Answers

Cases are given in the answers for educational purposes. Unless specifically requested, candidates are not required to quote specific case names to obtain the marks. Only the general principles involved are required.

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1 Report to the directors of Lufer (HK) Ltd

To: The directors, Lufer (HK) Ltd
From: Tax adviser
Date: 5 June 2015
Subject: Hong Kong tax position of Lufer (HK) Ltd (Lufer-HK)

We refer to our earlier meeting discussing the overall tax position of Lufer-HK and the transactions between Lufer-HK and its group companies. We provide our advice on the respective issues as follows.

(a) (i) Chargeability of the profits from sales in Hong Kong

For there to be a charge to profits tax, various cumulative conditions are required to be satisfied (s.14(1)). These are: (1) a business is carried on in Hong Kong; (2) profits are from that business; and (3) those profits arise in or are derived from Hong Kong. In Lufer-HK's case, both conditions (1) and (2) are satisfied and condition (3) is therefore critical.

Hong Kong profits tax operates on a 'territorial' concept. To determine the source of profits, the broad guiding principle is that one looks to see what the taxpayer has done to earn his profits and where he has done it: the *Hang Seng Bank* case and *HK-TVB International* case. In the case of manufacturing profits, the profit-making activity is considered to be the manufacturing operation and profits are made where this is carried out. In the case of trading profits, the profit-generating activity is considered to be the place where the purchase and sale contracts are negotiated, concluded and effected. The Inland Revenue Department (IRD) has set out what the Department regards as the general principles in the Departmental and Practice Note (DIPN) No. 21 (paragraphs 30 to 32) which literally confirms the principles stated by the courts in the aforesaid *Hang Seng Bank* case, *HK-TVB International* case, and other subsequent cases (e.g. the *Kwong Mile* case and the *ING Barring* case).

In the case of manufacturing profits, the IRD considers that where goods are manufactured in Hong Kong, the profits arising from the sale of such goods will be fully taxable because the profit-making activity is considered to be the manufacturing operation carried out in Hong Kong. Where goods are manufactured partly in Hong Kong and partly outside Hong Kong, then that part of the profits which relates to the manufacture of goods outside Hong Kong will not be regarded as arising in Hong Kong; and apportionment is generally allowed on a 50:50 basis, unless compelling circumstances dictate otherwise. However, in the exceptional case where the sale activities in Hong Kong are so substantial that the nature of the business in Hong Kong actually constitutes a retailing or trading business, profits attributable to such business are to be determined based on the place where the relevant contracts are negotiated, concluded and effected.

In the case of Lufer-HK and Lufer (PRC) Ltd (Lufer-China), there is an import processing agreement, whereby Lufer-HK exports raw materials into the Mainland by way of sale to Lufer-China, and imports finished goods from the Mainland by way of purchase from Lufer-China. The transactions between Lufer-HK and Lufer-China are effectively transfers of raw materials and finished products by way of sale and purchase at a consideration. From the IRD's perspective, Lufer-HK is dealing with Lufer-China in terms of selling raw materials and buying finished products. Lufer-HK does not make profits out of selling the raw materials to Lufer-China, but does make profits out of buying the finished products from Lufer-China and selling the same finished products to retailers in Hong Kong. Lufer-HK is actually running a trading business rather than a manufacturing business, and thus the nature of its profits is trading profits. The source of trading profits is determined by the locations at which Lufer-HK carried out the purchase and sale activities, which from the facts given are both substantially, if not exclusively, Hong Kong. Hence Lufer-HK derives profits in Hong Kong which are chargeable to profits tax in Hong Kong.

The above approach had been adopted by the Commissioner (*CIR* v *Datatronic Ltd* and *CIR* v *CG Lighting Ltd*) and endorsed by the Court of Appeal, which found that the arrangement between the Hong Kong taxpayer and its subsidiary in the Mainland, in each case was by way of import processing, i.e. activities similar to those of Lufer-HK as referred to above. Accordingly, the taxpayer's profits were found by the courts not to be manufacturing profits. Instead, the courts found that the taxpayer's profit-making transactions consisted of purchasing goods from the subsidiary and then reselling them at a profit, which took place in Hong Kong. The source of the profits was therefore located in Hong Kong and the profits were fully taxable in Hong Kong. Although some activities were performed by the Hong Kong taxpayer in the Mainland, the court concluded that these activities were merely antecedent or incidental to the production of profits, and were not sufficient to render the sale profits as originating from outside Hong Kong.

The concession of a 50:50 apportionment basis only applies in the case of manufacturing profits (paragraph 34 of DIPN 21). As such it is only available in the case of 'contract processing' (pursuant to an arrangement by which the Hong Kong taxpayer maintains his ownership in the materials to be manufactured into finished goods throughout the manufacturing process and carries out substantial activities in the manufacturing in the Mainland) and not to 'import processing'.

In conclusion, the sale profits earned by Lufer-HK are all earned in Hong Kong and will be 100% taxable in Hong Kong.

(ii) Deduction in respect of the cost of machinery and moulds

Any expense or outgoing incurred in the production of assessable profits is deductible (s.16(1)). However, expenditure which is capital in nature is not allowed (s.17(1)(c)) although a tax depreciation allowance may be granted and certain specific deductions are available also subject to conditions.

In the case of Lufer-HK, the machinery and moulds are obviously capital assets for use in the manufacturing of products, so the capital expenditure will not be allowed under the general deduction rule (s.17(1)(c)). Since the machinery and moulds are used in the manufacture of products which are sold at a profit which is assessable to profits tax, and the machinery and moulds will qualify as 'plant and machinery', *prima facie*, a tax depreciation allowance at 20% or 30% should be granted. However, a tax depreciation allowance is denied to a taxpayer where there is a lease of the machinery or plant in which the taxpayer is a lessor and the asset is used by a person other than the taxpayer wholly or principally outside Hong Kong (s.39E(1)(b)). 'Lease' in relation to any machinery or plant is defined as including '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). In the case of Lufer-HK, when the machinery and moulds are transferred to the China factory for use outside Hong Kong, these assets would be regarded as 'leased assets' and thus a tax depreciation allowance would be denied to Lufer-HK (DIPN 15) regardless of whether any rental is charged.

For the same reason, Lufer-HK will not be eligible for a 100% deduction for the cost of the moulds as prescribed fixed assets (s.16G) as 'prescribed fixed assets used by any person holding rights as a lessee under a lease' are excluded from the concession (s.16G(6)).

In conclusion, Lufer-HK is neither eligible for a tax depreciation allowance nor allowed a specific tax deduction for the cost of the machinery and moulds.

Tutorial note: *Reference may be made to* Braitrim (Far East) Limited *v* CIR*, in which the Court of Appeal held that the term 'lease' in s.16G(6) should follow the statutory definition under s.2(1).*

(b) (i) Loan interest income received from Lufer (PRC) Ltd

Lufer-HK has extended an interest-bearing loan to Lufer-China and earns interest income. Interest income derived by a company carrying on business in Hong Kong will be deemed to be assessable profits subject to profits tax, if the interest is derived from a source in Hong Kong (s.15(1)(f)). Based on DIPN 13, the IRD used to adopt the 'provision of credit' test to ascertain the source of interest income, i.e. the place where the credit is first made available to the borrower. On this basis, if the moneys comprising the loan to Lufer-China were first made available to Lufer-China at a place outside Hong Kong, such as by remitting the loan money to Lufer-China's bank account in the PRC, the loan interest may be regarded as sourced outside Hong Kong and not taxable to Lufer-HK. However, the IRD has also expressed the opinion that the 'provision of credit' test would be restricted to the situation where the loan is extended from idle surplus cash and the interest earned is in the nature of passive income. Therefore the IRD may possibly apply the operations test to determine the source of interest income if the IRD considers that the lending of money is in fact of the nature of a money lending transaction (based on the *Orion Caribbean* case).

In the case of Lufer-HK, the loan to Lufer-China is financed by the loan from Lufer (UK) Ltd (Lufer-UK), and the interest charge is arranged so as to enable Lufer-HK to earn a small spread. It is likely that such a loan arrangement would be challenged by the IRD as a money-lending transaction carried on by Lufer-HK. In this case, the nature of the interest income is similar to that of a trading income, and its source would be determined by the place where the loan is negotiated, concluded and effected (the 'contract-effected' test). Therefore, if the loan arrangement between Lufer-HK and Lufer-China is negotiated, concluded and effected in Hong Kong, then the loan interest income from Lufer-China would be sourced in Hong Kong and taxable in Hong Kong. Further details regarding the arrangement will be required for us to advise fully on this point.

Loan interest paid to Lufer (UK) Ltd

To finance the loan to Lufer-China, Lufer-HK obtains a loan from Lufer-UK at an interest of 3%. The tax deductibility of the interest payment to Lufer-UK would depend on:

(1) whether the loan interest expense is incurred in the production of assessable profits (s.16(1)(a)); and

(2) whether the interest on the borrowing, being a loan from a person other than a financial institution, is taxable in Hong Kong in the hands of the recipient, i.e. Lufer-UK (s.16(2)(c)).

As explained above, the taxability of the loan interest income received from Lufer-China is dependent upon the place where the loan agreement is concluded and effected. Assuming that the loan interest from Lufer-China is treated as sourced in Hong Kong and taxable in the hands of Lufer-HK, then the loan interest expense paid to Lufer-UK will be incurred in the production of assessable profits and thus condition (1) above will be satisfied.

However, condition (2) is not likely to be fulfilled for the reason that Lufer-UK would not be taxable in Hong Kong in respect of the loan interest received from Lufer-HK, unless Lufer-UK is regarded as carrying on business in Hong Kong by virtue of putting the loan moneys into the possession of Lufer-HK or its agent within Hong Kong (hence the credit is also provided in Hong Kong) thereby rendering Lufer-UK chargeable to profits tax in Hong Kong in regard to the interest income from that loan; or Lufer-UK is itself carrying on business as a financial institution, which is unlikely. As such, the interest payment from Lufer-HK to Lufer-UK will not be tax deductible for profits tax purposes.

Lufer-HK will be placed in an ineffective position if it is taxed on the interest income from Lufer-China but is not eligible for a tax deduction for the interest paid to Lufer-UK, which is likely to be the case if viewed solely from a Hong Kong tax perspective (i.e. disregarding any UK and/or PRC tax consequences) for the corporate group as a whole. Further, even if the loan interest income from Lufer-China is not itself taxable, there will remain the Chinese withholding tax of 7% deducted from the interest payment made to Lufer-HK.

(ii) China withholding tax

On remitting the interest from China to Hong Kong, China tax at 7% is payable on the gross amount of interest remitted. This tax is settled by way of withholding and is deducted from the remittance, as a result of which Lufer-HK receives only the net balance of 93%. The 7% tax amount is therefore recorded as an expense in the accounts of Lufer-HK. A specific tax deduction is available for the overseas tax paid (s.16(1)(c)) if the tax is paid on interest income or gains from bills of exchange deemed as taxable trading receipts (i.e. under s.15). In the case of Lufer-HK, such a specific deduction will be allowed because the 7% tax is paid on interest income which is deemed taxable under s.15(1)(f).

We trust that the above addresses all the significant Hong Kong profits tax implications for the issues raised. Should there be any questions, please let us know.

End of Report

2 John and Mary

(a) Option for Mary to take over the boutique business

In the event that Mary takes over the shares in the BVI company which owns the boutique business, any profits earned by the boutique will belong to the BVI company. Although the BVI company is incorporated in the BVI, it will be regarded as carrying on business in Hong Kong for the reason that its retail shop is located in Hong Kong. Moreover, the boutique business profits will be considered as sourced in Hong Kong since the boutique is located in Hong Kong. As a result, the BVI company will be assessed to profits tax in Hong Kong at 16·5% in respect of the profits earned by the boutique in Hong Kong. Any after-tax profits may be distributed by the company to Mary in the form of a dividend. From the perspective of Mary's Hong Kong tax position, this dividend income of Mary will not be taxable in Hong Kong on the basis that it is excluded from Mary's assessable profits because it has been paid out of profits which have already been subject to profits tax in the hands of the BVI company (s.26(a)). On the other hand, if the boutique business incurs losses, the losses will remain in the BVI company and be carried forward to set off the future profits earned by the BVI company. In these circumstances, there will not be any tax consequences to Mary. Even if Mary elects for personal assessment, any boutique business income earned or losses incurred by the BVI company will not be eligible to be combined with Mary's other income assessed to tax in Hong Kong. As the dividend income is not taxable, it also is not required to be included in the personal assessment.

In the event that Mary takes over the boutique business directly and runs the business as a sole proprietor, the profits from the business will be directly attributable to Mary. In this case, Mary will be charged to profits tax in respect of the assessable profits of the business at 15%, i.e. 1·5% less than is the case where the profits are derived by the BVI company. There can be legally no dividend distribution and any after-tax profits will automatically become part of Mary's disposable income. If the boutique business incurs losses, the losses will be carried forward to set off against future profits earned by the same business. However, if Mary also has other assessable income, it will be more tax effective for her to elect for personal assessment so that the losses from the boutique business will be combined with her other income to achieve an off-set effect.

(b) Participation in the partnership business

For Hong Kong tax purposes, a partnership is assessed as a person and the tax law and rules applicable to ascertaining the assessable profits of a partnership are basically similar to those applicable to a sole-proprietorship business. Any assessable profits or adjusted losses of a partnership shall be allocated to the respective partners according to the profit/loss sharing ratio. If a partner is allocated a share of profits, their share of profits will be assessed to tax under the partnership. If a partner is allocated a share of loss, the loss will be carried forward under the partnership and can only be offset by the partner against his/her share of future profits allocated from the same partnership. In the case of Mary, any share of profits or loss allocated from the partnership will be assessable to profits tax or carried forward under the partnership. However, if Mary so elects she will be able to transfer the partnership profits or loss to her personal assessment.

In the event that Mary draws a salary from the partnership business, the salary will be regarded as an advanced allocation of profits and is not tax deductible to the partnership. A salary paid to a partner, or a partner's spouse, is required to be adjusted before the annual partnership profits are allocated. Since the salary will be treated as part of Mary's share of partnership profits, Mary will not be assessed to salaries tax in respect of any partnership salary paid to her. This tax treatment remains the same for any salary paid to John. However, if Mary's sister is engaged by the partnership as an employee, the income earned by the sister will be treated as normal income from employment and be assessed to salaries tax accordingly. Also, any salary paid by the partnership to Mary's sister will be tax deductible.

(c) John's Hong Kong salaries tax position

Salaries tax is charged on income from employment, office and pension arising in, or derived from Hong Kong (s.8). Income from employment includes income derived from services rendered in Hong Kong and excludes income derived from services rendered outside Hong Kong (s.8(1A)). In the case of employment income, in the *Goepfert* case the court ruled that the source of the employment income should first depend on the source of employment, which is where the employment is located. Based on that case the Inland Revenue Department (IRD) takes the position (DIPN 10) that an employment is located outside Hong Kong (a foreign employment) where the following three factors are present:

(1) the contract of employment was negotiated and entered into, and is enforceable outside Hong Kong;
(2) the employer is resident outside Hong Kong; and
(3) the employee's remuneration is paid to him outside Hong Kong.

If not all of the above factors are outside Hong Kong, it appears that the first two factors are more important than the third factor. The IRD also reserves the right to look beyond the three factors where in reality the employment is a Hong Kong employment but manipulation exists.

In the case of John's new employment, given that the negotiation and conclusion of the contract is in China, and the new employer is resident in China, it is likely that the IRD will accept the employment as a foreign employment with its source outside Hong Kong. As John performs some of his duties in Hong Kong, he will still be subject to Hong Kong salaries tax in respect of his income derived from the services rendered in Hong Kong, including any leave pay attributable to such services (s.8(1A)(a)). In ascertaining John's taxable income, the usual time apportionment basis would be used, i.e. his employment income will be apportioned according to the number of days that he is present in Hong Kong. The 60-day rule will not apply to John because he is not a visitor, given that his work base and family base are in Hong Kong. Thus, in any future year in which John may stay less than 60 days in Hong Kong, he will still be required to pay Hong Kong salaries tax based on time apportionment.

In respect of the major items of John's remuneration package, the tax treatments, subject to time apportionment if assessable, are:

Monthly salary – the gross salary of $100,000, instead of $90,000, will be brought into tax assessment. The 10% amount withheld by the employer is not tax deductible for salaries tax purposes.

Lump sum incentive – the $80,000 incentive is taxable to John in Hong Kong on the basis that it is an inducement for him to enter into the new employment and thus a reward for future services.

Housing allowance – the $30,000 is taxable to John in Hong Kong as it is paid in cash for his services. The rationale of the payment to compensate for John's mortgage loan repayment is not relevant to the item's assessability. Moreover, rental value is not required to be calculated in John's case.

Reimbursement of any additional China tax liability – any reimbursement paid by the employer to John will be taxable on John in Hong Kong as it remains a reward for services from the employment. Moreover, tax liability is a personal expense and thus reimbursement from the employer is a discharge of John's liability by the employer and hence taxable.

Holiday package – holiday expense is another kind of personal expense, and thus any reimbursement from the employer to cover John's personal expenses spent during holiday also represents a discharge of John's liability and is taxable to John. In the event that the benefit is given in the form of a holiday package, the value of the package is still taxable to John on the basis that it is convertible into cash.

(d) Swap of residence with John's parents

Currently, the couple live in an apartment which is held jointly by the couple and is under mortgage. Under the current accommodation arrangement, the couple can claim a tax deduction for the home loan interest based on the amount of mortgage loan interest paid during the year, subject to a maximum of $100,000 per year for a total of 15 years. However, eligibility for a home loan interest deduction requires that the property must be occupied by the couple as their principal residence. If they choose to move out of the apartment and move into John's parents' property, the original mortgaged property will no longer be occupied by the couple as their principal residence. As a result, they will not be able to claim a home loan interest deduction once they move out. This remains the case regardless of whether they continue to pay the mortgage loan interest after they move out of the property.

As regards the residence owned by John's parents, there is no tax implication to the couple. The payment of nominal rent to John's parents will be a private expense which is not eligible for a deduction under salaries tax.

(e) Claim for child allowance

In Hong Kong, child allowance is granted to any taxpayer who, during the year of assessment, maintains an unmarried child who is under 18 years old, or is of or over 18 but under 25 years old and receiving full-time education, or is of or over 18 years old and is unable to work due to physical or mental disability. In the year of birth of a child, an additional one-off child allowance will be granted to the same parent claiming the child allowance. However, the law stipulates that only one parent, not both, is eligible to claim all child allowances in respect of all his/her children, unless the husband and wife are living apart. No apportionment is allowed. As such, John and Mary will have to decide and agree who will claim both child allowances, and they will need to be nominated by the other spouse in the tax return. Nomination of a particular spouse to claim child allowances can alter from year to year.

In the current year when the twins are born, a total amount of $280,000 (being $70,000 for each child, with an additional one-off $70,000 for each new-born) can be claimed by either John or Mary, not both nor apportioned.

3 Metoo (HK) Ltd

(a) Tax position of the Metoo group

The relationship between Metoo (HK) Ltd (Metoo-HK) and Metoo (PRC) Ltd (Metoo-China) is not only that of parent and subsidiary, but also of purchaser and seller. Metoo-HK purchases goods from Metoo-China and sells the goods for income. The price paid for the goods represents the cost of purchase (or cost of goods sold) in the accounts of Metoo-HK, and will be reported as a deduction against its sales income for Hong Kong profits tax purposes. At the same time, the price charged on the goods represents the sales income to Metoo-China and will be reported as taxable income for China enterprise income tax purposes. Given the discount, the cost of purchase deducted by Metoo-HK will be understated for Hong Kong tax purposes, resulting in a higher Hong Kong tax liability. However, the sales income assessed to Metoo-China will be understated by the discount, resulting in a lower China tax liability. Since Metoo-HK is the parent company of Metoo-China, they are associated enterprises as defined under the Arrangement between the Mainland of China and HKSAR for the avoidance of double taxation and the prevention of fiscal evasion with regard to taxes on income. Transactions between them are associated party transactions which is a common subject for scrutiny under the transfer pricing regulations.

While the selling price of the products was challenged and adjusted upwards by the China tax bureau so that the taxable sales income of Metoo-China was increased, the corresponding cost of purchase by Metoo (HK) Ltd was not adjusted accordingly. This has resulted in Metoo-HK being assessed for Hong Kong profits tax purposes on the invoice value which is lower than the amount assessed as sales income to Metoo-China. The combined effect from the group's perspective is that the adjusted income of $100,000 is double-taxed, and the additional China enterprise income tax of $25,000 is a double taxation liability paid by the group.

(b) Ability to revise the assessment under Hong Kong law

An assessment which has become final and conclusive may not be re-opened unless there is an error or omission made by the taxpayer. If it is proved to the satisfaction of the IRD that an assessment is excessive by reason of an error or omission in a tax return or statement submitted by the taxpayer, the taxpayer has the right to apply for the error or omission to be corrected (s.70A). The circumstances in which such an application can be made are:

(1) an error or omission in a return or statement submitted; or
(2) an arithmetical error or omission in the calculation of the assessable profits or the tax charged.

However, the assessment cannot be re-opened for an error or omission in a return or statement where that return or statement was made on the basis of a prevailing practice.

The application must be made within six years after the end of the relevant year of assessment or within six months after the service of the notice of assessment, whichever is the later.

In the case of Metoo-HK, it is unlikely that an application will be successful since there is no error or omission in the Hong Kong tax returns filed. The cost of purchase was recorded based on the invoice value which is after the 10% discount from the market selling price. The transfer pricing adjustment made by the China tax bureau does not alter the invoice value agreed between Metoo-HK and Metoo-China, and thus does not constitute an error or omission on the side of Metoo-HK.

(c) (i) Types of double taxation

In the context of a double taxation arrangement (DTA) according to the IRD, there are in general two types of double taxation: economic double taxation and juridical double taxation. Economic double taxation arises where two companies residing in the corresponding DTA sides are taxed on the same profit or income while there is no relief granted by either side for the tax imposed by the other side. A typical example is when a company is additionally assessed in its country (one DTA side) due to a transfer pricing adjustment (a primary transfer pricing adjustment) but its corresponding party to the same business transaction (residing in the other DTA side) is not given a corresponding adjustment. Juridical double taxation usually occurs when a company is being taxed on the same profit or income in two different countries (or DTA sides). For example, a company with a head office in one DTA side may have a permanent establishment in the other DTA side, and the same profit or income is taxed on both sides.

In the case of Metoo-HK, since the pricing adjustment in China does not adjust the pricing in Metoo-HK, the additional China enterprise income tax of $25,000 is an economic double taxation from the group's perspective.

(ii) Ability to revise the assessment under the DTA

The DTA signed between the Mainland of China and HKSAR, Article 9 – Associated Enterprises, provides a mechanism whereby a relief from economic double taxation may be available if tax is charged on the same profits in both Mainland China and Hong Kong as a result of a pricing adjustment based on the arm's length principle. Therefore, if the pricing adjustment made to Metoo-China was by reference to the arm's length price, and as a result of this pricing adjustment, Metoo-HK is also assessed in Hong Kong on the same profit (i.e. the difference between the invoice value and the assessed value after the pricing adjustment), Metoo-HK will be eligible to apply for double taxation relief relying on Article 9. Such a claim has to be made within six years from the end of the relevant year of assessment.

If the IRD agrees, the assessment for the relevant year of assessment (i.e. 2013/14) will be revised and the excessive tax refunded accordingly (s.79). However, DIPN 45 makes it clear that corresponding adjustment in the case of double taxation is not mandatory, and it requires that the primary transfer pricing adjustment is justified both in principle and in amount.

On the other hand, if the Commissioner of Inland Revenue considers it necessary, he may consult with the competent authority in Mainland China with a view to resolving the double taxation issue on a mutually agreed basis (Article 23 of the DTA between the Mainland of China and HKSAR).

4 Happy Club

(a) Current Hong Kong tax position

Under the Hong Kong profits tax regime, a club is deemed as carrying on a business if less than half of the club's gross receipts are received from its members (s.24(1)). For this purpose, 'gross receipts' are defined to include all gross receipts on revenue account including entrance fees and subscriptions. 'Members' only refer to voting members. If a club is deemed to be carrying on a business, the whole of its profits both from members or others, including those entrance fees and subscriptions, will be deemed to be receipts from the business and thus subject to profits tax.

In the case of Happy Club (the Club), information shows that all receipts are currently sourced from the Club's members and all of its members are voting members. As such, the Club will not be deemed to be carrying on a business and so will not be chargeable to profits tax.

Furthermore, no property tax will arise since under the current circumstances, the Club does not receive any consideration for the use or right to use land and/or buildings in Hong Kong.

(b) Potential implications of the two proposals

Under proposal 1, catering services will be open for use by non-members. Under proposal 2, part of the car park rental will also be received from non-members. As a result, the Club is expected to generate receipts from non-members as well as from members. This could potentially lead to a change in the Club's profits tax position depending on the proportion of its gross receipts received from members versus non-members. If following the implementation of the two proposals the portion of receipts from members as compared to the total gross receipts is less than 50%, then the Club will be chargeable to profits tax on the whole of its profits, from both members and non-members. Since the Club is not a corporation, the applicable profits tax rate will be 15%. The determination of the Club's chargeability is done for each year of assessment. Therefore, it is possible that the Club may be deemed to be carrying on a business and thus chargeable to profits tax for one assessment year, but may not be such for another assessment year.

Another implication to the Club arising from the proposals is the exposure to property tax. Under proposal 2, the Club will own car park space and earn rental income from leasing the car park space to both the public and its members. The Club will be subject to property tax in Hong Kong in respect of its letting income from the car park on the basis that it is the owner of land and/or buildings located in Hong Kong (s.5(1)). Car park space is included in the definition of 'land and/or buildings' for property tax purposes. It is worth noting that chargeability to property tax is not affected by the Club's profits tax position, that is, regardless of whether the Club is chargeable to profits tax in a particular year, it will still be liable to property tax in respect of the car park rentals earned during that year, unless exemption is granted.

Thus even in an assessment year when the Club is not deemed to be carrying on a business and not subject to profits tax in Hong Kong in respect of any of its receipts generated (including the car park letting income), the Club will be liable to property tax in respect of its car park letting income. Property tax will be imposed at the standard rate of 15% on the net assessable value, which is defined to include any consideration payable in money or money's worth in respect of the right to use the land and/or buildings, as reduced by two types of deductions: (1) government rates paid by the owner if it has been so agreed between the owner and the tenant; and (2) a statutory allowance of 20% of the assessable value after deducting rates if applicable (s.5B). The statutory allowance is deemed to cover all related expenses incurred by the owner on the property, therefore, all other actual expenses incurred, including management fees and interest, will not be deductible for property tax purposes. In the Club's case, this means that the interest incurred on the bank loan to finance the acquisition of the car park will not be deductible under property tax.

However, in any year in which the Club is deemed to be carrying on a business in Hong Kong and is thus liable to profits tax for that year in respect of all its receipts including the car park letting income, the interest payment on the bank loan to finance the acquisition of the car park will be deductible in computing the Club's assessable profits for profits tax purposes (s.16(1) and s.16(2)(d) subject to the restrictions under s.16(2A) and s.16(2B)). At the same time, the Club will continue to be chargeable to property tax for the year in respect of the car park letting income. Because the Club is not a corporation, it is not eligible for exemption from property tax (s.5(2)(a)) and so the car park letting income will potentially be double-taxed under both profits tax and property tax. In this case, a relief to eliminate the double taxation burden is available by which the property tax paid is eligible for set off against the Club's profits tax liability (s.25). Strictly under the IRO, it is a condition of this relief that the property tax must have been paid before it can be offset against the profits tax liability, thereby creating a cash flow issue. In practice, however, the IRD is prepared to discharge the property tax charged upon receipt of proof that the property tax would be refundable if paid. The relief only provides for the offset of the property tax against the profits tax liability, but not the opposite.

(c) Stamp duty implications from acquiring the car park

Conveyances on the sale or transfer of immovable property in Hong Kong are subject to Hong Kong stamp duty under Head 1 of the Stamp Duty Ordinance (SDO). The chargeable document is the agreement for sale and purchase. For agreements executed on or after 23 February 2013, the new Scale 1 duty rates apply unless the purchaser is a Hong Kong permanent resident and does not own any other residential property in Hong Kong at the time of acquiring the subject property. The Club is not a Hong Kong permanent resident, therefore, the new *ad valorem* rates ranging from 1·5% (for value not exceeding $2,000,000) to 8·5% (for value exceeding $20,000,000) will apply.

The dutiable value is usually based on the transaction price or consideration, unless the consideration is below market price, in which case the property market value will be used for stamping purposes. Where the sale and purchase agreement is stamped, the subsequent formal assignment or conveyance executed in conformity with the stamped agreement will be liable to a fixed duty of $100. The law stipulates that both parties to the transaction are jointly and severally liable to pay the stamp duty, but it is market practice that the purchaser is normally the person to pay.

Neither special stamp duty nor buyer's stamp duty will be payable in addition to the *ad valorem* stamp duty, because the subject of the conveyance, the car park, is not a residential property.

5 Joyce Ltd

(a) Profits tax and stamp duty implications of the lease

(i) The definition of 'business' (s.2) includes letting by a corporation, therefore, Joyce Ltd will be subject to profits tax because it is deemed to be carrying on a business. Thus, it will not be entitled to the statutory allowance of 20% of its rental income, as this is available only under property tax, but it can deduct its actual expenses paid (which might or might not exceed 20%), as well as depreciation allowances with respect to the building.

A person subject to profits tax is taxable on its 'profits'. For this purpose, profits are calculated according to generally accepted accounting principles (GAAP). Provided that apportioning the upfront payment over three years is permitted under GAAP in Hong Kong and this appears to be the case (see DIPN 4 and HKAS 17), Joyce Ltd is entitled to bring only $800,000 into account, and to be taxed on that amount only. A further $800,000 will be taxable in each of the following two years.

Even if GAAP would also permit Joyce Ltd to account for the whole of the $2·4 million in the year of assessment 2014/15, it nevertheless is entitled to choose between accepted accounting principles when a choice applies. The IRD is not entitled to insist that Joyce Ltd adopts the accounting principle which is more favourable to the IRD.

Stamp duty on a three-year lease is calculated at the rate of 0·5% of the average yearly rent. The market rent is $200,000 per month, but the actual rent payable is $100,000 plus an unascertainable amount attributable to the future turnover of the business conducted in the shop. It is axiomatic that stamp duty can only be charged upon amounts which are ascertainable at the time the lease is entered into. At the beginning of the lease, the amount of future turnover is speculative, and it therefore follows that no stamp duty can be levied in respect of the rental payment attributable to the turnover. Therefore, stamp duty will only be assessed on the monthly rental of $100,000; and so the stamp duty payable is $6,000 ($100,000 x 12 x 0·5%). Moreover, where the consideration includes an upfront payment in addition to the rent, this is also deemed to be stampable at the rate of 4·25%. The duty payable on the upfront payment of $2·4 million is therefore $102,000.

(ii) Where a lease stipulates a certain figure (as a minimum or maximum amount) on account of an unascertainable amount, that figure can be taken into account in ascertaining the stamp duty. Thus, the average yearly rent, to which the 0·5% rate would be applied, will be $2·4 million ($200,000 x 12) and the stamp duty payable is therefore $12,000.

(b) Advantages of an appeal being heard before the Board of Review

The major advantages of having an appeal heard before the Board of Review, rather than the Court of First Instance are:

(1) The hearings are held in private and published reports do not identify the taxpayer.

(2) The taxpayer can appoint any person who is not necessarily a barrister as their representative, and thus, whose fee is likely to be lower than that to be charged by a barrister who will be required in a court hearing.

(3) The hearing is more informal.

(4) Unlike the case in a court where the loser generally pays the legal costs of the successful party, each party before the Board of Review bears its own costs regardless of the outcome (subject to a potential costs order of a maximum of $5,000 if the Board feels that the appeal was vexatious).

(c) Tax treatment of the licence

By having effectively given up its rights to its premises for ten years, Joyce Ltd has effectively disposed of an important asset for a significant term, in a manner which affects the fundamental structure of its business. It therefore seems strongly arguable that the lump sum of $20 million should be treated as a capital gain from the disposal of a capital right which it owned, and is therefore tax free. Indeed, this is consistent with the accounting for the sum received, which Joyce Ltd has recorded as a 'disposal of a fixed asset' in its statement of profit or loss. Joyce Ltd could therefore be advised to take the position that the $20 million is not subject to profits tax.

Even though the amount has not been charged to profits tax, it will nevertheless be chargeable to property tax and there will be no profits tax for it to be set off against. Effectively, such a payment represents consideration payable to the owner of the premises in respect of the right to use the land and buildings concerned (s.5B(2)). There is no exemption from property tax for payments merely because they are on capital account (see *Harley Development Ltd* v *CIR*). However, because the payment received extends beyond the year of payment, it can be apportioned and spread over a maximum period of three years for property tax purposes (s.5B(4)).

				Available	Maximum
1	**(a)**	**(i)**	**Profits from sales in HK**		
			Conditions of s.14(1)	1	
			Hang Seng Bank case – what and where	1	
			Source of manufacturing profits: operations test	1	
			Source of trading profits: contract effected test	1	
			Basis of taxing manufacturing profits, including apportionment	3	
			Import processing arrangement making Lufer-HK a trading company	3	
			Basis of taxation of trading profits	1	
			Implications of *Datatronic* and *CG Lighting*	3	
			50/50 concession does not apply	2	
			Overall conclusion	1	
				17	14
		(ii)	**Deduction re machinery and moulds**		
			General deduction rule: s.16(1)	1	
			Depreciation allowance for plant and machinery	2	
			Restriction under s.39E(1)(b)	1	
			Meaning of lease and application to Lufer-HK	2	
			Deduction for moulds as 'prescribed fixed asset' under s.16G also excluded	2	
			Conclusion: no deduction nor depreciation allowance	1	
				9	8
	(b)	**(i)**	**Interest margin earned by Lufer-HK**		
			Loan interest from Lufer-China		
			Interest deemed as assessable profits if HK-sourced (s.15(1)(f))	0·5	
			Provision of credit test	1	
			If loan is made to China outside HK, interest offshore and non-taxable	0·5	
			Test only applies to idle funds or passive interest income	0·5	
			Money lending transaction, operations test or contract effected test	1	
			If loan is effected in HK, interest is HK-sourced and taxable	0·5	
			More information required	0·5	
			Loan interest to Lufer-UK		
			Interest is incurred in the production of assessable profits (s.16(1))	0·5	
			Interest on loan from a person other than financial institution (s.16(2)(c))	0·5	
			Interest is taxable on the recipient (s.16(2)(c))	0·5	
			If interest from Lufer-China is taxable, first condition is met	0·5	
			But Lufer-UK is not taxable on the interest received	0·5	
			Therefore, interest payment is not deductible	0·5	
			Proposed funding is not tax effective if loan interest from Lufer-China is taxable but interest to Lufer-UK is not deductible	1	
				8·5	7
		(ii)	**China withholding tax**		
			7% tax is payable on the gross amount of interest	0·5	
			Specific deduction for overseas tax paid on interest income (s.16(1)(c))	1	
			Withholding tax on interest deductible under s.16(1)(c)	0·5	2
	Appropriate format and presentation			1	
	Logical development			1	
	Effectiveness of communication			2	4
					35

			Available	Maximum
2	(a)	**Options for Mary to take over the boutique business**		
		BVI company is managed and controlled in HK, thus carrying on business in HK	0·5	
		Boutique profit is sourced in HK	0·5	
		BVI company is subject to profits tax in HK	0·5	
		After-tax profits distributed to Mary as dividend, not taxable	0·5	
		Losses by BVI company carried forward	0·5	
		No tax impact on Mary	0·5	
		Under personal assessment, BVI company's profit/loss not eligible to combine	0·5	
		Dividend income not taxable, so not combined under PA	0·5	
		If taken over directly, Mary is assessable to profits tax	0·5	
		Lower 15% v 16·5% tax rate	0·5	
		Business profit/loss can be combined with other income under PA	0·5	
		More tax effective to elect for PA if boutique business is held directly	0·5	
			6	5
	(b)	**Participation in partnership business**		
		Partnership is assessed as a person	0·5	
		Profits/losses allocated to partners per profits/loss sharing ratio	0·5	
		Share of loss is carried forward under partnership	0·5	
		Share of partnership profit/loss is combined with other income under PA	0·5	
		Mary's salary is allocation of profit, not a deductible expense to partnership	0·5	
		Partner's salary needs to be adjusted before annual profit is allocated	0·5	
		Mary is not assessable to salaries tax on salary drawn from partnership	0·5	
		Same implication if John draws salary	1	
		But salary earned by Mary's sister is employment income, deductible to partnership and taxable to Mary's sister	0·5	
			5	4
	(c)	**John's HK salaries tax position**		
		Scope of charge under s.8	0·5	
		Source of employment under the *Goepfert* rule (three criteria)	2	
		John's employment likely to be a foreign employment	0·5	
		Taxable under time apportionment basis	0·5	
		60-day rule not applicable as John is not a visitor	1	
		Monthly salary taxable on gross as 10% withheld is not deductible	1	
		Incentive taxable as inducement for future services	1	
		Housing allowance taxable, rationale irrelevant, no rental value	1·5	
		Tax reimbursement taxable, tax liability is a personal expense, discharge of employee's liability	1	
		Holiday package taxable, personal expense discharged by employer, convertible into cash	1	
			10	9
	(d)	**Swap of residence with John's parents**		
		Currently home loan interest eligibility and amount	1	
		Home loan interest no longer eligible after swap	0·5	
		Not primary principal residence	0·5	
		Regardless continue to pay interest	0·5	
		Nominal rent a personal expense, not deductible	0·5	3
	(e)	**Child allowance claim**		
		Eligibility for child allowance claim	1	
		Additional allowance in the year of birth	0·5	
		Only one parent can claim, no apportionment	1	
		Need to decide and nominate which spouse to claim	0·5	
		Nomination can alter from year to year	0·5	
		$280,000 in total for current year	0·5	4
				25

			Available	Maximum
3	(a)	**Tax position of the Metoo group**		
		Parent–subsidiary and purchaser–seller relationship	1	
		Invoice price is deductible cost to Metoo-HK for HK tax	0·5	
		Invoice price is taxable income to Metoo-China for China tax	0·5	
		Discount means lower deduction for HK	0·5	
		Discount means lower taxable profits and tax liability for China	0·5	
		Associated enterprise	0·5	
		Transfer pricing scrutiny	0·5	
		China pricing adjustment does not adjust pricing in HK	0·5	
		Therefore $100,000 is double-taxed	0·5	
			5	4
	(b)	**Ability to revise assessment under HK law**		
		Final and conclusive assessment is not re-opened	0·5	
		Unless s.70A claim due to error or omission	0·5	
		Definition of error or omission	1	
		Apply within six years after end of relevant YA or six months after notice	1	
		Not applicable for Metoo-HK, with reasons	1	4
	(c)	**(i) Types of double tax relief**		
		Two types of double taxation: economic and juridical	1	
		Explain economic double taxation with an example	3	
		Explain juridical double taxation with an example	2	
		China's adjustment does not adjust Metoo's cost accordingly	1	
		$25,000 is double-taxed	0·5	
		This case is economic double taxation	0·5	
			8	7
		(ii) Ability to revise assessment under the DTA		
		PRC–HK DTA Article 9 provides relief	1	
		Pricing adjustment is made on arm's length basis	0·5	
		Apply within six years	0·5	
		Revise assessment and refund excessive tax	1	
		Adjustment is not mandatory, needs justification	1	
		Mutual agreement under Article 23	1	5
				20

			Available	Maximum
4	(a)	**Current tax position**		
		Deeming provision under s.24 (50% rule)	1	
		Gross receipt to include entrance fee and subscriptions	0·5	
		Members to include voting members	0·5	
		Whole profit including entrance fee and subscription is taxable	0·5	
		Happy Club is not carrying on a business/subject to profits tax	0·5	
		Happy Club is not subject to property tax	0·5	
			3·5	3
	(b)	**Potential implications of the proposals**		
		Receipts from non-members may change the tax position – 50% rule	1	
		If deemed as business, whole of profits taxable	0·5	
		Tax rate 15%	0·5	
		Section 24 assessment to be done each year	0·5	
		Property tax exposure (s.5 eligibility)	1·5	
		Property tax liability regardless of s.24 position	0·5	
		In the year not deemed as business, only property tax is liable	0·5	
		Mechanism of property tax (s.5)	1	
		Bank loan interest not deductible	0·5	
		In the year deemed as business, profits tax plus property tax	1	
		Bank loan interest deductible under profits tax (ss.16(1) and (2) conditions)	1	
		Not eligible for s.5(2)(a) exemption	0·5	
		Double taxation under property tax and profits tax	0·5	
		Section 25 offset property tax against profits tax	0·5	
		Property tax must have been paid	1	
			11	10
	(c)	**Stamp duty implications**		
		Transfer of immovable property (Head 1)	0·5	
		Agreement for sale/purchase of property	0·5	
		New *ad valorem* rate with effect from 23 February 2013	0·5	
		Conditions for exclusion from new *ad valorem* rate	1	
		Happy Club charged to new *ad valorem* rate	0·5	
		Range of new rates	0·5	
		Dutiable value – transaction or market value, whichever is higher	0·5	
		Formal assignment $100	0·5	
		Both parties jointly and severally liable	0·5	
		In practice, borne by purchaser	0·5	
		No SSD or BSD	1	
		Car park is not residential property	0·5	7
				20

			Available	Maximum
5	**(a)**	**Profits tax and stamp duty implications**		
	(i)	Joyce Ltd subject to profits tax pursuant to s.2	0·5	
		Not entitled to the 20% statutory allowance	0·5	
		Actual expenses deductible	0·5	
		Depreciation allowances in respect of the building	0·5	
		Taxable on profits calculated according to generally accepted accounting principles	1	
		Apportionment of upfront payment permitted (DIPN 4 and HKAS 17)	1	
		Entitled to choose between accepted accounting principles	1	
		The IRD cannot insist on accounting principles which are more favourable to the IRD	1	
		Stamp duty at 0·5% of the average yearly rent	0·5	
		Stamp duty can only be charged upon amounts which are ascertainable at the time the lease is entered into	0·5	
		Rental attributable to turnover is unascertainable, so no stamp duty	0·5	
		Stamp duty on monthly rental of $100,000 is $6,000	1	
		Upfront payment of $2·4 million subject to stamp duty at 4·25%	1	
		Stamp duty payable is $102,000	0·5	
			10	9
	(ii)	Maximum rent is ascertainable and taken in account	1	
		Stamp duty payable on $2·4m at 0·5%, $12,000	1	2
	(b)	**Advantages of appeal being heard before the Board of Review**		
		Identity of taxpayers not disclosed	1	
		Representative cheaper than a lawyer	1	
		Hearing more informal	1	
		Each party bears its own cost	1	4
	(c)	**Tax treatment of licence**		
		Disposal of an asset for a significant term	0·5	
		Affects the fundamental structure of the business	0·5	
		Lump sum of $20 million treated as a capital gain	1	
		Therefore not subject to profits tax	0·5	
		But subject to property tax under s.5B(2)	1	
		No exemption from property tax merely because capital in nature	1	
		Lump sum spread over three years	1	
			5·5	5
				25