adequate business records without reasonable excuse, this is an offence under s.80(1A). Under s.80(1A) the court may impose a maximum fine at level 6 ($100,000) but the Commissioner may, and often does, compound the offence under s.80(5).

(b) At the outset, you should require *inter alia*:

- A list of the business books (if any)
- A list of the bank accounts in operation, both business and personal
- A list of property, investments and other assets, including such items acquired in the name of other persons
- A list of bank accounts which have been closed and particulars of property etc, sold during the relevant period
- A list of all liabilities
- A list of the assets and liabilities on hand at the beginning of the relevant period
- A copy of the tax returns and assessments raised
- A list of the name of all family members
- A list of debtors and creditors at the beginning and end of the period under investigation

Exam practice

Mr. Brown

18 minutes

Mr. Brown, a property agent, advises you that he is being investigated by the IRD. Since he is unable to substantiate his business expenses amounting to $300,000, he has been required by the IRD to pay tax of $48,000 under an additional assessment.

Required

(a) Explain the difference between additional assessment and additional tax. **(3 marks)**

(b) Explain the difference between tax avoidance and tax evasion. **(3 marks)**

(c) Advise Mr. Brown on the possible consequences if the IRD takes legal action against him under s.82(1). **(4 marks)**

(Total = 10 marks)

Varian Inc. 28 minutes

Varian Inc. is a company incorporated and carrying on business in the United States in the software development sector. The company did not perform any business in Hong Kong in prior years, but recently the board of directors of the company resolved to extend its scope of business in Hong Kong in the near future by setting up a limited company in Hong Kong (Newco). To facilitate the development of its business activities, Newco's business plan will include the employment of staff in Hong Kong for daily business operations, appointment of local individuals as independent software consultants and the appointment of third party entities as sales agents in Hong Kong.

Required

Evaluate the Hong Kong Tax compliance obligations and disclosure requirements of Newco. Your answer should include the following matters:

(a) Obligations of taxpayers for doing business in Hong Kong from a profits tax perspective.

(4 marks)

(b) Obligations of taxpayers as employers. **(5 marks)**

(c) Obligations of taxpayers for engaging local individuals as independent consultants instead of employees to perform software development in Hong Kong. **(4 marks)**

(d) Payment of concealed commission to third parties (identities of the recipients not properly disclosed to the IRD) for the referral of business in Hong Kong. **(3 marks)**

(Total = 16 marks)

HKICPA December 2011

Barry Fisher

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

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)

HKICPA June 2012 (Extract)

Mr. Wong

Comment on the circumstances below from the Hong Kong tax perspective and, where appropriate, provide your recommendations. Support your answers with relevant provisions of the IROs:

Mr. Wong received his salaries tax assessment notice (2010/11 Final and 2011/12 Provisional) in the middle of October 2011. He simply set it aside without making any reminder of his own tax payment due dates. On 3 January 2012, Mr. Wong accidentally noted from the assessment notice that the first tax payment of his salaries tax liabilities was due on that day(3 January 2012), whilst the second tax payment was due on 2 April 2012. He would then like to apply for a complete holdover of the 2011/12 provisional salaries tax demanded in this notice as he retired on 1 April 2011 and did not have any income chargeable to salaries tax after his retirement.

(5 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 7 – Returns and Assessments, Chapter 8 – Objections and Appeals, Disputes to Assessments and Tax Collection)

Hong Kong Master Tax Guide, CCH Asia Pte Ltd (Chapter 9 – Returns and Information, Assessment, Provisional Tax; Chapter 11 – Objections, Appeals, Chapter 12 – Offences and Penalties)

Hong Kong Taxation and Tax Planning, Pilot Publishing Co Ltd (Chapters 2,3 and 5)

Hong Kong Taxation – Law & Practice, The Chinese University Press (Chapter 7 – Returns and Information to be Supplied, Penalties, Chapter 8 - Assessments and Payment of Tax, Chapter 9 – Objections and Appeals)

Inland Revenue Ordinance (Parts IX, X, XA, XB, XC, XI, XIV, XV)

DIPN 6 (Revised) Part A: Objections to the Commissioner, Part B: Appeals to the Board of Review, Part C: Appeals to the Courts

DIPN 11 (Revised) Field Audit and Investigation

DIPN 15 (Revised) (A) Limitation of loss relief (Section 22B); (B) Leasing arrangements (Section 39E); (C) General anti-avoidance provision (Section 61)); (D) General anti-avoidance provision (Section 61A); (E) Loss companies (Section 61B); (F) Ramsay principle; (G) Penalty on tax avoidance cases; (H) Guidelines on lease financing; (I) Advance rulings.

DIPN 31 Advance Rulings

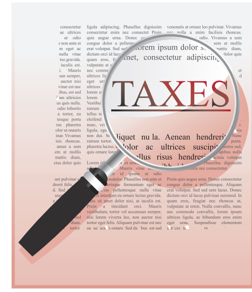
Supplementary Reference

Hong Kong Tax Manual, CCH Hong Kong Ltd (Para 25 – Returns, assessment; Para 35 – Objections, Appeals, Offences & Penalties)

Part B

Profits tax

Profits tax is the important tax in terms of revenue raised. The territorial source principle restricts the taxation of profits to Hong Kong sourced profits. Both corporation and individuals can be subject to the charge of profits tax. The general charging provision is Section 14 of the Inland Revenue Ordinance. For non-residents who fall outside the general charging provision, deeming provisions may apply. It is important to properly apply the right section to ascertain the profits tax liability.



chapter 3

Hong Kong profits tax

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Appendix
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Learning focus

Profits tax is one of the most important taxes in Hong Kong. The general charging provision is under s.14 of the Inland Revenue Ordinance. There are also deemed trading receipts under s.15 (which will be dealt with in later chapters). It is important for tax advisors to be able to identify the related profits tax issues and their tax treatments. They should also be able to ascertain the tax liability of their clients, taking into account the deductibility of various items of expenditure. Important topics like badges of trade will be dealt with.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Taxation of businesses		
2.14	**Scope of profits tax charge**	
2.14.01	Identify and explain the scope of charge to profits tax	3
2.14.02	Identify the specific rules applicable to special classes of corporate entities including financial institutions, insurance companies, ship owners, aircraft owners, clubs and associations	2
2.15	**Badges of trade**	3
2.15.01	Explain the criteria for determining whether a person carried on a trade, business or profession in Hong Kong	
2.15.02	Apply badges of trade in the context of recent Board of Review decisions and tax cases	
2.16	**Source of business profits**	3
2.16.01	Describe the rules governing the sources of profits for profits tax purposes (including the chargeability of e-commerce transactions)	
2.16.02	Describe the latest developments in tax cases on source issues	
2.16.03	Explain and apply DIPN 21 and DIPN 39	
2.17	**Deemed trading receipts**	3
2.17.01	Explain the rules governing the taxation of deemed trading receipts under s.15 and s.15A of the IRO	
2.17.02	Explain and apply DIPN 22 and 49	
2.18	**General deductions and specific deductions**	3
2.18.01	Explain the rules governing allowable and non-allowable profits tax deductions under the IRO	
2.18.02	Explain and apply DIPN 3, 5, 13, 13A, 24, 28, 33 and 49	
2.19	**Distinction between capital and revenue items**	2
2.19.01	Distinguish the capital and revenue items and explain its significance	
2.20	**Computation and treatment of losses**	2
2.20.01	Explain the treatment of losses and its computation	
2.20.02	Explain and apply DIPN 8	

		Competency level
2.21	**Business cessation and post-cessation receipts and payments**	2
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2.25	**Ascertainment of profits tax liability**	3
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2.25.02	Ascertain the basis period for computing assessable profits for the years in which the business commenced, ceased or there is a change in accounting date	
2.25.03	Prepare profits tax computations	
2.25.04	Recognise the relevance of accounting policies in the context of tax computations	
2.25.05	Explain and apply DIPN 1, 20, 34 and 40	
2.26	**Partnerships and allocation of profit/loss**	2
2.26.01	Identify the tax rules governing partnerships and joint ventures	
2.26.02	Apply the rules relating to partnerships and joint ventures in evaluating the choice of entity for business purposes and the tax reporting requirements	
2.27	**Depreciation allowances: plant and machinery**	2
2.27.01	Explain the rules governing the grant of allowances on plant and machinery	
2.27.02	Compute the allowances on plant and machinery	
2.27.03	Explain and apply DIPN 7	
2.28	**Depreciation allowances: industrial buildings and commercial buildings**	2
2.28.01	Explain the rules governing the grant of allowances on industrial buildings and commercial buildings	
2.28.02	Compute the allowances on industrial and commercial buildings	
2.28.03	Explain and apply DIPN 2	

1 Scope of profits tax charge

Topic highlights

Businesses pay profits tax on their profits chargeable to profits tax.

1.1 Scope of charge

Profits tax is charged on every person carrying on a trade, profession or business in Hong Kong in respect of his profits arising in or derived from Hong Kong (excluding profits arising from the sale of capital assets).

There are three conditions under s.14, the major charging section for profits tax, as follows:

(a) the person must carry on a trade, profession or business in Hong Kong;

(b) the profits to be charged must be from such trade, profession or business carried on by the person in Hong Kong; and

(c) the profits must be profits arising in or derived from Hong Kong.

Pursuant to s.2, 'profits arising in or derived from Hong Kong' for the purposes of Part IV (profits tax), shall, without in any way limiting the meaning of the term, include all profits from business transacted in Hong Kong, whether directly or through an agent.

Key terms in s.2

The term **'person'** includes a corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons.

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

(a) the agent, attorney, factor, receiver, or manager in Hong Kong of such person or partnership; and

(b) any person in Hong Kong through whom such person or partnership is in receipt of any profits or income arising in or derived from Hong Kong.

1.2 Chargeable persons, chargeable profits and tax rates

Foreign companies carrying on business in Hong Kong are charged to profits tax on the same basis as local companies. Rule 5 of the Inland Revenue Rules ('IRR') provides for the method of ascertainment and determination of the profits of the Hong Kong branch of a person whose head office is situated elsewhere than Hong Kong. (Non-residents is discussed in **chapter 4**.)

For persons not carrying on any trade, profession or business in Hong Kong, a charge to profits tax may arise under the deeming provisions in s.15.

The term 'profits' is not defined in the IRO. The ordinary meaning of profits refers to net profits, being the balance derived from deducting expenditures from income. In practice, commercial principles are applied as far as they do not conflict with the statute and taxable profits are usually computed by making adjustments to the accounting profits.

As 'profits arising from the sale of capital assets' are outside the scope of charge to profits tax (subject to other provisions of the IRO), it is important to identify the nature of the asset of a taxpayer. An investment will not change into a trading stock simply because it is sold. The intention and the activities of the taxpayer with regard to the subject matter are relevant.

There is no tax on dividends (s.26(a)). The profits tax rate for corporations (16.5%) is slightly higher than the standard rate (15%).

2 Trade, profession or business

Topic highlights

The first condition to profits tax charge is whether the taxpayer carries on a trade, profession or business in Hong Kong.

2.1 Trade

Key terms in s.2

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

Trade usually connotes some activities. Whether a trade is carried on is a question of fact to be determined by looking at all the circumstances of the case. Its existence is often determined by the six **badges of trade** (arrived at by the Royal Commission on the Taxation of Profits and Income in 1955) as follows:

Badges of trade	Implications and reference to case law
Subject matter of the realisation	An asset may be purchased for personal enjoyment, production of income or trading. If neither personal enjoyment nor income could be obtained from the asset, the asset is likely to be acquired for trading purposes. In *Rutledge v CIR* [(1929) 14 TC 490] a money lender acquired one million rolls of toilet paper and sold them at a profit. Having regard to the nature and quantity of the subject matter, the judge was of the view that the toilet paper had been acquired for trading as such large quantity of toilet paper could not be acquired for personal enjoyment or production of income.
Motive	The intention to make a profit is relevant but not decisive in determining whether or not an activity constitutes a trade. In the absence of direct evidence, it is often necessary to infer the seller's intention from the surrounding circumstances. In *Rutledge's* case, the trading motive of the taxpayer was inferred from the circumstances of the purchase and the quantity and nature of the subject matter.
Length of ownership	Short period of ownership is likely to exist in trading transactions. However, there are many exceptions. In *Johnston v Heath* [(1970) 1 WLR 1567], the taxpayer contracted to sell a property before he had purchased it. It was held that an adventure in the nature of trade was embarked on.
Frequency of similar transactions	If there are a number of similar transactions, it is likely that a trade is being carried on. In *Martin v Lowry* [(1927) AC 312], a wholesale machinery merchant purchased a large quantity of Government surplus aircraft linen and disposed of the linen in a number of lots. It was held that a trade was carried on with regard to the methods adopted for the resale of the linen, the number of operations entered into and the time occupied by the resale.
Supplementary work done	If there is work done to enhance the value of the asset to make it more marketable, it is likely that a trade is being carried on. In *Cape Brandy Syndicate v IRC* [(1921) 12 TC 358], the taxpayers

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Badges of trade	Implications and reference to case law
	purchased a quantity of brandy which was blended and re-casked and then disposed of in lots. It was held that there was a trade carried on by the taxpayers.
Circumstances responsible for the realisation	Assets realised in a sudden emergency may show that there is no plan to carry on a trade in respect of the subject matter. In *Cohan's Executors v IRC* [(1924) 12 TC 602], the executors of the deceased sold a ship after completing a shipbuilding contract which was entered into by the deceased before he died. It was held that the executors did not continue the trade but were performing their duty to realise an asset to the best advantage.

The badges of trade are by no means exhaustive. It is important to consider the relevant facts and merits of each case. Other relevant factors will also be considered:

(a) **Method and reason of acquisition** – If the asset is not acquired through purchase (e.g. through inheritance), it is more likely that a trade is not carried on.

(b) **Trading interest in the same field** – If the person is engaged in the same field and shows expertise or specialised knowledge of the commodity, it is more likely that he is trading in the asset. For example, a property agent is more likely to be trading in properties.

(c) **Method of financing the acquisition** – If the asset is acquired with short-term finance such as bank overdraft, it is likely that the asset is acquired with the purpose of quick disposal for profit; particularly in property transactions.

(d) **Utilisation of sale proceeds** – The way the sale proceeds were put into use may indicate the purpose for sale and thus the intention of the person carrying on such a business. For example, the sale money may have been retained for use in a similar activity or for making another form of investment.

(e) **Classification of asset in the accounts** – If the asset is shown as a current asset or trading stock in the accounts of a business, it is very likely that the asset is acquired for trading purposes.

Example 1

Mr. Man inherited a piece of land in Tuen Mun on the death of his father. He immediately sold it to a property developer. He then bought a second piece of land in the Tuen Mun area, constructed roads and drainage, advertised the land for sale and employed staff to handle enquiries. He finally sold the land at a large profit.

Mr. Man acquired the first piece of land by inheritance rather than by purchase. His immediate disposal would very likely indicate that he was merely realising his legacy and the sale would not amount to a trading adventure.

However, he did a lot of work to the second piece of land and set up an organisation for its sale. Therefore, it is likely that he would be regarded as carrying on a trade and the profits would be chargeable to profits tax.

Self-test question 1

John Chan acquired Property A in January 2008 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, Mary, moved into Property A after they returned from their honeymoon.

Mary gave birth to a baby in October 2012. The couple 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:

Discuss whether the gain on sale of Property A is subject to profits tax.

HKICPA June 2011 (Amended)
(The answer is at the end of the chapter)

2.2 Profession

The term 'profession' is not defined in the IRO.

In *IRC v Maxse* [(1919) 1 KB 647], the COA stated as follows:

> *"a profession in the present use of language involves the idea of an occupation requiring either purely intellectual skill, or of any manual skill, as in painting and sculpture, or surgery, skill controlled by the intellectual skill of the operator, as distinguished from an occupation which is substantially the production, or sale, or arrangement for the production or sale of commodities."*

A profession usually involves the exercise of intellectual skill or manual skill controlled by intellectual knowledge. In practice, most professions also fall within the meaning of business.

2.3 Business

Key terms in s.2

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

Due to this definition, rental income of a corporation from real property situated in Hong Kong is chargeable to profits tax, and rental income from sub-letting of a person other than a corporation is chargeable to profits tax. As an owner of the property, the corporation is also chargeable to property tax on the rental income from letting of premises.

The tax position is as follows:

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

The term 'business' is considered to have a wider meaning than that of trade. In practice, business connotes activities of a commercial character. Whether a business is carried on in Hong Kong is a matter of fact. It will depend on the nature and extent of the activities of the person.

In *Lee Yee Shing and Another v CIR* (2008) Justice McHugh NPJ commented that:

> *"Nevertheless, ever since Smith v Anderson (1880), common law courts have never doubted that the expression 'carrying on'* ***implies a repetition of acts*** *and that, in the expression 'carrying on a business',* ***the series of acts must be such that they constitute a business*** *… Much assistance in this context is also gained from the statement of Richardson J in Calkin v CIR (1984) at 446 where he said 'that underlying … the term 'business' itself when*

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> *used in the context of a taxation statute, is the fundamental notion of* ***the exercise of an activity in an organised and coherent way and one which is directed to an end result****'."* (emphasis added)

Where trade and profession are normally associated with some active function, the wider term business includes those circumstances where there is a purely passive receipt of income. Whether the passive receipt of interest by a company constitutes the carrying on of a business depends on the facts of each particular case. In DIPN 13 (para 5), the IRD states that:

(a) The mere receipt of interest by a company does not constitute the carrying on of a business;

(b) Actions that go beyond "mere passive acquiescence" may constitute the carrying on of a business;

(c) A period of inactivity does not rebut the fact that a company is still carrying on a business.

In *CIR v Bartica Investment Ltd* [(1966) 4 HKTC 129], the company placed deposits with financial institutions ('FIs') as security for back-to-back loans, held investments and purchased shares in a listed Hong Kong company. It was held that the company carried on a business in Hong Kong. Its principal on-going activity of placing deposits and furnishing securities was, of itself, sufficient to constitute carrying on a business, i.e. its activities had gone beyond "mere passive acquiescence". The case turned on its own facts and can be distinguished from situations involving the mere passive receipt of interest.

Under the doctrine of mutuality, to the extent that mutual insurance companies, clubs and trade associations trade only with members, they are not regarded as carrying on business. However, ss.23AA and 24 deem mutual insurance companies, clubs and trade associations as carrying on business for profits tax purposes under certain circumstances (see **section 14.8** on "Mutual insurance companies" and **section 14.8** on "Clubs and trade associations").

Prior to 1996, many insurance agents claimed that they were self-employed and should be chargeable to tax under profits tax instead of salaries tax. The IRD examined the operations of the insurance agents of the major insurance companies in Hong Kong and considered that most of the insurance agents were indeed employees. DIPN 33, which was first published in June 1998 and revised in October 2009, provides guidance on the tax position of insurance agents. In brief, insurance agents who are self-employed (with regard to the criteria outlined in DIPN 25) are assessed under profits tax whereas those who are employees are assessed under salaries tax. For those who are chargeable to profits tax, the IRD has provided examples of queries concerning expenses claimed as deductions under profits tax in DIPN 33.

In *Lo Tim-fat v CIR* (6 HKTC 725), it was held that upfront payments such as 'initial signing fees', 'goodwill payments' and 'sign-on bonus' are paid because the agent agrees to the appointment and to remain as the company's agent. Once the upfront payment is received, the insurance agent holds the sum beneficially and is entitled to use it for whatever purposes he likes, including for his trade and business. In any event, the upfront payment is clearly a trading receipt chargeable to profits tax.

3 Trade or business carried on in Hong Kong

Topic highlights

To be chargeable to profits tax, the trade or business must be carried on in Hong Kong.

3.1 Business carried on in Hong Kong

In *De Beers Consolidated Mines Ltd v Howe* [(1906) 5 TC 198], it was held that *"a company resides for purposes of income tax where its real business is carried on … and the real business is carried on where the central management and control actually abides"*. Therefore, traditionally as a

general rule, a company carries on a business in Hong Kong if its central management and control is in Hong Kong, which is usually the place of directors' meeting.

In *CIR v Bartica Investment Ltd* [(1966) 4 HKTC 129], the company was held to carry on a business in Hong Kong based on the following facts:

(a) Board meetings of the nominee directors were held in Hong Kong;

(b) All accounting and other records were kept and maintained by the accountants in Hong Kong;

(c) Bank accounts and their legal authorised signatories also were in Hong Kong.

Therefore, apart from the place of central management and control, other factors have to be considered as well. In general,

(a) If the company was incorporated in Hong Kong,

  (i) and directors' meetings are held in Hong Kong, the IRD usually regards the business as being carried on in Hong Kong.

  (ii) but argued that directors' meetings are held outside Hong Kong and thus the business is not carried on in Hong Kong, the IRD will examine other activities carried out in Hong Kong to determine whether the business is carried on in Hong Kong.

(b) If the company was incorporated outside Hong Kong,

  (i) but directors' meetings are held in Hong Kong, the IRD usually regards the business as being carried on in Hong Kong.

  (ii) and directors' meetings are held outside Hong Kong, the company is regarded as carrying on business with Hong Kong only. It is therefore not chargeable to profits tax, unless it is deemed to be carrying on business in Hong Kong or it is carrying on business in Hong Kong through a permanent establishment ('PE'); or earns deemed trading receipts taxable under s.15 (see **section 5.1** on 'Sums specifically chargeable to profits tax').

3.2 Non-resident trading through an agent

A non-resident which has no permanent business presence in Hong Kong may carry on a business in Hong Kong through an agent if the agent constitutes a PE of the non-resident.

The term **'PE'** is defined in IRR 5(1) to include:

(a) a branch, management or other place of business; and

(b) an agent who 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.

Example 2

American Inc carries on business in the USA as a trader in electrical appliances. It plans to expand its business into the Hong Kong market. In order to facilitate a more cost effective delivery network, American Inc has appointed an agent in Hong Kong, HK Co, and inventories will be shipped to HK Co's warehouse in Hong Kong. When an order is received by American Inc, HK Co will arrange for the corresponding merchandise to be delivered to the customers accordingly.

Although American Inc is a non-resident, it is regarded as carrying on business in Hong Kong through an agent. As stock will be kept in Hong Kong from which HK Co regularly fills orders, HK Co constitutes a PE of American Inc. Profits from sale of goods will be chargeable to profits tax unless the profits arise outside Hong Kong.

4 Source of profits

Topic highlights

Under s.14, only 'profits arising in or derived from Hong Kong' are taxable.

It is important to ascertain the source of a person's profits. In general, there are two main sources of income or profits:

(a) rendering services or performing activities (e.g. commission income); and

(b) holding of property (e.g. interest).

The former is often described as 'active income' in contrast with 'passive income' in the latter.

The BOR, in *CIR v Hang Seng Bank* [(1990) 1 HKRC 90-044], differentiated active and passive income as follows:

> *"In general there are two forms of income. One is the reward for services or activities carried out or performed. This is active income. The other form of income is the reward received from the ownership of rights in property which is passive income. Obviously this categorisation of income is not always precise because it is normally necessary to utilise some property to earn a reward for service, e.g. a typist who uses a typewriter, and some personal effort is required to obtain income from property, e.g. a landlord must rent out a flat to enable him to receive rent from the flat. In each case it is a matter of degree and there are no rigid rules. It is necessary to look at all of the facts and ascertain what the true and real source of the income is."*

In *United Aircraft Corporation* [(1943) 7 ATD 318], Latham CJ made a similar analysis as follows:

> *"Property is one possible source of income. The works of persons or acts done by persons are other possible sources of income. ... I have not been able to think of any source of income other than property and acts done. If a person has rights over property or in relation to property he may derive income from that property. ... If a person by himself or by his servants or agents does work of some kind or acts in some way, he may derive income from that work or act. ... A person who neither owns anything in a country nor does nor has done anything in that country cannot, in my opinion, derive income from that country."*

Active income, in general, includes:

(a) trading profits;

(b) profits from purchase and sale of listed securities;

(c) profits from purchase and sale of unlisted securities;

(d) manufacturing profits; and

(e) commissions or service fees.

Passive income, in general, includes:

(a) interest income;

(b) rental income from immovable property;

(c) rental income from movable property; and

(d) royalties or licence fees from intangible assets.

4.1 Traditional tests of source of profits

4.1.1 The broad guiding principle

The Privy Council in *Hang Seng Bank* provided a general guiding principle for the determination of source: "*one looks to see what the taxpayer has done to earn the profit in question"*. By way of illustration, the Privy Council considered:

(a) The profit earned by rendering of service or carrying out an activity is derived where the service was rendered or the profit-making activity was carried on.

(b) The profit from the manufacture of goods is derived where those goods were manufactured.

(c) The profit earned from the letting of property arises where the property is located.

(d) The profit from the lending of money arises at the place where the money is lent.

(e) The profit from dealing in commodities has its source where the contracts of purchase and sale are effected.

The following tests are therefore relevant in determining the source of income:

(a) operations test;

(b) contract effected test;

(c) provision of credit test;

(d) situs (or location) test; and

(e) activities test.

4.1.2 Operations test

For active income, the proper approach in ascertaining its source is usually the operations test. As Lord Atkin pointed out in *Smidth & Co V Greenwood* [(1922) 8 TC 203], *"the question is, where do the operations take place from which the profits in substance arise?"* What constitutes the relevant operations has to be determined based on the factual context of each case. This test is commonly applied to commissions or service fees.

The operations test was approved by the Privy Council in *CIR v HK-TVB International Ltd* [(1992) 1 HKRC 90-064]. The Privy Council considered that the proper approach was to ascertain *"what were the operations which produced the relevant profits and where those operations took place".*

Lord Millet in *ING Baring Securities (Hong Kong) Ltd v CIR* [(2007) FACV 19/2006] considered that the operations in question must be the operations of the taxpayer, not the operations of a separate person (e.g. a subsidiary or parent company). Relevant operations do not comprise the whole of the taxpayer's activities carried out in the course of its business, but only those that produce the profits in question:

> *"In Kwong Mile Services Ltd v Commissioner of Inland Revenue….. 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 purposes of s.14."*

Whether an act is an antecedent or incidental activity is a question of fact depending on the nature of the transaction.

4.1.3 Contract effected test

In the case of trading profit, *"the most important and indeed the crucial question is where the contracts of sales are made"* (*Maclaine & Co v Eccott* [(1926) 10 TC 572]).

When there is income provided in a contract with no services requested, the contract effected test may be used in determining the source of such income. In *Tariff Reinsurance Limited v The Commissioner of Taxes (Victoria)* [(1938) 59 CLR 194], the taxpayer, an English reinsurer, entered into a contract of reinsurance with an Australian insurer in England and received two-thirds of the gross premiums received by the Australian company in Australia. The High Court held that the source of the taxpayer's income was England, being the place where the contract was entered into.

This case involved one of the rare types of income that arise not from activity, and not from property, but from simply undertaking to perform a contingent future obligation. In that case, the making of the contract was the source that produced the income to the English insurer.

4.1.4 Provision of credit test

In the case of passive interest income from the lending of money, the source is *"where is the place where the credit is made available to the borrower?"* (*CIR v Lever Brothers & Unilever Ltd* (14 SATC 1)). The operations test may not be appropriate as the taxpayer does not need to perform any activities.

However, in the case of a money lending business, the taxpayer's business would normally encompass a broader range of activity, including the borrowing and/or lending of money. For this type of business, the IRD will apply the operations test instead of the provision of credit test in determining the source of the interest income (see DIPN 13).

4.1.5 Situs (or location) test

For other passive income earned by the possession of asset or properties, such as dividends or rent, the operations test will also not be appropriate as the taxpayer does not need to perform any activities other than making and holding the investment. In such circumstances, the situs test may be used. The test is *"the situation / location of the asset or property from which income is derived"*.

4.1.6 Activities test

The rationale is similar to the 'operations test'. The source is *"where the profit making activities are carried out?"* This test normally applies to manufacturing business where the conversion from raw materials to merchantable product is the critical activity, i.e. the manufacturing process.

4.1.7 Summary of source rule in DIPN 21

In view of the Privy Council's comments in *Hang Seng Bank* and other decided cases relating to the locality of profits, DIPN 21 was issued by the IRD in November 1992 and revised in April 1996, March 1998, December 2009 and July 2012 to specify the tax treatments for different income as follows:

Income	Determining factor	Examples of tax treatment
Trading profits	***'Contract effect test'*** – place where the contracts of purchase and sale are effected* **and** all of the relevant operations that produce the trading profits.	• Both contracts are effected in Hong Kong – fully taxable. • Both contracts are effected outside Hong Kong – exempt. • Either contract is effected in Hong Kong – the IRD will initially presume the profit is sourced in Hong Kong and will examine all of the relevant operations (DIPN 21, para18) to determine whether or not the profit is sourced in Hong Kong.

* According to DIPN 21 (para 21), the word 'effected' does not merely mean legally executed. It will contemplate all relevant operations carried out to earn profits, including the solicitation of orders, negotiation, conclusion, trade financing, shipment and performance of contracts.

Income	Determining factor	Examples of tax treatment
Profit from sale of listed shares and other listed securities	***'Situs test'*** – location of the stock exchange where the securities are traded. ***'Contract effect test'*** – where the purchase and sale took place over-the-counter, the place where the contracts of purchase and sale are effected.	• For non-over-the-counter trading, where the Stock exchange is located outside Hong Kong – exempt. • For over-the-counter trading, where both contracts of purchase and sale are effected outside Hong Kong – exempt.
Profit from sale of unlisted shares and other unlisted securities	***'Contract effect test'*** – place where the contracts of purchase and sale are effected (not applicable to FIs to which s.15(1)(l) applies).	• Both contracts are effected outside Hong Kong – exempt.
Manufacturing profit	***'Activities test'*** – place where the manufacturing activities are carried out. Need to consider whether the manufacturing is under contract processing or import processing (see **section 4.3** on 'Source of manufacturing profits').	• Goods are manufactured in Hong Kong – fully taxable. • Goods are manufactured partly in Hong Kong – apportionment (generally on a 50:50 basis).
Service fees	***'Operations test'*** – place where the services are performed which give rise to the payment of fees.	• Services are performed outside Hong Kong – exempt.
Commission income	***'Operations test'*** – place where the activities giving arise to the payment of commission take place.	• Activities from which commission is earned are performed outside Hong Kong – exempt.
Interest earned by persons other than FIs	***'Provision of credit test'*** – place where the credit is provided to the borrower for passive interest. ***'Operations test'*** – for money lending business.	• For simple loans with credit provided in Hong Kong – fully taxable. • For money lending business where both borrowing and lending of money are made outside Hong Kong – exempt.
Rental income	***'Situs test'*** – location of the property.	• Property is located outside Hong Kong – exempt.
Profit from sale of real property	***'Situs test'*** – location of the property.	• Property is located outside Hong Kong – exempt.

Income	Determining factor	Examples of tax treatment
Royalties other than those deemed chargeable under s.15(1)(a), (b) or (ba)	Place of acquisition and granting of the license or right of use.	• Contracts of acquisition and granting of the license or right of use are effected in Hong Kong – fully taxable. Please also refer to **section 4.8**.
Cross-border land transportation income	Normally the place of uplift of the passengers or goods. Apportionment between inbound and outbound is allowed only when they can be identified and specified in the contracts.	• Passengers or goods are uplifted in Hong Kong – fully taxable.

4.2 Source of trading profits

Trading profits are earned by buying goods or commodities and selling them for a higher price. Both the making of the purchase and sale contracts and the performance of them are part of the source of the trading profits. The contract effected test and the operations test are therefore relevant in determining the source of trading profits.

In DIPN 21, the IRD indicates that while the purchase and sale contracts are important factors, all of the relevant operations and not just the purchase and sale of the products must be looked at to determine the locality of the profits.

Examples of questions in connection with the **relevant operations** are as follows (DIPN 21, para 18):

(a) How were the goods procured and stored?

(b) How were the sales solicited?

(c) How were the orders processed?

(d) How were the goods shipped?

(e) How was the financing arranged?

(f) How was payment effected?

The following is a summary of the views of the IRD regarding the tax treatments of trading profits of a business carried on in Hong Kong (DIPN 21, para 23 and 24):

(a) Where both the contract of purchase and contract of sale are effected in Hong Kong, the profits are fully taxable.

(b) Where both the contract of purchase and contract of sale are effected outside Hong Kong, no part of the profits is taxable.

(c) Where either the contract of purchase or contract of sale is effected in Hong Kong, the initial presumption will be that the profits are fully taxable. Questions such as those mentioned above (DIPN 21, para 18) will be examined to determine the issue.

(d) Where the sale is made to a Hong Kong customer, the sale contract will usually be taken as having been effected in Hong Kong.

(e) Where the commodities or goods are purchased from either a Hong Kong supplier or manufacturer, the purchase contract will usually be taken as having been effected in Hong Kong.

(f) Where the effecting of the purchase and sale contracts does not require travel outside Hong Kong but is carried out in Hong Kong by telephone, fax etc., the contracts will be considered as having been effected in Hong Kong.

(g) The purchase and sale contracts are important factors but all relevant operations that produce the trading profits must be looked at to determine the locality of the profits.

(h) The IRD takes the view that the question of apportionment does not arise in relation to trading profits.

Normally the activities of an agent or an employee are accorded the same weight as activities of the principal or employer if it can be shown that the agent or employee has full authority to conclude contracts without reference to the business in Hong Kong. However, claims that contracts are concluded overseas by fully authorised employees travelling overseas must be proved by details of travelling, hotel and subsistence expenses in respect of each transaction; and claims that contacts are effected by fully authorised overseas agents must be supported by agency agreements or other documentary evidence (DIPN 21, para 26).

On the other hand, persons who are merely trading with Hong Kong by either selling goods to customers in Hong Kong or buying goods from suppliers in Hong Kong will not be regarded as carrying on a business in Hong Kong, and its trading profits will not be taxable.

Self-test question 2

Zoda Inc, a US company, is planning to set up a branch in Hong Kong to sell certain products of the Zoda Group. Goods would be supplied by group companies carrying on business outside Hong Kong and would be sold mainly to customers in the Mainland.

Required:

Discuss the potential profits tax liabilities of Zoda Inc in respect of the profits made from the sale of the group's products by the branch to be set up in Hong Kong.

(The answer is at the end of the chapter)

4.2.1 Re-invoicing activities

Profits derived from the buying and selling of goods by a re-invoicing centre had in the past been regarded as trading profits by the IRD. A trading transaction involves the taking of commercial risks (e.g. product risks, inventory risks, credit risks, exchange risks, capital risks, etc). Confirmation of sales and issue of purchase orders are indications that it is a trading transaction, and the source of trading profits depends on the locality of the trading operations.

However, the current view of the IRD is that a re-invoicing centre may in substance be rendering services in Hong Kong. The mark-up it earns from the buying and selling of goods may in fact represent profits from services rendered in Hong Kong and taxable.

In the revised DIPN 21 (2009), the IRD mentions that it is not possible to categorise the circumstances under which income or profit derived by a 're-invoicing centre' would be regarded as a service income and not as a trading profit. In each case, the IRD would examine the nature of the operations and the type of risks in question to determine whether they constitute the provision of service or trading. The label 're-invoicing centre' clearly does not in itself provide the answer as it can mean different business structures. If it is a service income, the source is determined by the place where the services are rendered. If it is a trading profit, the source depends on the locality of the trading operations.

Example 3 (Adapted from DIPN 21, Example 1)

Company A, incorporated in Hong Kong, is a re-invoicing centre of a group of companies with a holding company incorporated in the United States. It manages in Hong Kong all foreign currency exposures from intra-company trade, guarantees the exchange rates for future orders and

manages intra-affiliate cash flows, including lead and lags of payments. Manufacturing affiliates in the Mainland sell goods to Company A, which in turn resells to the distribution affiliates in North America and Europe. Company A resells at cost plus a mark-up for its services. The mark-up covers the cost of the re-invoicing centre and a reasonable return on the services provided.

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

Self-test question 3

Philip carries on a business in Hong Kong ('the Company') of providing corporate services to overseas companies that have established companies in Hong Kong to conduct re-invoicing activities. One of his clients, NR Inc, which is based in the USA, would travel to the factories of suppliers in the Mainland to negotiate the terms of purchase transactions with those suppliers. When an agreement was reached, NR Inc would tell the factory that the transaction would be conducted through the Company. Upon returning to the USA, NR Inc would send a purchase order to the Company offering to buy the goods such that a profit is 'booked' in the books of the Company.

The Company has no premises or employees of its own. On behalf of the Company Philip would follow NR Inc's instructions to automatically accept the purchase order, and issue a purchase order on behalf of the Company to the supplier in the Mainland to buy the goods for the originally agreed price.

Required:

Explain whether or not the profits from re-invoicing activities conducted by the Company will be subject to profits tax.

(The answer is at the end of the chapter)

4.2.2 Buying office

An overseas trading company may set up a branch, a subsidiary or an agent in Hong Kong to purchase goods or to collect information. Provided that the activities are confined to the purchase of goods or the collection of information and the branch, subsidiary or agent is not involved in the sale of goods, a liability to profits tax would not arise. However, any commission or remuneration earned by the subsidiary or agent for performing its services in Hong Kong will be fully taxable (DIPN 21, para 29).

4.2.3 Purchase and sale of listed securities

Listed securities can only be purchased and disposed of through the stock exchange on which the securities are listed. The situs test is therefore essential in determining the source of the profit from purchase and sale of listed securities. For example, profit from the purchase and sale of Hong Kong company shares listed in the London Stock Exchange will have a source outside Hong Kong.

However, where the purchase and sale took place over-the-counter, the place where the contracts of purchase and sale are effected would become the locality of the profits.

Where a non-resident buys and sell shares in the Hong Kong Stock Exchange either directly or through an agent and makes profits, the profits arise in Hong Kong. However, the non-resident may not be chargeable to profits tax in respect of such profits. Section 20AA 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-residents for whom they act, and DIPN 30 provides guidance on the application of s.20AA. The Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006 exempts offshore funds from profits tax, and DIPN 43 provides guidance on the profits tax exemption for offshore funds. (Taxation of non-residents is discussed in **chapter 4.**)

4.2.4 Purchase and sale of unlisted securities

In general, the situs test is not applicable to unlisted securities. According to DIPN 21, the contract effected test applies. Locality of the profit derived from the purchase and sale of unlisted securities will be taken as the place where the contracts of purchase and sale are effected (except FIs in instances where s.15(1)(l) applies).

4.2.5 Purchase and sale of real property

The source of profit from sale of real property is located where the property is located. Property transactions are an important part of economic activities in Hong Kong. There are a large number of cases involving the question whether the gains from disposal of a property are trading profits or 'profits arising from sale of capital assets' (this is discussed in **section 7.3** on 'Property and share transactions).

4.2.6 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 90-929
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

These tax cases are discussed in **Appendix 4**.

4.3 Source of manufacturing profits

The IRD takes the view that where goods are manufactured in Hong Kong, profits arising from the sale of such goods will be fully taxable because the profit making activities are considered to be the manufacturing operation carried out in Hong Kong, which includes the procurement of raw materials, the employment of labour, the design of products and the use of machinery and plant (DIPN 21, para 30). Where goods are manufactured partly in Hong Kong and partly outside Hong Kong, apportionment of profits on a 50:50 basis is usually accepted.

Example 4 (Adapted from DIPN 21, Examples 2 and 3)

(a) Company B manufactures goods in Hong Kong and sells them to overseas customers. The fact that Company B has sales staff based overseas does not give a part of the profit an overseas source.

This is not a case for apportionment. The whole of the profits are liable to profits tax.

(b) Company C manufactures in the Mainland and sells the finished goods through a retailing branch in Hong Kong. The retailing branch has sales staff and a fixed place of business, and has registered for business in Hong Kong.

Company C is both a manufacturer and a retailer. Profits are derived from the manufacturing operations in the Mainland and the retailing operations in Hong Kong. It is necessary to apportion the profits derived by Company C. Profits attributable to the Hong Kong retailing branch are chargeable to profits tax.

The IRD provides examples of the different tax treatments of manufacturing profits derived from contract processing arrangement and import processing arrangement in DIPN 21 as follows:

Arrangement	The IRD's view and tax treatment
Contract processing	
A Hong Kong manufacturing business, which does not have a license to carry on a business in the Mainland, enters into a processing or assembling arrangement with a Mainland enterprise. Under the processing arrangement, the Hong Kong company is responsible for the supply of raw materials and machinery without consideration and to provide technical and managerial know-how while the Mainland processing enterprise is responsible for the provision of factory premises, utilities and labour force. In return for the processing service, the Hong Kong company pays a subcontracting charge to the Mainland enterprise. The legal title to the raw materials and finished goods remains with the Hong Kong company.	The IRD takes the view that the Hong Kong company's operations in the Mainland complement its operations in Hong Kong. Recognising the operations of the company in the Mainland, an apportionment of profits on a 50:50 basis is usually accepted; and any rational basis put forward by the company will be considered. However, if the Hong Kong company has restricted involvement in the processing arrangement, apportionment of profits could not be appropriate. Given that the Hong Kong company does not carry out any manufacturing operations outside Hong Kong, its profits should be fully chargeable to profits tax without any apportionment.
Import processing	
In import processing, the manufacturing operations are carried out by a foreign investment enterprise ('FIE') related to the Hong Kong company. An FIE is often a separate legal entity incorporated in the Mainland. The Hong Kong company sells raw materials to the FIE and buys back the finished goods from the FIE. The Hong Kong company engages in the trading of raw materials and finished goods whilst the FIE manufactures the finished goods. The legal title to the raw materials and the finished goods passes to/from the FIE.	50:50 apportionment not available as the taxpayer is a trader not a manufacturer. The gross profits arise from trading transactions whereby the Hong Kong company purchases finished goods from an FIE and sells them for a profit. The manufacturing operations of the FIE in the Mainland are not performed on behalf of, or for the account of, the Hong Kong company even though the Hong Kong company and the Mainland enterprise might be within the same group of companies. The IRD holds the view that profits which accrued to the Hong Kong company from 'trading transactions' carried out in Hong Kong cannot be attributed to the manufacturing operations of the FIE carrying on business in the Mainland. The source of the trading profits must be attributed to the operations of the Hong Kong company which produced them (supported by *Consco Trading, Datatronic* and *CG Lighting*).

4.3.1 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
CG Lighting Limited	Manufacturing profits	HCIA 8/2009, CACV 119/2010

These tax cases are relevant only for import processing companies attempting to claim apportionment of profits. They are discussed in **Appendix 5**.

4.4 Source of commissions or service fees

Commissions or service fees, being a reward for services rendered, generally arise in the place where the relevant services of the agents are performed. The place where the principals are located, how they are identified by the agents and where incidental activities are performed prior to or subsequent to the earning of the commissions are not generally relevant.

In general, the operations test is relevant in determining the source of commissions or service fees for services rendered. If the services are performed both in Hong Kong and overseas, apportionment of the service fees may be made if there is an appropriate basis.

Example 5

A Ltd, a company incorporated in Hong Kong, was appointed under a five-year agreement to be the foreign distributor of the products of B Inc (a US company), with the exclusive right to sell the products outside the USA. A Ltd procured buyers, guaranteed orders of a minimum quantity and guaranteed the performance of orders placed by buyers. B Ltd agreed prices, entered into contracts directly with the buyers, and the buyers made payment directly to B Ltd.

The place where a contract is made and the place where the operations producing the profit are undertaken are both important considerations. The contract by which A Ltd was appointed sole distributor was executed in Hong Kong. The buyers were procured by A Ltd and put in touch with the seller, B Inc. Important services were rendered by A Ltd, e.g. undertaking to place orders of not less than a certain quantity and also guaranteeing the performance of orders, an obligation that is enforceable in Hong Kong. It makes no difference whether the obligations are called operations or services; the source of the profit is the agency agreement. Therefore, the profits arose in and were derived from Hong Kong (see *BR 2/75*).

In DIPN 21, the IRD also agrees to exclude from the charge to profits tax commissions from offshore services or derived in cases where no services are required, as in the following example.

Example 6 (Adapted from DIPN 21, Example 6)

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

(a) actively solicit orders ex-Hong Kong, on behalf of its principals by sending employee representatives overseas or by employing sub-agents overseas; or

(b) factually do nothing whatsoever, either itself or through sub-agents.

The IRD also indicates in paragraph 45(e) of DIPN 21 that, in the case of an investment adviser where the adviser's organisation and operations are located only in Hong Kong, rebates, commissions and discounts received by the adviser from brokers located in Hong Kong or

elsewhere in respect of the securities transactions executed on behalf of the adviser's clients are fully chargeable to tax.

4.4.1 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) Limited	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]

These tax cases are discussed in **Appendix 6**.

4.5 Source of interest income

For persons other than a FI, the IRD indicates in DIPN 21 that the locality of their interest income will be determined on the basis set out in DIPN 13.

In DIPN 13, the IRD states that the provision of credit test is generally applied to determine whether interest received by a business, other than a FI or money lender, carried on in Hong Kong is assessable. The provision of credit test places emphasis on the place where the sum of money is first made available to the borrower, and the following factors are not relevant in determining the source of interest income:

(a) the currency in which the loan is denominated;

(b) the place of residence of the debtor / creditor;

(c) the place where the debtor uses the loan;

(d) where the loan agreement is concluded;

(e) where the interest is payable; and

(f) the location of the funds from which the debtor draws money to pay interest.

Thus, it is not difficult for a Hong Kong resident to derive offshore interest income without leaving Hong Kong.

However, for money lending businesses, in light of *Orion Caribbean Ltd v CIR* [(1997) 4 HKTC 432] and *CIR* v *Kim Eng Securities Hong Kong Limited* [(2007) FACV 11/2006], it appears that the above factors which form part of the relevant operations cannot be completely ignored. In fact, the IRD has indicated in the revised DIPN 13 that it would apply the operations test instead of the provision of credit test; and the source of interest should be determined by looking to what the recipient of the interest has done to earn it and where he has done it.

For FIs, interest is chargeable to tax under the deeming provision of s.15(1)(i) if it is derived 'through or from the FI's business in Hong Kong'. There are agreed tax treatments of the income of a FI which are outlined in **section 14** on 'Special classes of business'.

For interest on trade debts, the source is usually the same as that of the trading profits. The judge in *Studebaker Corporation of Australia Limited v Commissioner of Taxation for New South Wales* [(1921) 29 CLR 225] made an analysis of interest on trade debts as follows:

> *"It was part and parcel of one business transaction. The obligation to pay and the right to receive the interest flowed from the agreement in America. It is impossible to divide the transaction into two distinct parts, and treat one as referable to America and the other... as referable to … New South Wales. ...The facts must be examined and when we find that the interest arises from business transacted and wholly carried out in America the conclusion must be that it was not derived from a source in New South Wales."*

In the case of bank deposits, the IRD takes the view that the source of the interest is the location of the branch with which the account is maintained, irrespective of where that account is physically operated or how and where the deposit funds are made available to the bank. In other words, the provision of credit took place when the branch in whose books the account was maintained entered the liability in their accounts.

DIPN 13 provides guidance on the taxation of interest received.

4.5.1 Tax case on source of interest income

There is one case involving the determination of the source of profits from borrowing and lending of money.

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

This tax case is discussed in **Appendix 7**.

4.6 Source of rental income from immovable property

The relevant test in determining the source of rental income from immovable property is the situs test. Activities occurring elsewhere in connection with the letting of the property such as negotiation and conclusion of the lease agreement are not taken into account. DIPN 21 indicates that the location (the situs) of the immovable property is the source of the rental income.

4.7 Source of rental income from movable property

Movable property includes:

(a) ships and aircrafts; and

(b) other movable properties.

Chargeability of the rental income from ships and aircrafts is governed by ss.23B, 23C, 23D and 23E, which are briefly outlined in **section 14** on 'Special classes of business'.

Pursuant to s.15(1)(d), sums received by or accrued to a person by way of hire, rental or similar charges for the use of, or the right to use, movable property in Hong Kong are chargeable to tax in Hong Kong. However, s.15(1)(d) only applies where the sums are not otherwise chargeable to profits tax.

In *Commissioner of Taxation v British United Shoe Machinery (SA) (Pty) Limited* [(1964) 26 SATC 163], the Court decided that the rental income in respect of leased machines arose where the machines were used by the lessee. The judge made the following analysis:

> *"With the hire of smaller things for a more limited period, for example motor cars, it was rather the business of the lessor than the property leased which was the source, and the*

location of the source in such a case would probably be the location of the business and the occasional use of the property in another country would probably be ignored. But in this case, having regard to the nature of the property leased instead of the business of the lessor, the source of the rental income derived from the use of property was where the property was used."

Example 3 in DIPN 15 (para 17) indicates that rental income from machinery or plant will generally be regarded as non-taxable in cases where the recipient is not allowed to claim depreciation allowance in respect of the property by virtue of s.39E.

Section 39E disallows depreciation allowances on leased machinery or plant if any of the independent conditions are satisfied. One such condition is that "the machinery or plant, not being a ship or aircraft ... is, while the lease is in force, used wholly or principally outside Hong Kong by a person other than the taxpayer". This is further discussed in **chapter 9, section 4.18**.

It appears that the IRD is, in general, taking the place where the movable property is used wholly or principally as the originating cause of the rental income, i.e. the situs test applies.

However, it is possible that the rental income from movable property may be viewed as arising in the place where the taxpayer provides the movable property to the lessee if there are a number of short-term leases and that the lessor exercises no control on the place(s) where the movable property is to be used.

4.8 Source of royalties or licence fees from intangible assets

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

In July 2012 the IRD issued DIPN 49. Part B 'Taxation of royalties derived from licensing of intellectual property rights' (para 71 - 76) outlines the IRD's interpretation and practices in relation to royalties derived from intellectual property rights ('IPRs') by taxpayers carrying on business in Hong Kong:

(a) Whether royalties derived from the licensing of IPRs by taxpayers carrying on business in Hong Kong are chargeable to tax in Hong Kong is a question of fact to be determined by the totality of the facts and circumstances in each case and no single test is decisive.

(b) Where the IPR is created or developed by the licensor

If the IPR is licensed by a taxpayer to another party for use outside Hong Kong, the royalty income will generally be regarded as Hong Kong sourced as it is generated by the taxpayer using his wits and labour to create or develop the IPR in Hong Kong.

(c) Where the IPR is purchased by the licensor

If the IPR is licensed by a taxpayer to another party for use outside Hong Kong, the royalty income will generally be regarded as non-Hong Kong sourced.

(d) Where the IPR is not owned by the licensor

If a taxpayer only obtains a licence to use an IPR from its owner (i.e. the taxpayer has not obtained the proprietary interest of the IPR) and sub-licenses the IPR to another party for use outside Hong Kong, the IRD will take the place of acquisition and granting of the licence as the source of income.

If the taxpayer acquires in Hong Kong the licence for use of the IPR and grants a sub-licence also in Hong Kong, the royalty income from sub-licensing the IPR will be regarded as derived from Hong Kong.

Royalties deemed chargeable under ss.15(1)(a), (b) and (ba) are discussed in **section 5.1** on 'Sums specifically chargeable to profits tax'.

4.8.1 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 trade mark is used):

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

These tax cases are discussed in **Appendix 8**.

4.9 Source of cross-border land transportation income

Pursuant to DIPN 21 (para 45(h)), the locality of the cross-border land transportation income will normally be the place of uplift of the passenger or goods. However, where the contract of carriage does not distinguish between outward and inward transportation, apportionment will not be permitted.

Example 7

Metropolitan Express Ltd ('MEL'), a Hong Kong company, provides bus services between Hong Kong and the Mainland. MEL was incorporated in January 2012 and is a wholly owned subsidiary of a German company. Its German holding company invested $25 million as share capital. In addition, the German holding company provided a $20 million loan to MEL at an interest rate of 5% per annum. The loan was provided in Germany. MEL purchased a fleet of 30 buses at a cost of $33 million and started its bus operations in March 2012. MEL spent an additional $1 million to install LCD monitors and computer systems for these buses. The monitors are used to show commercials to passengers aboard.

MEL leased a piece of land in Sheung Shui where its buses are parked at night and spent $5 million to construct a building on the land for the administration and accounting office. MEL rented two shops as ticket offices, one in Wanchai and the other in Mongkok.

In June 2012, MEL started its bus services between Hong Kong and Shenzhen after it had obtained all necessary permission from the Chinese government. All MEL's buses were licensed to operate in China. For trips from Hong Kong to Shenzhen, tickets are sold to passengers through MEL's ticket offices in Hong Kong. Passengers can purchase either one-way tickets or round-trip tickets at the Hong Kong offices. Passengers are picked up at designated pickup points in Hong Kong and in Kowloon. Occasionally one-way tickets are sold at the pickup points by MEL's staff.

Passengers who buy round-trip tickets board at designated pickup points in Shenzhen. These pickup points are at various hotels in Shenzhen. MEL also sells one-way tickets from Shenzhen to Hong Kong through the White Swan Hotel in Shenzhen, on a commission basis. MEL maintains neither office nor staff in Shenzhen. The contract with the Shenzhen hotel was negotiated and made in Shenzhen. Upon departure of a bus from Hong Kong, the Hong Kong office of MEL faxes the availability of places for the return trip to the White Swan Hotel which then sells the available places to customers over the counter. The monies received, after deduction of commissions, are remitted to MEL.

The first account of MEL was closed on 31 December 2012. During the year ended 31 December 2012, MEL generated around $4 million revenue from its bus operations between Hong Kong and Shenzhen. Sales of round-trip tickets accounted for 60% of the revenue, while 30% were from sales of one-way tickets from Hong Kong to Shenzhen. The remaining 10% were from sales of one-way tickets from Shenzhen to Hong Kong.

To provide road series for its buses before they cross the border, MEL has an emergency repair team in Hong Kong consisting of one tow truck and three mechanics. MEL has contracted a garage in Shenzhen to provide services to any bus that breaks down in Shenzhen. All the staff of MEL,

including the bus drivers, have been recruited in Hong Kong. Because the first bus service from Shenzhen to Hong Kong is scheduled at 6:00 a.m., some buses are parked in Shenzhen overnight. Drivers are required to arrange their own accommodation in Shenzhen and MEL pays the drivers a cash allowance.

In September 2012, MEL made a loan of $10 million to Tai Hoi Ltd ('THL') in Hong Kong. THL was a business competitor that was in financial difficulties. Interest has been charged at 6% per annum, payable monthly. The amount of interest received by MEL during the year ended 31 December 2012 from THL was $200,000. In addition, MEL earned $100,000 interest from its deposit with a Hong Kong bank.

Required:

Discuss the extent to which the revenue MEL generated from its bus operations between Hong Kong and Shenzhen is chargeable to tax in Hong Kong and whether MEL will need to address the issue of double taxation.

Solution

Profits tax is charged on business profits arising in or derived from Hong Kong (s.14). The place where the operations are carried out is regarded as the key to determining whether business profits are arising in or derived from Hong Kong. If the operations are carried out in Hong Kong, the profits are considered to originate from Hong Kong.

In the case of MEL, the profits from its bus operations between Hong Kong and Shenzhen can be argued as derived partly from Hong Kong and partly outside Hong Kong. The important services that generate the profits are (1) the actual delivery of passengers from one location to another location; and (2) the supporting arrangements such as ticket sales and road services.

The IRD has taken the view that the place of picking up passengers is important in determining the source of profits generated from cross-border land transportation. If the uplift of passengers is in Hong Kong, the source is Hong Kong. Hence, the revenues derived from bus services from Hong Kong to Shenzhen are from a Hong Kong source as the point of uplift of passengers is in Hong Kong. Revenue derived from taking passengers from Shenzhen to Hong Kong including from tickets for return trips sold in Hong Kong is likely to be considered by the IRD as profits generated outside Hong Kong (see DIPN 21, para 45(h)).

It is further explained in DIPN 21 that if it is not possible to identify separately the revenue generated from the return trip to Hong Kong from Shenzhen, no apportionment will be allowed. This represents only the view of the IRD; one may argue for an apportionment basis even though it is not possible to distinguish between outward transportation and inward transportation.

Arrangement for the Avoidance of Double Taxation between Hong Kong and the Mainland provides that the income from all cross-border transportation will be taxed in the place where the taxpayer is resident. As MEL is a Hong Kong company, its income will not be taxed in the Mainland and hence double taxation is not an issue.

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4.10 Source of underwriting income

The source of underwriting income is not covered by DIPN 21, except for para 54 which relates to underwriting income for FIs. There is a case concerning the source of income from underwriting the sale of a property situated in the Mainland as outlined below.

4.10.1 Tax cases on source of underwriting income

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

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

This case is often cited together with the broad guiding principle in determining the source of profit in general. Refer to **Appendix 9** for details.

4.11 Chargeability of e-commerce transactions

The Electronic Transactions Ordinance was enacted in 2000. Contracts that are concluded in the cyberspace and signed digitally have the same effects as those concluded and signed in the normal way.

The IRD, in DIPN 39, indicates that it will apply the provisions of the IRO to electronic commerce on the same basis as those applied to conventional forms of business. That is to say, no particular business form is placed at an advantage or disadvantage as far as taxation is concerned. The conventional broad guiding principle as outlined in case law and DIPN 21 will continue to apply in determining the source of profits earned by different types of business via electronic commerce. It is well understood that whether or not a person is carrying on a trade, profession or business in Hong Kong is largely a question of fact and degree, which can only be determined after examining all the circumstances of the case. The IRD is of the view that:

(a) There is a presumption that in the case of a company incorporated for the purpose of making profits for its shareholders, any gainful use to which it puts any of its assets *prima facie* amounts to the carrying on of a business (see *American Leaf Blending Co. Sd Bhd v Director General of Inland Revenue* [(1978) STC 561] cited with approval in *CIR v Bartica Investment Ltd* [(1996) 4 HKTC 145]);

(b) A person carrying on a business in Hong Kong does not necessarily have an office, staff or organisation in Hong Kong; and

(c) Extensive activities are not necessarily required in determining whether a person is carrying on a trade or business.

A PE is usually the place where an enterprise carries on its business. According to the Organisation for Economic Co-operation and Development ('OECD'), a server may amount to a PE of an enterprise if an essential and significant part of its business activities are conducted through the server. The IRD holds another view that the mere presence of a server (even an intelligent one that is capable of concluding contracts, processing payments or delivering digital goods) in a particular jurisdiction without the involvement of human activities in the same jurisdiction would not generally amount to the carrying on of a business in that jurisdiction. That is to say, a server does not constitute a PE unless there is a physical place and personnel involved at the place where the server is located. However, the IRD also considers that the absence of a PE does not mean that no business is carried on in Hong Kong. This indicates that although a person does not have a PE in Hong Kong, it may still be treated as carrying on a business here.

By nature, electronic commerce transactions involve less human activity and may be conducted using a server located outside Hong Kong. The IRD's view is that it is generally the location of the physical business operations, rather than the location of the server alone, that determines the locality of the profits. It will give greater weight to the underlying physical operations conducted by a taxpayer to earn the profits in question than to the location of the electronic processes.

It is expected that a person who carries on business via the Internet may require less physical operations, personnel and facilities in a particular location than a person engaged in a conventional business such as manufacturing, trading or consultancy services. In such a situation, apart from the nature of the contracts concluded via the Internet, the IRD will look at the location of the following processes in determining the source of the profits of the relevant person:

(a) Where goods are stored and delivered;
(b) Where services are provided;
(c) Where payments are made and received;
(d) Where purchases and sales are made;
(e) Where bank accounts are maintained; and
(f) Where business back-up services are provided.

The following three examples in DIPN 39 provide clarification on this matter.

Example 8 (Adapted from DIPN 39, Example 1 on trading business)

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

Example 9 (Adapted from DIPN 39, Example 2 on servicing business)

A company carries on a consultancy business in Hong Kong, and operates a server (at its disposal) located outside Hong Kong. The company supplies details of its services, answers enquiries and receives payment through the server. The company obtains consultancy projects from overseas clients through the server, but the work relating to the consultancy services is performed in Hong Kong. Although the client receives the final product in the form of a report through the server, the activities giving rise to the profit are substantially performed in Hong Kong. In this case, the income is chargeable to Hong Kong profits tax.

Example 10 (Adapted from DIPN 39, Example 3 on manufacturing business)

A company carries on a manufacturing business in Hong Kong, and operates a server (at its disposal) located outside Hong Kong. The company supplies details of its products and prices, negotiates the terms with clients, accepts orders and receives payments through the server. If the company's manufacturing processes are carried out in Hong Kong, the profits are sourced in Hong Kong even though the goods are sold to overseas customers. In this case, the income is chargeable to Hong Kong profits tax.

The above three examples demonstrate that the IRD uses the conventional broad guiding principle as illustrated in the case law and stipulated in DIPN 21, to determine the source of e-commerce profits earned by different types of business.

The virtual nature of e-commerce raises practical challenges for enforcement of taxation of profits derived from internet trading which include:

(a) Identification of taxpayer – Internet trading can be carried on with much less use of conventional physical office and personnel. Such trading transactions can therefore be invisible to the IRD, making it difficult to enforce the tax law, e.g. registration of taxpayers and issuance of tax returns.

(b) Determination of chargeability – The virtual form of many electronic transactions baffles the questions of in which jurisdiction the business is carried on and in which jurisdiction the profits are derived (i.e. sourced). For those jurisdictions where the concept of residence is relevant, there is also the question of where the person conducting internet trading is resident.

(c) Collection of tax – Even if taxpayers are properly identified and taxed, they may not have any physical presence in the taxing jurisdiction to enable enforcement of tax collections. It is usually impracticable to identify an administratively reasonable number of local business counterparts or agents to impose withholding obligations.

A person who is in doubt of his/her chargeability to tax in Hong Kong may, subject to the payment of a fee, apply to the Commissioner in accordance with s. 88A and Schedule 10 for a ruling on any matters relating to the locality of profits.

DIPN 31 (Revised) provides guidance on the application for an advance ruling under s.88A.

Example 11

A Ltd launched its property consultancy business in the Mainland of China ('the Mainland'). It established a number of representative offices in the Mainland. At each representative office, A Ltd employed certain staff to operate a computer server and perform the liaison work. The offices obtained job orders from the Mainland clients through the servers and passed the orders to the Hong Kong office to carry out the research work. The final reports would then be delivered back to the clients through the Mainland servers.

Required:

Discuss whether A Ltd's consultancy service income from the Mainland clients was derived outside Hong Kong.

Solution

The broad guiding principle for determining the source of profits, as laid down by Lord Bridge in *Commissioner of Inland Revenue v Hang Seng Bank Ltd* [(1991) 1 AC 306] and expanded by Lord Jauncey in *Commissioner of Inland Revenue v HK-TVB International Ltd* [(1992) 2 AC 397], is "one looks to see what the taxpayer has done to earn the profit in question and where he has done it".

In DIPN 39, the IRD stated that the above principle would continue to apply in determining the source of profits earned by different types of business via electronic commerce. But as electronic commerce transactions involved less human activity and may be conducted using a server located outside Hong Kong, the IRD took the view that it was generally the location of the physical business operations, rather than the location of the server alone, that determined the locality of the profits. It would give greater weight to the underlying physical operations conducted by the taxpayer to earn the profits in question than the location of the electronic processes.

Although A Ltd established certain representative offices in the Mainland to carry on a consultancy business via the internet, the staff members of those offices were only responsible for liaison work, whilst the servers there merely acted as a gateway for obtaining orders from and delivering the consultancy reports to the Mainland clients. All these functions were antecedent or incidental matters which did not determine the source of the consultancy income: see *Kwong Mile Services Limited v. Commissioner of Inland Revenue* [(2004) 3 HKLRD 168]. The effective cause of such income was the research work and it was done in Hong Kong. As such, the income should not be regarded as having a source outside Hong Kong.

HKICPA December 2011 (Amended)

5 Miscellaneous income and exemptions

Topic highlights

Certain sums, such as recovery of bad debts and proceeds from sale of machinery and plant, previously allowed as deductions are specifically chargeable to profits tax while other sums, such as profits arising from the sale of capital assets, are specifically exempted from profits tax.

5.1 Sums specifically chargeable to profits tax

Section 15 extends the scope of charge of s.14 by providing that certain sums 'shall be deemed to be receipts arising in or derived from Hong Kong from a trade, profession, or business carried on in Hong Kong'. It applies where the receipts are not otherwise chargeable to profits tax under s.14. The deemed trading receipts cover several types of income which are generally subject to withholding tax in other jurisdictions (e.g. interest, royalties and rent). These deeming provisions were brought into the IRO on the recommendation of the Second Inland Revenue Ordinance Review Committee, in accordance with a proposal advanced by the then Commissioner.

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The deemed trading receipts are discussed below:

Section	Sums specifically chargeable to profits tax
15(1)(a)	Sums received by or accrued to a person from 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, trade mark, 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. In DIPN 39, the IRD provides a distinction between the following payments for the use of computer software: (1) A payment for the use of or the right to use only the actual software programme (where s.15(1)(b) would not apply)*; and (2) A payment for the use of or the right to use the copyright which subsists in the software programme (where s.15(1)(b) would apply)**. **Notes** * Including the purchase of pre-packed (shrink-wrapped) software, which grants the customer a licence to use the software to a limited extent, i.e., to use the software either: (i) on a single computer; or (ii) on a specified number of the customer's computers or network servers. ** Including a contract granting the customer: (i) the right to make copies for distribution to the public; (ii) the right to prepare derivative programmes; (iii) the right to make a public performance of the programme; or (iv) the right to display publicly the programme.
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. Effective from 25 June 2004, s.15(1)(ba) was enacted to counteract the impact of the CFA's decision in *CIR v Emerson Radio Corporation* [(2000) HKRC 90-102]). 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. 'Owned' refers to direct ownership, e.g. by a corporation, not its shareholders. The meaning of an 'associate' depends on whether the person is a natural person, a corporation or a partnership. It may include a relative, a partner, any director or principal officer of a corporation. It may also mean any associated corporation over which the person has control, or under the same control of the same person. This definition is similar to those used in other anti-avoidance provisions (e.g. ss.16EC(8) and 39E(5)). Section 20B imposes a withholding obligation on the resident person who pays or credits the sums described in s.15(1)(a), (b) or (ba) (discussed in **chapter 4,**

Section	Sums specifically chargeable to profits tax
	section 2.4 on 'Withholding obligations on resident persons paying or crediting certain payments to non-resident persons'). The application of ss.15(1)(b) and (ba) are discussed in **Example 12** below. DIPN 22 provides guidance on the application of s.21A.
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 or 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 or 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. This is discussed in **section 5.3** on 'Sums specifically exempt from profits tax' below.
15(1)(h)	Refund of contributions made by a person as an employer to a recognised occupational retirement scheme ('RORS') or to a mandatory provident fund scheme ('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. Whether interest arises through or from the carrying on of a business in Hong Kong is a question of fact. Ascertainment of the assessable profits of FIs is discussed in **section 14.1**.
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 or 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 or business in Hong Kong, and the profit is in respect of funds of the trade, profession or business.

Section	Sums specifically chargeable to profits tax
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. Sections 15(1)(m) and 15A are specific anti-avoidance provisions enacted in 1987 to counter the possibility that a person could sell the right to receive taxable income to another person for a lump sum which might be treated as a receipt for the sale of a capital asset and so exempt from profits tax, whilst retaining the ownership of the underlying asset that produces the income. This is further discussed in **chapter 9, section 4.7**.
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.

Sections 15(1)(a), (b) and (ba) start with the phrase "sums, not otherwise chargeable to tax under this Part, received by or accrued to a person". A non-resident licensor is therefore chargeable to profits tax in Hong Kong notwithstanding that no trade, profession or business has been carried on in Hong Kong. Section s.21A provides that the licensor will be taxed on 30% of the gross receipts. However, if the following two circumstances arise, the assessment will become 100% of the gross receipts instead of 30%:

(a) The receipts came from an associated person of the non-resident; and

(b) The asset or property on which the royalty was paid has been owned, partly or wholly, by any person carrying on business in Hong Kong.

Example 12

Mr. Crazy, a scientist living in France, has invented a secret formula of a health product in France. He plans to produce the health product for sales to Hong Kong. He is now considering the following proposal.

Mad Ltd ('Mad') is to be set up in Hong Kong with Mr Crazy as the sole beneficial owner. Mr. Crazy will license the use of the secret formula to produce the health food to Mad for an annual fee of $200,000. Mad will enter into a contract processing arrangement with a Mainland entity to produce the health product in the Mainland. Mad will provide raw materials, production skills, training and supervision for locally recruited labour and manufacturing machinery. The Mainland entity will provide factory premises, land and labour. It will charge a processing fee and export the completed products to Mad. All products will be sold by Mad in Hong Kong.

Required:

(a) Advise Mr. Crazy of the taxability of the annual fee of $200,000 in the above proposal.

(b) Advise Mr. Crazy as to whether there is any difference in the taxability of the annual fee if Mad produces the health product in Hong Kong and sells the products in Hong Kong.

(c) Advise Mr. Crazy as to whether there is any difference in the taxability of the annual fee if he had not invented the secret formula but acquired it from a Hong Kong company carrying on business in Hong Kong.

The tax implications are as follows:

(a) As Mr. Crazy does not carry on any business in Hong Kong, he is not taxable under s.14. His royalty from licensing the secret formula also is not chargeable to profits tax under s.15(1)(b) as the secret formula is not used in Hong Kong, but in China.

For a contract processing arrangement, the concession under para 34 of DIPN 21 is applicable and the IRD will allow an apportionment of profits on a 50:50 basis. Mad can claim 50% of the royalty as an allowable deduction under s.16(1). Therefore, 50% of the royalty will be chargeable to profits tax under s.15(1)(ba).

Under s.21A, the deemed profit is 30% of the gross receipts, i.e. $30,000 ($200,000 × 50% × 30%), with tax payable at 15% ($4,500). Although the royalty is received from an associate, 100% is not applicable as the secret formula had not been previously owned by any person carrying on business in Hong Kong (s.21A(1)(a)).

Mad will have an obligation to withhold profits tax of $4,500 before paying the balance of the annual fee for the use of the secret formula to Mr. Crazy pursuant to s.20B(3).

(b) As the secret formula will be used in Hong Kong, the royalty will be fully chargeable under s.15(1)(b). Under s.21A(1)(b), the deemed profit is 30% of the gross receipts, i.e. $60,000 ($200,000 × 30%), with tax payable at 15% ($9,000). Again, Mad will have an obligation to withhold profits tax of $9,000 before paying the balance of the annual fee to Mr. Crazy.

(c) 100% is applicable as the secret formula is previously owned by a person carrying on business in Hong Kong. Under s.21A(1)(a), the deemed profit is 100% of the gross receipts, i.e. $200,000, with tax payable at 15% ($30,000). The withholding obligation under s.20B(3) also applies.

Example 13

A Hong Kong company carries on a garment manufacturing business and has the following income during the year:

(a)	Interest from a Hong Kong dollar deposit with a local bank	$20,000
(b)	Subsidy from its trade association	$50,000
(c)	Profits on presentment of a certificate of deposit with a bank in Singapore	$80,000

By virtue of s.15(1)(f), the interest of $20,000 shall be deemed to be a trading receipt of the company despite that its normal business would not be an interest earner, as the provision of credit is likely to be in Hong Kong. However, the interest is exempt from the payment of profits tax under the Exemption from Profits Tax (Interest Income) Order 1998.

According to s.15(1)(c), subsidy from the trade association is deemed to be a trading receipt unless the money is used for capital expenditure purposes.

The presentment of a certificate of deposit was effected outside Hong Kong and the profit would not be taxable under s.15(1)(j), assuming the acquisition of the certificate was also made outside Hong Kong.

The application of ss.15(1)(a), (b) and (ba) was examined in the following case:

Taxpayer	Subject matter	Reference
Turner Entertainment Networks Asia, Inc for Muse Communication Company Limited	Whether sums relating to the exhibition of television programmes are assessable under s.15(1)(b) or (ba)	(2012) HCIA 4/2010

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. 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 ss.15(1)(b) or (ba). This case is discussed in **Appendix 10**.

There are other deemed trading receipts, which are discussed below:

Section	Sums specifically chargeable to profits tax
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 research and development ('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 intellectual property rights ('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 prescribed fixed asset ('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 environmental protection machinery ('EPM') or environment-friendly vehicle ('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 environmental protection installation ('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 charge on disposal of machinery and plant (discussed in **section 9.4** on 'Depreciation allowances on machinery or plant').

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

Income derived from qualifying debt instruments (short or medium term) and the assessable profits of an insurance company derived from qualifying reinsurance business are only taxed at half of the profits tax rate.

Taxpayer	Concessionary trading receipts chargeable to tax at half of the profits tax rate
14A(1)(a)	Sums received by or accrued to a person as interest paid or payable on a medium term or short term debt instrument.
14A(1)(b)	Sums received by or accrued to a person as any gain or profit on the sale or other disposal or on the redemption on maturity or presentment of a medium term or short term debt instrument.
14B	Assessable profits of a corporation, to the extent they are the assessable profits of the corporation derived from the business of reinsurance of offshore risks as a professional reinsurer within the meaning of s.23A(2). An election for the tax concession, once made, is irrevocable.

Key terms in s.14A(4)

A **'debt instrument'** means an instrument specified in Part I of Schedule 6 that:

(a) is lodged with and cleared by the Hong Kong Monetary Authority;

(b) is issued by a person who has an acceptable credit rating;

(c) has a minimum denomination of $50,000 (with effect from 1 April 1999) or its equivalent in a foreign currency;

(d) is issued in Hong Kong to 10 or more persons, or less than 10 persons none of whom is an associate of the issuer of the insturment; and

(e) if it is a scripless instrument, is one that would qualify if it were in a physical form.

A **'medium term debt instrument'** means

(a) a debt instrument that is issued before 5 March 2003,

(i) has an original maturity of not less than 5 years or is undated; and

(ii) cannot be redeemed within 5 years from the date of its issue; or

(b) a debt instrument that is issued on or after 5 March 2003,

(i) has an original maturity of less than 7 years but not less than 3 years or is undated; and

(ii) can be redeemed within 7 years from the date of its issue but not within the first 3 years.

A **'short term debt instrument'** means a debt instrument that:

(a) is issued on or after 25 March 2011;

(b) has an original maturity of less than 3 years or is undated; and;

(c) can be redeemed within 3 years from the date of its issue.

(Note: Following the Financial Secretary's proposal in the 2010/11 Budget to extend the concessionary profits tax rate at 50% of the normal rate to qualifying debt instruments with a maturity period of less than 3 years, 'short term debt instrument' is included in ss.14A(1)(a) and (b) with effect from 25 March 2011).

See the **table in section 5.3** below for a summary of the tax treatments for qualifying debt instruments.

The concessionary profits tax rate at 50% of the normal rate will not apply if the person is an associate of the issuer of the debt instrument.

The following statutory corporations or corporations wholly owned by the Government are exempt from the requirement of a proper credit rating:

(a) Mass Transit Railway Corporation Limited

(b) Airport Authority

(c) The Hong Kong Mortgage Corporation Limited

The minimum denomination of the debt instruments issued by these statutory corporations or corporations wholly owned by the Government is $50,000, or its equivalent in a foreign currency.

The ascertainment of assessable profits of a corporation derived from the business of reinsurance of offshore risks as a professional reinsurer is outlined in **section 14.3.1** on 'Qualifying reinsurance business'.

Losses suffered from concessionary trading receipts are to be treated in accordance with the provisions in ss.19CA and 19CB (discussed in **section 13** on 'Loss relief').

5.3 Sums specifically exempt from profits tax

The following items are specifically exempt from profits tax:

Section	Sums specifically exempt from profits tax
14(1)	Profits not arising in or deriving from Hong Kong, and profits arising from the sale of capital assets (subject to other provisions of the IRO).
15E	Profits from stock borrowing and lending transactions ('SLBTs') and repurchase transactions ('Repos') (discussed in **section 5.4**)
20AC	Assessable profits of offshore funds from dealing in transactions specified in Schedule 16 carried out through or arranged by a specified person (discussed in **chapter 4, section 2.8** on 'Exemption for offshore funds').
26(a)	Dividends from corporations chargeable to profits tax.
26(b)	Profits already charged to profits tax in the name of another person. For example, a corporate partner's share of a partnership's profits would not be subject to profits tax again as that part of the profits has been duly assessed in the name of the partnership.
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 instrument.
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 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 Securities and Future Ordinance ('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	With effect from 22 June 1998, 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 was granted under s.87. It applies to deposits with an authorised institution (a bank, a restricted license 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. It should be noted that bank interest remains taxable under s.15(1)(f) or (g), as the Order exempts the payment of profits tax on interest income from bank deposits in Hong Kong, and not the interest income. DIPN 34 provides guidance on the Exemption from Profits Tax (Interest Income) Order 1998. Where the Exemption Order applies, the IRD treats the interest income as exempted from profits tax in the profits tax computation.
87	Sums received by or accrued as interest or profits arising from Renminbi Sovereign Bonds as from the year of assessment 2009/10.

Key terms in s.26A(2)

'Long term debt instrument' means a debt instrument as defined in s.14A that:

(a) is issued on or after 5 March 2003;

(b) has an original maturity of not less than 7 years or is undated; and

(c) cannot be redeemed within 7 years from the date of issue.

Summary of tax treatments for interest on and profit from qualifying debt instruments				
Period of maturity	*Issued before 5 March 2003*	*Issued between 5 March 2003 & 24 March 2011*	*Issued on or after 25 March 20011*	*Section*
< 5 years	Full tax rate			14A(1)(a) & (b)
≥ 5 Years	Half of tax rate			14A(1)(a) & (b)
< 3 Years		Full tax rate	Half of tax rate	14A(1)(a) & (b)
≥ 3 Years but < 7 years		Half of tax rate	Half of tax rate	14A(1)(a) & (b)
≥ 7 Years		Exempt	Exempt	26A(1)(h) & (i)

DIPN 20 provides guidance on unit trusts, mutual fund corporations and similar collective investment schemes that qualify for the exemptions under s.26A(1A)(a).

DIPN 43 (Revised) provides guidance on the exemption for offshore funds.

5.4 Stock borrowing and lending transactions

Section 15E was introduced by the Inland Revenue (Amendment) (No. 2) Ordinance 1994, and came into effect on 8 July 1994, to provide relief from profits tax for stock borrowing and lending transactions ('SBLTs') and repurchase transactions ('Repos'). On the same date, relief from stamp duty in respect of SBLTs was also introduced (this is discussed in **chapter 8, section 4.1.1**).

5.4.1 SBLTs

Under a SBLT, a borrower borrows stock from a lender for the purposes of settling a transaction (stock borrowing); and returns the stock of the same type to the lender within the period specified in the agreement (stock return). The borrower gives the lender a fee (borrowing fee) as compensation for the services provided (the lending), and a deposit as security. During the borrowing period, any distribution (e.g. dividends) on the borrowed stock is payable to the borrower, who is required to pay the distribution or a compensatory payment (sometimes called a 'manufactured dividend') to the lender.

A SBLT is legally a sale and purchase of stock because the legal title and beneficial interest are transferred from the lender to the borrower. As the market values of the stock at the time of borrowing and at the time of return are unlikely to be the same, without relief, any profit could be taxable (and loss deductible) under profits tax.

A SBLT is exempted from profits tax when the following conditions in s.15E(1) are satisfied:

(a) The borrower has used borrowed stock obtained from the lender for at least one 'specified purpose' and has effected a stock return;

(b) The lender has received from the borrower a distribution, right or option issued in respect of the borrowed stock, or identical property or an equivalent payment as compensation;

(c) The lender does not dispose of the right to receive any part of the consideration payable by the borrower;

(d) The borrower and the lender have dealt with each other at arm's length in relation to the stock borrowing and stock return; and

(e) The lender has not entered into the stock borrowing with the purpose of avoiding or deferring the taxation of profits.

'Specified purpose' is defined in s.19(16) of the Stamp Duty Ordinance to mean:

(a) the settling of a sale of Hong Kong stock;

(b) the settling of a future sale of Hong Kong stock;

(c) the replacement of Hong Kong stock obtained by a borrower under another stock borrowing;

(d) the on-lending of the stock borrowed to another person who effects another stock borrowing; or

(e) any other purpose as the Collector may, in writing, allow.

'Distributions' is defined to include interests, dividends, bonus shares, payments by the trustee of a unit trust (other than by way of redemption, realisation or liquidation) and units issued by the trustee of a unit trust (s.15E(8)).

Before the amendment made by the Inland Revenue (Amendment) (No. 4) Ordinance 1996, s.15E applies to Hong Kong stock only. With effect from the year of assessment 1996/97, the exemption is extended to 'specified securities', which relate to non-Hong Kong stock approved by the Commissioner.

'Specified securities' is defined in s.15E(8) to mean any of the following, not being Hong Kong stock the sale and purchase of which in Hong Kong are subject to the rules and practices of a recognised stock market:

(a) any shares, stocks, debentures, loan stocks, funds, bonds or notes of or issued by any body, whether corporate or unincorporated, or any government or local government authority, or any other similar investment of any description;

(b) any units under a unit trust scheme;

(c) any right, option or interest in or in respect of any security referred to in (a) or (b) above;

which the Commissioner may specify in writing.

When s.15E applies, any profit derived under a SBLT by either a borrower or a lender is excluded from profits tax. This is achieved by:

(a) in the case of a lender, deeming the transaction to have never taken place (s.15E(2)), and

(b) in the case of a borrower, deeming the stock borrowing and stock return to have taken place for a consideration equal to the market value of the borrowed stock at the time of the stock borrowing (s.15(E)(5).

Distributions received by a lender and profit derived from the variation in market values of the stock at the time of borrowing and return are exempt from profits tax (s.15E(3)). In addition, compensatory payments received by a stock lender in respect of a distribution made or the grant of a right or option are not taxable (s.15E(4)).

However, the borrowing fee receivable by the lender is income for services rendered and taxable. The fee payable by the borrower in the nature of a service fee is an allowable expense.

5.4.2 Repos

In economic terms Repos are very similar to SBLTs. A Repo is initiated by a person (the seller) who has stock in the form of equity or debt securities but needs cash. The seller sells the stock for cash to a person (the buyer) who has the cash. At a later date or on demand, the buyer agrees to sell equivalent stock to the seller at a specified price. The repurchase price paid by the seller to buy the stock back includes a predetermined premium, usually referred to as a 'price differential' calculated with reference to published inter-bank interest rates.

A reverse Repo is essentially the same but is initiated by the person (the buyer) who has cash and is willing to exchange it for stock. The seller also agrees to repurchase equivalent stock from the buyer. Repos or reverse Repos are carried out for the purpose of exchanging cash for stock for a temporary period, or to cover short sales or 'fails' to deliver by customers.

Similar to SBLTs, a Repo is legally a sale and purchase of stock because the legal title and beneficial interest are transferred from the seller to the buyer; and liability to profits tax may arise. When the conditions in s.15E(1) are satisfied, a Repo is also exempted from profits tax.

DIPN 26 provides guidance on 'specified securities' for the purposes of s.15E and DIPN 27 provides guidance on the exemption for SBLTs and Repos.

6 Stock valuation

Topic highlights

Different stock valuation methods can have a significant impact on the reported profit of a trade or business. In practice, not all stock valuation methods are accepted for tax purposes.

DIPN 1 provides general guidance on the valuation of stock-in-trade and work-in-progress and the ascertainment of profits and the valuation of work-in-progress in building and engineering contracts, property development and property investment cases.

6.1 Stock valuation methods

The following is a summary of the views of the IRD on various stock valuation methods.

Stock valuation method	Acceptability for tax purposes
Adjusted selling price	Acceptable
Average cost	Acceptable
Base stock cost	Not acceptable

Stock valuation method	Acceptability for tax purposes
First in first out (FIFO)	Acceptable
Last in first out (LIFO)	Not acceptable
Latest purchase price	Not acceptable
Lower of cost and market	Acceptable
Replacement cost	Not acceptable
Standard cost	Acceptable
Unit cost (specific identification)	Acceptable

6.2 Stock taken for own use

It is not unusual for a trader to take goods out of his stock for his own use. From an accounting point of view, such goods will be regarded as a withdrawal of capital and a reduction of purchase, being expenditure of a private nature. From a tax point of view, this means that the cost of those goods will be added to the profits.

In *Sharkey v Wernher* [(1955) 36 TC 275], the taxpayer, Lady Wernher, took valuable horses from her stub farm business for her hobby of horse racing. It was, however, held that the market value of the horses should be brought into the farm business's profits, not the cost. This is a departure from the well-known principle that one cannot trade with oneself.

A similar principle was established in *Petrotim Securities Ltd v Ayres* [(1963) 41 TC 389]. In that case, valuable investments held as trading stock were sold to an associate at a nominal price to produce a loss. It was held that the transaction could not constitute a trading transaction and the open market value of the investments was substituted for the nominal price.

The IRD applies the decision in *Petrotim Securities* to extend the principle in *Sharkey v Wernher* to cases where stock is disposed of other than in the normal course of trade, e.g., where a trader sold goods at a very low price to his family members, or a company made a sale at non-arm's length price to its associates. The substitution of market value for the computation of notional profits had been adopted in the BOR cases *D21/76* and *D26/84*.

However, the CFI in *Nice Cheer Investment Limited v CIR* [(2011) HCIA 8/2007] has concluded that *Sharkey v Wernher* was decided on the basis of a very different tax regime, and its principle cannot be quoted as authority in Hong Kong for the proposition that a man can trade with himself. See the discussion in **section 6.3.4** below.

6.3 Change of intention of holding an asset

An asset which has been acquired for long term investment purposes may change its nature to that of a revenue asset such as trading stock. Conversely, a previously acquired trading stock may be changed to a fixed asset, e.g. the property is occupied by the business as its office. Although there has not been any money going into or leaving the business, the change of intention of holding the asset is treated as a disposal of asset by the IRD.

The above situations and the IRD's assessing practice are summarised and discussed below:

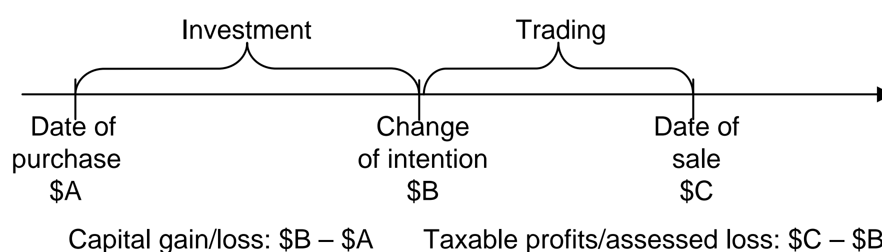
Situation	IRD's assessing practice	Tax implications
Capital asset ⇒ Trading stock	Business is deemed to have sold a capital asset at its market value and purchased a trading stock at its market value.	Difference between the cost and market value is a capital gain/loss.
Trading stock ⇒ Capital asset	Business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

6.3.1 Capital asset transferred to trading stock

Applying the *Sharkey v Wernher* principle, the business is deemed to have sold a capital asset at its market value and purchased a trading stock at its market value on the date of change of intention of holding the asset. The difference between the original cost of the asset and its market value is a capital gain/loss and hence not taxable/deductible.

The market value of the capital asset is taken as the deemed cost of the trading stock for the purpose of computing the taxable profit/assessed loss when the trading stock is disposed of in the future. The taxable profit/assessed loss is the difference between the sales proceed and the deemed cost, i.e. the market value at the date of change of intention.

Transfer from 'investment' to 'trading':

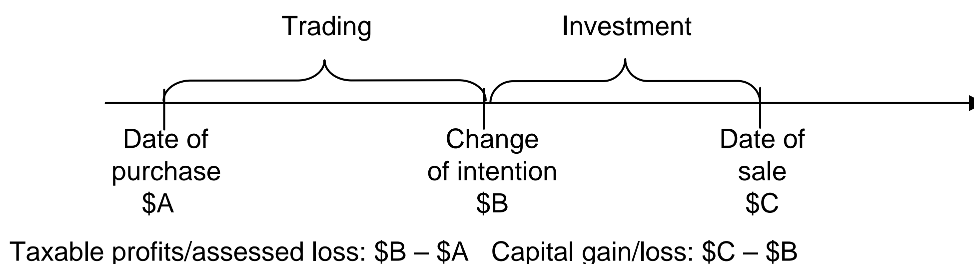


6.3.2 Trading stock transferred to capital asset

Applying the *Sharkey v Wernher* principle, the business is deemed to have sold a trading stock at its market value and purchased a capital at its market value on the date of change of intention of holding the asset. The taxable profit/assessed loss from the deemed disposal of the trading stock is the difference between the market value and the original cost.

The market value of the trading stock is taken as the deemed cost of the capital asset. Any gain/loss on subsequent disposal of the capital asset, being the difference between the sales proceed and the deemed cost, i.e. the market value at the date of change of intention, is a capital gain/loss and hence not taxable/deductible.

Transfer from 'trading' to 'investment':



6.3.3 Evidence of change of intention

There needs to be clear evidence to support the change of intention of holding the asset and to ascertain the date of change of intention. These may include minutes of the board of directors' meetings, the relevant feasibility and financial studies and correspondences with third parties, like the government, banks, etc.

6.3.4 Doubt on the application of *Sharkey v Wernher* principle

The *Sharkey v Wernher* principle is generally applied when a taxpayer's intention for holding an asset is changed, from short-term to long-term or vice versa, such that the market value of the asset at the time of change of intention is taken into account in computing the taxpayer's taxable profits/assessed loss. Although the principle in *Sharkey v Wernher* has been adopted in Hong Kong in many cases, its applicability and appropriateness are subject to a very careful review since Hong Kong has its own general anti-avoidance provisions of ss.61 and 61A. In *D41/91* and *D47/91*, the BOR was of the view that s.14 does not provide a charge to tax on notional profit, and only actual profit realised from sale can be chargeable to profits tax. In *D41/91*, the taxpayer sold a flat to one of its directors. The Commissioner claimed that the flat had been sold at less than its market value and assessed the taxpayer on a notional profit based on the higher market value of the flat. However, the BOR, having regard to the existence of specific anti-avoidance provisions in the IRO, held that the principle only applies provided that the 'actual sale' should be disregarded for tax purposes in the first place. Since there is an actual sale, the substitution of market value was inappropriate in the circumstances and the BOR refused to adopt the principle. In *D47/91*, the BOR has the same decision of the non-applicability of the principle. In *D75/96*, the BOR also refused to apply the principle and to impose tax on the notional profits of the taxpayer.

The applicability of the *Sharkey v Wernher* principle was also raised in *CIR v Quitsubdue Ltd* ([(1999) 1 HKRC 90-099]. In that case, the IRD considered the taxpayer's intention from the time it acquired certain properties in 1986 to September 1987 was to trade in the properties and there was a change of intention in holding the properties from trading to investment when the second shareholders sold their shares to the third shareholders in September 1987. By applying the principle in *Sharkey v Wernher*, the Commissioner assessed the taxpayer to profits tax on a notional profit representing the difference between the cost and the market value of the properties as at the date of change of intention. The BOR considered that there was no change in the taxpayer's intention and decided in favour of the taxpayer. On appeal, the CFI upheld the BOR's decision. The Court considered the properties were acquired by the taxpayer as its fixed assets and that the shareholders' intentions for their own shares should not be equated with the taxpayer's intention for the properties. As a casual comment, the Court said that the principle in *Sharkey v Wernher* did not apply generally in Hong Kong nor in the circumstances of the case. However, as it is not a *ratio decidendi* and has no binding force on later cases, the IRD continues to apply the *Sharkey v Wernher* principle to substitute the cost of the stock with its market value where stock is sold at a gross undervalue.

However, the recent CFI decision in *Nice Cheer Investment Limited* has held that the *Sharkey v Wernher* principle does not apply to Hong Kong.

CIR v Nice Cheer Investment Limited [(2011) HCIA 8/2007, (2012) CACV 135/2011]

The facts: Nice Cheer Investment Limited ('NCIL') is a Hong Kong company principally engaged in investment trading of Hong Kong listed securities. In preparing its financial statements, NCIL adopted the then prevailing generally accepted accounting principles (HKAS 24 and HKAS 39) to revalue its trading securities held as trading investments and the financial statements in the relevant years gave a true and fair view of NCIL's affairs and profits. Under HKAS 39 'Financial Instruments: Recognition and Measurement', unrealised gains and losses arising from a revaluation of trading securities are recognised as profits and losses in the income statement. However, in computing its assessable profits or allowable losses, NCIL excluded the unrealised gains from assessment but claimed a deduction for the unrealised losses on trading securities at year end.

NCIL argued that unrealised gains arising from revaluation do not constitute 'profits' chargeable to tax under s.14(1) because the word 'profit' means real profits and not notional profits. As such, profits can only be assessed when they have been earned, realised, ascertained, arisen and derived and cannot be anticipated. Accounting standards and principles cannot have the effect of changing the meaning and scope of the word 'profits' in s.14(1) .

The Commissioner was of the view that unrealised gains and losses arising from revaluation of trading securities should be chargeable to tax and allowable as deductions for profits tax purposes. Applying the principle established by the CFA in *CIR v Secan Ltd & Ranon Ltd* (5 HKTC 266), the Commissioner argued that under the statutory regime, profits and losses must be ascertained in accordance with ordinary commercial accounting principles, as modified to conform with the IRO. The Commissioner applied the 'tax follows accounting' principle and placed particular importance on ordinary commercial accounting principles. As NCIL prepared its financial statements according to prevailing accounting standards and recognised the unrealised gains arising from revaluation of the trading securities, the assessment of profits tax on the unrealised gains was not a case of charging profits tax on notional or anticipated profits. Since there is no provision in the IRO expressly prohibiting the inclusion of unrealised gains as profits, the accounting treatment in NCIL's financial statements were not inconsistent with the IRO.

Decision: The CFI ruled in favour of NCIL that the unrealised gains from revaluation are not taxable, whereas unrealised losses are deductible. The judge held that s.14(1)must be construed to mean "profits arising in or derived from commercial transactions, which of necessity means real profits from actual transactions and exclude anticipated profits or gains arising from revaluation of trading stock." Only real profits arising in or derived from actual buying and selling of commodities in commercial transactions are taxable. Notional or unrealised profits arising out of revaluation of the taxpayer's trading stock are not taxable.

In the present case, there was no trading between NCIL and a third party. There was no exchange, no transfer by NCIL of the listed securities from itself in one capacity to itself in another, or to its shareholders, directors or employees, or a sale of the listed securities at undervalue. There was a total lack of commercial activity and the unrealised profits recognised by ordinary commercial accounting principles cannot be chargeable to profits tax.

The CFI agreed that ordinary commercial accounting principles are useful and important in ascertaining profits and losses, but they only apply in the absence of statutory provisions to the contrary. The calculation of profits and losses in accordance with ordinary commercial accounting principles is subject to the provisions of the tax statute, the IRO, and judge made rules interpreting that statute. If statutory provisions are applicable, the interpretation of the statutory provision takes precedence over ordinary commercial accounting principles.

The CFI rejected the Commissioner's arguments relating to the *Secan* principle, clarifying that *Secan* "was not about what profits were chargeable under the Ordinance. It did not have the effect of putting ordinary commercial accounting principles above the law. The jurisdiction to determine the question of what profits are chargeable to tax remains with the court. Lord Millett NPJ unequivocally reaffirmed [in *Secan*] the unshakable legal principle that ordinary commercial accounting principles have to be modified to conform with the Ordinance."

The CFI also examined the relevance and application of the *Sharkey v Wernher* principle to the assessment of notional profits when a taxpayer's asset is changed from one category to another. The judge concluded that the charge on 'profit' in s.14(1) is a charge on real profits, profits derived from trading or business activities; not notional profits, anticipated profits or gains from the revaluation of trading securities that the taxpayer never made. The judge also reiterated that as *Sharkey v Wernher* was decided on the basis of a very different tax regime, its principle does not apply to Hong Kong.

As regards the tax deductibility of unrealised losses, the CFI took the view that while s.14 requires that profits must be 'arising … from … trade' and therefore can only be assessable if they arise from some exchange, losses are not so qualified and can be recognised even without realisation through exchange. As such, the dichotomy in treatment between profits and losses has to be accepted. Nevertheless, there was no unfairness in allowing a taxpayer to claim unrealised losses

and not to pay profits tax on unrealised profits as the taxpayer would not obtain any genuine monetary benefit. When there is actual disposal and realised gains, the taxpayer will be properly taxed on the gains.

The Commissioner appealed to the COA. The COA unanimously upheld the decision of the CFI that the unrealised gains are not 'profits' for the purposes of s.14(1). The COA took the view that as a matter of statutory construction, to be chargeable under s.14(1), the profits must be received, accrued or earned and not anticipated. Since there was no realisation of the trading securities, there was no profit arising from the trading of these assets which may be chargeable to profits tax. To tax the unrealised gains would offend the case-law principle that 'profits shall not be taxed until realised'. This principle is also reflected in ss.14A, 15(1), 15A and 18B, which use the phrase of either 'arising in or derived from (a trade or Hong Kong)' or 'received by or accrued to'. This supports the view that there must be a receipt, an accrual or earning before there is a profit for tax purposes.

The COA rejected the CIR's argument that, applying the principle in *Secan*, profits or losses for tax purpose must be ascertained by reference to ordinary commercial accounting principles. The financial statements prepared in accordance with accounting standards merely reflect the financial position of NCIL, and not what is profit for the purpose of s.14(1). The COA was unconvinced that the current accounting practice can turn the unrealised gains on revaluation of the trading securities into profits chargeable to profits tax.

The COA also concluded that treating the unrealised gains as non-taxable and the unrealised losses as tax deductible do not conflict with s.19D, which requires the amount of allowable loss to be computed in like manner as assessable profits. The loss from a decrease in market value is an aspect of the cost of an asset which is actually incurred by the act of purchase (which had already happened for NCIL) whereas a profit is earned by an act of disposition (which had not yet happened for NCIL). Accordingly, losses are incurred when stock falls in value whereas gains are realised only when disposition of the stock occurs.

As regards the application of the *Sharkey v Werner* principle, the COA considered that it was not necessary to discuss it for the purpose of the appeal.

The Commissioner lodged an appeal against the COA's judgement to the CFA, which is scheduled to be heard on 16 and 17 October 2013.

It is therefore arguable that the unrealised gain from the deemed disposal of the trading stock when it is changed to a capital asset should not be taxable. The trading stock has not yet been sold; the unrealised gain is not a real profit but notional profit which is not taxable.

6.4 Stock valuation on cessation of trade or business

Pursuant to s.15C, trading stock of a trade or business at the date of cessation should be valued as follows:

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

In *Southtime Ltd v CIR* [(2002) HKRC 90-119], the taxpayer transferred a number of unsold shops to its shareholders and director at cost. The IRD sought to value the unsold shops at open market value pursuant to s.15C and tax the deemed profit on disposal on the ground that the taxpayer ceased its property trading business. The CFI decided in favour of the Commissioner.

7 Distinction between capital and revenue items

Topic highlights

Under s.14, profits arising from the sale of capital assets are excluded from the charge to profits tax. In practice, the exemption also applies to other receipts of a capital nature, e.g. compensation payment. By applying the same principle, any accretion to a capital asset will be of a capital nature and therefore not chargeable to tax (subject to certain specific exceptions) and any loss in relation to a capital asset will also not be tax deductible. On the other hand, expenditure of a capital nature or any loss or withdrawal of capital and the cost of any improvement are not tax deductible under ss.17(1)(c) and (d), subject to certain specific exceptions. However, capital is not defined in the IRO, and general commercial rules and case law are therefore important in distinguishing capital receipts from trading receipts, and capital expenditures from revenue expenditures.

7.1 Capital receipts and revenue receipts

Apart from the exclusion of capital items in s.14(1), the IRO gives little guidance in relation to receipts. When deciding whether a receipt is capital or revenue in nature, the general test is to distinguish between fixed capital and circulating capital. Receipts are capital in nature if connected with fixed capital (fixed assets) of the business but revenue in nature if connected with circulating capital (current assets) of the business.

In *BP Australia Ltd v FCT*, it was held that *"fixed capital is* prima facie *that which you look to get a return by your trading operations. Circulating capital is that which comes back in your trading operations"*. Fixed capital is what a person turns to profit by keeping it in his possession; circulating capital is what a person makes a profit from by parting with it, i.e. for resale purpose. In *Ammonia Soda Ltd v Chamberlain* [(1918) 1 CH D 266], a distinction is made between fixed and circulating capital. A summary of the analysis is as follows:

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

In general, revenue or trading receipts include:

(a) receipts from disposal of trading stock or services in the course of business; and

(b) receipts arising incidentally to the business, e.g. forfeiture of deposits from customers who failed to collect goods ordered.

On the other hand, capital receipts are those relating to the structure of the business, e.g. proceeds from sale of office premises.

Sometimes the dividing line is not that clear between a sum incidental to the normal course of the business and a sum relating to the structure of the business. The question is one of degree. The following principles established in case law help to illustrate the distinction:

(a) Any sum received for permanent loss or destruction of a fixed asset is a capital receipt, even though loss of profits has been taken into account in arriving at the capital sum received (*Glenboig Union Fireclay Co Ltd v CIR* [(1922) 12 TC 427]). However, the sum should be deducted from the pool balance in calculating the depreciation allowances under s.39B(4)(e).

(b) Any sum received for temporary loss of use of a fixed asset, or payment for loss of profits is a revenue receipt (*London and Thames Haven Oil Wharves Ltd v Attwool* (43 TC 491)).

(c) Any sum received for repairable damage to a fixed asset is a capital receipt, but it should be set off under s.17(1)(e) against the cost of repairs which would otherwise be allowable (*London and Thames Haven Oil Wharves Ltd v Attwool* (43 TC 491)).

(d) Any sum received for the loss of trading stock is a trading receipt while any sum received for the loss of capital asset is a capital receipt (*Green v J. Gliksten & Son Ltd* (14 TC 364)).

(e) Any sum received for the cancellation of a trading contract is a revenue receipt (*Short Bros Ltd v CIR* (12 TC 955)).

(f) Any sum received for the cancellation of one of a number of agency contracts is a revenue receipt (*Kelsall Parson & Co v CIR* [(1938) 21 TC 608]).

(g) Any compensation received for the cancellation of the major or only contract which led to the cancellation of a material part or the whole of the company's business is a capital receipt (*Barr Crombie & Co Ltd v CIR* [(1945) 26 TC 406]).

DIPN 4 provides guidance on business receipts such as lease premiums, non-returnable deposits, key or tea money and construction fees.

There is one tax case relating to capital receipts:

Taxpayer	Subject matter	Reference
Aviation Fuel Supply Company	Capital receipts	(2011) HCIA 6/2009

The case is discussed in **Appendix 11**.

7.2 Compensation

The question of capital or revenue often arises in relation to compensation payments. As a general principle in common law, a compensation payment usually takes the character of the item which it replaces.

(a) Compensation received in lieu of trading receipts is taxable as trading income. This includes damages for breach of contract or for tortious acts, in the normal course of the business.

(b) Compensation for loss or damage to the profit making structure of the business (e.g. goodwill) or cancellation or variation of an agreement which related to the structure and conduct of the business rather than one for disposal of stock in trade is capital in nature.

(c) Compensation received in relation to the sterilisation of business assets, closure of business or entering into a restrictive covenant for not performing certain acts nor carrying on business within a certain period of time or within a certain region is also of a capital nature.

If a lump sum is received without making any distinction between compensation for the loss of capital and compensation for the loss of revenue assets or income, the whole sum may be regarded as a capital receipt (*Mclaurin v FC of T* [(1961) 12 ATD 273]).

Another problem area is related to exchange differences. In general, the nature of the exchange gain or loss arising from a foreign currency borrowing or lending is given by the nature of the underlying transaction.

Example 14

Smart Ltd is a garment retailer. A fire occurred during the year, and the company received compensation from an insurance company. The assets destroyed in the fire and the amounts of compensation received are detailed below:

(a) $88,000 for the loss of office equipment and furniture. The amount was credited to the 'Other income' account.

(b) $120,000 for the loss of trading stock. The amount was credited to the 'Purchases' account.

Compensation for the loss of office equipment and furniture is a capital receipt which is not taxable. The amount should be excluded in computing the assessable profits in the profits tax computation, but deducted from the 20% pool in calculating the depreciation allowances.

Compensation for the loss of trading stock is a revenue receipt which is taxable. No matter whether the amount was credited to the sales account or the purchases account, the result was an increase in taxable profits. Hence, no adjustment in the profits tax computation is needed.

Self-test question 4

Joyce Ltd ('JL') is a garment manufacturer for many US and European brands. During the year ended 31 December 2012, a US brand terminated its manufacturing contract with JL, which accounted for 15% of JL's turnover. After negotiation, the US brand agreed to compensate JL with a sum of $20 million. The compensation was decided with reference to the profits which JL derived during the remaining period of the contract.

Required:

Analyse the taxability of the compensation received from the US brand for the termination of the manufacturing contract.

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(The answer is at the end of the chapter)

7.3 Property and share transactions

Property and share transactions have represented an important part of Hong Kong's economic activities for a long period of time. Properties or shares are assets capable of being acquired by a person for trading or investment purposes. Over the years, there have been a lot of disputes over the issue whether the sale of real properties or shares amounts to an adventure in the nature of trade at both the BOR and Court levels. To determine whether an asset was acquired by a person as an investment or a trading stock and whether the gains on disposal of the asset are revenue or capital in nature, reference is often made to the 'badges of trade'. The original intention of holding the asset as an investment or trading stock has become very important for making such a decision; and it is not uncommon that the person might change the intention of holding the asset during the period of ownership.

Certain statements of principles outlined in the cases such as *Simmons v IRC* [53 TC 461], *All Best Wishes Ltd* [1 HKRC 90-067], and *Marson v Morton* [59 TC 381] are often referred to by the BOR and Courts in Hong Kong. For example, the well-known dictum of Lord Wilberforce in *Lionel Simmons Properties Ltd v IRC* [(1980) 35 TC 461] is as follows:

> *"Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment? Often it is necessary to ask further questions: a permanent investment may be sold in order to acquire another investment thought to be more satisfactory; that does not involve an operation of trade, whether the first investment is sold at a profit or at a loss. Intentions may be changed. What was first an investment may be put into the trading stock – and, I suppose, vice versa. If findings of this kind are to be made precision is required, since a shift of an asset from one category to another will involve changes in the company's accounts, and possibly, a liability of tax. What I think is not possible is for an asset to be both trading stock and permanent investment at the same time, nor to possess an indeterminate status – neither trading stock nor permanent asset. It must be one or other, even though, and this seems to me legitimate and intelligible, the company, in whatever character it acquires the asset, may reserve an intention to change its character."*

The intention of a person will usually be identified with regard to subjective and objective factors. A person who acquires an asset with a contingent hope to hold it for the long term while he does not have the ability to do so will not be regarded as having a long term investment intention. There needs to be an objective, realistic and realisable intention supported by circumstantial facts.

While the taxpayer is not a natural person, its intention could only be inferred and defined from the acts and intention of its controlling minds (see *Brand Dragon Ltd* (in members' voluntary liquidation) and *Harvest Island International Ltd* (in members' voluntary liquidation) [(2002) HKRC 90-115]).

The accounting treatment of an item is by no means conclusive. However, if an asset is to be claimed as capital, its treatment in the accounting records or other documents should be consistent with such a claim. Otherwise, the taxpayer may not be able to discharge the burden of proof.

A person may change his/her intention from trading to investment or *vice versa*. There needs to be clear evidence to support the change of intention and to ascertain the date of change of intention. In *Wing On Cheong Investment Ltd* [(1990) 1 HKRC 90-035], the judge was of the view that the sales of the properties were forced realisation of investments and the finding of the BOR that the taxpayer changed its intention from investment to trading on 1 May 1976 was based on speculation and ill-founded.

Whether there had been a change of intention was also considered in *CIR v Quitsubdue Ltd* [(1999) 1 HKRC 90-099]. Refer to the discussion of this case under **section 6.3.4** on 'Doubts on the application of *Sharkey v Wernher* principle'.

Example 15

Centre Investment Ltd ('CIL') was incorporated in Hong Kong in the year 1985. CIL described the nature of its business as 'Property Investment'. CIL acquired KC Plaza shortly after its incorporation and all the shops located in KC Plaza were rented out. The rental income derived from the shops was CIL's major source of income.

In January 2012, CIL purchased a vacant shop unit ('the Shop') next to KC Plaza. Renovations were made to the Shop at a cost of $2 million. The Shop was ready for use in June 2012. CIL then gave an order to a property agent to sell the Shop, but adding that it could consider leasing the Shop if the offer was on favourable terms. As the offer from potential tenants was not so attractive, CIL did not lease out the shop. Finally, in January 2013, the Shop was sold making a handsome profit for CIL.

Jeffrey, the director and major shareholder of CIL, alleged that the Shop was intended to be leased out for rental income. However, the rental return from the shop was not as profitable as previously expected. He decided to sell the Shop. Except for KC Plaza and the Shop, CIL has not engaged in any other property transactions.

Required:

Discuss whether the gain from disposal of the Shop is chargeable to tax.

Solution

The profit on sale of a trading stock is subject to profits tax whereas the gain on disposal of a capital asset is exempt from tax under s.14(1). If the Shop was CIL's trading stock, the profit on sale is taxable. If the Shop was CIL's long term investment, the gain on disposal is not taxable. In determining whether the Shop is a long term investment (capital asset) or a trading stock, the intention of the purchaser at the time of acquisition must be ascertained (*Lionel Simmons Properties Limited*).

Whether an asset is acquired as a trading stock or a long term investment is a question of fact. The stated intention of the taxpayer is not conclusive. The intention must be identified by reference to objective factors. Each case is decided on its own facts and the whole of the evidence must be considered in reaching a conclusion (*All Best Wishes Limited*).

The following facts support the argument that the Shop was CIL's trading stock:

(a) Short period of ownership. The Shop was only held by CIL for one year. It is inconsistent with the claim that CIL intended to hold it on a long term basis for rental income.

(b) The extensive renovations made the Shop more attractive for sale and CIL could ask for a higher selling price.

(c) CIL appointed a property agent to sell the Shop soon after the Shop was renovated and ready for use. The readiness to sell indicates that CIL did not have a settled intention to hold the Shop on a long term basis.

(d) The reason for sale is not convincing. CIL should have known the return on rental income at the time it made the decision to buy the Shop. CIL owned some shops at KC Plaza which is just next to the Shop. The shops were rented out for the relevant period.

The following facts support the argument that the Shop was CIL's long term investment:

(a) The business of CIL was 'Property Investment' and its major source of income was rental income. Buying the Shop for rental income is consistent with the nature of the business carried on by CIL.

(b) CIL has no history of trading in property.

(c) If the Shop was CIL's trading stock, they should have offered the Shop for sale immediately after the purchase. However, CIL decided to carry out extensive renovations to the Shop. The renovations lasted for around five months. CIL might miss many opportunities for the profitable sale of the shop due to the delay in offering the Shop for sale.

(d) CIL told the property agent that it was willing to lease the Shop if the offer was on favourable terms.

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Example 16

A Ltd is engaged in property consultancy business in Hong Kong with an annual turnover of around $10 million. It has sustained a loss and recorded an overall deficit in its statements of financial position for years. In February 2012, A Ltd came across an offer for sale of a new 10-storey industrial building ('the Building') from a developer. It decided to use a Hong Kong shelf company, B Ltd, to acquire the Building. First, A Ltd acquired the only issued share (par value of $1) in B Ltd in March 2012. Then, in April 2012, B Ltd acquired the Building for $200 million which included the land price of $100 million and the estimated construction cost of $60 million. The Building was classified as a fixed asset in the accounts of B Ltd. The purchase consideration was mainly financed by a mortgage loan from Bank C. The mortgage loan led to instalment payments (including interest) of around $15 million per annum.

As B Ltd had yet to decide on the usage of the Building, it left the Building vacant from April 2012 to October 2012. In August 2012, Mr Y approached A Ltd and showed great interest in acquiring the Building. A Ltd sold the share in B Ltd to Mr Y in the same month and made a substantial profit.

After acquiring the share in B Ltd, Mr Y caused B Ltd to solicit tenant(s) for the Building. B Ltd eventually let the Building to a manufacturing company as a factory (7 floors), office (2 floors) and showroom (1 floor) for three years in November 2012.

Required:

Discuss whether the profits from selling the share in B Ltd are revenue or capital in nature.

Solution

The chargeability of the profits in question depends on whether the share in B Ltd is a trading stock or a long term investment. In *Simmons v IRC* [(1980) 1 WLR 1196], Lord Wilberforce held that trading requires an intention to trade and the question to be asked is whether this intention existed at the time of the acquisition of the asset. In the present case,

(a) B Ltd started off as a shelf company with no business activity;

(b) it mainly relied on the mortgage loan from Bank C to finance the purchase consideration of the Building;

(c) by the sale of the subject share in August 2012, the Building had yet to generate any income for B Ltd to meet the mortgage repayment; and

(d) the financial position of A Ltd was also not good enough to assist B Ltd in repaying the mortgage loan.

For the above reasons, it is difficult to contend that A Ltd intended to acquire the share in B Ltd as a long term investment. In addition, A Ltd acquired and sold the subject share within a short period (only five months). All these facts clearly show that the relevant share transaction was a trading venture and the profits so derived should thus be chargeable to profits tax.

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7.3.1 Tax cases on property and share transactions

There are a number of cases involving the determination of whether a property or shares was acquired as an investment or a trading stock, and whether the gains on disposal of the property or shares are revenue or capital in nature:

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	Profit on disposal of property	(2002) 1 HKRC 90-119
Kaifull Investments Ltd	Profit on disposal of property	(2002) 1 HKRC 90-120

Taxpayer	Subject matter	Reference
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
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

Each of these cases was decided on its own facts and has its own merits, and the whole of the evidence in each case must be considered in arriving at a conclusion. Some of these cases are discussed in **Appendix 12**.

7.4 Capital expenditure and revenue expenditure

Capital expenditure, as defined in s.40(1), includes interest paid for the provision of building and plant but excludes any financial subsidy. This definition, however, does not provide guidance on what capital expenditure is.

The analysis made by the judge in *Ammonia Soda Co Ltd v Chamberlain* [(1918) 1 Ch 266] on fixed and circulating capital is useful in distinguishing the nature of an expenditure. A summary of the analysis is provided in **section 7.1** on 'Capital receipts and revenue receipts'.

It is apparent that the distinction between fixed and circulating capital is not easy in borderline cases. The same asset may be treated differently depending on the nature of the business. For example, machinery would be capital asset to an ordinary manufacturer, but trading stock to a machinery manufacturing business. Similarly, a car is a fixed asset to a travel business but trading stock to a car dealer.

In *Nchanga Consolidated Copper Mines Ltd* [(1964) AC 948], a distinction was made between capital and revenue expenditure:

> *"'The cost of creating, acquiring or enlarging the permanent structure of which the income is to be the produce or fruit' is of a capital nature. 'The cost of earning that income itself or performing the income-earning operations' is a revenue expense."*

In deciding whether an expenditure is capital or revenue in nature, the following tests are relevant:

(a) **Fixed capital vs. circulating capital test**

An expenditure incurred in connection with the acquisition of fixed capital (e.g. machinery and plant) is capital in nature. An expenditure incurred to acquire circulating capital (e.g. trading stock) is revenue in nature.

(b) **Once and for all test**

"Capital expenditure is a thing that is going to be spent once and for all, and income (revenue) expenditure is a thing that is going to recur every year." (*Vallambrosa Rubber Co Ltd v Farmer* [(1910) 5 TC 529])

(c) **Enduring benefit test**

"When an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, there is a very good reason for treating such an expenditure as properly attributable not to revenue but to capital." (*Atherton v British Insulated & Helsby Cables Ltd* [(1926) 10 TC 155])

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

Capital expenditures	Revenue expenditures
• Once and for all	• Often recur
• Usually of large amount	• Usually of small amount
• Provide an enduring benefit to the business	• Provide short term benefits or temporary influence to the business
• Influence the profit yielding structure of the business	• No or limited effect on the profit yielding structure of the business
• May be fixed within the business in the form of an asset (e.g. machinery or plant)	• May circulate within or depart from the business (e.g. trading stock)
• Shown in the statement of financial position as assets	• Charged to the income statement as expenses

The following principles established in case law help to distinguish between capital and revenue expenditure:

(a) The cost of acquiring raw materials in their natural state, e.g. coal in the ground, oil in wells, etc. is a capital expenditure. The established rule is that the right to acquire the stock has been purchased, but not the stock itself (*Hughes v British Burmah Petroleum Co Ltd* (12 TC 286)).

(b) The cost of taking over a business is a capital expenditure (*John Smith and Son v Moore* [(1921) 12TC 266]).

(c) The cost of acquiring or disposing of an agreement or a lease which is part of the fixed assets of a trade is a capital expenditure (*John Smith & Son v Moore* [(1921) 12 TC 266]).

(d) The cost of removing and replacing part of an entire asset is a revenue expenditure (*Samuel Jones & Co (Davonvale) Ltd v CIR* [(1951) 32 TC 513]).

(e) Expenses incurred in erecting a new structure 'in its entirety' or the cost of replacing an entire asset so that a new capital asset is created is a capital expenditure (*Bullcroft Main Collieries Ltd v O'Grady* [(1932) 17 TC 93]).

(f) If instead of repairing an asset, an alternative or improved part is constructed, the expenditure is a capital expenditure ad no allowance is due for the hypothetical repairs which might have been carried out (*William P. Lawrie v CIR* (34 TC 20)).

(g) The cost of initial repairs to improve a newly acquired asset to put it into a usable condition is a capital expenditure (*The Law Shipping Co Ltd v CIR* [(1923) 12 TC 621]).

(h) The cost of initial repairs to remedy normal wear and tear of a newly acquired asset which is in working condition is a revenue expenditure (*Odeon Associated Theatres Ltd v Jones* [(1971) 12 TC 621]).

(i) A lump sum payment to dispense with a continuing revenue expense asset does not create any new intangible asset and is therefore a revenue expenditure (*General Reversionary & Investment Co Ltd v Hancock* (7 TC 358)).

(j) A payment to get rid of an unsatisfactory director is a normal revenue expense which is regarded as part of the cost of engaging and dismissing servants (*Mitchell v B.W. Nobles Ltd* [(1927)11 TC 372]).

(k) A payment to retiring directors for agreeing not to compete with the company would increase the company's goodwill by buying off potential competitors and is therefore a capital expenditure (*Associated Portland Cement Manufacturers Ltd v Kerr* [(1946) 27 TC 103).

8 General deductions and specific deductions

Topic highlights

A company pays profits tax on its assessable profit which is computed by, among other things, deducting allowable expenditures.

8.1 General deduction rule under s.16

Section 16(1) provides for a deduction of all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by a person in the production of profits in respect of which he is chargeable to profits tax for any period, including the items listed in ss.16(1)(a) to (h).

8.1.1 'To the extent'

With regard to the phrase 'to the extent' in s.16(1), apportionment of outgoings and expenses is required if:

(a) income is derived partly in Hong Kong and partly outside Hong Kong; or

(b) expenses are incurred partly for the production of taxable profits and partly for non-business purpose.

For example, if money has been borrowed to finance a share investment (that generates non-taxable dividend income) and trading stock (that generates taxable profits), an apportionment of the interest expense is required. Only interest incurred on money borrowed to finance the trading stock is allowable under s.16(1).

The Privy Council in *Mutual Investment Co Ltd* [(1966) 1 HKTC 185] decided that the Commissioner had correctly restricted the expenses incurred by a company to earn dividend and interest income.

Apportionment is permitted but only when it is reasonable (not excessive), identifiable (can be split or calculated), verifiable (can be proved), and substantiated (can be supported with documents). The general rule on the apportionment of deductible expenses is governed by IRR 2A, 2B and 2C.

(a) **IRR 2A** specifies the basis for apportionment of general expenses. An apportionment shall be made on such basis as is most reasonable and appropriate to the activities of the trade, profession or business concerned.

(b) **IRR 2B** provides for the basis of apportionment of interest on money borrowed for share investment and share dealing. If interest expense was paid on money borrowed and used partly to acquire shares which only earn non-taxable dividends/profits and partly for other business purposes, apportionment is required to disallow part of the interest cost.

(c) **IRR 2C** provides for adjustment to expenses of supervision and management attributable to substantial investment portfolio. If a taxpayer's investment portfolio is sufficiently substantial, a portion of the portfolio value has to be calculated and deemed as 'management, clerical

and other general expenses' incurred in the supervision and management of the investment portfolio which generates no or limited taxable profits. This portion is to be disallowed, calculated on the following basis:

(i) if investments involve share dealing: 1/8% of the cost of the investment portfolio to be disallowed; and

(ii) in any other cases: ½% to be disallowed.

DIPN 3 provides guidance on apportionment of expenses. The following example illustrates apportionment on the basis of turnover and profits.

Example 17

Z Ltd sells electrical equipment in Hong Kong (onshore and taxable) and Singapore (offshore and not taxable). Its financial statements show the following:

	Hong Kong	*Singapore*	*Total*
	$	$	$
Gross profit	450,000	150,000	600,000
Turnover	1,800,000	900,000	2,700,000

Total overhead expenditure relating to the whole business was $200,000. The amount of allowable overhead expenditure may be computed on the following basis:

	$	$
Total overhead expenditure	200,000	
Deductible based on gross profits:		
$200,000 × $450,000/$600,000		150,000
Deductible based on turnover:		
$200,000 × $1,800,000/$2,700,000		133,333

8.1.2 'Incurred'

Expense not yet paid but 'incurred' may be allowable. The Privy Council, in *CIR v Lo and Lo* [(1984) 2 HKTC 34], decided that the meaning of 'incurred' should not be confined to sums actually paid. An expense is considered incurred when it becomes due and payable, or when the taxpayer becomes definitively committed to the expense, or has a legal liability to pay the expense. A contingent liability is not allowable, but a deduction is allowed once the liability crystallises (*CIR v Cosmotron Manufacturing Co Ltd* [(1997) 4 HKTC 562]).

The taxpayer in *Lo and Lo* was a firm of solicitors. It introduced a system to provide a lump sum payment on retirement to its employees under certain conditions. A provision for staff retirement benefits was made in the accounts and a tax deduction was claimed. The Commissioner disallowed the deduction on the basis that the expense was not 'incurred' during the basis period. Although the BOR held in favour of the Commissioner, the High Court, COA and Privy Council allowed the deduction on the basis that the taxpayer has an obligation to pay the retirement benefits and the provision was specific and ascertainable with substantial accuracy. Following the decision in *Lo and Lo*, s.17(1)(j) was added which renders provisions for special payments in respect of retirement schemes non-deductible (s.17(1)(j) is discussed in **section 8.6** on 'Deductions not allowable under s.17').

In *Banque Nationale de Paris Hong Kong Branch v CIR* [(1985) 2 HKTC 139], interest charged by the bank's head office to the Hong Kong branch was disallowed on the ground that the head office and the branch were part of the same legal entity, no loan existed and the interest was only a 'notional expense'. In practice, the IRD may allow a deduction for payments made by a branch to a head office when:

(a) the charge is commercially justified;

(b) the amount can be substantiated with reasonable basis of calculation; and

(c) it satisfies s.16(1), e.g. a charge by a head office to a branch to recover part of the head office's administration expenses plus a reasonable mark-up.

Deductions are allowable provided that the outgoings and expenses have been incurred in the production of profits chargeable to tax for any period. Prior to the issuance of DIPN 40, it had been a common practice of the IRD to allow a deduction by way of a computational adjustment for the whole amount of a prepaid expense in the year it was incurred, even when the expense was not charged to the taxpayer's income statement. However, following the decision of *CIR v Secan Limited and Another* [(2001) 1 HKRC 90-107], the IRD has indicated in DIPN 40 that they now consider that the tax treatment should follow the accounting treatment of prepaid revenue expenses if the treatment in the accounts is in accordance with the prevailing generally accepted accounting principles and is not inconsistent with any provision in the IRO.

8.1.3 'In the production of profits'

'In the production of profits' is equivalent to 'for the purpose of the trade' in the United Kingdom. This is interpreted as 'for the purpose of enabling a person to carry on and earn profits in the trade'. It is not enough that the expense is made in the course of, or arises out of, or is connected with the trade, or is made out of the profits of the trade (*Strong & Co of Romsey v Woodfield* [(1906) 5 TC 215]). It is necessary to look at the real intention for the expenses incurred.

In *CIR v Swire Pacific Ltd* [(1979) HKTC 1145], the taxpayer was going to cease business and would merge with another company in a few months. Payments made to end the strike of its whole labour force were held to be incurred in the production of profits. The only immediate purpose of the expenditure was to get the workers back to work so that business could continue. The expenses were incurred 'with a view to producing assessable profits' (i.e. with the expectation of generating assessable profits) and were deductible.

In *CIR v Cosmotron Manufacturing Co Ltd* [(1997) 4 HKTC 562], the taxpayer ceased business and made severance payments as required under the Employment Ordinance. It was held that one must look at the underlying (unavoidable) obligation to pay the expense rather than simply at the payment. *"The immediate purpose was probably to comply with the mandatory requirement of the law ….. requirement was unavoidable and must have been accepted as the clearly known price of procuring and retaining employees for the purpose of producing profit"'.* Expenditure which was already 'accrued' as a cost of employing staff is considered incurred in the production of profits; although the liability only crystallised at the time of cessation of the business. therefore, severance payment was held deductible.

'In the production of profits' is distinguished from 'income producing'. A person may have an asset which can rightly be said to be used in producing profits, but the asset itself may not be income producing, e.g. a company's car used by the directors. In *D3/72*, the BOR held it was sufficient that the asset was used 'in the production of profits'. The asset itself need not be income producing.

8.1.4 'For any period'

The law allows deduction of expenses incurred in the production of chargeable profits 'for any period'. It is not necessary that an expense is only deductible in the basis period in which the related income is assessed. An expense may be deducted in the basis period in which the expense is incurred, and the related income may be charged to tax in a prior or subsequent year of assessment (*Lo and Lo* and *Secan*).

Example 18

Owing to the termination of the manufacturing contract by its customer, Excel Ltd closed the relevant production line and laid off 20 workers. The company provided the redundant workers with severance payments of $1 million in accordance with the Employment Ordinance.

On the authority of *Cosmotron Manufacturing Co Ltd v CIR*, the severance payment is deductible for the following reasons:

(a) The liability for the payment, though crystallised upon the closing of the production line, was not incurred to close the production line.

(b) The obligation to make such payment, though contingent, was incurred as a necessary condition of retaining the services of the employees concerned.

HKICPA December 2010 (Amended)

8.1.5 Anonymous payments

DIPN 12 indicates that payments (such as commissions, rebates and discounts) to anonymous persons are not to be allowed by the assessor. The Commissioner also reiterates the importance of correct reporting of taxpayers' affairs and the rules in disclosing commissions, rebates and discounts in profits tax returns and supporting schedules (e.g. full name, address and identity card number or business registration number of the recipient; whether the recipient has any relationship with the taxpayer; amount of the payment; details of services rendered; and preferably, evidence of payment). Both the public and professional accountants are reminded that they may be prosecuted for concealed payments of commissions, rebates and discounts, or for providing misleading information in tax returns.

8.2 Deductible items under ss.16(1)(a) to (h)

Section 16(1) includes a list of deductible items. Deductions specified in (a) to (h) are as follows:

Section	Allowable deductions
16(1)(a)	Subject to the conditions in ss.16(2) and (2A) to (2G), interest payable on money borrowed for the purpose of producing chargeable profits, and sums payable by way of legal fees, procuration fees, stamp duties and other expenses in connection with such borrowing.
16(1)(b)	Rent in respect of land or buildings occupied for the purpose of producing chargeable profits. In the case of 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)	Tax paid elsewhere in respect of interest income and gains or profits from sale or redemption of a certificate of deposit or bill of exchange chargeable under s.15(1)(f), (g), (i), (j), (k) or (l). If the corporation or person concerned is eligible for the double taxation relief in respect of such profits, no deduction will be made. Other foreign tax paid may be deductible under s.16(1) if the tax is an expense that must be borne regardless of whether a profit is derived, e.g. withholding tax on interest or royalties (see DIPN 28), sales tax or custom duties.
16(1)(d)	Bad and doubtful debts proved to the satisfaction of the assessor to have become bad, provided that the debt has been included as a trading receipt, or the debt has been money lent in the ordinary course of a money lending business. Whether the activities of placing money on deposit in various sums with a FI amounted to a money lending business was discussed in *Asia Securities International Ltd* [(1991) 3 HKTC 433]. It was held that the deposit of money had been an investment of capital and thus the claim for a deduction for deposits written off as a result of the liquidation of the FI was not allowed. Recovery of bad debts which have been previously allowed are taxable in the year of recovery.

Section	Allowable deductions
16(1)(e)	Expenditure on repairs to any premises, machinery, plant, implement, utensil or article employed in the production of chargeable profits. The deductible amount is reduced by any sum recoverable under any insurance contract (s.17(1)(e)). Repairs must be distinguished from improvement and replacement of an entire asset, which are capital expenditure and not deductible. Initial repairs to bring a newly acquired asset into workable condition is also capital expenditure.
16(1)(f)	Expenditure on the replacement of any implement, utensil or article employed in the production of chargeable profits, provided that no depreciation allowances have been claimed. Implements, utensils or articles are defined in IRR 2 as including crockery and cutlery, loose tools, soft furnishing (e.g. curtains and carpets), kitchen utensils, etc. The initial purchase of these items are capital expenditure excluded from the definition of machinery or plant and thus does not qualify for depreciation allowance.
16(1)(g)	Capital expenditure expended for the registration of a trade mark, design or patent, used in the production of chargeable profits.
16(1)(ga)	The payments and expenditure specified in ss.16AA, 16B, 16C, 16E, 16EA, 16F 16G and 16I, as provided therein (discussed in **section 8.5** on 'Specific deductions').
16(1)(h)	Such other deductions as may be prescribed by any rule made under the IRO.

Example 19

Sam is the sole proprietor of a securities brokerage firm in Hong Kong, Sam & Co. During the year of assessment 2012/13, Sam & Co incurred the following loss and expenditure in the course of business:

(a) A customer lodged a complaint of misconduct against Sam to the Securities and Futures Commission ('SFC'). After investigation, the SFC found the complaint substantiated. Pursuant to the SFO, Sam was suspended from practice for three months and was ordered to pay a fine of $900,000.

(b) One of the major customers of Sam & Co, George, sustained a huge loss in share dealing and eventually went bankrupt. George maintained a margin share account, under which a balance of $4 million (including commission and interest of $300,000 charged by Sam & Co) remained outstanding.

Required:

Analysis of the deductibility of the payment for the fine and bad debt:

Solution

(a) The fine was not deductible because:

 (1) It was not made in the production of assessable profits, but was made as a result of a wrongdoing act of Sam;

 (2) The purpose of the fine was to punish the wrongdoer, and the legislative policy would be diluted if the wrongdoer was allowed to share the burden with the rest of the community; and

 (3) It was made for preserving the brokerage business of Sam and was capital in nature.

Relevant authorities: *CIR v Alexander von Glehn & Co Ltd* [(1920) 12 TC 232]
McKnight v Sheppard [(1999) STC 669]
CIR v Chu Fung Chee [(2005) 6 HKTC 743]

(b) The relevant balance consisted of two components, namely (i) the advance made by Sam & Co for George's share acquisition and (ii) the unpaid commission and interest charged by the firm in respect of the advance. Their deductibility should be considered separately.

There is no question that the recoverability of the whole balance was remote since George had already gone bankrupt.

In respect of the advance portion, it might not qualify as a deduction under s.16(1)(d)(i) because Sam & Co did not carry on a business of money lending. But where the advance arose in the normal course of its brokerage business, it should be allowable under s.16(1).

As for the unpaid commission and interest, it might be deductible if such items had been included as the trading receipt of Sam & Co, so that the condition under s.16(1)(d)(i) was satisfied.

HKICPA September 2009 (Amended)

8.3 Deductible interest under ss.16(1)(a) and (2)

For interest on a loan of money to be deductible, in addition to satisfying the general test in s.16(1)(a) of being incurred in the production of assessable profits, it must also meet at least one of the six conditions specified in s.16(2). A deduction is given if either one condition in s.16(2) can be satisfied, on the basis that s.16(1)(a) is satisfied (*CIR v County Shipping Co Ltd* [(1990) 3 HKTC 267]).

Section	Conditions
16(2)(a)	Money is borrowed by a FI.
16(2)(b)	Money is borrowed by a public utility company (The Hong Kong Electric Co Ltd, China Light and Power Co Ltd and The Hong Kong and China Gas Co Ltd), at a rate of interest not exceeding the rate prescribed by the Financial Secretary by notice in the *Gazette*.
16(2)(c)	Money is borrowed from a person other than a FI or an overseas FI, and the lender is liable to tax on the interest.
16(2)(d)	Money is borrowed from a FI or an overseas FI.
16(2)(e)	Money is borrowed wholly and exclusively to finance the provision of machinery or plant or the purchase of trading stock used in the production of chargeable profits, and the lender is not an associate of the borrower. Where the lender is a trustee of a trust estate or a corporation controlled by such a trustee, neither the trustee nor the corporation nor any beneficiary under the trust is the borrower or an associate of the borrower. No apportionment of the interest is allowed where the loan is not wholly applied in the manner specified above.
16(2)(f)	Money is borrowed by a corporation (i) by way of debentures listed on Hong Kong stock exchange or on other stock exchange, or other marketable instruments issued in Hong Kong or in a major financial centre outside Hong Kong recognised by the Commissioner; or (ii) from an associated corporation which lends the proceeds from an issue of debentures or marketable instruments to the corporation at an interest not exceeding the interest payable by the associated corporation to the holders of such debentures or instruments.

The words 'associate', 'relative', 'associated corporation' and 'control' are widely defined in s.16(3).

'Associate' in relation to a person

(a) who is a **natural person**, includes his relative, partner, relative of his partner; a partnership in which he is a partner; any corporation controlled by him (or by his partner or by a partnership in which he is a partner), and any director or principal officer of any such corporation controlled by him.

(b) which is a **corporation**, includes its associated corporation, any person who controls the corporation and this person's partner or relative, any director or principal officer of this corporation or its associated corporation or the director or principal officer's relative, and any partner of this corporation and the partner's relative.

(c) which is a **partnership**, includes its partner and where this partner is a partnership, any partner of this partnership, the partner with this partnership in another partnership and where such partner is a partnership, any partner of that partnership and relatives of all partners mentioned in this paragraph, any corporation controlled by the partnership or by any partner thereof or his relative, or any director or principal officer of such corporation, and any corporation of which any partner is a director or principal officer.

'Relative' means the spouse, parent, child, brother or sister of the relevant person. An adopted child shall be deemed to be a child both of the natural parents and the adopting parent; and a step child shall be deemed to be a child of both the natural parents and any step parent.

'Associated corporation', in relation to a person, means:

(a) a corporation over which the person has control;

(b) if the person is a corporation, a corporation which has control over the person; or a corporation which is under the control of the same person as is the first-mentioned person.

With regard to **'control'**, s.16(3A) provides that:

(a) a corporation shall be regarded as being controlled by a person if the person has the power to secure that the affairs of the corporation are conducted in accordance with his wishes; and

(b) a person (other than a corporation) shall be regarded as being controlled by another person if the person is accustomed or under an obligation to act, in relation to his investment or business affairs, in accordance with the directions, instructions or wishes of that other person.

A summary of the six criteria specified in s.16(2) is as follows:

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

8.4 Deductible interest from 25 June 2004 onwards

To combat tax avoidance schemes involving transactions which enable taxpayers to claim interest deductions not otherwise allowable under s.16(2)(c) to (f), s.16(2) was amended with effect from 25 June 2004 to impose additional requirements and restrictions for interest to be deductible. The

major amendments are to disallow interest expenses in those cases where the loan is secured by a deposit or another loan made by the borrower or its associates (the 'secured-loan test' in s.16(2A)); or the interest on money borrowed is ultimately paid back to the borrower or its associates (the 'interest flow-back test' in ss.16(2B) and (2C)).

The IRD issued DIPN 13A in November 2004 to explain its practice regarding the deductibility of interest expense.

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

Where the condition for interest deduction in s.16(1)(a) is satisfied under s.16(2)(c), (d) or (e), if the borrowing (whether principal or interest) is secured by a deposit or a loan, whether wholly or in part, directly or indirectly, made by the borrower or its associate with or to:

(a) the lender or its associate;

(b) a FI or its associate; or

(c) an overseas FI or its associate, and

any interest payable on the deposit or loan is not chargeable to profits tax (e.g. the deposit is offshore or the lender does not carry on business in Hong Kong), the amount of the interest deduction shall be reduced, having regard to the interest payable on the deposit or loan, on such basis as is most reasonable and appropriate in the circumstances of the case.

Section 16(2D) provides that if a deposit or loan is made by a trustee of a trust estate or a corporation controlled by such a trustee, the deposit or loan shall be deemed to have been made by each of the trustee, the corporation and the beneficiary under the trust.

If the taxpayer uses local bank deposits to secure or guarantee money borrowed (a **collateral deposit**) and deductions of interest expense are allowed under ss.16(1)(a) and 16(2)(c), (d) or (e) where the restriction on interest expense deduction under s.16(2A) does not apply, the Exemption from Profits Tax (Interest Income) Order made by the Chief Executive in Council under s.87 will not apply. The interest expense will be deductible and the interest income on the collateral deposit will be chargeable to profits tax. Even if the interest expense on the loan is less than the interest income from the bank deposit, the taxpayer cannot choose to give up the interest expense deduction and claim exemption in respect of the interest income (DIPN 34, para 12).

Example 20

E borrowed $1 million from a bank at 5% per annum to finance its onshore business activities. The loan was secured by a personal guarantee provided by his mother and some shares which worth $400,000.

The loan is borrowed from a FI to produce chargeable profits and ss.16(1)(a) and (2)(d) are satisfied. As the loan is not secured by a deposit or another loan, all loan interest is therefore deductible.

Example 21 (Adapted from DIPN 13A, Example 5)

F borrowed $1 million from a bank at 5% per annum to finance its onshore business activities. The loan was secured by a fixed deposit of $1 million earning interest income of 4% per annum. In the year of assessment F earned tax-free interest of $40,000 from the deposit and paid $50,000 interest on the loan.

The whole of the deposit is used to secure the loan. Allowable interest is reduced by the tax-free interest of $40,000 on the deposit.

Allowable interest = $50,000 – $40,000 = $10,000

Example 22 (Adapted from DIPN 13A, Example 6)

The $1 million loan in Example 21 was secured by a deposit of $500,000 that generated tax-free interest of $20,000 and some shares which worth $500,000.

The whole of the deposit is used to secure the loan. Allowable interest is reduced by the tax-free interest of $20,000 on the deposit.

Allowable interest = $50,000 – $20,000 = $30,000

Example 23 (Adapted from DIPN 13A, Example 7)

The $1 million loan in Example 21 was secured by a deposit of $2 million that generated tax-free interest of $80,000.

Part of the deposit is used to secure the loan. Allowable interest is reduced by a portion of the tax-free interest on the deposit, calculated as:

$$\$80{,}000 \times \frac{\$1\text{m loan}}{\$2\text{m deposit}} = \$40{,}000$$

Allowable interest = $50,000 – $40,000 = $10,000

Example 24 (Adapted from DIPN 13A, Example 8)

The $1 million loan in Example 21 was secured by a deposit of $1 million that generated tax-free interest of $40,000 and some shares which worth $500,000.

Part of the deposit is used to secure the loan. Allowable interest is reduced by a portion of the tax-free interest on the deposit, calculated as:

$$\$40{,}000 \times \frac{\$1\text{m deposit}}{\$1\text{m deposit} + \$0.5\text{m share}} = \$26{,}667$$

Allowable interest = $50,000 – $26,667 = $23,333

The value of shares used as security may vary from time to time. For the purposes of this calculation, a reasonable basis of averaging, such as by reference to month end balances, will be accepted.

Example 25 (Adapted from DIPN 13A, Example 9)

A deposit of $2 million that generated tax-free interest of $80,000 was used to secure a loan of $1 million which is used to finance onshore business activities and another loan of $1.5 million which is used to finance offshore business activities. Interest incurred on the onshore business loan was $50,000 and that on the offshore business loan was $75,000.

Part of the deposit is used to secure the onshore loan. Allowable interest is reduced by a portion of the tax-free interest on the deposit, calculated as:

$$\$80{,}000 \times \frac{\$1\text{m onshore loan}}{\$2.5\text{m total loan}} = \$32{,}000$$

Allowable interest = $50,000 – $32,000 = $18,000

Example 26 (Adapted from DIPN 13A, Example 10)

The two loans in Example 25 were secured by a deposit of $4 million that generated tax-free interest of $160,000. There was no other security.

Part of the deposit is used to secure the onshore loan. Allowable interest is reduced by a portion of the tax-free interest on the deposit in the amount of $40,000, calculated as:

Part of the deposit that was used to secure the two loans is $\frac{\$2.5\text{m total loan}}{\$4\text{m deposit}}$

The part attributable to the onshore loan is $\frac{\$1\text{m onshore loan}}{\$2.5\text{m total loan}}$

$$\$160{,}000 \times \frac{\$2.5\text{m}}{\$4\text{m}} \times \frac{\$1\text{m}}{\$2.5\text{m}} = \$40{,}000$$

Allowable interest = $50,000 – $40,000 = $10,000

Example 27

The two loans in Example 25 were secured by a deposit of $3 million that generated tax-free interest of $120,000 and some shares which worth $1 million.

Part of the deposit is used to secure the onshore loan. Allowable interest is reduced by a portion of the tax-free interest on the deposit in the amount of $30,000, calculated as:

Part of the deposit used to secure the two loans is $\frac{\$3\text{m deposit}}{\$3\text{m deposit} + \$1\text{m share}} \times \frac{\$2.5\text{m total loan}}{\$3\text{m deposit}}$

The part attributable to the onshore loan is $\frac{\$1\text{m onshore loan}}{\$2.5\text{m total loan}}$

$$\$120{,}000 \times \frac{\$3\text{m}}{\$4\text{m}} \times \frac{\$2.5\text{m}}{\$3\text{m}} \times \frac{\$1\text{m}}{\$2.5\text{m}} = \$30{,}000$$

Allowable interest = $50,000 – $30,000 = $20,000

8.4.2 Interest flow-back test in s.16(2B)

Where the condition for interest deduction in s.16(1)(a) is satisfied under s.16(2)(c), (d) or (e), and arrangements are in place whereby any of the interest on the money borrowed is payable, whether directly or through any interposed person, to the borrower or to a person (other than the lender) who is **connected** with the borrower and the borrower or the person is not an **excepted person**, the amount of the interest deduction shall be reduced by an amount calculated in accordance with the following formula:

$$\text{Interest disallowed} = \begin{array}{c}\text{Interest that would}\\ \text{have been deductible}\\ \text{under s.16(1)(a)}\end{array} \times \frac{\text{Total no. of days during the basis period the loan is outstanding and the arrangement is in place}}{\text{Total no. of days during the basis period the loan is outstanding}}$$

Section 16(3B) provides that a person shall be regarded as being **'connected'** with a borrower if the person is:

(a) an associated corporation of the borrower;

(b) a person (other than a corporation):

 (i) who controls the borrower;

 (ii) who is controlled by the borrower; or

 (iii) who is under the control of the same person as is the borrower.

'Excepted person' as defined in s.16(2E)(c) means:

(a) a person who is chargeable to profits tax in respect of the interest; or

(b) in the case of a person (other than the lender) who is connected with the borrower, a trustee, a beneficiary of a unit trust in respect of a specified investment scheme to which s.26A(1A)(i) or (ii) applies, a member of a recognised retirement scheme, a public body, a body corporate in which the Government owns more than half in nominal value of the issued share capital, and a FI or an overseas FI.

Example 28 (Adapted from DIPN 13A, Example 11)

Co H borrowed $100 million from Bank J. Bank J entered into a loan sub-participation arraignment with Co K, an associated company of Co H. Co K advanced $100 million to Bank J on the condition that the repayment of the principal and interest of this loan by Bank J to Co K would only be made when the principal and interest of the loan due by Co H to Bank J is repaid. In practical terms, Bank J is risk-free.

In this situation, the interest paid by Bank J to Co K is treated as if it were the interest on the loan borrowed by Co H from Bank J when the restriction of s.16(2B) is considered. As the interest was paid to an associated company of Co H, the interest deduction claimed by Co H would be denied.

Example 29 (Adapted from DIPN 13A, Example 12)

Co L borrowed $10 million from Bank M at 10% per annum. At its inception, $7 million of the loan was sub-participated by Co N, an associated company of Co L. The repayment by Bank M to Co N of the principal and interest of the $7 million loan was made conditional to or secured by the repayment of the principal and interest of the $10 million loan made by Co L to Bank M.

In a year of assessment Co L paid interest of $1 million to Bank M. Bank M paid interest attributable to the $7 million loan to Co N. Co N is not chargeable to profits tax (i.e. Co N is not an 'excepted person').

$7 million of the total loan was sub-participated by a person (Co N) connected with the borrower (Co L). Interest attributable to the sub-participated portion, i.e. $700,000 ($10m × 10% × $7m/$10m), which flows back to Co N, is subject to the adjustment under s.16(2B). Since this part of the loan was participated for the whole period during which interest was incurred, the full amount of $700,000 would be disallowed.

$$\text{Disallowable interest expense} = \$1\text{m} \times \frac{\$7\text{m}}{\$10\text{m}} = \$700{,}000$$

Interest on the remaining part of the loan ($300,000) which was not sub-participated by the borrower or a person connected to him, would be deductible.

Total interest deduction = $1m – $700,000 = $300,000

Example 30 (Adapted from DIPN 13A, Example 13)

The $7 million loan in Example 29 was sub-participated by Co N for only 6 months during the basis period of the year of assessment.

$$\text{Disallowable interest expense} = \$1\text{m} \times \frac{\$7\text{m}}{\$10\text{m}} \times \frac{182.5 \text{ days}}{365 \text{ days}} = \$350{,}000$$

Total interest deduction = $1m – $350,000 = $650,000

8.4.3 Interest flow-back test in s.16(2C)

Where the condition for interest deduction in s.16(1)(a) is satisfied under s.16(2)(f) and arrangements are in place whereby any of the interest on the debentures or instruments was paid, whether directly or through any interposed person, to the borrower or to a person who is **connected** with the borrower and the borrower or the person is not an **excepted person**, the amount of the interest deduction shall be reduced by an amount calculated in accordance with the following formula:

$$\text{Interest disallowed} = \text{Interest that would have been deductible under s.16(1)(a)} \times \frac{\text{Total no. of days during the basis period the loan is outstanding and the arrangement is in place}}{\text{Total no. of days during the basis period the loan is outstanding}}$$

The definition of **'excepted person'** in s.16(2F)(c) is similar to that in s.16(2E)(c).

Section 16(2G) provides that s.16(2C) shall not apply where, under the relevant arrangements, the relevant sum payable by way of interest on the debentures or instruments concerned or on any interest in the debentures or instruments concerned is payable to a **market maker** who, in the ordinary course of conduct of his trade, profession or business in respect of market making, holds such debentures or instruments or such interest for the purpose of providing liquidity thereof.

'Market maker' as defined in s.16(2H) means a person who:

(a) is licensed or registered for dealing in securities under the SFO or authorised to do so by a regulatory authority in a major financial centre outside Hong Kong recognised by the Commissioner;

(b) in the ordinary course of conduct of his trade, profession or business in respect of market making holds himself out as being willing to buy and sell securities for his own account and on a regular basis; and

(c) is actively involved in market making in securities issued by a wide range of unrelated institutions.

Example 31 (Adapted from DIPN 13A, Example 14)

Co P issued $100 million debentures in a recognised overseas stock market. Out of the issue, Q Ltd, an associated company of Co P, subscribed $80 million and acquired the remaining $20 million debentures from the market in the middle of the year of assessment. During the year of assessment, total interest of $10 million was paid. Co P prepares accounts to 31 March. Co Q is not chargeable to profits tax (i.e. it is not an 'excepted person').

$80 million of the debentures were subscribed by a person (Co Q) connected with the borrower (Co P) for the whole period. Interest attributable to that portion which flows back to the associate is subject to the adjustment under s.16(2C), and the amount would be disallowed, calculated as follows:

$$\$10m \times \frac{\$80m}{\$100m} = \$8m$$

Interest on the remaining part of the debentures ($20 million) which was subscribed by Co Q for half of the period would also be subject to the adjustment under s.16(2C). Half of the interest attributable to that portion would be disallowed, calculated as follows:

$$\$10m \times \frac{\$20m}{\$100m} \times \frac{182.5 \text{ days}}{365 \text{ days}} = \$1m$$

Total interest deduction = $10m – ($8m + $1m) = $1m

Example 32

Refer to the facts in Example 16. Discuss whether B Ltd is entitled to a deduction of the mortgage interest payable to Bank C in respect of the Building for the year of assessment 2012/13:

Solution

B Ltd obtained a mortgage loan from Bank C to finance the purchase of the Building. The Building was a capital asset of B Ltd which produced chargeable rental income, whilst Bank C was a FI. In the circumstances, the mortgage interest satisfied the conditions under ss.16(1)(a) and 16(2)(d) and should be deductible. On the other hand, there is no evidence that the mortgage loan was secured by a deposit made by B Ltd or its associate, or an arrangement was in place such that the interest payment was ultimately paid back to B Ltd or to a connected person. Thus, the mortgage interest should not be subject to any restriction pursuant to ss.16(2A) or 16(2B).

HKICPA December 2011 (Amended)

Self-test question 5

P Ltd is a property investment company carrying on business solely in Hong Kong. Its income statement for the year ended 31 March 2013 shows an interest expense of $7 million paid on a loan of $100 million raised to finance the acquisition of a commercial building that has generated rental income since its acquisition. The loan was borrowed in 2011 from F Ltd, a wholly-owned subsidiary of P Ltd incorporated in the Cayman Islands. F Ltd had raised the funds of $100 million by the issue of $100 million debentures. The debentures were issued in Hong Kong but listed in an overseas financial centre.

On 1 November 2012, Q Ltd, another wholly-owned subsidiary of P Ltd, acquired $60 million of the debentures. Q Ltd was incorporated in the British Virgin Islands and does not carry on business in Hong Kong. As at 31 March 2013, the principal of the debentures was still outstanding.

Required:

Explain the profits tax treatments for the interest expense of $7 million paid to F Ltd and compute the amount of allowable deductions. Also state the additional information you may require.

(The answer is at the end of the chapter)

8.5 Specific deductions

General deductions under the IRO are governed by the provisions in ss.16 and 17. Sections 16A to 16G provide for deductions of the following items which are not generally allowable.

Section	Specific deductions
16A	Special payment under an approved retirement scheme
16AA	Mandatory contributions in self-employment cases
16B	Expenditure on R&D
16C	Payments for technical education
16D	Approved charitable donations ('ACDs')
16E	Purchase and sale of patent rights, rights to know-how, etc.
16EA – EC	Purchase and sale of specified IPRs
16F	Expenditure on building refurbishment

Section	Specific deductions
16G	Capital expenditure on the provision of a PFA
16H – K	Capital expenditure on the provision of environmental protection facilities ('EPF') which include EPM, EPI and EFV.

A summary of the allowable deductions under ss.16A to 16K and the treatment of refund or sale proceeds of the items allowed as deductions is as follows:

Section	Expenditure	Allowable deductions	Treatment of refund/sale proceeds
16A	Special payment under a RORS or contributions other than regular contributions to a MPFS	20% per year of assessment from the year of assessment in which the expenditure was incurred.	Refund of contributions to a RORS or voluntary contributions to a MPFS, to the extent that the sums were previously allowed as deductions, is taxable.
16AA	Mandatory contributions to a MPFS in self-employment cases	Mandatory contributions to a MPFS made by a self-employed person (a sole-proprietor or a partner in a partnership) which are not otherwise allowable and not exceeding $15,000.	N/A
16B	Expenditure on R&D	General expenditure / expenditure on machinery or plant fully deductible (subject to apportionment if the expenditure is incurred outside Hong Kong and the trade, profession or business is carried on partly outside Hong Kong) in the year of assessment in which the expenditure was incurred. Expenditure on buildings or structures qualifies for industrial building allowance.	Sale proceeds (subject to apportionment if a deduction is only allowed for part of the expenditure) of rights in, or arising out of, the R&D, to the extent that they are not otherwise chargeable to profits tax and do not exceed the amount of the deduction previously allowed, are taxable. Sales proceeds of buildings or structures are not taxable, but are deducted from the reducing value to compute the balancing adjustment for depreciation allowance.
16C	Payments for technical education	Fully deductible in the year of assessment in which it was incurred.	N/A
16D	ACDs	Allowable if the aggregate is not less than $100 and not exceeding 35% of the assessable profits.	N/A

Section	Expenditure	Allowable deductions	Treatment of refund/sale proceeds
16E	Purchase of patent rights or rights to know-how	If not purchased from an associate, fully deductible (subject to apportionment for non-business purpose) in the year of assessment in which the expenditure was incurred.	Sale proceeds (subject to apportionment if a deduction is only allowed for part of the expenditure) of patent rights or rights to know-how, to the extent that they are not otherwise chargeable to profits tax and do not exceed the amount of the deduction previously allowed, are taxable.
16EA – EC	Purchase of specified IPRs (copyright, registered trade mark/ design)	If not purchased from an associate, 20% per year of assessment (subject to apportionment for non-business purpose) from the year of assessment in which it was incurred.	Sale proceeds (subject to apportionment if a deduction is only allowed for part of the expenditure) of specified IPRs, to the extent that they are not otherwise chargeable to profits tax and do not exceed the amount of the deduction previously allowed, are taxable.
16F	Expenditure on building refurbishment	20% per year of assessment from the year of assessment in which it was incurred.	N/A
16G	Capital expenditure on the provision of a PFA	Fully deductible (subject to apportionment for non-business purpose) in the year of assessment in which the expenditure was incurred.	Sale proceeds of the PFA, to the extent that they are not otherwise chargeable to profits tax and do not exceed the amount of the deduction previously allowed, are taxable.
16H – K	Capital expenditure on EPM and EFV	Fully deductible (subject to apportionment for non-business purpose) in the year of assessment in which the expenditure was incurred.	Sale proceeds of the EPM and EFV, to the extent that they are not otherwise chargeable to profits tax and do not exceed the amount of the deduction previously allowed, are taxable.
16H – K	Capital expenditure on EPI	20% per year of assessment (subject to apportionment for non-business purpose) from the year of assessment in which it was incurred.	Sale proceeds of the EPI, to the extent that they are not otherwise chargeable to profits tax and do not exceed the amount of the deduction previously allowed, are taxable.

8.5.1 Special payment under an approved retirement scheme: s.16A

Pursuant to s.16A, employers carrying on a trade, profession or business in Hong Kong are entitled to deductions for:

(a) contributions (other than ordinary annual contributions) to a fund established under a RORS; or

(b) premiums (other than ordinary annual premiums) in respect of a contract of insurance under a RORS; or

(c) contributions (other than regular contributions) paid to a MPFS.

The deduction is allowable on a straight-line basis over five years (i.e. 20% per year of assessment).

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 the insured do not qualify as occupational retirement schemes.

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

(a) registered under s.18 of the Occupational Retirement Schemes Ordinance ('ORSO');

(b) exempt from registration by virtue of s.7(1) of the ORSO;

(c) operated either by a foreign government, or by a non-profit making agency or undertaking of a foreign government; or

(d) established by or contained in any other Hong Kong Ordinance.

A **'MPFS'** is a scheme governed by the Mandatory Provident Fund Scheme Ordinance ('MPFSO').

'Regular contributions' are contributions made to a MPFS at regular intervals and are either of similar or substantially similar amounts, or of amounts calculated by reference to a scale or a fixed percentage of a person's salary or other remuneration (s.16A(3)).

DIPN 23 provides guidance on recognised retirement schemes.

8.5.2 Mandatory contributions in self-employment cases: s.16AA

With effect from 1 December 2000, where a person carrying on a trade, profession or business in Hong Kong as a sole proprietor or as a partner in a partnership, pays any mandatory contributions in the basis period for any year of assessment in respect of any liability of himself to pay such contributions as a self-employed person under the MPFSO, the payment shall be deemed to be an expense wholly and exclusively incurred in the production of the assessable profits of that trade, profession or business and shall be allowed as a deduction from such profits for that year of assessment.

No deduction is allowable if the payment has been allowed as a deduction under profits tax or salaries tax. The allowable amount is limited to $15,000 per year of assessment (with effect from 2013/14).

Voluntary contributions are not deductible as they are expenditures of a private nature and are not incurred in the production of chargeable profits (s.17(1)(a)(ii) and s.17(2)(d)(iii)).

8.5.3 Expenditure on research and development: s.16B

Pursuant to s.16B(1), the following expenditures incurred for R&D purposes are deductible:

(a) payments to an approved research institute for R&D related to the taxpayer's trade, profession or business;

(b) payments to an approved research institute, the object of which is the undertaking of R&D related to the class of trade, profession or business to which the taxpayer's trade, profession or business belongs; and

(c) expenditure on R&D related to the taxpayer's trade, profession or business, including capital expenditure except to the extent that it is expenditure on land or buildings.

Any specified capital expenditure incurred before a trade, profession or business commenced is treated as if it had been incurred on the first day of commencement (s.16B(6)(b)).

If the expenditure is made or incurred in Hong Kong, there is no requirement for apportionment even if part of the profits derived from the R&D expenditure arises outside Hong Kong. However, if the expenditure is incurred outside Hong Kong and the trade, profession or business is carried on partly in Hong Kong and partly outside Hong Kong, a deduction is only allowed for that part of the expenditure which is reasonable and apportionment will be required.

Expenditures incurred on buildings or structures used for R&D purposes are not deductible but will qualify for industrial building allowance.

If a deduction for expenditure on R&D has been previously allowed, the sale proceeds (subject to apportionment if a deduction is only allowed for part of the expenditure) of the rights in, or arising out of R&D (not exceeding the amount of the deduction) will be treated as a taxable trading receipt. Where the sale occurs after the permanent discontinuance of a trade, profession or business, the sale is deemed to occur immediately before the discontinuance (s.16B(3A)(a)).

'An approved research institution' as defined in s.16B(4) means any university, college, institute, association or organisation which is approved in writing by the Commissioner as an institute, association or organisation for undertaking R&D which is or may prove to be of value to Hong Kong.

'Research and development' as defined in s.16B(4) means:

(a) any activities in the fields of natural or applied science for the extension of knowledge;

(b) any systematic, investigative or experimental activities carried on for the purposes of any feasibility study or in relation to any market, business or management research;

(c) any original and planned investigations undertaken with the prospect of gaining new scientific or technical knowledge and understanding; or

(d) the application of any research findings or other knowledge to a plan or design for the production or introduction of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of their commercial production or use.

R&D is related to a trade, profession or business if it may lead to an extension, or improvement, in the technical efficiency of that trade, profession or business, or of trades, professions or businesses of that class.

Research is also related to a trade if it is essential medical research that is related to the welfare of workers employed in the trade or that class of trade.

DIPN 5 (Revised) provides guidance on profits tax deductions for expenditures on R&D.

8.5.4 Payment for technical education: s.16C

Pursuant to s.16C, payments made by a taxpayer for any technical education which is related to his trade, profession or business, and is provided by a university, university college, technical college or other similar institution approved in writing by the Commissioner are deductible.

Technical education is 'related to a trade, profession or business' if it is specially required by employees in that class of trade, profession or business. There is no requirement that the payment has to be made directly for the education of employees actually employed by the taxpayer. Payments which are made to establish or maintain a unit at an approved institution in order to provide the technical education specially suited to the taxpayer's particular class of business are

allowable. When payments are made by a taxpayer for the technical education of particular employees through an approved institution, they are deductible regardless of whether they are paid to the institution or to the employees receiving the education.

DIPN 5 (Revised) provides guidance on profits tax deductions for expenditures on technical education.

8.5.5 Approved charitable donations: s.16D

Section16D provides for the deduction of ACDs that are not incurred in the production of assessable profits. The aggregate of the ACDs must be at least $100 and do not exceed 35% (25% for the years of assessment 2003/04 to 2007/08; 10% for the years of assessment prior to 2003/2004) of the taxpayer's assessable profits after adjustments for depreciation allowances and balancing charges. If the taxpayer incurred a tax loss, no deduction of donations would be allowed.

'Approved charitable donation' is defined in s.2 as a donation of money made for charitable purposes to:

(a) any charitable institution or trust of a public character which is exempt from tax under s.88; or

(b) the Government.

The following purposes have been accepted as charitable:

(a) the relief of poverty;

(b) the advancement of education;

(c) the advancement of religion; and

(d) any other purpose of a charitable nature beneficial to the community and not coming within the preceding three categories.

Donation is not defined in the IRO. Its ordinary meaning is a gift. To qualify as a gift, the money must be transferred voluntarily and no material advantage is received by the transferor. In *CIR v Sanford Yung-Tao Yung* [(1977) 1 HKTC 959]), it was held that tickets to social events organised by a charitable organisation did not constitute a donation as there was consideration received by the purchaser.

8.5.6 Purchase and sale of patent rights or rights to know-how: s.16E

Key terms in s.16E(4)

'Patent rights' means the rights to do, or authorise the doing of anything which would otherwise be an infringement of a patent.

'Know-how' means any industrial information or techniques likely to assist in the manufacture or processing of goods or materials.

Tax deduction rules

Pursuant to s.16E(1), capital expenditure incurred by a taxpayer on the purchase of patent rights or rights to know-how, to be used in the production of assessable profits, is allowable in the basis period in which the expenditure is incurred. Where the right is partly owned by a taxpayer, a deduction is allowed with reference to the amount of capital expenditure the taxpayer incurred in acquiring the right (s.16E(5)).

Effective from 16 December 2011, a new deduction is introduced for capital expenditure incurred on the purchase of specified IPRs under s.16EA. The legislation also revised s.16E to unify the tax deduction regimes for patent rights or rights to know-how and specified IPRs.

Allowable expenditure now includes legal expenses and valuation fees incurred in connection with the purchase of such rights: S.16E(1A). For the purpose of this section, any specified capital expenditure incurred before a trade, profession or business commenced is treated as if it had been

incurred on the first day of commencement: s.16E(3A). However, any expenditure incurred on the acquisition of a licence is not deductible: s.16E(9).

Where the right is used partly in the production of assessable profits and partly for other purposes, a deduction is only allowed for that part of the expenditure that is proportionate to the extent of the use of the right in the production of assessable profits: s.16E(2). The previous requirement that the right must be used in Hong Kong has been removed as from the year of assessment 2011/12.

Section 16EC(2) provides that no deduction is allowed if the right is purchased wholly or partly from an associate, which is broadly defined in s.16EC(8).

Example 33

Mr. Littlewood has invented a secret formula of a health product in Germany. He plans to produce the health product in Hong Kong for sales to Europe. However, he will continue to live in Germany. He is now considering the following alternatives:

(1) Two companies are to be set up with Mr. Littlewood as the sole beneficial owner. Light Ltd is to be set up in the Channel Islands (a tax haven) and Dark Ltd is to be set up in Hong Kong. Mr. Littlewood will sell the secret formula to Light Ltd for $1. Light Ltd will then sell the secret formula to Dark Ltd for $5 million, being the fair market value of the secret formula. Dark Ltd will make an annual profit of $1 million from sales of the health product, before deducting the cost of the secret formula.

(2) Two companies are to be set up with Mr. Littlewood as the sole beneficial owner. Master Ltd is to be set up in the Channel Islands and Servant Ltd is to be set up in Hong Kong. Mr. Littlewood will sell the secret formula to Master ltd for $1. Master Ltd will then license the use of the secret formula to Servant Ltd for an upfront payment of $0.3 million and an annual fee of $0.5 million. Servant Ltd will make an annual profit of $1 million from sales of the health product, before deducting the upfront payment and the annual fee.

Required:

(a) Advise Mr. Littlewood of the profits tax implications of the two alternatives.

(b) Advise Mr. Littlewood as to whether there is any difference in the tax treatment under alternative 2 if he were a Hong Kong resident carrying on business in Hong Kong and invented the secret formula in Hong Kong.

Solution

(a) **Alternative 1**

Dark Ltd's profits on sale of the health product ($1 million per annum) will be subject to profits tax at the profits tax rate for corporations of 16.5%. Although the secret formula is within the meaning of 'know-how' of s.16E which means 'any industrial information or techniques likely to assist in the manufacture or processing of goods or materials', the cost of the secret formula ($5 million) is not deductible pursuant to s.16EC(2) as Light Ltd is an 'associate' of Dark Ltd (the two companies are under the common control of Mr. Littlewood). Such a deduction will be denied notwithstanding the fact that the secret formula is not previously owned by any person in Hong Kong and that the price is at arm's-length.

As Mr. Littlewood and Light Ltd does not carry on any business in Hong Kong and the secret formula was invented/acquired by it outside Hong Kong, it is unlikely that the IRD will impose any tax on the sale proceeds of the secret formula.

Alternative 2

Assuming the license fee of $0.5 million per annum paid to Master Ltd is not challenged by the IRD as excessive, it is revenue expenditure incurred in the production of chargeable profits and deductible under s.16(1). However, the upfront payment of $0.3 million which is capital in nature will be prohibited from deduction under s.17(1)(c). Servant Ltd's profits on

the sale of the health product after deducting the license fee ($0.5 million per annum) will be subject to profits tax at the rate of 16.5%.

Although Master Ltd does not carry on any business in Hong Kong, its profits from licensing the secret formula for use in Hong Kong will be chargeable to profits tax under s.15(1)(b). Servant Ltd will have an obligation to withhold the tax of $39,600 ($0.8m x 30% x 16.5%) in the first year and $24,750 ($0.5m × 30% × 16.5%) in subsequent years before paying the balance of the fee for the use of the secret formula to Master Ltd pursuant to s.20B. Although Master Ltd is an associate of Servant Ltd, the deemed profit of the license fee is 30% instead of 100% as the secret formula had not been previously owned by any person carrying on business in Hong Kong (s.21A(1)(b)).

(b) The tax position of Servant Ltd will be the same.

Servant Ltd is an associate of Master Ltd as the two companies are under the common control of Mr. Littlewood. Although Master Ltd does not carry on any business in Hong Kong, it will still be subject to Hong Kong profits tax under the deeming provisions of s.15(1)(b). As Mr. Littlewood had been carrying on business in Hong Kong, invented and owned the secret formula in Hong Kong, the deemed profit of Master Ltd from licensing the use of the secret formula in Hong Kong will be 100% instead of 30% pursuant to s.21A(1)(a). Servant Ltd will need to withhold $132,000 ($0.8m x 100% x 16.5%) and $82,500 ($0.5m × 100% × 16.5%) before paying the balance of the fee for the use of the secret formula to Master Ltd pursuant to s.20B.

Example 34 (Adapted from DIPN 49, Example 2)

Co HK purchased a patent registered in the US and subsequently conducted R&D in Hong Kong using that US patent to create a new invention. Co HK applied for registering the US patent and the new invention in Hong Kong. The capital expenditure incurred on the purchase of the US patent will be deductible under s.16E if it is used to produce chargeable profits. However, as the new invention is self-created and not purchased from others, no deduction can be allowed under s.16E, but the R&D expenditure may be deductible under s.16B provided that the prescribed conditions are fulfilled.

Taxation of proceeds from the sale of rights

If a deduction has been allowed for the purchase of the right and the right is subsequently sold, the sale proceeds are, to the extent that they are not chargeable to profits tax and do not exceed the amount of the deduction, treated as a trading receipt at the time of the sale: s.16E(3). Up to the year of assessment 2010/11, the whole of the sale proceeds, including any capital gains, would be taxable.

If the sale of the right occurs after the permanent discontinuance of a trade, profession or business, the sale is deemed to occur immediately before the discontinuance: s.16E(3)(b).

Where the right has been used only partly for the production of assessable profits and partly for other purposes, the taxable sale proceeds would be proportionately reduced: s.16E(4).

Example 35 (Adapted from DIPN 49, Example 8)

Co HK purchased a patent at a cost of $500,000 during 2011/12. The patent was used partly (50%) in the production of chargeable profits. A deduction of $250,000 ($500,000 × 50%) was allowed in the year of purchase.

During 2012/13, Co HK sold the patent for $600,000. The relevant sale proceeds are $300,000 ($600,000 × 50%), which exceed the deduction previously allowed ($250,000). Therefore, the deemed trading receipt chargeable under s.16E(3) is restricted to $250,000.

Rights purchased/sold for one price and substitution of market value

Where the rights are purchased or sold together or with any other assets for one consideration, the Commissioner may, having regard to all the circumstances of the transaction, allocate a consideration for the purchase or sale of each right for the purpose of granting the deduction or assessing the sales proceeds: s.16E(7).

Furthermore, where the Commissioner is of the opinion that the consideration for the purchase or sale of the right does not represent its true market value, the Commissioner may determine the true market value of such right. The amount so determined would then be treated as the cost or sale proceeds for the purpose of granting the deduction or assessing the sales proceeds: s.16E(8).

8.5.7 Purchase and sale of registered trade marks, copyrights and registered designs: s.16EA

The s.16E relief does not apply to acquisitions of trade marks or other IPRs. To promote wider application of IPRs by local enterprises and to facilitate the development of creative industries in Hong Kong, s.16EA was enacted to extend the scope of deduction to cover registered trade marks, copyrights and registered designs (collectively referred to as **'specified IPRs'**) as from the year of assessment 2011/12.

Key terms in s.16EA(11)

'Copyright' means

(a) a copyright within the meaning of s.2(1) of the Copyright Ordinance, including an unregistered corresponding design as defined by s.87(5)(b) of that Ordinance; or

(b) any right that subsists under the law of a place outside Hong Kong in any work in which a copyright referred to in (a) above may subsist; and corresponds to a copyright referred to in (a) above.

'Registered design' means a design registered under s.25 of the Registered Designs Ordinance or under the law of any place outside Hong Kong.

'Registered trade mark' means a trade mark registered under s.47 of the Trade Marks Ordinance or under the law of any place outside Hong Kong.

'Specified capital expenditure' means any capital expenditure incurred on the purchase of any specified intellectual property right and includes legal expenses and valuation fees incurred in connection with the purchase.

'Specified intellectual property right' means copyright, registered design or registered trade mark.

Tax deduction rules

Pursuant to ss.16EA(2) and (3), specified capital expenditure incurred by a taxpayer on the purchase of specified IPR is deductible over 5 years in equal instalments (i.e. 20% per year), commencing with the year of purchase if:

(a) the IPR has been used in the trade in the production of assessable profits: s.16EA(6)(a);

(b) in the case of a copyright, the copyright subsists: s.16EA(6)(b);

(c) in the case of a trade mark and a design, it is registered (in Hong Kong or overseas) at the time of purchase (there is no registration requirement for copyright): s.16EA(6)(c) and (d);

(d) the IPR has not been sold at the end of the basis period: s.16EA(5).

There is no deduction for unregistered trade mark or design even if it is registered immediately after acquisition. Moreover, if the registration is later invalidated, revoked or surrendered, tax deductions previously granted will be withdrawn.

The deduction should be spread over 5 succeeding years in equal instalments starting from the year of purchase: s.16EA(3). Where the specified IPR is only subsequently put to use, e.g. in the fourth year after the year of purchase, the taxpayer could only claim deductions for the portion of capital expenditure spread over the fourth and fifth years.

Where the maximum period of protection for copyright or design expires within the 5-year deduction period, tax deductions will be claimed in equal instalments over the remaining years of protection: s.16EA(4). As legal protection of trade mark could be perpetual, tax deductions for trade mark will not be spread over a period of shorter than 5 years.

Allowable expenditure includes legal expenses and valuation fees incurred in connection with the purchase of the right: s.16EA(11). Any specified capital expenditure incurred before a trade, profession or business commenced is treated as if it had been incurred on the first day of commencement: s.16EA(10). However, any expenditure incurred on the acquisition of a licence is not deductible: s.16EA(13).

Where the specified IPR is partly owned by a taxpayer, a deduction is allowed with reference to the amount of capital expenditure the taxpayer incurred in acquiring the IPR: s.16EA(12).

Where the specified IPR is used partly in the production of assessable profits and partly for other purposes, a deduction is only allowed for that part of the expenditure that is proportionate to the extent of the use of the right in the production of assessable profits: s.16EA(7).

Section 16EC(2) provides that no deduction is allowed if the specified IPR is purchased wholly or partly from an associate, which is broadly defined in s.16EC(8).

Example 36

As the tax rate in Country X is very high, Global Inc would like to transfer the IPRs which it has developed over the years to its subsidiary incorporated in Hong Kong, Star Ltd. After the transfer, Star Ltd will be collecting royalties from related companies which are using the IPRs in their jurisdictions.

Required:

(a) Explain the tax implications of the following:

  (i) Would the cost of the IPRs be deductible for Star Ltd?

  (ii) If the cost of the IPRs includes the cost of one trade mark, would the trade mark cost be deductible?

  (iii) Would the royalties be taxable?

(b) Star Ltd will engage research companies in Country Z to carry out research for the purpose of developing new IPRs. Comment on the deductibility of the R&D expenditure.

Solution

(a) Costs incurred in acquiring IPRs are capital expenditure and are not deductible under s.17(1)(c). However, under s.16E(1), specific deductions for patent rights or rights to any know-how which are not acquired from related companies and are used for producing assessable profits are allowed. In the present case, the IPRs were acquired from a related company, therefore it is not deductible under s.16EC(2).

Effective from the year of assessment 2011/12, if the required conditions are satisfied, the trade mark is also deductible under s.16EA(2). However, since the trade mark was acquired from a related company, it is not deductible under s.16EC(2).

As the IPRs would be owned by Star Ltd, a company carrying on business in Hong Kong, the royalty income from group companies would be taxable under s.14 if the source of the royalty income is in Hong Kong. Royalties withholding tax incurred in the various jurisdictions should be deductible under s.16(1) as they are incurred to produce chargeable profits.

(b) The R&D costs incurred for bringing into existence an enduring asset, the IPR, are capital in nature and will not be deductible. However, s.16B allows a deduction for R&D expenditure in

the year of assessment in which it was incurred in respect of payments made to any approved research institute for R&D related to that trade, profession or business. In the present case, payments to research companies in Country Z which are not approved research institutes would not be deductible under s.16B.

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Example 37 (Adapted from DIPN 49, Example 5)

During 2011/12, Co HK purchased a trade mark registered both in Hong Kong and the US at a total consideration of $1 million. The Hong Kong trade mark and the US trade mark are valued at $600,000 and $400,000 respectively; and a valuation fee of $50,000 was incurred.

In 2011/12, the branded goods were sold to Hong Kong customers only. In 2012/13, the branded goods were also sold to US customers; and the profits derived from such sales were chargeable to tax in Hong Kong.

In 2011/12, since the Hong Kong trade mark was wholly used for the sale of the branded goods in Hong Kong, Co HK is entitled to deduct one-fifth of the purchase cost of the Hong Kong trade mark pursuant to ss.16EA(2), (3) and (11) in the amount of $126,000 [($600,0000 + $50,000 × 6/10)/5]. However, no deduction for the US trade mark is allowed as it has not been used at all.

In 2012/13, Co HK also used the US trade mark for sale of the branded goods in the US to produce chargeable profits. The deduction allowable in respect of the US trade mark is $84,000 [($400,0000 + $50,000 × 4/10)/5]. In respect of the Hong Kong trade mark, the deductible amount is the same as in 2011/12, i.e. $126,000. Hence, the total allowable deduction is $210,000 ($126,000 + $84,000).

Taxation of proceeds from the sale of rights

If a deduction has been allowed for the purchase of specified IPR and the right is subsequently sold, the sale proceeds would be compared with the balance of the costs not yet deducted (i.e. the ‘unallowed amount’ where the right is sold within the 5-year deduction period), if any, to arrive at a balancing adjustment.

(a) If the sale proceeds exceed the unallowed amount or there is no unallowed amount, the excess or the sale proceeds (limited to the deduction previously allowed) is treated as a trading receipt (as a balancing charge) at the time of sale; or immediately before the permanent discontinuance of the trade, profession or business if sold after discontinuance: s.16EB(2)(b) and (c).

(b) If the unallowed amount exceeds the sale proceeds, the excess is deductible (as a balancing allowance) at the time of sale: s.16EB(2)(a).

Where the specified IPR has been used only partly for the production of assessable profits and partly for other purposes, the balancing adjustment would be proportionately reduced: s.16EB(3).

Example 38 (Adapted from DIPN 49, Example 9)

Co HK purchased a registered trade mark at a cost of $2 million during 2011/12. The trade mark was used partly in the production of chargeable profits, and the allowable proportion is 50% and 60% for 2011/12 and 2012/13 respectively. Deductions of the purchase cost in the amount of $200,000 and $240,000 would be allowed for 2011/12 and 2012/13 respectively, calculated as follows:

Year of assessment	Purchase cost to be spread over the 5-year deduction period	Percentage of use	Allowable deduction	Deduction not allowed
	(1)	(2)	(3) = (1) × (2)	(4) = (1) - (3)
2011/12	$400,000	50%	$200,000	$200,000
2012/13	$400,000	60%	$240,000	$160,000
Total	$800,000	55%	$440,000	$360,000

During 2013/14, Co HK sold the trade mark for $3 million. The relevant sale proceeds are $1.65 million ($3 million × 55%). The unallowed amount is $660,000 [($2 million – $800,000) × 55%], which is less than the relevant sale proceeds. The deemed trading receipt in 2013/14 is $990,000 ($1.65 million - $660,000), but is restricted to the deduction previously allowed of $440,000: s.16EB(2)(b).

Example 39 (Adapted from DIPN 49, Example 10)

The facts are the same as Example 38 except that the trade mark is sold for $1 million. The relevant sale proceeds are $550,000 ($1 million × 55%). The unallowed amount is still $660,000, which exceeds the relevant sale proceeds. The excess of $110,000 ($660,000 – $550,000) is deductible in 2013/14: s.16EB(2)(a).

Rights purchased/sold for one price and substitution of market value

Where specified IPRs are purchased or sold together or with any other assets for one consideration, the Commissioner may, having regard to all the circumstances of the transaction, allocate a consideration for the purchase or sale of each right for the purpose of granting or making the relevant tax deductions or balancing adjustments: s.16EA(8).

Furthermore, where the Commissioner is of the opinion that the consideration for the purchase or sale of the specified IPR does not represent its true market value, the Commissioner may determine the true market value of such right. The amount so determined would then be treated as the cost or sale proceeds for the purpose of granting or making the relevant tax deductions or balancing adjustments: s.16EA(9).

8.5.8 Denial of tax deductions under anti-avoidance provisions in s.16EC

Section 16EA extends the scope of deductions to cover specified IPRs, effective from the year of assessment 2011/12. The new law however contains several anti-avoidance provisions which deny tax deductions for patent rights or rights to know-how, copyrights, designs and trade marks (collectively referred to as the **'relevant rights'**) when:

(a) the relevant right is purchased wholly or partly from an associate: s.16EC(2);

(b) the relevant right is transferred under a 'sale and licence back' arrangement: s.16EC(4)(a);

(c) the relevant right is licensed for use wholly or principally outside Hong Kong by a person other than the taxpayer: s.16EC(4)(b);

(d) the whole or predominant part of the purchase consideration is financed directly or indirectly by a non-recourse debt ('leveraged licensing arrangements'): s.16EC(4)(c) (this is discussed

in **chapter 9, section 4.18** on 'Section 39E – Depreciation allowances on leased machinery and plant'); and

(e) the specified IPR had been used by the taxpayer before the new law becomes operational, and the taxpayer early terminated the licence which would otherwise expire after the new law becomes operational and then purchases the specified IPR at an unreasonable consideration: s.16EC(1).

It is worth to note that ss.16EC(4)(a), (b) and (c) mirror the controversial ss.39E(1)(a) and (b) that deal with plant and machinery (see the detailed discussions in **chapter 9, section 4.18** on 'Section 39E – Depreciation allowances on leased machinery and plant').

Sale and licence back arrangement

Key terms in s.16EC(8)

'**End-user**' means any person (whether alone or with others) holding rights as a licensee under a licence of any relevant right or any associate of the person.

'**Licence**', in relation to a relevant right,

(a) means a licence (however described and whether general or limited) authorizing the licensee to use the relevant right in the manner authorised by the licence; but

(b) does not include an agreement under which the ownership of the relevant right will or may be sold to or pass to the licensee unless, in the opinion of the Commissioner, the right under the agreement to purchase or obtain the ownership of the relevant right would reasonably be expected not to be exercised,

and licensee is to be construed accordingly.

Section 16EC(4)(a) applies to a sale and licence back arrangement when a relevant right which, at any time prior to its acquisition by the taxpayer (the lessor), was owned and used by the **'end-user'** who is either:

(a) the licensee, either alone or with others; or

(b) an 'associate' of the licensee.

'Owned' and 'used' are not defined in the IRO and will be given its ordinary meaning. The term 'associate' had been defined widely in s.16EC(8) to prevent circumvention of the provisions by the interposition of third parties.

Escape clause in ss.16EC(5) and (6)

To ensure that normal business activities will not be affected, ss.16EC(5) provide that s.16EC(4)(a) will not apply to deny a tax deduction if:

(a) the taxpayer purchases the relevant right from an end-user at a price not greater than the price paid to the supplier by the end-user (s.16EC(5)(a);

(b) the relevant right was purchased by the end-user from the supplier on or after the new law becomes operational (s.16EC(5)(a)); and

(c) no deduction under s.16E or 16EA has been allowed to the end-user in respect of the relevant right before (s.16EC(5)(a).

The end-user may submit a notice of disclaimer for his entitlement of the deduction to the Commissioner within three months of the date on which the capital expenditure was incurred on the relevant right or within such further period as may be permitted by the Commissioner: s.16EC(6).

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Example 40 (Adapted from DIPN 49, Example 12)

During the year of assessment 2012/13, Co HK purchased a copyright for $1 million. Before putting it into use and claiming any deduction, Co HK sold the copyright to Co F for $1 million. Co F licensed the copyright back to Co HK for an annual fee of $110,000 for a period of 10 years.

By virtue of the sale and license back arrangement, Co HK obtained cash proceeds of $1 million which was the price it paid to the supplier. Assuming each instalment contained an effective finance charge of $10,000 whereas the market interest should have been $20,000, Co HK in effect transferred the deduction to Co F in return for a lower rate of interest. The conditions in s.16EC(5) are satisfied and Co F would not be denied deductions. Co HK, the end-user, in effect made use of the sale and license back arrangement to obtain cheaper finance for its business use. Co F, the licensor, had in effect committed capital into the copyright, incurring genuine commercial risk. The whole arrangement is a normal commercial transaction.

However, if Co HK sold the copyright to Co F at a price exceeding the price it paid to the supplier, the condition in s.16EC(5)(c) will not be satisfied and Co F would be denied deductions.

Relevant rights used wholly or principally outside Hong Kong by a person other than the taxpayer

Section 16EC(4)(b) is modelled on s.39E(1)(b)(i). When the taxpayer allows its contract manufacturer outside Hong Kong to use its relevant right at no cost to manufacture goods ordered by it, it has effectively granted a royalty-free license of the relevant right to the contract manufacturer. As such, the IRD is of the view that the relevant right is only used by the contract manufacturer for the purposes of producing its own profits. Therefore, the relevant right is not used by the taxpayer to produce profits chargeable to profits tax and no deductions should be allowed.

However, when the relevant right such as a trade mark is used both for manufacturing and sales outside Hong Kong in the place where the contract manufacturer is located, the IRD considers that the relevant right could be regarded as being partly used by the manufacturer in its production activity and partly used by the taxpayer in its sales activity. This requires allocation of the purchase cost of the relevant right to different territories in which the relevant right is used and to different activities. The apportioned cost of the relevant right allocated to the part used by the taxpayer in its sales activity is deductible, provided that the trading profit is chargeable to profits tax.

Example 41 (Adapted from DIPN 49, Example 15)

Co HK, carrying on a trading business in Hong Kong, has during the year of assessment 2012/13 purchased a trade mark registered both in Hong Kong and the Mainland at a total cost of $3 million. The Hong Kong trade mark and the Mainland trade mark were each valued at $1.5 million. Co HK contracted Co M, a contract manufacturer located in the Mainland, to produce goods bearing the trade mark.

Co M manufactured 1,000,000 pieces of goods during the year of assessment 2012/13 and they were sold by Co HK to customers in HK and the Mainland in the respective quantities of 400,000 and 600,000. The profits so derived are all chargeable to tax in Hong Kong.

(1) Insofar as the trade mark registered in Hong Kong is concerned, it was used by Co HK for selling the finished goods to produce profits chargeable to profits tax. Section 16EC(4)(b) is therefore not applicable. In the year of assessment 2012/13, Co HK is entitled to deduct one-fifth of the purchase cost of the Hong Kong trade mark pursuant to s.16EA(3) in the amount of $300,000 ($1.5 million/5).

(2) As for the trademark registered in the Mainland, it was partly used by Co M for producing goods in the Mainland and partly used by Co HK for selling some of the finished goods in the Mainland. In the circumstances, s.16EC(4)(b) is applicable to the part of the Mainland trade mark that was used by Co M in the Mainland manufacturing activities. Nevertheless, Co HK is still entitled to deduct part of the purchase cost of the Mainland trade mark which was

used by Co HK to sell the finished goods in the Mainland and thereby produce profits chargeable to profits tax.

The amount of deduction for the Mainland trade mark is calculated with reference to the ratio of deductible activities (i.e. sales) to total activities (i.e. sales and manufacturing) as follows:

$$\text{Purchase cost of the Mainland registered trade mark} \times \frac{\text{No of units sold in the Mainland}}{\text{No of units manufactured \& sold in the Mainland}} \div 5$$

= $1,500,000 × 600,000/(1,000,000 + 600,000) ÷ 5

= $ 112,500

Where the use and the purchase cost of a relevant right such as a trade mark could be attributable to a particular territory, s.16EC(4)(b) will have no application if the trade mark used by the contract manufacturer outside Hong Kong is not the trade mark registered in Hong Kong.

Example 42 (Adapted from DIPN 49, Example 13)

Co HK, carrying on a trading business in Hong Kong, has during the year of assessment 2012/13 purchased a trade mark registered in Hong Kong at a cost of $1 million. The trade mark has not been registered in places other than Hong Kong. Co HK contracted a Mainland manufacturer, Co M, to produce in the Mainland goods bearing the Hong Kong trade mark. The goods produced by Co M were sold in Hong Kong and the US by Co HK and the profits derived are chargeable to tax in Hong Kong.

Co HK has only purchased the Hong Kong trade mark and has not acquired any right to use the trade mark in places other than Hong Kong. The trade mark used by Co M in the production of goods in the Mainland is an unregistered trade mark in the Mainland, not the trade mark registered in Hong Kong. In addition, Co HK when selling the goods in the US market is not using the trade mark registered in Hong Kong. In the circumstances, s.16EC(4)(b) is not applicable. Since the profits derived by Co HK from selling the finished goods are chargeable to profits tax, in accordance with s.16EA(3), it is entitled to deduct one-fifth of the purchase cost of the Hong Kong trade mark for the year of assessment 2012/13 in the amount of $200,000 ($1 million/5).

Example 43 (Adapted from DIPN 49, Example 14)

Co HK, carrying on a trading business in Hong Kong, has during the year of assessment 2012/13 purchased a trade mark registered in Hong Kong at a cost of $2 million. The trade mark has not been registered in places other than Hong Kong. Co HK subsequently registered the trade mark in the Mainland and contracted a Mainland manufacturer, Co M, to produce in the Mainland goods bearing the trade mark. The goods produced by Co M were sold in Hong Kong by Co HK and the profits derived are chargeable to tax in Hong Kong.

Co HK has only purchased the Hong Kong trade mark but not the Mainland trade mark. It becomes the registered owner of the Mainland trade mark because it has subsequently registered the trade mark in the Mainland. The trade mark used by Co M in the production of goods in the Mainland is the one registered in the Mainland by Co HK and not the Hong Kong trade mark purchased by Co HK. As such, s.16EC(4)(b) is not applicable. Since the profits derived by Co HK from selling the finished goods are chargeable to profits tax, in accordance with s.16EA(3), it is entitled to deduct one-fifth of the purchase cost of the Hong Kong trade mark for the year of assessment 2012/13 in the amount of $400,000 ($2 million/5).

Relevant rights used wholly or principally outside Hong Kong under a contract processing arrangement and import processing arrangement

Under a contract processing arrangement where an apportionment of the profit derived by a Hong Kong company on a 50:50 basis is allowed, the IRD agrees that 50% deduction of the expenses incurred by the Hong Kong company for producing the assessable profits, including the capital expenditure incurred on the purchase of the Mainland relevant rights and the Hong Kong relevant rights, will be allowed.

However, this concession is not applicable to an import processing arrangement where the profits of the Hong Kong company are treated as trading profits and no apportionment will be allowed.

DIPN 49 provides guidance on profits tax deduction of capital expenditures on relevant IPRs.

8.5.9 Expenditure on building refurbishment: s.16F

Pursuant to s.16F(1), a person who incurs capital expenditure on the renovation or refurbishment of a building or structure other than a domestic building or structure may claim a deduction of the refurbishment expenditure. Where a deduction for the expenditure is allowed, the person is not entitled to any depreciation allowance on the capital expenditure (s.16F(3)).

The deduction is allowable on a straight-line basis over five years, i.e. 20% per year of assessment (s.16F(2)), similar to that of a special payment under a RORS or a MPFS.

If the building or structure for which a deduction is allowed under s.16F is sold before the five instalments are fully granted, the person will continue to be granted the remaining instalment(s) as if the building or structure had not yet been sold. Any sale proceeds for the refurbishment expenditure, however, are not chargeable to tax.

The deduction does not apply to capital expenditure incurred (s.16F(4)):

(a) for a building or structure which is used or intended to be used as a domestic building or structure;

(b) by a person to enable a building or structure to be first used substantially by the person for the production of profits in respect of which the person is chargeable to profits tax; and

(c) by a person to enable a building or structure to be used for a purpose different from that for which it was used immediately before the capital expenditure was incurred.

However, such capital expenditure may qualify for industrial or commercial building allowance.

'Building or structure' includes part of a building or structure.

'Domestic building or structure' means any building or structure used for habitation, but does not include any building or structure used as a hotel or guesthouse, or any part of a hotel or guesthouse (s.16F(5)).

'**Hotel' and 'guesthouse**' have the same meaning as in the Hotel and Guesthouse Accommodation Ordinance (s.16F(5)).

DIPN 5 (Revised) provides guidance on profits tax deductions for expenditures on building refurbishment.

8.5.10 Capital expenditure on the provision of a prescribed fixed asset: s.16G

Pursuant to s.16G(1), a person who incurs specified capital expenditure on the provision of a PFA during the basis period for a year of assessment is entitled to a deduction of the specified capital expenditure incurred for that year of assessment. Any specified capital expenditure incurred before a trade, profession or business commenced is treated as if it had been incurred on the first day of commencement: s.16G(5).

Key terms in s.16G(6)

'**Prescribed fixed asset**' means

(a) such of the machinery or plant specified in items 16, 20, 24, 26, 28, 29, 31, 33 and 35 of the First Part of the Table annexed to IRR 2 as is used specifically and directly for any manufacturing process;

(b) computer hardware, other than that which is an integral part of any machinery or plant;

(c) computer software and computer systems;

but does not include an excluded fixed asset.

'**Excluded fixed asset**' means a fixed asset in which any person holds rights as a lessee under a lease.

'**Specified capital expenditure**', in relation to a person, means any capital expenditure incurred by the person on the provision of a PFA, but does not include:

(a) capital expenditure that may be deducted under any other section under profits tax; or

(b) capital expenditure incurred under a hire-purchase agreement.

If an asset does not fall within the definition of a PFA and the cost is not deductible under s.16G, the taxpayer may claim depreciation allowance in respect of the asset.

If a PFA is used partly in the production of assessable profits and partly for other purposes, a deduction is only allowed for that part of the expenditure that is proportionate to the extent of the use of the asset in the production of assessable profits: s.16G(2).

The sale proceeds of a PFA or such part of the sale proceeds as is proportionate to the extent to which the specified capital expenditure has been allowed, shall, to the extent that they are not otherwise chargeable to profits tax and do not exceed the amount of the deduction previously allowed, be treated as a trading receipt and chargeable to tax: s.16G(3)(a).

If the sale of a PFA is a controlled sale and the Commissioner is of the opinion that the sale price does not represent the true market value, he may substitute the sale price with the true market value: s.16G(3)(c). A sale is a controlled sale when:

(a) the buyer is a person over whom the seller has control:

(b) the seller is a person over whom the buyer has control;

(c) both the seller and the buyer are persons over both of whom some other person has control; or

(d) the sale is between a husband and his wife, not being a wife living apart from her husband.

DIPN 5 (Revised) provides guidance on profits tax deductions for expenditures on PFAs.

Pursuant to DIPN 5, capital expenditure on computer hardware and software includes the relevant consultancy fees and associated costs. Manufacturing plant and equipment does not include those used in construction work (such as bulldozer and graders).

The application of s.16G was examined in the following case:

Taxpayer	Subject matter	Reference
Braitrim (Far East) Limited v CIR	Deduction for the cost of moulds as PFA	(2012) CACV 45/2012

The COA upheld the decision of the BOR that the provision of moulds by the taxpayer to the unrelated manufacturers constituted a 'lease' arrangement under which a right to use the moulds was granted at no cost 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). This case is discussed in **Appendix 13**.

8.5.11 Capital expenditure on the provision of environmental protection facilities: ss.16H – K

Sections 16H – K were enacted to provide accelerated tax deductions for specified capital expenditure incurred on EPFs, which include:

(a) the provision of EPM (effective from 27 June 2008);

(b) the construction of EPI (effective from 27 June 2008); and

(c) the provision of EFVs (effective from 18 June 2010).

Tax deduction rules

Specified capital expenditure incurred in a year of assessment on the provision of EPM and EFVs is wholly deductible in that year of assessment: s.16I(2).

Specified capital expenditure incurred on the construction of EPI is deductible in five equal yearly instalments (i.e. 20% per year of assessment), as long as the installation has not been sold at the end of the basis period: s.16I(3).

If an EPF is used partly in the production of chargeable profits and partly for other purposes, a deduction is only allowed for that part of the expenditure that is proportionate to the extent of the use of the EPF in the production of chargeable profits: s.16I(4).

For qualifying EPM in use before 27 June 2008, the capital expenditure, as reduced by initial and annual allowances, is deemed to have been incurred in the year of assessment with basis period covering 27 June 2008, and is fully deductible in that year of assessment (usually 2008/09): ss.16K(1) and (3).

For qualifying EPI in use before 27 June 2008, the residue of expenditure in relation to any building or structure is deemed to have been incurred in the year of assessment with basis period covering 27 June 2008. This deemed cost is deductible equally in five years of assessment, starting from that year of assessment (usually 2008/09): ss.16K(4) and (6).

For qualifying EFV in use before 18 June 2010, the capital expenditure, as reduced by initial and annual allowances, is deemed to have been incurred in the year of assessment with basis period covering 18 June 2010, and is fully deductible in that year of assessment (usually 2010/11): ss.16K(1) and (3).

Taxation of proceeds from the sale of EPFs

If an EPM is subsequently sold, the sale proceeds are, to the extent that they are not otherwise chargeable to profits tax and do not exceed the amount of the deduction, treated as a taxable trading receipt at the time of the sale. If the sale occurs on or after the permanent discontinuance of the trade, profession or business, it is deemed to occur immediately before discontinuance: s.16J(2).

If an EPI is subsequently sold, the excess of sale proceeds (limited to the amount of the deduction) over any unallowed amount, if any, is treated as a taxable trading receipt at the time of the sale. If the sale occurs on or after the permanent discontinuance of the trade, profession or business, it is deemed to occur immediately before discontinuance: s.16J(3)(b) and (c). However, if the unallowed amount exceeds the sale proceeds, the excess is deductible in the basis period for which the sale occurs: s.16J(3)(a).

If an EPV is sold, the sale proceeds are, to the extent that they are not otherwise chargeable to profits tax and do not exceed the amount of the deduction, treated as a taxable trading receipt at the time of the sale: s.16J(2A).

If an EPF is destroyed or stolen, it is deemed to have been sold immediately before it was destroyed or stolen, and the insurance money or other compensation is treated as the sale proceeds: ss.16J(5) and (5A).

If the sale of an EPF is a controlled sale and the Commissioner is of the opinion that the sale price does not represent the true market value, he may substitute the sale price with the true market value: s.16J(4). A sale is a controlled sale when:

(a) the buyer is a person over whom the seller has control:

(b) the seller is a person over whom the buyer has control;

(c) both the seller and the buyer are persons over both of whom some other person has control; or

(d) the sale is between a husband and his wife, not being a wife living apart from her husband.

If a taxpayer ceases its trade, profession or business, the EFV should be taken as being sold immediately before the cessation and the taxpayer shall be chargeable to tax as if it had received the sale proceeds (which is to be determined based on the market value). If the EFV is sold, destroyed or stolen within 12 months from the date of cessation, the taxpayer may apply for an adjustment to the sale proceeds so as to reflect the actual sales income, insurance money and other compensation: ss.16J(5B), (5C), (5D) and (5E).

'Specified capital expenditure' means any capital expenditure incurred on (ss.16H(1) and (2)):

(a) the provision of any EPM or EFVs; or

(b) the construction of any EPI; and

includes any capital expenditure incurred on alterations to an existing building incidental to the installation of that EPM; but does not include:

(a) any capital expenditure that may be deducted under any other sections of profits tax;

(b) any capital expenditure incurred under a hire-purchase agreement;

(c) any capital expenditure incurred on the acquisition of, or of rights in or over, any land; and

(d) any machinery or plant held by a person as a lessee under a lease.

'Environmental protection machinery' means (s.16H(1) and Part 1 of Schedule 17)):

(a) low noise construction machinery or plant registered under the system administered by the Environmental Protection Department ('EPD');

(b) air pollution control machinery or plant in compliance with the requirements under the Air Pollution Control Ordinance;

(c) waste treatment machinery or plant in compliance with the requirements under the Waste Disposal Ordinance; and

(d) waste water treatment machinery or plant in compliance with the requirements under the Water Pollution Control Ordinance.

'Environmental Protection Installation' means (s.16H(1) and Part 2 of Schedule 17):

1 Any of the following installations:

(a) solar water heating installations;
(b) solar photovoltaic installation;
(c) wind turbine installations;
(d) offshore wind farm installations;
(e) landfill gas installations;
(f) anaerobic digestion installations;
(g) thermal waste treatment installations;
(h) wave power installations;
(i) hydroelectric installations;
(j) bio-fuel installations;
(k) biomass combined-heat-and-power installations;
(l) geothermal installations.

2 Energy efficient building installations registered under the Hong Kong Energy Efficiency Registration Scheme for Buildings administered by the Electrical and Mechanical Services Department.

Environment-friendly Vehicles

Part 3 of Schedule 17 sets out the eligible EFVs which cover the following three categories:

(a) Vehicles eligible for the remission of first registration tax under the 'Tax Incentives Scheme for Environment-friendly Commercial Vehicles' and the 'Tax Incentives Scheme for Environment-friendly Petrol Private Cars' administered by the EPD;

(b) Hybrid electric vehicles; and

(c) Electric vehicles.

The specified EFVs do not include any vehicle in which any person holds rights as a lessee under a lease. Also, EFVs acquired under hire-purchase arrangements are not eligible for the tax deduction, but the usual depreciation allowances can be claimed.

Buyers of second-hand EFVs are also entitled to the tax deduction as long as the vehicle is an eligible EFV at the time of purchase.

DIPN 5 (Revised) provides guidance on deductions for expenditures on EPFs.

8.6 Deductions not allowed under s.17

Section 17 prohibits deductions of the following items:

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

Section	Non-allowable deductions
17(2)	Salaries or other remuneration of, or interest on capital or loans provided by, the sole-proprietor, partners and/or their spouses; or contributions made to a MPFS in respect of the sole-proprietor's or partners' spouses

Example 44

Refer to the facts in Example 16. Discuss whether B Ltd is entitled to a deduction of the stamp duty incurred on purchase of the Building for the year of assessment 2012/13:

Solution

B Ltd classified the Building as its fixed asset and let it to a manufacturing company for three years. Plainly, the Building was used for producing rental income and the stamp duty incurred on its acquisition can satisfy the conditions prescribed under s.16(1). The fact that the shareholder, A Ltd intended to trade in the Building through the transfer of the share in B Ltd should have no relevance to the intention of B Ltd towards the Building: see *Commissioner of Inland Revenue v Quitsubdue Limited* [(1999) 2 HKLRD 481].

However, the Building was a capital asset. The relevant stamp duty should thus be of capital nature and prohibited from deduction pursuant to s.17(1)(c). It would be added to the cost of the Building on which IBA and CBA could be claimed (see **Example 54**).

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8.7 Contributions to retirement schemes

All contributions to non-recognised retirement schemes are not allowed. The tax treatments for contributions made to and refunds from approved retirement schemes are summarised as follows:

Section	Expenditure	Treatment of expense	Treatment of refund
17(1)(j)	Provision for initial and special contributions to RORS	Not deductible.	N/A
16A 15(1)(h)	Initial and special contributions to RORS and contributions other than regular contributions to MPFS	Deductible over 5 years in equal annual instalments, commencing from the year the contributions are made.	Refund of contributions, to the extent that the sums were previously allowed as deductions, is taxable.
16(1) and 17(1)(i) 15(1)(h)	Provision for ordinary contributions to RORS and regular contributions (mandatory or voluntary) to MPFS	Deductible, but limited to 15% of each employee's remuneration.	Refund of contributions, to the extent that the sums were previously allowed as deductions, is taxable.
16(1) and 17(1)(h) 15(1)(h)	Ordinary contributions to RORS and regular contributions to MPFS	Deductible, but limited to 15% of each employee's remuneration.	Refund of contributions, to the extent that the sums were previously allowed as deductions, is taxable.
17(1)(k)	Contributions to RORS and MPFS where a provision has previously been allowed as a deduction	Not deductible.	N/A

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Section	Expenditure	Treatment of expense	Treatment of refund
16AA	Mandatory contributions to MPFS made by a self-employed person	Deductible, if not otherwise allowable and not exceeding $15,000 (effective from 2013/14).	N/A

The IRD has issued a notice on "Tax Treatment for Defined Benefit Retirement Schemes" on 18 July 2011 detailing its revised assessing practice on "Net Total" recognised in the profit and loss account or statement of comprehensive income of an entity participating in a defined benefit retirement scheme. See **www.ird.gov.hk/eng/tax/bus_dbs.htm**.

8.8 Summary of general tax treatment for common expenses

Example 45

The following is a summary of the general tax treatment for common business expenses. It should be noted that the deductibility of an expense depends on the particular facts of each case and the application of the relevant tax rules in the circumstances.

Expenses	General tax treatment
Bad debts in respect of	
• Trade debts	• Allowable
• Money lost in a money lending business	• Allowable
• Advance/loan	• Not allowable
Embezzlement	
• By director	• Not allowable
• By employee	• Allowable
Exchange loss	
• On trade debts	• Allowable
• On bank balances/loans	• Not allowable
Ex gratia payment or compensation for loss of office	
• For past services	• Allowable
• For removing an unwanted employee	• Allowable
• For prevention of future competition	• Not allowable
Insurance	
• On fixed assets	• Allowable
• On goods or employees	• Allowable
Initial set-up cost or special payment to an occupational retirement scheme	
• Recognised scheme (RORS)	• Allowable by 5 instalments (20% per annum) in 5 years of assessment pursuant to s.16A
• Unrecognised scheme	• Not allowable

Expenses	General tax treatment
Contributions other than regular contributions to a MPFS	• Allowable by 5 instalments (20% per annum) in 5 years of assessment pursuant to s.16A
Ordinary contributions to an occupational retirement scheme	
• Recognised scheme (RORS)	• Allowable if not exceeding 15% of the total remuneration of each employee
• Unrecognised scheme	• Not allowable after 15 October 1995
Regular contributions to a MPFS	• Allowable if not exceeding 15% of the total remuneration of each employee
Legal and professional fees	
• For acquisition of capital assets	• Not allowable
• For amendment to Memorandum and Articles of Association	• Not allowable
• For arrangement of mortgage loans	• Allowable if the property is occupied or used for the production of assessable profits
• For collection of trade debts	• Allowable
• For company formation	• Not allowable
• For criminal proceeding	• Not allowable
• For increase of corporate capital	• Not allowable
• For new tenancy	• Not allowable
• For renewal of existing tenancy	• Allowable
• For protection of business asset	• Not allowable
• For tax appeals	• Not allowable
Penalty	
• For breach of the law (e.g. parking fines, late filing of tax return)	• Not allowable
• For late settlement of debts	• Allowable
• For late delivery of goods	• Allowable
Pre-commencement expenses (salaries, rent, etc)	• Allowable in the first basis period by the IRD's concession
Redundancy/severance payments	
• For closing down a line of unprofitable business	• Allowable
• On cessation of business, in accordance with the Employment Ordinance	• Allowable (see *Cosmotron Manufacturing Company Ltd*)
Removal expenses	
• For trading stock	• Allowable
• For machinery or plant	• Not allowable (but rank for depreciation allowances)

Expenses	General tax treatment
• On compulsory removal • On voluntary removal	• Allowable • Not allowable
Repairs • To make a newly acquired asset usable • To replace the entire asset • To restore the asset to a usable stage	 • Not allowable • Not allowable • Allowable

8.9 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 expenses	(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 expenses	(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 expenses	(1998) 1 HKRC 90-094
Secan Ltd / Ranon Ltd	Interest incurred during the 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

Taxpayer	Subject matter	Reference
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 Co 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

These cases are discussed in **Appendix 13**.

8.10 Taxation of financial instruments and foreign exchange differences: DIPN 42

8.10.1 Financial instruments

In November 2005, the IRD issued DIPN 42 and mentioned that the decision by the CFA in *Secan* and *Ranon* has reaffirmed the general principle that, subject to statutory modifications, in the measurement of profits/losses or the timing of assessment, the ordinary principles of commercial accounting should be followed. Thus, in deciding when and how the profit or loss derived from a financial instrument is to be recognised or measured, the accounting treatments under HKAS 39 are relevant, except where there is a specific express statutory provision or where the accounting classification and the legal classification of a financial instrument differ. HKAS 39 divides financial assets and financial liabilities into four categories, each with a different accounting treatment.

(a) **Financial assets or financial liabilities at fair value** through profit or loss: they are measured at fair value with all resulting gains and losses recognised in the income statement as and when they arise;

(b) **Held-to-maturity investments**: they are accounted for at amortised cost. Profits or losses are recognised upon impairment, derecognition or through amortisation;

(c) **Loans and receivables**: they are accounted for at amortised cost. Profits or losses are recognised upon impairment, derecognition or through amortisation; and

(d) **Available-for-sale financial assets**: they are measured at fair value with all resulting gains and losses taken to the equity account. On disposal, gains or losses previously taken to the equity account are recycled or transferred to the income statement.

It should be pointed out that the accounting treatments, by itself, cannot operate to change the character of an asset from investment to trading and vice versa. Whether the asset is of capital or revenue nature is a question of fact and degree and all the surrounding circumstances, including the accounting treatment, have to be considered. Well established tax principles like the 'badges of trade' will continue to be applicable. In deciding whether a financial instrument is a capital or trading asset, the intention at the time of acquisition of the financial instrument is always relevant.

8.10.2 Timing of assessment

The IRD has indicated in DIPN 42 (para 13) that "for financial assets or financial liabilities at fair value through profit or loss, the change in fair value is assessed or allowed when the change is taken to the profit and loss account". In other words, for profits tax purposes, the increase in fair

value of the financial assets through profit or loss would be treated as assessable profits. The IRD will not accept the argument that when the financial instruments are marked to market, the profits recognised in the income statement are unrealised profits and therefore not taxable until the profits are actually realised on disposal in later periods.

However, the COA in *Nice Cheer* has held that unrealised gains from revaluation of trading securities are not taxable, even if the gain was credited to the income statement in accordance with ordinary commercial accounting principles (see the discussion of *Nice Cheer* in **section 6.3.4** on 'Doubts on the application of *Sharkey v Wernher* principle'). Because financial instruments are, in general, like trading securities in that they are not freely exchangeable or replaceable (unlike currencies discussed in **section 8.10.8** on 'Exchange difference' below), it is arguable that the increase in fair value of financial assets are unrealised and should not be treated as assessable profits.

Example 46 (Adapted from DIPN 42, Example 1)

Co A is a securities trading company incorporated in Hong Kong. It closes its books on 31 December each year. At the beginning of 2012, it purchased by way of subscription a medium term note due 2015 issued by the treasury arm of a listed company. The note has a face value of $100,000 and an interest of 8% per annum payable at year end. Assume at the end of 2012, the fair value of the note is $110,000 indicating that the market interest rate has fallen. On 31 December 2012, in accordance with HKAS 39, the following journal entries should be made:

Account	*Debit* $	*Credit* $
Investment – medium term note	10,000	
Income statement – increase in fair value		10,000
Interest receivable	8,000	
Income statement – interest income		8,000

According to DIPN 42, the interest of $8,000 and the increase of $10,000 in fair value recognised in the income statement are accrued profits under HKAS 1. For profits tax purposes, the increase in fair value would be an assessable profit of the year of assessment 2012/13 even though Co A has not sold or disposed of the note in that year of assessment.

However, based on the above-mentioned COA decision in *Nice Cheer*, it is arguable that the unrealised gain of $10,000 from revaluation should not be assessed because the taxpayer has not actually made the profits as the securities have not yet been sold.

8.10.3 Derivates

A financial asset or financial liability at fair value through profit and loss includes a financial asset or financial liability that is held for trading. Unless a derivative is a designated and effective hedging instrument, it will be classified as held for trading. The change in fair value and gain or loss on disposal will be taxable or deductible, as the case may be.

8.10.4 Insurance of finance business

Financial instruments held by a FI or a taxpayer which carries on an insurance, money lending, securities dealing or finance business should be regarded as trading assets as they are often acquired in the course of the business with a view to resale at a profit (see *Sincere Insurance and Investment Co Ltd* (1 HKTC 602).

8.10.5 Currency forward contract

The gain or loss arising from currency forward contract acquired for the purpose of hedging the future payment of a capital asset like machinery is capital in nature. It will be taken into account in computing the depreciation allowance of the capital asset.

If the currency forward contract is acquired for the purpose of hedging the purchase of trading stock, the relevant gain or loss is revenue in nature. By the same token, the profit or loss on an interest rate contract acquired to protect future increase in interest cost of borrowing used to finance the purchase of trading stock is revenue in nature.

8.10.6 Hedge accounting

For hedge accounting, if the hedging relationship qualifies for hedge accounting under HKAS 39 and is accounted for as such, the IRD considers that the hedged item and the hedging instrument should not be considered separately because hedging is an attempt to mitigate the impact of economic risks of the hedged items. The locality of the hedging instrument should follow that of the hedged item. If the hedged item and the hedging instrument are accounted for separately in the accounts, the facts and circumstances of each individual case need to be examined to determine whether the hedging instrument is really a hedge against the hedged item. If the hedging instrument is as a matter of fact a hedge against the hedged item, the hedged item and the hedging instrument may not be considered separately. Regarding the nature of the profit or loss, capital or revenue arising from the hedging instrument, the IRD accepts that it depends on the nature of the hedged item.

8.10.7 Embedded derivatives

The IRD considers that the nature (capital or revenue) and locality of profit arising from an embedded derivative (e.g. put options on bonds, callable bonds, put options on preference shares) and its host contract should be determined on the basis that it is one single instrument, and the same tax treatment will be applied.

Example 47 (Adapted from DIPN 42, Example 3)

Co C issued 2,000 convertible bonds each having a face value of $1 million with a five-year term and an annual interest rate of 10%. At any time up to maturity, each bond can be converted into 250,000 ordinary shares. The terms of issue provide for a monetary settlement of bonds that have not been converted into ordinary shares.

For tax purposes, the convertible bonds will be treated as a debt because Co C stands in the position of debtor of a money debt and the subordinate right to convert need not be exercised. The interest will be allowed for deduction if the conditions in ss.16(1)(a),16(2)(f) and 16(2C) are satisfied.

Taking the above example further, if no interest is payable (i.e. the bond was issued at a discount), the taxpayer may be required to amortise the discount for accounting purposes. Whether the amount amortised each year would be deductible will depend on whether the IRD is willing to accept that the amount is interest for tax purposes. Refer to FAQ for DIPN 42, Question 1 for reference.

8.10.8 Exchange difference

HKAS 21 deals with the effects of changes in foreign exchange rates. Under DIPN 42, all taxpayers including FIs should treat exchange gains or losses recognised in the income statement, whether realised or not, as taxable receipts or deductible expenses. An adjustment in the tax computation on the ground that an exchange difference has not yet realised will not be accepted. The revised practice is applied by the IRD to the foreign exchange differences for the year of assessment 2005/06 and subsequent years. The exchange gains or losses of a capital nature or arising in or derived from outside Hong Kong are still neither taxable nor allowable.

The CFI considered, in *Nice Cheer*, that unlike trading securities, unrealised gains are not taxable should not apply to foreign exchange transactions. Unrealised gains in foreign exchange transactions are different from those in trading securities transactions because the underlying trading assets in foreign exchange transactions are foreign currencies, i.e. fungible assets that have a ready market and a value against the reporting currency. These gains are not 'anticipated'

but actual accrued profits valued on the year end date. Therefore, unrealised exchange gains recorded at the year end date are treated as profits and are taxable.

Example 48 (Adapted from DIPN 42, Example 12)

Co M is carrying on an import and export business in Hong Kong. It makes up its accounts to 31 December each year. On 31 October 2012, it sold goods at a price of €10,000 to a customer in Germany. The exchange rate at the time of sale was €1 = $9. A receivable of $90,000 shows up in the accounts. Assuming that as at 31 December 2012, the exchange rate is €1 = $10, the journal entries at year end will be:

Account	*Debit* $	*Credit* $
Receivable	10,000	
Income statement – exchange gain		10,000

The exchange gain of $10,000 will be assessable profit for the year of assessment 2012/13.

9 Depreciation allowances

Topic highlights

Depreciation allowances are available for capital expenditures incurred on (i) industrial buildings or structures; (ii) commercial buildings or structures; and (iii) machinery or plant.

Depreciation allowances are available for capital expenditure incurred on:

(a) industrial buildings or structures;

(b) commercial buildings or structures (buildings or structures other than an industrial building or structure); and

(c) machinery or plant (other than assets qualifying for deductions as PFA and EPFs; and assets used for R&D purposes).

The depreciation allowances on these fixed assets are as follows:

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

DIPN 2 provides guidance on industrial building allowances and commercial building allowances; and DIPN 7 provides guidance on depreciation allowances for machinery and plant.

9.1 Basis period under s.40(1)

When a period forms part of the basis period for more than one year of assessment (i.e. there is an overlapping of basis periods) or a period does not fall within the basis period for any year of assessment (i.e. there is gap between basis periods), for depreciation allowances purposes, the basis period is determined as follows:

(a) Capital expenditure incurred in the **overlapping** basis period for two years of assessment is treated as incurred in the basis period of the **first** year of assessment.

(b) Capital expenditure incurred in the **gap** between the basis periods for two years of assessment is treated as incurred in the basis period of the **later** year of assessment.

See **Example 58** and **section 11** for a discussion on basis period.

9.2 Industrial building allowance ('IBA')

Key terms

An **'industrial building or structure'** means any building or structure, or part thereof, which is used in a **qualifying trade**. 'Structure' covers artificial works not commonly regarded as buildings, such as walls, bridges, dams, roads, fish ponds, boreholes and wells, sewers, water mains, tunnel linings, wharves and railway sidings.

9.2.1 Qualifying trade

Pursuant to s.40(1), qualifying trade means:

(a) a trade carried on in a mill, factory or similar premises;

(b) a transport, tunnel, dock, water, gas or electricity undertaking or a public telephonic or telegraphic service;

(c) a trade consisting of the manufacture of goods or materials or the subjection of goods or materials to any process;

(d) a trade consisting of the storage of goods or materials:

  (i) which are to be used in the manufacture of other goods or materials;

  (ii) which are to be subjected in the course of a trade to any process; or

  (iii) on their arrival into Hong Kong;

(e) a farming business; or

(f) for the purposes of R&D related to any trade, profession or business.

There is no provision for making an allowance where only part of a trade qualifies. In *Tai On Machinery Works Ltd* [(1969) 1 HKTC 411] , it was held that the packing of goods of a retail distributor was only part of the taxpayer's trade and no industrial building allowance was available as the taxpayer's trade was not for the manufacturing or processing of goods or materials.

In *Aberdeen Restaurant Enterprises Ltd* [(1989) 2 HKTC 330], it was held that a restaurant was not an 'industrial building or structure' where 'goods or materials are subjected to a process'. 'Process' connotes a substantial measure of uniformity of treatment or system of treatment. Although cooking of food is subjecting it to a process, the process is only incidental to the service business of running a restaurant.

For a trade to qualify as a trade of storage, mere storage of a trader's or manufacturer's goods is not enough. In *Tai On Machinery Works Ltd* [(1969) 1 HKTC 411], it was held that a trade of importing leather goods for sale in Hong Kong did not qualify. The trader's goods were stored pending sale; its trade was not a trade of storage.

9.2.2 Qualifying building or structure

Section 40(1) provides that once a qualifying trade is established, all buildings or sturctures (or part) used in that trade qualify, except:

(a) dwelling housess (other than for housing manual workers);

(b) retail shops;

(c) showrooms;

(d) hotels; and

(e) offices (except design office: *CIR v Lambhill Ironworks Ltd* (1950)).

If part of a building or structure is not used for a qualifying purpose (e.g. showroom), provided that the capital expenditure incurred on that part of the building or structure does not exceed 10% of the whole expenditure, the whole building or structure will be regarded as falling within the definition. Otherwise, an apportionment of the capital expenditure on the building or structure is required. A commercial building allowance will be granted for the part of the building or structure not used as an industrial building or structure.

9.2.3 Qualifying expenditure

In order to qualify for the allowance, the expenditure must be capital expenditure incurred on the construction of a building or structure, which includes:

(a) interest paid and commitment fees incurred in respect of a loan made for the sole purpose of financing the provision of an industrial building or structure (see *Wharf Propperties Limited v CIR* (1997) 1 HKRC 90-085); and

(b) expenditure incurred on site investigation, on ordinary work done in preparation for the laying of foundations, or on the laying of drains, sewers and water mains for a building;

and excludes expenditure reimbursed by grant, subsidy or similar financial assistance; and expenditure incurred on:

(a) the acquisition of land, or of rights in or over land: s.40(3);

(b) demolishing the existing building on the land; and

(c) preparation and levelling of the land.

Capital expenditure incurred prior to commencement of a trade, profession or business is treated as if it was incurred on the day the trade, profession or business commences: s.40(2).

9.2.4 Qualifying person

Industrial building allowance is granted to a person who incurs the capital expenditure on the construction of an industrial building or structure and/or is entitled to the relevant interest in relation to the qualifying expenditure and uses the building or structure for the purposes of his trade, profession or business to produce assessable profits (s.34).

9.2.5 Initial allowance under s.34(1)

An initial allowance of 20% of the qualifying expenditure is granted to:

(a) a person who has incurred the cost of construction; or

(b) a purchaser who has purchased an unused building or structure and brought it into use.

Initial allowance is granted for the year of assessment in the basis period for which the expenditure is incurred, even though the building or structure is not yet in use as an industrial building or structure (s.34(1)). If the building or structure does not qualify as an industrial building or structure when it is first brought into use, any initial allowance already given will be withdrawn by an additional assessment (s.34(1) proviso (b)).

9.2.6 Annual allowance under s.34(2)

An annual allowance is granted to a person who has a 'relevant interest' in relation to the qualifying expenditure incurred on the construction of the building or structure. Under s.40(1), 'relevant interest' means the interest in a building or structure to which the person who incurred the expenditure was entitled when he incurred it. To qualify for the annual allowance, the building or structure must be in use as an industrial building or structure at the end of the basis period (s.34(2)(a)).

Before 1965/66, annual allowance was 2% of the qualifying expenditure. From 1965/66 onwards, annual allowance is increased to 4%.

9.2.7 Balancing charge or balancing allowance under s.35

Pursuant to s.35, a **balancing adjustmen**t (balancing charge or balancing allowance) in respect of a building or structure may arise in the following circumstances (s.35(1)):

(a) the relevant interest in the building or structure is sold; or

(b) if it is a leasehold interest, the lease comes to an end except where the lessee acquires the reversionary interest (e.g. the lessee purchases the property from the lessor), the lessee remains in possession, an old lease is extended, or a new lease is granted (s.35A); or

(c) the building or structure is demolished or destroyed, or ceases altogether to be used; and

(d) the building or structure has been a commercial or an industrial building or structure at any time before the occurrence of such event.

A balance is computed between the residue of expenditure immediately before any of the above events and the sale price, insurance, salvage, or compensation moneys (if any).

If the residue of expenditure exceeds the sale price, insurance, salvage or compensation moneys the difference is allowed as a **balancing allowance** (s.35(2)(a)). However, no balancing allowance will be made where:

(a) the building or structure is demolished for purposes unconnected with or not in the ordinary course of conduct of the trade, profession or business (s.35(2)(b)(ii)). For example, a balancing allowance can be given where a factory is demolished to build a better one for the same trade but cannot be given if it is redeveloped for sale.

(b) the building or structure did not qualify as a commercial or an industrial building or structure immediately before the occurrence of such event (s.35(2)(b)(i)).

If the sale price, insurance, salvage, or compensation moneys exceed the residue of expenditure, the difference is taxable as a **balancing charge** (s.35(3)(a)). However, the balancing charge shall not exceed the total amount of allowances granted to the person under ss.33A and 34 (s.35(3)(b)).

Pursuant to s.40, **'residue of expenditure'**, in relation to an industrial building or structure, means the amount of the capital expenditure incurred on the construction of the building or structure, reduced by the amount of:

(a) any initial allowance made under s.34(1);

(b) any annual allowance made under s.33A or s.34(2);

(c) any balancing allowance made under s.35; and

increased by any balancing charge made under s.35.

For any year of assessment that the building or structure is not used as a commercial or an industrial building or structure at the end of the basis period, a so-called **notional allowance** at the same rate of the annual allowance (2% or 4%) on the qualifying expenditure is to be written off in computing the amount of the residue of expenditure of the building or structure: s.40(1).

9.2.8 Purchase of Used building or structure

If there is a change of relevant interest in an industrial building or structure, the purchaser of the used industrial building or structure can claim an annual allowance calculated as follows:

(a) **For a building or structure used before the basis period for 1965/66:**

$$\text{Annual allowance} = \text{Residue of expenditure after sale} \times \frac{2}{\text{Number of years from the year of assessment in the basis period of which the sale takes place to the 50th year after the year of assessment in which the building or structure was first used (year of } 1^{st} \text{ use)}}$$

(b) **For a building first used during or after the basis period for 1965/66:**

$$\text{Annual allowance} = \text{Residue of expenditure after sale} \times \frac{1}{\text{Number of years from the year of assessment in the basis period of which the sale takes place to the 25th year after the year of assessment in which the building or structure was first used (year of } 1^{st} \text{ use)}}$$

The amount of annual allowance for any year of assessment should not exceed the residue of expenditure at the end of the basis period for that year of assessment (s.33A(3)).

Residue of expenditure after sale is calculated as follows:

Qualifying expenditure			A
Less:	Initial allowance	(B)	
	Annual allowance	(C)	
	Notional allowance	(D)	(E)
Residue of expenditure before sale			F
Add:	Balancing charge **or**		G
Less:	Balancing allowance		(G)
Residue of expenditure after sale			H

Example 49 (Adapted from DIPN 2, Example 2)

A constructed a factory at a cost of $2 million. It was completed and brought into use in July 2008. The building contract provided that instalments should be paid monthly and $500,000 was due and paid before 31 March 2008. The balance was paid during the year ended 31 March 2009. A carries on a qualifying trade, and has his accounts prepared annually to 31 March.

The factory was sold to B in July 2011 for $5 million (including the value of the site). The site value is estimated at $2.5 million. B carries on a qualifying trade and closes accounts on 30 June each year.

A	$	$
Cost		2,000,000
2007/08		
Initial allowance ($0.5m × 20%)		(100,000)
(No annual allowance as building not in use at 31/3/2008)		(1,900,000)
2008/09		
Initial allowance ($1.5m × 20%)	300,000	
Annual allowance ($2m × 4%)	80,000	(380,000)
		1,520,000

2009/10 & 2010/11	
Annual allowance ($80,000 × 2)	(160,000)
Residue of expenditure before sale	1,360,000
2011/12	
Sale proceeds ($5m – $2.5m)	(2,500,000)
Excess	1,140,000
Balancing charge, limited to allowances given	640,000

B	
Residue of expenditure before sale	1,360,000
Add: Balancing charge	640,000
Residue of expenditure after sale	2,000,000

Year of first use	2008/09
Year of assessment in the basis period of which the sale takes place	2012/13
25th year from the year of first use	2033/34
No. of years from 2012/13 to 2033/34	22 (inclusive)

Annual allowance to B = $2m/22 = $90,909

Final year of allowance 2033/34 (Annual allowance = $90,911)

Neither A nor B receives annual allowance in respect of 2011/12. However, no notional allowance is written off, as the building was an industrial building throughout.

Example 50 (Adapted from DIPN 2, Example 3)

C constructed a building at a cost of $800,000 in September 2007 and used it as a workshop in his existing manufacturing trade. He makes up accounts to 31 December.

In January 2010, he sold the building for $700,000 to D, who used it for a time as a showroom in his existing manufacturing business. In May 2012, D converted it to a workshop again. D makes up accounts to 31 March. (Site values are excluded throughout.)

C	$	$
Cost		800,000
2007/08		
Initial allowance ($800,000 × 20%)	(160,000)	
Annual allowance ($800,000 × 4%)	(32,000)	(192,000)
		608,000
2008/09 & 2009/10		
Annual allowance ($32,000 × 2)		(64,000)
Residue of expenditure before sale		544,000
2010/11		
Sale proceeds		(700,000)
Balancing charge		(156,000)
D		
Residue of expenditure before sale		544,000
Add: Balancing charge		156,000
Residue of expenditure after sale		700,000

Year of first use	2007/08
Year of assessment in the basis period of which the sale takes place	2009/10
25th year from the year of first use	2032/33
No. of years from 2009/10 to 2032/33	24 (inclusive)

Had D used the building for a qualifying purpose throughout, his first year of allowance would have been 2009/10, and the allowance would be $700,000/24 = $29,167.

D, however, does not qualify for industrial building allowances until 2012/13. So no one gets an allowance for 2010/11 and 2011/12. Notional allowances must therefore be written off for 2010/11 and 2011/12 at an amount of 4% of the capital expenditure. Notional allowance need not be written off for 2009/10 because C received an annual allowance for that year.

	$
Residue of expenditure after sale	700,000
2010/11 & 2011/12 Notional allowance ($800,000 × 4% × 2)	(64,000)
Total industrial building allowances available to D	636,000
Annual allowance from 2012/13 onwards (22 years)	29,167
Final year of allowance 2033/34	23,493

D would get commercial building allowance of $29,167 (calculated using the same formula above) for each of the years of assessment 2009/10, 2010/11 and 2011/12. This has no effect on the industrial building allowance.

9.2.9 Purchase of Unused building or structure under s.35B

Pursuant to s.35B(a), no initial allowance is available to the vendor. Any initial allowance already given will be withdrawn by an additional assessment. Under s.35B(b), the purchaser is deemed to have incurred capital expenditure and is entitled to initial allowance and annual allowance.

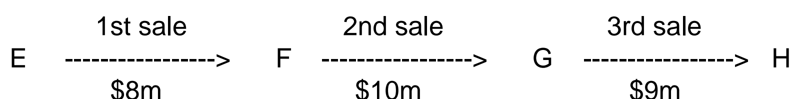
If the building is purchased from a property developer, the deemed capital expenditure is equal to the net price (excluding the price of the land) paid by the purchaser (s.35B(b)(i)). If the building is sold more than once before it is used, only the last purchaser is entitled to the allowance. The deemed capital expenditure is equal to the lesser of the net price paid on the first sale and the net price paid by the last purchaser (s.35B(b) proviso (a)).

If the building is purchased from a person other than a property developer, the deemed capital expenditure is equal to the lesser of the actual cost of construction and the net price paid by the purchaser (s.35B(b)(ii)). If the building is sold more than once before it is used, only the last purchaser is entitled to the allowance. The deemed capital expenditure is equal to the lesser of the actual cost of construction and the net price paid by the last purchaser (s.35B(b) proviso (b)).

The deemed capital expenditure will be ascertained as follows:

	Being the first sale of the unused building or structure:	Not being the first sale of the unused building or structure:
Vendor is a property developer	Deemed capital expenditure = Net price paid by the purchaser	Deemed capital expenditure = Lesser of the net price paid on the first sale and on the last sale
Vendor is a person other than a property developer	Deemed capital expenditure = Lesser of the cost of construction and the net price paid by the purchaser	Deemed capital expenditure = Lesser of the cost of construction and the net price paid on the last sale

Example 51



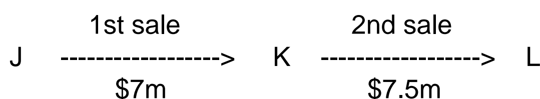
Cost of construction $5m

F purchased an unused building from E for $8 million and sold it to G for $10 million. G subsequently sold the unused building to H for $9 million. H uses the building in its manufacturing business. The cost of construction to E is $5 million. H is entitled to claim industrial building allowance based on the deemed capital expenditure calculated as follows:

(a) If E is a property developer, deemed capital expenditure is the lesser of $8 million and $9 million, i.e. $8 million.

(b) If E is not a property developer, deemed capital expenditure is the lesser of $5 million and $9 million, i.e. $5 million.

Example 52



Cost of construction $8m

K purchased an unused building from J for $7 million and sold it to L for $7.5 million. L uses the building in its manufacturing business. The cost of construction to J is $8 million. L is entitled to claim industrial building allowance based on the deemed capital expenditure calculated as follows:

(a) If J is a property developer, deemed capital expenditure is the lesser of $7 million and $7.5 million, i.e. $7 million.

(b) If J is not a property developer, deemed capital expenditure is the lesser of $8 million and $7.5 million, i.e. $7.5 million.

9.3 Commercial building allowance ('CBA')

Under s.40(1), a **'commercial building or structure'** means any building or structure (or part) which is not an industrial building or structure, used by a person entitled to the relevant interest for the purposes of his trade, profession, or business. Up to the year of assessment 1997/98, a rebuilding allowance of 2% (3/4% up to 1989/90) of the cost of construction was granted to the person who had a relevant interest in the building or structure at the end of the basis period for the year of assessment. With effect from 1 April 1998, the rebuilding allowance is replaced by an annual allowance under s.33A. There are also new provisions for balancing adjustments.

9.3.1 Qualifying expenditure

Qualifying expenditure is any capital expenditure incurred on the construction of a building or structure. This is calculated in the same way as that for industrial building or structure. However, s.35B, which is concerned with industrial building or structure bought unused, has no application to a commercial building or structure.

9.3.2 Qualifying person

Commercial building allowance is granted to a person who is entitled to the relevant interest in relation to the qualifying expenditure and uses the building or structure for the purposes of his trade, profession or business to produce assessable profits (s.33A).

9.3.3 Annual allowance under s.33A

Annual allowance is granted for every year of assessment in which the building or structure is in use as a commercial building or structure and the relevant interest is not sold at the end of the basis period. The annual allowance is 4% of the qualifying expenditure.

Where the commercial building or structure is used before the year of assessment 1998/99, the building or structure is deemed to be first used in the year of assessment 1998/99. The qualifying expenditure as at the beginning of 1998/99 is deemed to be the cost of construction less the rebuilding allowance that would have been granted in all prior years before 1998/99. The annual allowance for the year of assessment 1998/99 and thereafter are computed based on the deemed qualifying expenditure (s.33A(4)).

9.3.4 Balancing charge or balancing allowance under s.35

Up to the year of assessment 1997/98, there was no balancing adjustment upon sale or disposal of a commercial building or structure. Starting from the year of assessment 1998/99, on sale or disposal of a building or structure while it is a commercial building or structure, balancing adjustment has to be made.

With effect from 2004/2005, the balancing adjustment with regard to industrial and commercial buildings and/or structures has been consolidated into the new s.35. Details of the provision are discussed in **section 9.2.7** above.

9.3.5 Purchase of used building or structure

Where the relevant interest in relation to any expenditure is sold while the building or structure is a commercial building or structure, the annual allowance to the purchaser shall be computed as follows (s.33A(2)):

$$\text{Annual allowance} = \text{Residue of expenditure after sale} \times \frac{1}{\text{Number of years from the year of assessment in the basis period of which the sale takes place to the 25th year after the year of assessment in which the building or structure was first used (year of } 1^{st} \text{ use)*}}$$

* Where before 1998/99, a person was entitled to the relevant interest in a commercial building or structure, 1998/99 is deemed to be the year of assessment in which the building or structure was first used.

The amount of annual allowance for any year of assessment should not exceed the residue of expenditure at the end of the basis period for that year of assessment (s.33A(3)).

Example 53 (Adapted from DIPN 2, Examples 5 and 6)

Company P purchased a shop from a developer at a price of $6 million in November 1988. The cost of construction is ascertained to be $2 million. Company P makes up accounts to 31 March each year.

In March 2013, Company P sold the shop to Company Q for (a) $4 million; or (b) $720,000 (site values are excluded throughout). Company Q makes up accounts to 31 March each year.

Company P	$	$
Cost of construction		2,000,000
1988/89 to 1989/90		
Rebuilding allowance ($2m × ¾% × 2)	30,000	
1990/91 to 1997/98		
Rebuilding allowance ($2m × 2% × 8)	320,000	(350,000)
Residue under s.33A(4)(a) (deemed qualifying expenditure)		1,650,000

1998/99 to 2011/12	
Annual allowance ($1.65m × 4% × 14)	(924,000)
Residue of expenditure	(792,000)

(a) Shop sold for $4 million

Company P

2012/13	
Residue of expenditure before sale	726,000
Sale proceeds	(4,000,000)
Excess	3,274,000
Balancing charge restricted to allowances made to Co P in 1998/99 to 2011/12	924,000

Company Q

2012/13	
Residue of expenditure before sale	726,000
Add: Balancing charge	924,000
Residue of expenditure after sale	1,650,000
Year of first use **(deemed)**	1998/99
Year of assessment in the basis period of which the sale takes place	2012/13
25th year from the year of first use	2023/24
No. of years from 2012/13 to 2023/24	12

Annual allowance to Company Q = $1.65m/12 = $137,500

(b) Shop sold for $840,000

Company P

2012/13	
Residue of expenditure before sale	726,000
Sale proceeds	(720,000)
Balancing allowance	6,000

Company Q

2012/13	
Residue of expenditure before sale	726,000
Less: Balancing allowance	(6,000)
Residue of expenditure after sale	720,000
Year of first use **(deemed)**	1998/99
Year of assessment in the basis period of which the sale takes place	2012/13
25th year from the year of first use	2023/24
No. of years from 2012/13 to 2023/24	12

Annual allowance to Company Q = $720,000/12 = $60,000

Example 54

Refer to the facts in Example 16. Discuss whether B Ltd is entitled to a deduction of industrial or commercial building allowance in respect of the Building for the year of assessment 2012/13:

Solution

B Ltd acquired the Building, being a new industrial building, for letting to a manufacturing company. Thus, by virtue of s.34, B Ltd was entitled to IBA (including initial allowance and annual allowance) in respect of the Building. As the Building was purchased from a property developer, for the purpose of computing the IBA, B Ltd was deemed to have incurred capital expenditure in relation to the Building equal to the net price paid by it pursuant to s.35B(b)(i).

The Building was let to a manufacturing company (a qualifying trade) which used 70% of the Building as a factory (a qualifying building) and 30% as office and showroom (non-qualifying buildings). As the non-qualifying part exceeds one-tenth of the Building, by virtue of s.40 and its provisos, only 70% of the net price should qualify for IBA. However, B Ltd is entitled to claim CBA in respect of the remaining 30% of the net price pursuant to s.33A.

In view of the foregoing, the IBA to which B Ltd was entitled for the year of assessment 2012/13 should be computed as follows:

Qualifying capital expenditure = Net price paid ($200 million x 60/160) × 70% = $52.5 million

Initial allowance = $52.5 million × 20% = $10.5 million

Annual allowance = $52.5 million × 4% = $2.1 million

B Ltd was also entitled to CBA for the year of assessment 2012/13, computed as follows:

Qualifying capital expenditure = Cost of construction $50m × 30% = $15 million

Annual allowance = $15 million × 4% = $0.6 million

HKICPA December 2011 (Amended)

Self-test question 6

A Ltd is a garment manufacturer established in 1980. It makes up accounts to 31 December each year. On 1 January 2010, it purchased an old factory building, demolished it, prepared the site and constructed a new 8-storey building. All floors of the new building are of equal area. The building was completed on 28 February 2012, on which date A Ltd sold it to B Ltd for a total consideration of $15 million (excluding the value of the land). A Ltd claimed and the IRD accepted that the profit from the sale of the building was a capital gain.

During the period from 1 January 2010 to 29 February 2012, A Ltd incurred the following expenditure:

	$
Cost of site including old factory building	8,000,000
Compensation paid to old tenant	950,000
Architect fees	200,000
Demolition work	400,000
Preparation and levelling of land	350,000
Construction cost	9,500,000
Interest on a loan of $10 million (used to finance the development cost)	800,000

B Ltd is also a garment manufacturer and it makes up accounts to 31 March each year. The building was occupied as from 1 May 2012 and used as follows:

Ground Floor	Office and showroom
1st Floor	Workers canteen and caretakers' quarters
2nd to 4th Floors	Manufacturing operation
5th to 7th Floors	Let for rental income to C Ltd, whose business was to import rattan goods manufactured in the Mainland and sell them in Hong Kong. (The rattan goods were stored on the premises pending sale, and were sorted and repacked. Repairs as were necessary to remedy defects were also carried out.)

Required:

(a) For tax purposes, explain the deduction or allowance that A Ltd is entitled to for the expenditure it incurred.

(b) Compute, with explanations, the tax allowances that B Ltd is entitled to for the years of assessment 2011/12 and 2012/13.

HKICPA February 2007 (Amended)
(The answer is at the end of the chapter)

9.4 Depreciation allowances on machinery or plant

Machinery or plant attracts much more generous depreciation allowances than buildings. It is therefore important to distinguish between machinery or plant and building, and to identify what assets qualify as machinery or plant and what assets are excluded.

Implements, utensils and articles under the second part of IRR 2 (including belting, crockery and cutlery, kitchen utensils, linen, loose tools, soft furnishings, surgical and dental instruments, tubes for X-ray and infra-red machines) are specifically excluded from the definition of machinery or plant. Instead, capital expenditures on such assets are allowed on a replacement basis under s.16(1)(f), i.e. initial purchase cost is neither deductible nor ranking for depreciation allowance while replacement cost is fully allowable.

Capital expenditures on assets used for R&D purposes are allowed as deductions under s.16B.

From the year of assessment commencing 1 April 1998, capital expenditures on PFAs (e.g. manufacturing equipment, computer) or the written down value of PFAs brought forward from 1997/98 are allowed as deductions under s.16G.

Capital expenditures on EPM and EPIs incurred on or after 27 June 2008, and capital expenditure on EFVs incurred on or after 18 June 2010 are allowed as deductions under ss.16H to K in the year of purchase.

9.4.1 Meaning of 'machinery or plant'

'Machinery' and 'plant' are not defined in the IRO. Section 40(1) provides, *inter alia*, that 'capital expenditure on the provision of machinery or plant' includes capital expenditure on alterations to an existing building incidental to the installation of that machinery or plant.

IRR 2 provides that the expression 'machinery or plant' shall include or be deemed to include the items specified in the second column of the First Part of the Table annexed to this rule. The Table lists specific items which are machinery or plant (e.g. domestic appliances) with rates of annual allowances (10%, 20% or 30%) prescribed by the Board of Inland Revenue. Some of the items in the Table (e.g. manufacturing equipment, computer) are to be allowed as PFAs from the year of assessment commencing 1 April 1998 under s.16G. The Table also deems certain items to be 'implement, utensil and article' to be allowed on a replacement basis under s.16(1)(f); and 'wharves' to be not machinery or plant. Where depreciation allowance is claimed in respect of expenditure on an item not specifically listed in IRR 2, it is necessary to consider whether the item falls within the general description of 'machinery or plant'.

In general, there is little argument on the meaning of machinery in contrast with the meaning of plant. In *Yarmouth v France* [(1887) 19 QBD 647], it was held that plant includes *"whatever apparatus used by a businessman for carrying on his business, not his stock-in-trade which he buys or makes for sale, but all goods and chattels, fixed or movable, live or dead, which he keeps for permanent employment in his business".*

In *IRC v Scottish & Newcastle Breweries* [(1982) 2 All ER 230], it was held that a hotel business involved not only the provision of accommodation but also the provision of the right ambience (atmosphere) to make the interior attractive to customers. The light fittings, tapestries, sculptures and murals were therefore held as 'plant' as they were specifically chosen to create the

atmosphere of the hotel and therefore fulfilled an important function as apparatus in that particular trade. Lord Wilberforce stated as follows:

> *"It naturally happens that as case follows case, and one extension leads to another, the meaning of the word 'plant' diverges from its natural or dictionary meaning ... no ordinary man, literate or semi-literate, would think that a horse, a swimming pool, movable partitions or even a dry dock was plant, yet each of these has been held to be so; so why not such equally improbable items as murals or tapestries or chandeliers."*

It is often difficult to distinguish plant from a building or part of a building. The general rule is as follows:

(a) Plant refers to the **tools or apparatus** with which the business is carried on (the **functional test**).

(b) Building refers to the **environment or a general setting** in which the business is carried on (the **setting test**).

The question to ask is whether the feature is something used in the business or something within which the business is carried out. Plant is used in the business while the business is carried on within the building.

To qualify as plant, the feature needs to perform a vital or specific function for the purposes of the trade, profession or business. The walls of a dry dock, even though they provide the setting and form an integral part of the building, are features with which the business is conducted.

In *CIR v Aberdeen Restaurant Enterprises Ltd* [(1989) 1 HKRC 90-009], although the restaurant boat was held to be neither an industrial building nor a plant, the bridges enabling customers to board the restaurant were held to be plant and therefore ranked for depreciation allowances.

In *D36/93*, the taxpayer purchased the roof of a building completed with a neon advertising sign erected thereon and he claimed depreciation allowance on the entire roof including the neon advertising sign on the grounds that the whole roof constituted machinery or plant. However, the BOR held that only the capital cost of the neon advertising sign was plant eligible for depreciation allowance and not the entire cost of the roof.

On the basis of the principles established by a number of court cases, Appendices B and C of DIPN 7 give the IRD's views on items which are recognised as 'machinery or plant'; and items which are not so recognised.

9.4.2 Qualifying person

Depreciation allowances for machinery or plant are available to:

(a) persons carrying on a trade, profession or business, and the machinery or plant is used in the production of assessable profits (ss.18F and 19E).

(b) persons chargeable to salaries tax, and the use of machinery or plant is essential for the production of assessable income (ss.12(1)(b) and (5)).

9.4.3 Qualifying expenditure

Capital expenditure, as defined under s.40(1),

(a) includes purchase price, freight, insurance, interest paid and commitment fees incurred in respect of a loan made for the sole purpose of financing the provision of machinery or plant, delivery and installation costs, and capital expenditure on alterations to an existing building incidental to the installation of that machinery or plant; but

(b) excludes expenditure which is reimbursed by way of or is attributable to any grant, subsidy or similar financial assistance, and those allowed under ss.16B(1)(b), 16F, 16G and 16J(2) and (3), and those on implements, utensils and articles.

9.4.4 Pooling system

In general, depreciation allowances on machinery or plant are computed under the pooling system. The pooling system was introduced from the year of assessment 1980/81 for computing the annual allowance for machinery or plant. The system is devised to avoid the frequent computation of balancing allowances or charges by creating a 'pool' of capital expenditure on machinery or plant which qualifies for an annual allowance at the same rate.

Initial allowance under s.39B(1)

An initial allowance of 60% is granted to the person who has incurred capital expenditure on the provision of machinery or plant, not being an expenditure related to machinery or plant used for R&D (allowable under s.16B), a PFA (allowable under s.16G), or EPFs (allowable under ss.16H to K), for the year of assessment in which the expenditure was incurred.

Provided that the machinery or plant is acquired or the capital expenditure is incurred with an intention to be used in the production of assessable profits/income and is so used in later years, there is no requirement for the machinery or plant to be in use in the basis period for the granting of the initial allowance.

Annual allowance under s.39B(2)

The annual allowance is given at the appropriate rate (10%, 20% or 30%) on the '**reducing value**' of the pool, which is ascertained as follows:

Opening reducing value (written down value ('WDV')) b/f		A
Add: Additions	B1	
Less: Initial allowance at 60%	(B2)	B
Hire-purchased assets (reducing value) (ownership passed in the preceding year)		C
Private assets brought into business use (original cost less notional allowance under s.39B(6))		D
Succeeded assets (reducing value under s.39B(7))		E
		F
Less: Sale, insurance, salvage or compensation moneys (limited to cost/deemed cost)		(G)
Assets taken from the pool for private use (market value)		(H)
Reducing value before annual allowance		I
Less: Annual allowance (10%, 20% or 30%) on I		(J)
Closing reducing value (WDV) c/f		K

Balancing charge or balancing allowance under s.39D

When the disposal proceeds (limited to cost) exceed the reducing value of the pool, a balancing charge arises and is taxable. When the reducing value of the pool exceeds the disposal proceeds (limited to cost), a balancing allowance arises. A balancing allowance is an allowable deduction, but can only be given on the cessation of the trade, profession or business.

9.4.5 Non-pooling system

The pooling system shall not apply in the following circumstances:

(a) An asset is acquired under a hire purchase agreement (s.39C(1)(a)).
(b) An asset is not wholly and exclusively for business use (s.39C(1)(b) and (3)).
(c) Application of the pooling system is impracticable or inequitable (s.36A(2)).

When the pooling system is not applicable, the old rules apply, i.e. depreciation allowance is calculated for each asset separately. The types of allowances are the same as those under the pooling system, and are calculated in the same way, with the following exceptions:

(a) Annual allowance is given at the appropriate rate (10%, 20% or 30%) on the 'reducing value' of the asset each year when it is **owned and in use** at the end of the basis period (s.37(2)).

(b) A balancing charge or balancing allowance arises when an asset is sold, destroyed or permanently put of use; either when the business is still carried on or at the time the business ceases (s.38(1)).

9.4.6 Assets acquired under hire purchase: s.37A

'Hire-purchase agreement' as defined in s.2 means an agreement for the bailment of goods under which the bailee may buy the goods, or under which the property in the goods will or may pass to the bailee.

'Lease', in relation to any machinery or plant, includes:

(a) any arrangement under which a right to use the machinery or plant is granted by the owner of the machinery or plant to another person; and

(b) any arrangement under which a right to use the machinery or plant, being a right derived directly or indirectly from a right referred to above, is granted by a person to another person,

but does not include a hire-purchase agreement or a conditional sale agreement unless, in the opinion of the Commissioner, the right under the agreement to purchase or obtain the property in the goods would reasonably be expected not to be exercised (s.2).

In practice, a lease that provides an option to the lessee to acquire the asset upon the expiry of the lease would be regarded as a hire purchase agreement.

Initial allowance

Initial allowance is granted at 60% on the capital portion of instalments made during the basis period: s.37A(1A).

Annual allowance

Annual allowance is granted at the appropriate rate (10%, 20% or 30%) on the reducing value (cash price minus initial allowance and annual allowance) of the asset in use at the end of the basis period: ss.37A(2) and (3).

For assets not wholly and exclusively used for business purpose, both the initial allowance and annual allowance are limited to the portion for business use.

After the lessee exercised the option to acquire the leased asset, the reducing value will be transferred to the relevant pool in the following year of assessment: s.39C(2).

Balancing charge or balancing allowance

When the asset under hire purchase is being sold, destroyed, or put out of use, a balancing charge or a balancing allowance will be recognised: s.38(1). When the disposal proceeds (limited to cost) exceed the reducing value of the pool, a balancing charge arises and is taxable. When the reducing value of the pool exceeds the disposal proceeds (limited to cost), a balancing allowance arises.

Example 55

Best Ltd carries on a printing business with annual accounts made up to 31 March. On 1 September 2010, Best Ltd entered into a hire-purchase agreement to acquire a printing machine. The cash price of the machine was $240,000 and Best Ltd agreed to pay $312,000 by 24 monthly instalments commencing 1 September 2010. The instalments are $13,000 per month. The capital portion is $10,000 per month. The interest element of $3,000 per month would be allowed as a revenue expense.

Best Ltd's depreciation allowance schedule for the machine is as follows:

	20%	*Allowances*
	$	$
Cash price 1/9/2010	240,000	
2010/11		
Initial allowance ($10,000 × 7 × 60%)	(42,000)	42,000
	198,000	
Annual allowance	(39,600)	39,600
WDV c/f	158,400	81,600
2011/12		
Initial allowance ($10,000 × 12 × 60%)	(72,000)	72,000
	86,400	
Annual allowance	(17,280)	17,280
WDV c/f	69,120	89,280
2012/13		
Initial allowance ($10,000 × 5 × 60%)	(30,000)	30,000
	39,120	
Annual allowance	(7,824)	7,824
WDV c/f	31,296	37,824

9.4.7 Assets used partly for the purpose of trade

When an asset is not used wholly for producing profits, the depreciation allowance due on the asset shall continue to be calculated as under the non-pooling system (s.39C(1)(b)). The depreciation allowance is then apportioned to identify the allowable portion (s.39A).

Even if non-business usage ceases and the asset is subsequently wholly for business use, separate calculations of deprecation allowance must continue as any balancing charge on disposal must be apportioned to take into account the earlier non-business usage.

Example 56

Mr. X is the owner of a trading company which makes up accounts to 31 December. Mr. X purchased a motor car in March 2010 at a cost of $100,000. The car was used partly for the company's business and partly for Mr. X's private purposes. It was agreed that the extent of non-business use was 40% in 2010 and 50% thereafter. The car was sold in May 2012 for $50,000.

Calculation of depreciation allowances for Trading Company

	Motor van 30%		Allowances
	$		$
Cost	100,000		
Initial allowance at 60% (2010/11)	60,000)	× 0.6	36,000
	40,000		
Annual allowance (2010/11)	(12,000)	× 0.6	7,200
	28,000		
Annual allowance (2011/12)	(8,400)	× 0.5	4,200
	19,600		47,400
Sale proceeds	(50,000)		
Balancing charge (2012/13)	30,400		

Balancing charge is restricted to the portion attributable to allowances previously granted, calculated as:

$$\$30,400 \times \frac{47,400}{100,000 - 19,600} = \$\ 17,922$$

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9.4.8 Assets brought into business after non-business use: ss.37(2A) & 39B(6)

When an asset previously acquired for private use is subsequently transferred to the relevant pool for business purposes, no initial allowance is granted as no capital expenditure is incurred. Annual allowance is to be computed based on the written down value of the asset added to the pool (i.e. cost of the asset less notional amount of annual allowances for the period of non-business use).

9.4.9 Assets removed from the pool for non-business use: s.39C(3)

When an asset used wholly for the purpose of earning assessable income/profits ceases to be so used (e.g. transferred to private use), the reducing value of the expenditure which is equal to the estimated open market value must be excluded from the pool. If the asset continues to be partly for business use, annual allowance is separately calculated and apportioned.

9.4.10 Miscellaneous provisions

Assets succeeded from a trade without purchase

There is no balancing adjustment for the transferor (s.39D(3)). The reducing value brought forward from the business to be succeeded is transferred to the successor (ss.37(4) and 39B(7)).

There is no initial allowance for the successor as he has not incurred any capital expenditure for the inherited assets (ss.37(5) and 39B(8)). Annual allowance is to be computed based on the reducing value transferred.

The issue of balancing adjustment for the transferor was examined in the following case:

Taxpayer	Subject matter	Reference
Aviation Fuel Supply Company	Making of balancing charge	(2012) CACV 150/2011

Under a franchise agreement, the taxpayer ('AFSC') designed and constructed an aviation fuel supply facility for the Airport Authority ('AA') to supply fuel to aircrafts. Under the agreement, AFSC had a right to receive part of the income from the operation of the facility for 20 years. It was also agreed that AFSC was to claim tax depreciation allowances in respect of the facility. As provided in the agreement, the AA paid AFSC a lump sum to buy out AFSC's right to receive the income. The Commissioner contended 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. 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. This case is discussed in **Appendix 11**.

Assets put out of use upon cessation

When assets have been put out of use upon cessation but have not yet been sold, such assets are deemed to have been sold immediately prior to cessation for the open market value (ss.38(4) and 39D(4)). If the assets are subsequently sold within 12 months of cessation, the taxpayer can claim to substitute the open market value with the actual sale proceeds for the purpose of calculating the balancing charge/allowance (ss.38(4) and 39D(5)).

However, these provisions will not apply where the assets are transferred to another trade carried on by the same person, though no initial allowance will be available.

Assets sold together for one price

When assets are sold together for one price and without specifying in detail the consideration in respect of each individual asset sold, s.38A provides that the Commissioner is empowered to allocate a price to each individual asset sold.

Assets sold between related parties

Section 38B provides that where an asset is sold in circumstances where it would appear that the transaction was not at arm's-length, the Commissioner shall determine the true market value of the

asset transferred and the value so determined is deemed to be the sale price for the purposes of calculating any allowances or charges.

A transaction is not at arm's-length when:

(a) the buyer is a person over whom the seller has control; or
(b) the seller is a person over whom the buyer as control;
(c) both the seller and buyer are persons over both of whom some other person has control; or
(d) the sale is between a husband and a wife (not being a wife living apart from her husband).

Replacement of non-pooled assets

When an asset is disposed of and replaced by another asset, any balancing charge arising on the disposal of the asset can be used to reduce the qualifying expenditure on the replacement asset if the taxpayer elects in writing for the roll over relief under s.39.

If the balancing charge arising on the disposal of the asset exceeds the qualifying expenditure on the replacement asset, balancing charge is made on the excess. No initial allowance or annual allowance will be made in respect of the replacement asset. On disposal of the replacement asset, the balancing charge, if any, is the smaller of the sales proceeds or the full amount of the expenditure on the replacement asset: s.39(a).

If the balancing charge arising on the disposal of the asset is smaller than the qualifying expenditure on the replacement asset, no balancing charge is made. Initial allowance and annual allowance are calculated as if the replacement expenditure has been reduced by the balancing charge. In computing the balancing allowance or balancing charge on disposal of the replacement asset, the initial allowance is deemed to be increased by the amount of balancing charge that would have been made: s.39(b).

Leased machinery or plant

There are special rules on depreciation allowances for leased machinery or plant under s.39E which are discussed in **chapter 9, section 4.18**.

Example 57

Gary is a practising barrister. He is also the proprietor of a high-class French restaurant in Lan Kwai Fong. In 2010, Gary purchased two paintings at $100,000 each from a reputable French artist. The paintings had been kept at Gary's home for collection purposes until January 2012, when Gary decided to place one painting at his chambers and the another one at his restaurant for decoration purposes. He closed the accounts of his chambers and restaurant on 31 December.

Required:

Determine whether Gary is entitled to claim depreciation allowance in respect of the two paintings for his legal practice and the French restaurant for the year of assessment 2012/13. Compute the allowance if Gary is so entitled.

Solution

Under s.39B, Gary, as the proprietor of his legal practice and the French restaurant, can only claim depreciation allowance in respect of the paintings if they were 'plant' for the purpose of producing his chargeable profits.

One of the paintings was used to decorate Gary's chambers. Following the BOR's decision in *D52/04*, such a painting could not be regarded as 'plant' because the creation of atmosphere and ambience is not an important trade function of a barrister so that he or she can solicit more quality clients and generate greater profits. Conversely, the painting which was used to decorate the French restaurant could be argued as 'plant' because for a high-class restaurant, ambience and atmosphere are ingredients in the product which it offers to customers: see *CIR v Scottish & Newcastle Breweries Ltd.* [(1981) 1 WLR 322].

Given that the painting was initially purchased by Gary for his collection and not for business use, Gary would not be entitled to any initial allowance by virtue of s.39B(1). Furthermore, as the

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painting had been used for private purposes before being used by the restaurant, the capital expenditure incurred on the painting has to be computed by deducting from its actual cost the notional allowances pursuant to s.39B(6) as follows:

		$
Actual cost of the painting		100,000
Less:	2010/11 Notional annual allowance ($100,000 × 20%)	(20,000)
		80,000
Less:	2011/12 Notional annual allowance ($80,000 × 20%)	(16,000)
Notional cost of the painting		64,000

Assuming that the restaurant had no asset in the 20% pool other than the painting, the annual allowance in respect of the painting for the year of assessment 2012/13 should be computed as follows:

		$
Notional cost of the painting		64,000
Less:	2012/13 annual allowance ($64,000 × 20%)	(12,800)
Tax written down value carried forward		51,200

HKICPA June 2012 (Amended)

Example 58

On 1 January 2011, Mr. Smiley succeeded to his brother's manufacturing business and took over all its machinery and plant. Particulars of this machinery and plant were as follows:

	Original cost	***Market value at 1/4/2011***	***Reducing value at 31/3/2011***
10% pool	$40,000	$26,000	$25,000
20% pool	$175,000	$100,000	$50,000
30% pool	$300,000	$140,000	$150,000

Mr. Smiley adopted 31 December as the accounting date of his business. In 2012, he changed the accounting date to 31 November. His adjusted profits for the two years were as follows:

Year ended 31/12/2011	$120,000
11 months to 30/11/2012	$140,000

A summary of the movements of his plant and machinery was as follows:

Date	***Particulars***
1/6/2011	Sold one machine of the 20% pool for $27,500.
15/6/2011	Bought a photocopier for $10,000 and a computer for $9,000.
20/6/2011	Replaced loose tools for $4,000.
1/8/2011	Bought a weaving machine under the following hire-purchase terms: Cash price: $150,000 Deposit: $30,000 Monthly instalment: $13,500 (commencing from 1/8/2011 for 10 months) Installation costs of $17,500 were incurred for the machine.
10/8/2011	A computer was brought into business use by Mr Smiley who had purchased it on 1 June 2009 for $14,000 for private use. The market value as at 10 August 2011 was $8,500.
18/10/2011	Bought a motor car for $200,000. The extent of its non-business use was agreed to be 50%.

Date	Particulars
22/12/2011	Paid in cash for 100 cutting machines at $1,300 each. These machines were delivered to the business for use on 3 January 2012.
5/1/2012	Sold all plant and machinery of the 10% pool for $26,500.
1/4/2012	Began to use for private purposes the photocopier of the business bought on 15 June 2011. The extent of such private use was agreed to be 50%. The market value of the photocopier as at 1 April 2012 was $8,000.
8/7/2012	Bought curtains and carpets for $16,000.
22/6/2012	Mr. Smiley sold his fax machine to the business for $2,500 (market value $2,000). He bought the fax machine in May 2011 for $3,000.
20/10/2012	The motor car bought on 18 October 2011 was traded-in for a new one, which cost $300,000. The trade-in value was $140,000. The balance of the purchase price was paid by cash in full. The new car was wholly for business use.

The depreciation allowances that Mr. Smiley can claim for the years of assessment 2011/12 and 2012/13 are computed as follows:

The business is a post-1974 business (i.e. a new business), and the basis periods for the years of assessment 2011/12 and 2012/13 are 12 months to 31 December 2011 and 12 months to 30 November 2012, respectively (see the discussion on basis period in **section 11**). Therefore, the period from 1 December 2011 to 31 December 2011 forms the basis period for the two years of assessment 2011/12 and 2012/13. Pursuant to s.40(1), capital expenditure on machinery and plant incurred in the **overlapping** basis period is treated as incurred in the basis period of the **first** year of assessment (i.e. 2011/12).

Year of assessment 2011/12
1/1/2011 – 31/12/2011

	10%	*20%*	*30%*		*50% private use Motor car 30%*		*Total all'ces*
	$	$	$		$		$
WDV of succeeded assets	25,000	50,000	150,000				
Additions					200,000		
Photocopier		10,000					
Cutting machine			130,000				
IA at 60%	–	(6,000)	(78,000)		(120,000)	× 1/2	144,000
		54,000	202,000		80,000		
Computer (Note 1)			6,860				
Disposals							
Machine	–	(27,500)					
		26,500	208,860				
AA	(2,500)	(5,300)	(47,058)	(Note 3)	(24,000)	× 1/2	66,858
WDV c/f	22,500	21,200	161,802		56,000		210,858

Weaving machine under HP – 30% (Note 2)		
Cost (150,000 + 17,500)	167,500	
IA (30,000+12,000x5+17,500) × 60%	(64,500)	64,500
	103,000	
AA	(30,900)	30,900
WDV c/f	72,100	
Total allowance for 2011/12		**306,258**

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Notes:

(1) *Computer brought into business use*

Cost	14,000
Notional allowance	
- 2009/10 at 30%	(4,200)
	9,800
- 2010/11 at 30%	(2,940)
Deemed cost	6,860

(2) The instalments are $13,500 per month. The capital portion is $12,000 per month [($150,000 – $30,000)/10]. The interest element of $1,500 per month ($13,500 – $12,000) would be allowed as a revenue expense.

Installation costs are added to the cost of the weaving machine.

(3) No annual allowance is available for the cutting machines because they were not in use during the basis period. Therefore, annual allowance is calculated as ($150,000 + $6,860) × 30% = $47,058.

(3) The computer bought on 15 June 2011 is allowed as a PFA.

(4) Loose tools are allowed on a replacement basis.

Year of assessment 2012/13
1/1/2012 – 30/11/2012

	10%	***20%***	***30%***	***50% private use Motor car 30%***	***Total all'ces***
	$	$	$	$	$
WDV b/f	22,500	21,200	161,802	56,000	
Additions					
Fax machine **(market value)**		2,000			
Motor car (Note 6)			258,000		
IA at 60%		(1,200)	(154,800)		156,000
		22,000	265,002		
Disposals					
Plant & machinery	(26,500)				
Photocopier **(market value)**		(8,000)			
Motor car				(140,000)	
Balancing charge	4,000			84,000	(Note 6) (4,000)
		14,000			
AA		(2,800)	(79,501)		82,301
WDV c/f		11,200	185,501		
Photocopier 20% (50% private use)					
Market value		8,000			
AA		(1,600)	× 50%		800
WDV c/f		6,400			

Weaving machine under HP - 30%		
WDV b/f	72,100	
IA (12,000 × 5) × 60%	(36,000)	36,000
	36,100	
AA	(10,830)	10,830
WDV c/f **(pooled in 2013/14)**	25,270	
Total allowance for 2012/13		**281,931**

Notes:

(6) The balancing charge on disposal of the motor car is restricted to the portion for private use, i.e. $42,000 ($84,000 × 1/2). Mr Smiley can elect under s.39 to set off the balancing charge against the cost of the replacement asset, which is reduced to $258,000 ($300,000 - $42,000).

(7) Curtains and carpets are allowed on a replacement basis.

9.4.11 Assets used in the Mainland by cross-border processing businesses

In the absence of s.39E, depreciation allowance could have been allowed under ss.37, 37A and 39B. However, s.39E(1)(b)(i) stipulates that where there is a lease of machinery or plant in which the taxpayer is a lessor and the asset is used by a person other than the taxpayer outside Hong Kong wholly or principally during the period of the lease, no depreciation allowance on capital expenditure on such asset shall be granted.

As noted in **section 9.4.6** above, 'lease' in relation to any machinery or plant includes "any arrangement under which a right to use the machinery or plant is granted by the owner of the machinery or plant to another person" (s.2). Therefore, if the asset is 'leased' to the Mainland factory, s.39E operates to deny depreciation allowance (DIPN 15). This is further discussed in **chapter 9, section 4.18** on 'Section 39E – Depreciation allowances on leased machinery and plant'.

As a concession, the IRD is prepared to grant 50% depreciation allowance if the arrangement between the Hong Kong company and the Mainland factory is a contract processing arrangement and the profits from manufacturing activities of the Hong Kong company are assessed on a 50:50 basis (see DIPN 15, para 19).

Example 59 (Adapted from DIPN 15, Example 4)

Co D is carrying on a manufacturing business in Hong Kong. Under a contract processing arrangement with a Mainland Chinese enterprise, Co D is required to provide machinery to the Mainland Chinese enterprise for the latter's processing work. Co D did not charge the Mainland Chinese enterprise any rental for the use of the machinery and plant.

Although no rental is charged, the arrangement is still a lease as defined in s.2. As the machinery is under a lease, it is an 'excluded fixed asset' under s.16G(6) and hence, no deduction under that section would be given. Strictly, Co D should be denied depreciation allowances in respect of the machinery leased to the Mainland Chinese enterprise under s.39E(1)(b)(i). However, if the profits from the manufacturing activities of Co D are assessed on a 50:50 basis, the IRD would be prepared to grant 50% of the depreciation allowances as a concession.

The concession does not apply if the Hong Kong company ceases to be the owner of the asset, e.g. where the Hong Kong company contributes capital to the Mainland factory in the form of machinery and plant (see DIPN 15, para 19, *D56/04* and *D24/06*). The concession also does not apply to import processing arrangements where apportionment of profit is not allowed (see *D61/08*).

Example 60 (Adapted from DIPN 15, Example 5)

Co G is carrying on business in Hong Kong and is the holding company of Co H. Co H is a wholly owned foreign enterprise set up as a separate legal person in the Mainland. Co G purchased machinery and plant and injected them into Co H as its capital contribution in specie.

As a result of the capital contribution, Co G has ceased to be owner of the machinery and plant. In effect, Co G has sold the machinery and plant in return for its equity interest in Co H. The question of a lease does not arise. Thus Co G would not be entitled to any depreciation allowances.

10 Preparation of the profits tax computation

Topic highlights

The tax system in Hong Kong does not recognise the group company concept for tax purposes. Group companies have to compute their taxable profits on a non-consolidated basis. In general, accounting profits often differ from taxable profits. It is usually necessary to adjust the accounting profits shown on the financial statements in order to determine the taxable profits.

The accounting policies adopted by a taxpayer are relevant to the computation of his/her assessable profits.

The IRD, in DIPN 1, indicates that in the absence of any express or implied statutory rule in the IRO specifying how profits from long-term contracts should be ascertained, established accounting principles also apply for profits tax purposes. This position is reflected in the judgment of Sir Thomas Bingham, MR, in *Gallagher v Jones* [1993] STC 537, where he said at page 555:

> *"Subject to any express or implied statutory rule, of which there is none here, the ordinary way to ascertain the profits or losses of a business is to apply accepted principles of commercial accountancy. That is the very purpose which such principles are formulated ... so long as such principles remain current and generally accepted they provide the surest answer to the question which the legislation requires to be answered."*

As SSAP 23 (now superseded by HKAS 11) does not adopt the realisation or completion of contract method, which recognises profits only when a contract is completed, the IRD will request the taxpayer to return the profits recognised in the financial statements of an accounting year under the percentage of completion method. The IRD will not accept a computational adjustment on the ground that the profits are not assessable until the entire contract is completed if financial statements are prepared using the percentage of completion method.

In *Secan Ltd & Ranon Ltd v CIR* [(2001) 1 HKRC 90-107], the Court declined to allow a full deduction of the loan interest expenses when the occupation permit was issued as the interest was capitalised as part of the cost of the property. The judges were of the view that *"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."* Secan would only be entitled to deduct the cost of the property (which included the capitalised interest) when the property was sold.

However, the CFI in *Nice Cheer Investment Ltd* has clarified that ordinary commercial accounting principles are useful and important in ascertaining profits and losses, but they only apply in the absence of statutory provisions to the contrary. The calculation of profits and losses in accordance with ordinary commercial accounting principles is subject to the provisions of the tax statute, the IRO, and judge made rules interpreting that statute. If statutory provisions are applicable, the interpretation of the statutory provision takes precedence over ordinary commercial accounting principles. *Secan* "did not have the effect of putting ordinary commercial accounting principles above the law. The jurisdiction to determine the question of what profits are chargeable to tax

remains with the court. Lord Millett NPJ unequivocally reaffirmed [in *Secan*] the unshakable legal principle that ordinary commercial accounting principles have to be modified to conform with the Ordinance." (See the discussion in **section 6.3.4.**)

In October 2002, the IRD issued DIPN 40 "Prepaid or deferred revenue expenses", indicating tax treatment should follow the accounting treatment for 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 statement of financial position will, with effect from the year of assessment 2002/03, no longer be deductible from the assessable profits in the year in which the expenses are incurred.

In November 2005, the IRD issued DIPN 42 "Taxation of financial instruments and taxation of foreign exchange differences". For profits tax purposes, the increase in fair value of the financial assets through the income statement would be treated as assessable profits. The IRD does not accept the argument that when the financial instruments are marked to market, the profits recognised in the income statement are unrealised profits and therefore not taxable until realised in later periods. In addition, all taxpayers including FIs should treat exchange gains or losses recognised in the income statement, whether realised or not, as taxable receipts or deductible expenses. An adjustment in the tax computation on the ground that an exchange difference has not yet realised will not be accepted. The revised practice will be applied by the IRD to the foreign exchange differences for the year of assessment 2005/06 and subsequent years. The exchange gains or losses of a capital nature or arising in or derived outside Hong Kong are still neither taxable nor allowable.

However, the COA in *Nice Cheer* has held that unrealised gains from revaluation of trading securities are not taxable. It is therefore arguable that the unrealised gains arising from the increase in fair value of financial assets are not taxable. However, the CFI considered that unrealised gains relating to foreign exchange transactions are not 'anticipated' but actual accrued profits which are taxable. (See the discussions of *Nice Cheer* in **sections 6.3.4, 8.10.2 and 8.10.8**.)

10.1 Preparing a profits tax computation

The following are areas for consideration when preparing a profits tax computation:

1 **Tax rules**

- To check changes in the tax rules (e.g. locality of trading profits);
- To check changes in tax rates, allowable deductions, etc.;
- To check new provisions, new definitions (e.g. s.16EA);
- To check changes in DIPNs (e.g. DIPN 21) and IRRs;

2 **Tax records**

- To review prior year assessments, profits tax returns, profits tax computations, enquiries from the IRD, outstanding objections, etc.;

3 **Operations review**

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

4 **Statement of financial position**

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

- To identify whether there is any transfer of trading stock to fixed assets or *vice versa* (the principle in *Sharkey v Wernher* may apply);
- To identify whether there is a large investment portfolio (a portion of the management, clerical and general expenses may need to be disallowed for a large investment portfolio pursuant to IRR 2C);
- To identify any additions to fixed assets (e.g. patent rights) which are specifically deductible (e.g. s.16E);
- To identify any disposal of fixed assets for which the sale proceeds of the assets are specifically taxable (e.g. sale proceeds of patent rights);
- To ensure that the total additions to fixed assets can be reconciled with additions in the depreciation allowances computation;

5 **Statement of cash flows**

- To reconcile the sale proceeds of fixed assets with the deductions in the depreciation allowances computation and the items shown in the profits tax computation which are specifically taxable (e.g. sale proceeds of patent rights);
- To reconcile the movement in the hire-purchase creditors with the initial allowance on assets acquired under hire purchase in the depreciation allowances computation;

6 **Statement of comprehensive income**

- To identify any offshore profits which should be excluded in preparing the profits tax computation together with the related expenses which should be added back in the tax computation; and
- To identify any non-taxable income or profits (e.g. dividends, capital gains).

FORMAT OF A PROFITS TAX COMPUTATION

Profit/(Loss) per account		x
Add: Non-deductible expenses and taxable income: e.g.		
Donations	x	
Depreciation	x	
Expenses attributable to offshore profits	x	
Fine/penalty	x	
Interest that failed to satisfy ss.16(1)(a), (2), 2A), (2B) or 2C)	x	
Non-trade debts written off	x	
Improvement & initial repairs	x	
Initial purchase of soft furnishings (carpet, curtain, etc.)	x	
Sale proceeds of fixed assets (limited to previous deductions allowed)	x	
Profits tax and property tax paid	x	
Salaries paid to proprietor/partners and spouses	x	
Non-deductible contributions to retirement schemes	x	
Share of joint venture loss	x	x
		x
Less: Non-assessable income and deductible expenses: e.g.		
Dividends	x	
Offshore profits	x	
Offshore interest	x	
Exempt interest income	x	
Recovery of bad debts previously not allowed	x	
Replacement of soft furnishings	x	
Refurbishment	x	

Deductible capital expenditure on fixed assets	x	
Allowable contributions to retirement schemes	x	
Share of joint venture profit	x	(x)
		x
Less: Depreciation allowance	x	
Industrial building allowance	x	
Commercial building allowance	x	(x)
		Y
Less: ACD (restricted to 35% of Y)		(Z)
Assessable profits		P
Less: Loss b/f from previous period under s.19C(1) or (2) or (4)	x	
Loss set off under s.19C(5)	x	(L)
Net assessable profits		N
Profits tax payable (15% or 16.5% on N)		T
Less: Provisional profits tax paid	x	
Property tax set off under s.25	x	(S)
Profits tax liability		R

Example 61

Nick is a famous composer. He transferred all the rights of his musical works to a Hong Kong company, Nick Production Workshop Ltd ('NPWL'), for commercial exploitation. Nick is the major shareholder and director of NPWL. During the year ended 31 March 2013, NPWL's accounts show the following particulars:

	$
Income	
Sale of album	3,996,200
Royalty income (Note 1)	379,266
Rental income (Note 2)	400,000
Compensation received (Note 2)	180,000
	4,955,466
Expenses	
Auditor's remuneration	2,250
Bank charges	150
Legal fee on transfer of the company's shares	4,800
Staff salary	1,923,117
Regular contributions to MPFS	
Mandatory	96,156
Voluntary	200,800
Property tax paid (Note 2)	36,000
Compensation payment (Note 3)	480,000
Accounts receivable written off (Note 4)	729,012
Penalty for late filing of tax return	205,000
Other operating expenses	228,000
	3,905,285
Profit before taxation	1,050,181

Notes:

(1) The royalty income was derived from XYZ Music Publishing Ltd ('XYZ'), a company incorporated in the UK. In February 2012, the Managing Director of XYZ visited Hong Kong and was impressed by the songs written by Nick. By a licensing agreement dated 16 February 2012 ('the Agreement'), NPWL agreed to grant an exclusive license to XYZ to exploit the rights of certain music works in the territory of Germany, Australia and New

Zealand ('the Territory') in return for a fee. The fee payable by XYZ to NPWL under the Agreement would be a percentage of the actual income received by XYZ from performance and broadcast of NPWL's musical works in the Territory.

XYZ settled the royalties under the Agreement by transfer from its bank account in Australia to NPWL's bank account, also maintained in Australia. The sum of $379,266 was the net royalty income after the deduction of applicable overseas withholding tax of $31,119 in Australia and New Zealand.

(2) NPWL and Company A had previously entered into a tenancy agreement where NPWL let its property located in Hong Kong to Company A for a term of three years, starting from 1 October 2011, at a monthly rental of $50,000. Property tax of $36,000 was paid for the year of assessment 2011/12. By an agreement dated 25 November 2012, NPWL and Company A agreed to terminate the tenancy agreement prematurely on 30 November 2012. Company A paid NPWL a sum of $180,000 as compensation. After taking possession, NPWL let the property to Company B with effect from 1 March 2013 at a monthly rental of $53,000. As the rental income was settled in cash by Company B directly to Nick, no entries were recorded in NPWL's ledgers.

(3) The compensation payment was made to John, the senior manager of NPWL, upon termination of his employment with NPWL. This amount was in consideration for his agreement not to enter the same industry for three years from the date of his termination.

(4) The account balance represented a loan advanced by NPWL to its related company, Best Ltd ('Best'), in year 2010. Best has been carrying on a business in Hong Kong and the loan was borrowed for the purpose of financing its operation. The sum comprised a principal of $560,000 and interest of $169,012. As Best was under compulsory liquidation, NPWL considered that the chance of recovering the debt was remote. Therefore, NPWL decided to write off the debt.

(5) Depreciation allowances as agreed by the assessor for the year is $199,400.

Required:

(a) Explain the profits tax position of NPWL in respect of:

(i) the royalty income derived from XYZ; and

(ii) the compensation received from Company A for the premature termination of the tenancy.

(b) Assuming the royalty income and the compensation are both chargeable to profits tax, prepare, with explanations, NPWL's profits tax computation for the year of assessment 2012/13.

Solution

(a) **The profits tax position of NPWL**

(i) Under s.14, profits tax shall be charged on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong. The broad guiding principle is that *'one looks to see what the taxpayer has done to earn the profit in question and where he has done it'* (see *Hang Seng Bank* and *TVBI*). It is only the operations of the taxpayer which are the relevant consideration.

NPWL was carrying on business in Hong Kong. There is no evidence that it had any PE outside Hong Kong. Therefore, the issue is whether the royalty income arose in or was derived from Hong Kong.

Pursuant to DIPN 21, the locality of royalties other than those deemed chargeable under s.15(1)(a), (b) or (ba) would be the place of acquisition and granting of the licence or right of use. NPWL acquired the music license rights from Nick in Hong Kong and executed a licensing agreement in Hong Kong to grant a licence in respect

of the music works. As the acquisition and granting of the music rights were carried out in Hong Kong, the source of the royalties was in Hong Kong. The place of payment has no bearing in determining the locality of profit. Although the broadcast and performance of the musical works took place overseas, they were not relevant considerations. These were the operations of XYZ and not NPWL.

However, it should be noted that in July 2012 the IRD issued DIPN 49 outlining the IRD's interpretation and practices in relation to royalties derived from IPRs by taxpayers carrying on business in Hong Kong. Where the IPR is purchased by the licensor and licensed to another party for use outside Hong Kong, the royalty income will generally be regarded as non-Hong Kong sourced. As NPWL purchased the IPR from Nick and licensed it to XYZ for use in Germany, it might be argued that the royalty income should be regarded as non-Hong Kong sourced and non-taxable.

(ii) The question to be considered is whether the compensation was a trading receipt or a capital receipt. Section 14 excludes from profits tax charge profits which are capital in nature. The early termination of the tenancy agreement did not destroy NPWL's profit-making apparatus. The property was let to another tenant soon after NPWL had taken possession of the property. The compensation was not a capital receipt for the loss of a capital asset.

NPWL has been carrying on the business of property letting. The tenancy agreement with Company A was entered into in the ordinary course of its business. The compensation for releasing the parties from their respective responsibilities and liabilities under the tenancy agreement in the ordinary course of business was revenue in nature.

As a general principle in common law, a compensation payment usually takes the character of the item which it replaces. The compensation was for the failure to receive, or for the loss of, trading receipts, i.e. rental income for the unexpired period covered in the tenancy agreement. The compensation was therefore a trading receipt.

(b) **Profits tax computation for Nick Production Workshop Ltd**
Year of assessment 2012/13
Basis period: year ended 31 December 2012

		$	$
Profit per account			1,050,181
Add:	Legal fee on transfer of the company's shares	4,800	
	Regular contributions to MPFS	8,488	
	Property tax paid	36,000	
	Compensation payment	480,000	
	Account receivable written off	560,000	
	Rental income from Company B	53,000	
	Penalty for late filing of tax return	205,000	1,347,288
			2,397,469
Less:	Depreciation allowances		(199,400)
			2,198,069
Profits tax payable at 16.5%			362,681
Less:	Property tax set off under s.25		(36,000)
Net profits tax payable			326,681

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Explanations:

(1) The withholding tax is deductible as it was charged on earnings rather than on profits. As the royalty income was taken to the income statement on a net basis, no adjustment is required.

(2) Legal fee on transfer of the company's shares was capital in nature and not deductible under s.17(1)(c).

(3) Regular contributions (mandatory or voluntary or both) to an MPFS by an employer are deductible under s.16(1). The allowable deduction is limited to 15% of the total emoluments of the employee (s.17(1)(h)). Therefore, amount added back is $8,488 [($96,156 + $200,800) – $1,923,117 × 15%].

(4) Any tax payable under the IRO, except salaries tax paid on behalf of employees, is disallowed under s.17(1)(g). However, NPWL can claim to set off the property tax paid against the profits tax payable under s.25.

(5) The compensation payment was for prevention of future competition. It is capital in nature and not deductible.

(6) The loss on the loan was not an expense under s.16(1). NPWL was not carrying on a money lending business. The loss on the loan is not deductible under s.16(1)(d). Since the provision of credit was in Hong Kong, interest on the loan should have been previously offered for tax. The writing off of the uncollected interest of $169,012 is deductible.

(7) The penalty for late filing of tax return is not deductible as it was not incurred in the production of chargeable profits.

(8) NPWL is the owner of the property. The rental income derived from letting the property to Company B for March 2013 should be treated as NPWL's assessable profits.

HKICPA May 2008 (Amended)

10.2 Post-cessation receipts and payments

Sums received after cessation of business are deemed to be profits for the year of assessment in which the cessation occurs; and are taxable in that year if such sums are taxable if received before cessation (s.15D(1)).

Sums paid after cessation of business are deemed to be expenditure for the year of assessment in which the cessation occurs; and are deductible in that year if such payments are deductible if paid before cessation (s.15D(2)). If the expense is not deductible under ss.16 or 17 (e.g. it is capital in nature, or not incurred in the production of chargeable profits), s.15D will not permit a deduction: *Overseas Textiles Ltd v CIR* [(1990) 3 HKTC 29].

Deduction is allowed for actual payment made. Thus, provisions or write off (e.g. bad debts written off) after cessation is not deductible. By concession, recovery of previously allowed bad debts after cessation will not be assessed.

Determining the date of cessation is a question of fact. 'Cessation' is to be distinguished from 'temporary suspension' of a trade. The fact that a liquidator is appointed does not mean that the business is ceased, as the liquidator may continue the trade for some time to protect the assets. If the liquidator continues the business for a period of time to protect the assets, the date of appointment of liquidator may not be the same as the date of cessation. If the liquidator is merely realising assets to wind up the company, it cannot be considered as continuing the business; and the date of appointment of liquidator is the same as the date of cessation.

In *Tai Shun Investment Co Ltd v CIR* [(1968) HKTC 370], a liquidator was appointed to wind up a property development company. The liquidator:

(a) collected arrears of rent;
(b) collected arrears of instalments and instalments which subsequently fell due; and
(c) conveyed legal title to flats which was paid in full.

As the action of the liquidator merely consisted of 'tidying-up', it was held that there was no evidence upon which it could reasonably be found that the liquidator did carry on any trade or business.

10.3 Pre-commencement expenditure

Expenses incurred before business commenced is not incurred in the production of assessable profits. However, by concession, the IRD allows pre-commencement expenditure of a revenue nature, which would be allowed if incurred after commencement, in the first accounting period. Capital expenditure on acquisition of capital assets subject to tax depreciation allowances is treated as incurred on the day on which business commenced (s.40(2)).

Again, determining the date of cessation is a question of fact. 'Commencement' is to be distinguished from 'preparatory work'. 'Formation activities' such as recruiting staff and leasing office, are irrelevant. In *Birmingham & District Castle By-Products Co Ltd v IRC* (12 TC 92), it was held that acts such as research, construction of buildings, acquisition of machinery and plant and entering into of agreements with suppliers were of a preparatory nature only and the trade or business did not commence until the company commenced to acquire raw materials for processing. This approach of disregarding preparatory acts was followed by the BOR in *D3/86.* In that case, land originally acquired for non-trading purposes was subsequently redeveloped for sale. The BOR held that the property development business only commenced when an architect was employed to draw up redevelopment plans.

The date of commencement is the date upon which the taxpayer's intentions begin to translate into an activity which can be characterised as trading. This normally follows the date when the income is first derived; or when 'profit-seeking' acts start, e.g. soliciting customers, negotiating sales terms, acquiring raw materials.

11 Basis period

Topic highlights

'Basis period' is the period which is used as a basis for the computation of assessable income or profit. For property tax and salaries tax purposes, the basis period is from 1 April to 31 March of the following year. For profits tax purposes, as each company has its own accounting year end date which may be a date other than 31 March, the IRD accepts a different basis period for the purpose of computing the assessable profits.

Section 2 defines 'basis period' for any year of assessment as the period on the income or the profits of which tax for that year ultimately falls to be computed. The various basis periods for profits tax can be classified under the following categories:

(a) Basis period for a normal or continuing business;

(b) Basis period for the commencement of business;

(c) Basis period for the cessation of business; and

(d) Basis period for a business which changes its accounting date.

11.1 Normal or continuing business

The IRD accepts the taxpayer's annual account as its basis period for that year of assessment.

(1) For accounts made up to 31 March, basis period is the same as the fiscal year.

(2) For accounts made up to a date other than 31 March, basis period is the accounting year ended within the year of assessment.

Example 62

Accounting year end	*Year of assessment*	*Basis Period*	
31/3/2012	2011/12	1/4/2011 – 31/3/2012	(s.18B(1))
1/4/2012	2012/13	2/4/2011 – 1/4/2012	(s.18B(2))
31/12/2012	2012/13	1/1/2012 – 31/12/2012	(s.18B(2))

11.2 Commencement of business

There are three possible cases for the first accounting period:

(1) When the first accounting period is less than or equal to 12 months and ended within the year the business commenced, the basis period for the year of commencement is from the date of commencement to the first accounting date (s.18C(1)(a)).

Example 63

A Ltd commenced business on 1 June 2011 and closes its accounts on 31 December each year. Its adjusted profits for the first three accounts are as follows:

1/6/2011 – 31/12/2011 (7 months)	$22,000
1/1/2012 – 31/12/2012	$35,000

The year of commencement is 2011/12. The basis period and assessable profits for the relevant years of assessment are determined as follows:

Year of assessment	*Basis Period*	*Assessable profits*	
2011/12	1/6/2011 – 31/12/2011	$22,000	(s.18C(1)(a))
2012/13	Year ended 31/12/2012	$35,000	(s.18B(2))

(2) When the first accounting period is less than or equal to 12 months and ended within the following year, there will not be any basis period for the year of commencement, and the assessable profit for the year of commencement is nil (s.18C(2)).

Example 64

B Ltd commenced business on 1 March 2011 and closes its accounts on 31 December each year. Its adjusted profits for the first two accounts are as follows:

1/3/2011 – 31/12/2011 (10 months)	$10,000
1/1/2012 – 31/12/2012	$22,000

The year of commencement is 2010/11. The basis period and assessable profits for the relevant years of assessment are determined as follows:

Year of assessment	*Basis Period*	*Assessable profits*	
2010/11	Nil	Nil	(s.18C(2))
2011/12	1/3/2011 – 31/12/2011	$10,000	(s.18B(2))
2012/13	Year ended 31/12/2012	$22,000	(s.18B(2))

(3) When the first accounting period is more than 12 months, the basis period for the first two years of the business will be determined at the Commissioner's discretion (s.18C(1)(b)). Usually the basis period for the second year of assessment is a period of 12 months counted backwards from the end of the first accounting period while the basis period for the year of commencement is the remaining accounting period counted from the date of commencement.

Example 65

C Ltd commenced business on 1 June 2010 and closes its accounts on 31 December each year. The first accounts were closed on 31 December 2011. Its adjusted profits for the first two accounts are as follows:

1/6/2010 – 31/12/2011 (19 months)	$66,500
1/1/2012 – 31/12/2012	$45,000

The year of commencement is 2010/11. The basis period and assessable profits for the relevant years of assessment are determined as follows:

Year of assessment	*Basis Period*	*Assessable profits*	
2010/11	1/6/2010 – 31/12/2010	$24,500 (66,500 × 7/19)	(s.18C(1)(b))
2011/12	1/1/2011 – 31/12/2011	$42,000 (66,500 × 12/19)	(s.18C(2))
2012/13	Year ended 31/12/2012	$45,000	(s.18B(2))

11.3 Cessation of business

There are four possible cases for a cessation of business.

(1) **New business (i.e. business commenced on or after 1 April 1974) under 2.18D(1)**

The basis period for the year of cessation is from the date following the end of the basis period of the preceding year of assessment to the date of cessation. The basis period may exceed 12 months.

Example 66

D Ltd commenced business in 2007 and closed its accounts on 31 October each year. It ceased business on 31 December 2012.

The year of cessation is 2012/13. The basis period for the year of cessation and the preceding year is determined as follows:

Year of assessment	*Basis Period*		
2011/12	Year ended 31/10/2011		(s.18B(2))
2012/13	1/11/2011 – 31/12/2012	(14 months)	(s.18D(1))

(2) **Old business (i.e. business commenced before 1 April 1974) under s.18D(2) proviso**

If the cessation is not due to the death of the proprietor and the business is transferred to a successor, the treatment is the same as Case (1), i.e. a new business case as mentioned above.

(3) **Old business (i.e. business commenced before 1 April 1974) under ss.18D(2) and (2A)**

If the accounting date falls on 31 March, the basis period for the year of cessation is from 1 April in the year of cessation to the date of cessation (s.18D(2)).

If the accounting date falls on a date other than 31 March and the cessation is due to the death of the proprietor, OR the business is NOT transferred to a successor, the basis period for the year of cessation is from 1 April in the year of cessation to the date of cessation (s.18D(2)) plus the excess of (i) profits for the period from the end of basis period of the preceding year of assessment to the following 31 March (i.e. the drop-out profits) over (ii) drop-out profits of the equivalent period in 1974/75 (i.e. the transitional amount): s.18D(2A).

Assessable profits for the year of cessation under s.18D(2) & (2A)
Basis period: 1 April in the year of cessation to date of cessation

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Assessable profits from 1 April to date of cessation		$A
Add: Assessable profits of the 'relevant period' (i.e. drop-out period in year of cessation)	$B	
Less: Transitional amount (i.e. profits of the equivalent drop-out period in 1974/75)	($C)*	
		$D
Assessable profits for the year of cessation		$A+$D

** $C is limited to $B, i.e. no loss can be allowed for $D; and equals zero if C is a loss.*

Example 67

E Ltd commenced business in 1960. Its normal accounting date was 31 December. It ceased business on 31 August 2012, and there is no successor. Its adjusted profits for the relevant years were as follows:

1/1/2012 – 31/8/2012	$72,000
1/1/2011 – 31/12/2011	$98,000
1/1/1975 – 31/12/1975	$15,000
1/1/1974 – 31/12/1974	$12,000

The year of cessation is 2012/13. The basis period and assessable profits for the year of cessation are determined as follows:

Assessable profits for the year of cessation 2012/13
Basis period: 1 April 2012 – 31 August 2012

	$	$
Assessable profits from 1/4/2012 – 31/8/2012 (72,000 × 5/8)		45,000
Add: Assessable profits from 1/1/2012 – 31/3/2012 (72,000 × 3/8)	27,000	
Less: Transitional amount from 1/1/1975 – 31/3/1975 (15,000 × 3/12)	(3,750)	23,250
Assessable profits for 2012/13		68,250

(4) **Short life business under s.18D(5)**

When a business is ceased within the year of assessment following the year of commencement, and there has been deemed to be no assessable profits for the year of commencement pursuant to s.18C(2), the basis period for the year of cessation is from the date of commencement to the date of cessation (s.18D(5)).

Example 68

F Ltd commenced business on 1 August 2011 and prepared its first accounts to 30 April 2012. It ceased business on 31 December 2012.

F Ltd commenced business in 2011/12 and ceased business in 2012/13. The basis period is determined as follows:

Year of assessment	*Basis Period*		
2011/12	Nil		(s.18C(2))
2012/13	1/8/2011 – 31/12/2012	(17 months)	(s.18D(5))

11.4 Change of accounting date

There is a change of accounting date for a year of assessment when either of the following cases occurs:

(1) Accounts are not made up to the corresponding day in the following year of assessment (s.18E(1)(a)); or

(2) Accounts are made up to more than one day in the following year of assessment (s.18E(1)(b)).

The Commissioner has the power to select the basis period for the year of change and to re-compute the assessable profits for the year preceding the year of change (s.18E(1)). There are different treatments for OLD and NEW businesses.

(1) **Old business (i.e. business commenced before 1 April 1974)**

The normal basis period is limited to 12 months. The IRD's objectives/principles for selecting the new basis period are:

(a) get on the new accounting date as soon as possible; and

(b) ensure that the period left out of assessment should not be of 'high profit'.

(2) **New business (i.e. business commenced on/after 1 April 1974)**

The basis period for the year of change may exceed 12 months (s.18E(2)(b)).The IRD's objectives/ principles for selecting the new basis period are:

(a) get on the new accounting date as soon as possible;

(b) ensure that no profit made over the life of the business is left out of assessment;

(c) accept a basis period of less than 12 months if there is compelling reason for the change; and

(d) otherwise, stick to a basis period of 12 months and some profits may be taxed twice.

Example 69

G Ltd's normal accounting date was 30 June. In 2012, it changed its accounting date to 31 October. The accounting date is not changed for the sole or dominant purpose to obtain a tax benefit. Its adjusted profits for the relevant years were as follows:

Year ended 30/6/2011	$24,000
16 months to 31/10/2012	$48,000

Since **accounts are not made up to the corresponding day** of 30 June in 2012, the year of change of accounting date is 2012/13. The basis period and assessable profits for the relevant years of assessment are determined as follows:

(1) **If G Ltd is a new business**

Year of assessment	*Basis Period*	*Assessable profits*
2012/13	1/7/2011 – 31/10/2012 (16 months)	$48,000
2011/12	Year ended 30/6/2011	$24,000

As no profits have dropped out of assessment, the IRD normally would not re-compute the assessable profits for the year preceding the year of change (2011/12).

(2) **If G Ltd is an old business**

Year of assessment	*Basis Period*	*Assessable profits*
2012/13	1/11/2011 – 31/10/2012 (12 months)	$36,000 (48,000 × 12/16)
2011/12	If follows the original assessment	
	Year ended 30/6/2011	$24,000
	If re-computed with the new accounting date	
	1/11/2010 – 31/10/2011	$28,000 (24,000 × 8/12 + 48,000 × 4/16)

As six months' profits would have dropped out of assessment, the IRD will likely re-compute the assessable profits for the year preceding the year of change (2011/12); and profits for the period from 1/7/2010 to 31/10/2010 would drop out of assessment.

Example 70

H Ltd's normal accounting date was 31 December. In 2012, it changed its accounting date to 30 September. Its adjusted profits for the relevant years were as follows:

Year ended 31/12/2011	$120,000
9 months to 30/9/2012	$40,000

Since **accounts are not made up to the corresponding day** of 31 December in 2012, the year of change of accounting date is 2012/13. The basis period and assessable profits for the relevant years of assessment are determined as follows:

(1) **If H Ltd is a new business**

Year of assessment	*Basis Period*	*Assessable profits*
2012/13	1/10/2011 – 30/9/2012 (12 months)	$70,000 (120,000 × 3/12 + 40,000)
2011/12	Year ended 31/12/2011	$120,000

If there is a compelling reason for the change of accounting date (e.g. to conform to the accounting date of the parent company), the IRD may accept a basis period of less than 12 months, i.e. nine months to 30/9/2012 as the basis period for the year of change (2012/13). As no profits have dropped out of assessment, the IRD normally would not re-compute the assessable profits for the year preceding the year of change (2011/12).

(2) **If H Ltd is an old business**

Year of assessment	*Basis Period*	*Assessable profits*
2012/13	1/10/2011 – 30/9/2012 (12 months)	$70,000 (120,000 × 3/12 + 40,000)
2011/12	Year ended 31/12/2011	$120,000

For old business, the basis period is limited to 12 months. Therefore, profits for the period from 1/10/2011 to 31/12/2011 will be assessed twice. As no profits have dropped out of assessment, the IRD normally would not re-compute the assessable profits for the year preceding the year of change (2011/12).

Example 71

J Ltd's normal accounting date was 30 June. In 2012, for a compelling reason, it changed its accounting date to 30 November and prepared two sets of accounts. Its adjusted profits for the relevant years were as follows:

Year ended 30/6/2011	$12,000
Year ended 30/6/2012	$30,000
5 months to 30/11/2012	$16,000

Since **accounts are made up to more than one day** in 2012, the year of change of accounting date is 2012/13. The basis period and assessable profits for the relevant years of assessment are determined as follows:

(1) **If J Ltd is a new business**

Year of assessment	*Basis Period*	*Assessable profits*
2012/13	1/7/2011 – 30/11/2012 (17 months)	$46,000 (30,000 + 16,000)
2011/12	Year ended 30/6/2011	$12,000

As no profits have dropped out of assessment, the IRD normally would not re-compute the assessable profits for the year preceding the year of change (2011/12).

(2) **If J Ltd is an old business**

Year of assessment	*Basis Period*	*Assessable profits*
2012/13	1/12/2011 – 30/11/2012 (12 months)	$33,500 (30,000 × 7/12 + 16,000)
2011/12	If follows the original assessment	
	Year ended 30/6/2011	$12,000
	If re-computed with the new accounting date	
	1/12/2010 – 30/11/2011	$19,500 (12,000 × 7/12 + 30,000 × 5/12)

As five months' profits would have dropped out of assessment, the IRD will likely re-compute the assessable profits for the year preceding the year of change (2011/12); and profits for the period from 1/7/2010 to 30/11/2010 would drop out of assessment.

11.5 Apportionment or aggregation

Where it is necessary to adopt as a basis period only a portion of the adjusted profits/losses of a longer accounting period or to aggregate such a portion with a portion of the adjusted profits/losses of another accounting period, apportionment or aggregation may be made on the basis of days or months in the respective periods (i.e. on a time basis). However, if it is inappropriate to apportion profits on a time basis, e.g. when a large proportion of profits fell within a specific part of an accounting period, the Commissioner may direct some other basis (s.18E(3)).

It should be noted that apportionment is made in respect of the adjusted profits before depreciation allowances, which are not apportioned. Depreciation allowances are recomputed in accordance with the new basis period: s.40(1) (see **section 9.1** on 'Basis period under s.40(1)' and **Example 58**).

Self-test question 7

NT Co commenced business on 1 January 2012, the date of its incorporation, with the first set of accounts ending on 30 June 2013.

Required:

Advise NT Co of the basis period for tax filing purposes and in particular, explain the basis period likely to be adopted by the IRD for the years of assessment 2011/12, 2012/13, 2013/14 and 2014/15. Also comment on the tax implications if NT Co is to change its accounting year end date later.

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(The answer is at the end of the chapter)

12 Partnerships

Topic highlights

Although a partnership is not a legal person, it is a taxable entity. Tax is imposed on the share of profits of a corporate partner 16.5%, and at the standard rate on the balance of the profits.

12.1 Partnership and joint ventures

The term **'partnership'** is defined under s.3(1) of the Partnership Ordinance as 'the relation that subsists between persons carrying on business in common with a view of profit'.

Although a partnership is not a legal person, it is a taxable entity for tax purposes. Tax is imposed on the share of profits of a corporate partner a 16.5%, and at the standard rate on the balance of the profits.

'Joint ventures' are another common form of business structure, where parties involved share, in agreed proportions, the benefits, risks and obligations in the venture in order to achieve mutual goals. There are many forms of joint venture. Whether a joint venture is a partnership is a question of fact. A joint venture which is not a partnership is not a taxable entity. The profits or losses shared from a joint venture will be combined with the operating result of the individual joint venturer and taxed in its own name.

A general comparison between a partnership and a joint venture is as follows:

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

12.2 Profits tax computation for a partnership business

Section 22(1) provides that where a trade, profession or business is carried on by two or more persons jointly, the assessable profits therefrom shall be computed in one sum and the tax in respect thereof shall be charged in the partnership name.

In general, there is no difference between the profits tax computation of a partnership and that of a sole trader or a limited company, except an allocation of profit and loss among the partners for a partnership in accordance with s.22A may be required. However, as a partnership is a single taxable entity separate and distinct from its partners, expenses incurred by individual partners are not allowed, even though such expenses are incurred for the benefit of the partnership.

Other provisions in the IRO relating to a partnership business are as follows:

Section	Provisions and implications
16(1)(b)	The deduction of rent paid by a partnership to any partners or partners' spouses is allowed, but restricted to the assessable value of the relevant property. In practice, this restriction has no operational significance now as the assessable value is often equal to the actual rent consideration.
16AA	Mandatory contributions under the MPFSO which are not otherwise allowable and not exceeding $15,000 (with effect from 2013/14) in respect of a partner of a partnership are deemed to be an expense wholly and exclusively incurred in the production of assessable profits and allowable as a deduction.
17(2)	No deduction is allowed for salaries or other remuneration to any partner or partners' spouses, and interest on capital and/or loan from any partner or their spouses or, subject to s.16AA, contribution made to a MPFS in respect of any partner or partners' spouses. The disallowable payments are regarded as appropriations of profits to the partners which are adjusted in the allocation of profits and loss.
22B	There are restrictions on the share of loss of a limited partner of a partnership which may be set off against the assessable profit of that limited partner, which are outlined in **chapter 9, section 4.16** on 'Limited partner loss relief'.

12.3 Allocation / reallocation of partnership profits and losses

Although partnership is not a separate legal entity, profits tax is charged in name of the partnership, and is not divided among the partners (s.22(1)). However, allocation and reallocation of profits and losses to the partners is required in the following situations:

(a) When a partner elects for personal assessment ('PA'), his/her share of profits/losses is transferred to PA.

(b) When there is a corporate partner, its share of profits is subject to the corporate standard rate.

(c) When the partnership has allowable loss and/or a partner has a share of loss brought forward, the loss is partners' personal losses.

(d) In making an allocation, the principle is that when the partnership has assessable profits, no partner should have a tax loss from the partnership. And when the partnership has allowable loss, no partner should have a taxable profit from the partnership. If that occurs, reallocation is required.

The share of profits or losses of each individual partner is ascertained in accordance with the profit/loss sharing ratio during the basis period for the year of assessment concerned. When there is a change in partnership in any year, it is necessary to divide the basis period into periods, one before and one after the change. The profit/loss is then allocated to the partners in accordance with the profit/loss sharing ratio in the respective periods.

Example 72

D, E and F Ltd carry on a partnership business since 1990. The partnership agreement states that:

(1) D and E would each receive an annual salary of $180,000;

(2) F Ltd would be paid interest at the rate of 12% per annum on its capital contribution of $750,000;

(3) any additional loans made by the partners to the partnership would attract interest at the rate of 10% per annum; and

(4) the balance of profits or losses is shared amongst the partners in the ratio of 1:1:2 (D:E:F).

E retired from the partnership on 31 January 2013. Thereafter, the profit/loss sharing ratio was changed to 1:2 (D:F).

The following is the income statement of the partnership for the year ended 31 March 2013:

	$	$
Turnover		3,737,000
Less: Cost of goods sold		(1,800,000)
Gross profit		1,937,000
Less: Rent	600,000	
Salaries	780,000	
Other expenses	47,000	
Depreciation	112,500	
Loan interest	400,000	(1,939,500)
Net loss		(2,500)

The partners also provide the following information:

(1) During the year the partnership employed E's wife as a bookkeeper and paid her an annual salary of $144,000.

(2) During the year D's wife loaned the partnership $1,800,000 and received interest thereon of $180,000.

(3) Tax depreciation allowances as agreed with the IRD for 2012/13 is $200,000.

(4) D and his wife elected to be personally assessed in 2012/13. E had no other sources of income and he did not elect for PA.

Required:

(a) Compute the assessable profits/adjusted loss of the partnership for the year of assessment 2012/13.

(b) Compute the allocation of profit/loss for the partnership together with the profits tax payable by the partnership, if any, for the year of assessment 2012/13.

(c) What advice what you give to E in relation to his share of the partnership loss for the year of assessment 2012/13?

Solution

(a)

D, E and F Partnership
Profits tax computation for the year of assessment 2012/13
Basis period: year ended 31 March 2013

	$	$
Loss per account		(2,500)
Add: Salaries to partners (180,000 + 180,000 × 10/12)	330,000	
Salaries to partner's spouse (144,000 × 10/12)	120,000	
Interest to partner's spouse	180,000	
Interest to F Ltd (750,000 × 12%)	90,000	
Depreciation	112,500	832,500
		830,000
Less: Depreciation allowance		(200,000)
Assessable profits		630,000

(b)

Allocation of profit or loss

1.4.2012 – 31.1.2013 ($630,000 × 10/12 = $525,000)

	Partnership	D	E	F Ltd
	$	$	$	$
Salaries to partners (180,000 × 10/12)	300,000	150,000	150,000	-
Salaries to partner's wife (144,000 × 10/12)	120,000	-	120,000	-
Interest to partner's wife (180,000 × 10/12)	150,000	150,000	-	-
Interest on capital (750,000 × 12% × 10/12)	75,000	-	-	75,000
Balance (1:1:2)	(1,170,000)	(292,500)	(292,500)	(585,000)
Share of allowable loss	(525,000)	7,500	(22,500)	(510,000)
Reallocation to E (7,500 × 22,500/532,500)		(317)	317	
Reallocation to F (7,500 × 510,00/532,500)		(7,183)	-	7,183
Net share of loss	(525,000)	-	(22,183)	(502,817)

1.2.2013 – 31.3.2013 ($630,000 × 2/12 = $105,000)

	Partnership	D	F Ltd
	$	$	$
Salaries to partners (180,000 × 2/12)	30,000	30,000	-
Interest to partner's wife (180,000 × 2/12)	30,000	30,000	-
Interest on capital (750,00 × 12% × 2/12)	15,000	-	15,000
Balance (1:2)	(180,000)	(60,000)	(120,000)
Share of allowable loss	(105,000)	-	(105,000)

Total allocation for 1.4.2012 – 31.3.2013

	Partnership	D	E	F Ltd
	$	$	$	$
Share of loss	(630,000)	-	(22,183)	(607,817)
Loss lapsed upon withdrawal	22,183	-	22,183	-
Loss c/f	(607,817)	-	-	(607,817)
Tax payable	Nil			

(c) Upon withdrawal from the partnership, E's share of the partnership loss lapses, and will not be available for set-off to the partnership or to him, unless he elects for PA. Although E had no other sources of income in 2012/13, he could have other assessable income in future years. To benefit from these losses he should elect to be personally assessed in 2012/13 so that the share of partnership loss could be carried forward to future year. (PA is discussed in **chapter 7**.)

13 Loss relief

Topic highlights

Losses suffered by different types of businesses (proprietorship, partnership and corporation) are treated differently. The general rule is that loss is carried forward and is available for set off against future profits. There is no time limit on the loss carry forward for set off purposes, and there is no provision for group loss relief in the IRO.

A loss is computed in a similar manner and for a similar basis period as profit (s.19D(1)). A loss should be converted to Hong Kong dollar each year and carried forward in Hong Kong dollar (see *CIR v Malaysian Airline System Berhad* (1994)), and set off against future profit. A loss cannot be allowed for more than once (s.19C(6)(a) and (b)). The treatment of loss depends upon whether the person incurring them is an individual, a partnership or a corporation.

13.1 Individual

A loss incurred by an individual is carried forward and set off against future profits of the same trade carried on by the same individual (s.19C(1)); unless PA is elected and the loss is transferred to and dealt with under PA (s.19C(3)). If PA is not elected, the loss lapses upon cessation of the trade carried on by the individual.

13.2 Partnership

A loss incurred by a partnership is to be allocated to the partners in accordance with the profit/loss sharing ratio during the basis period for the year of assessment concerned (s.22A(1)). Therefore, losses are individually related to the partners and are not partnership losses.

The part of the loss allocated to a partner who is an individual is carried forward and set off against his/her share of future profits of the partnership (s.19C(2)); unless PA is elected and the loss is transferred to and dealt with under PA (s.19C(3)). If PA is not elected, the loss lapses when the individual ceases to be a partner.

The treatment of loss allocated to a partner which is a corporation is discussed below.

13.3 Corporation

If a corporation carrying on a trade, profession or business is also a partner in a partnership, any loss incurred in respect of its own trading may be set off against its share of the partnership profits for that year of assessment. The balance of any loss not yet set off is carried forward to set off, firstly, against the future profits of its own trade (if any), and secondly, against its share of the partnership's future profits: s.19C(4). This order of set off is only a practice and there is no requirement in the IRO that this order of set off should be followed. However, it should be noted that this loss set off is available even though the partnership did not exist at the time the corporation incurred the loss (*D65/02*).

Likewise, if the partnership incurs a loss, the share of such loss allocated to the corporation may be set off against any other profits of that corporation for that year of assessment. The balance of any loss not yet set off is carried forward to set off, firstly, against its share of the partnership's future profits (if any), and secondly, against the future profits of its own trade: s.19C(5). The share of partnership loss does not cease to be available even if the corporate partner withdraws from the partnership. However, share of partnership profit cannot set off against the corporation's share of loss in another partnership, or vice versa.

13.4 Trust

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: s.19C(6)(e). In other words, losses of one trust are not available for set off against profits of

another trust administered by the same trustee, or against profits of the trustee himself in his personal capacity.

Example 73

G, H and J Ltd started a partnership business on 1 January 2011, sharing profits and losses equally. G and H draw salaries of $140,000 and $40,000 per annum, respectively.

In the first year of trading ended 31 December 2011, the agreed loss of the partnership is $120,000. The assessable profits for the second year of trading ended 31 December 2012 is $240,000. G has elected for PA for 2012/13 only. J Ltd has an agreed loss of $5,000 and assessable profits of $30,000 from its own trade for the years of assessment 2011/12 and 2012/13, respectively.

Required:

Compute the allocation of profit/loss for the partnership together with the profits tax payable, if any, for the years of assessment 2011/12 and 2012/13; claiming for J Ltd any relief that is available.

Solution

Allocation of profits and loss
Year of assessment 2011/12
Basis period: year ended 31 December 2011

	Total ($)	G ($)	H ($)	J Ltd ($)
Salary	180,000	140,000	40,000	-
Balance (1:1:1)	(300,000)	(100,000)	(100,000)	(100,000)
Agreed loss	(120,000)	40,000*	(60,000)	(100,000)
Reallocation	-	(40,000)	15,000*	25,000*
Net loss c/f – ss.19C(2) & (5)	(120,000)	-	(45,000)	(75,000)

* Reallocated according to the ratio of H and J's share of losses.
For H is $40,000 × 60,000/(60,000 + 100,000) and for J is $40,000 × 100,000/(60,000 + 100,000)

Year of assessment 2012/13
Basis period: year ended 31 December 2012

	Total ($)	G ($)	H ($)	J Ltd ($)
Salary	180,000	140,000	40,000	–
Balance (1:1:1)	60,000	20,000	20,000	20,000
Assessable profits	240,000	160,000	60,000	20,000
Loss b/f & set off – ss.19C(2) & (5)	(65,000)	–	(45,000)	(20,000)
	175,000	160,000	15,000	–
Transfer to PA – s.19C(3)	(160,000)	(160,000)	–	–
Net assessable profits	15,000	–	15,000	–
Tax thereon at 15%	2,250	–	2,250	–

Statement of loss for 2012/13

	Total ($)	G ($)	H ($)	J Ltd ($)
Balance b/f from 2011/12	120,000	–	45,000	75,000
Less: Utilised – s.19C(2)	(65,000)	–	(45,000)	(20,000)
Transferred – s.19C(5)	(25,000)	–	–	(25,000)
Balance c/f	30,000		–	30,000

Note: J Ltd has an agreed loss of $5,000 for the year of assessment 2011/12, which would be carried forward and set off against the assessable profits of $30,000 in 2012/13, resulting in a net assessable profit of $25,000. The net assessable profit can be set off by the share of loss of the partnership. The share of partnership loss of $30,000 not yet utilised can be carried forward in the partnership.

DIPN 8 provides guidance and examples on treatment and computation of losses after 1 April 1975.

Example 74

Refer to the facts in Example 61. You are provided with the following additional information by Nick:

NPWL and Best formed a partnership, N&B Partnership ('Partnership 1'). NPWL sustained a loss of $200,000 from Partnership 1 for the year of assessment 2012/13. Nick is also a partner in a partnership, Nick & Co ('Partnership 2'). The loss Nick sustained from Partnership 2 for the year of assessment 2012/13 amounted to $150,000. Nick would like to set off the losses of Partnership 1 and Partnership 2 against the assessable profits of NPWL.

Required:

Explain whether losses of Partnership 1 and 2 can be set off against the assessable profits of NPWL.

Solution

If a partnership incurs a loss, the share of partnership loss allocated to a partner which is a corporation can be set off against any other profits of that corporation for that year of assessment: s.19C(5). NPWL is therefore entitled to set off the loss sustained from Partnership 1 against the assessable profits of NPWL.

On the other hand, the share of partnership loss allocated to a partner who is an individual is to be set off against his/her share of future profits of the partnership (s.19C(2)), unless PA is elected and the loss is transferred to and dealt with under PA (s.19C(3)). Therefore, the loss of Partnership 2 cannot be set off against the assessable profits of NPWL. If Nick does not elect for PA, the loss sustained by him from Partnership 2 can only be carried forward to set off against his share of Partnership 2's assessable profits in subsequent years.

HKICPA May 2008 (Amended)

Self-test question 8

(a) HKCO Ltd ('HKCO') commenced business and incurred an agreed loss of $20 million in the first accounting year ending 30 June 2013. Advise HKCO of the relevant tax implications.

(b) HKCO is a subsidiary of Kowloon Ltd. Kowloon Ltd has a projected profit of $100 million for the year ending 30 June 2013.

  (i) Can Kowloon Ltd utilise the loss in HKCO?

  (ii) Would your answer be the same if Kowloon Ltd is a subsidiary of HKCO?

(c) What if HKCO is a partner in HK-Kowloon Partnership? The partnership has derived assessable profits of $60 million in the year ending 30 June 2013. HKCO has a 50% interest in the partnership.

(d) Comment on the agreed tax loss in HKCO for each of the following scenarios:

  (i) The management decided to close down HKCO in 2014 and leave it dormant.

  (ii) The management decided to liquidate HKCO.

  (iii) The shareholders decided to sell their investment in HKCO to Paris CO.

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(The answer is at the end of the chapter)