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.

The suggested answers are in the nature of general comment only. They are not offered as advice on any particular matter and should not be taken as such. No reader should rely on the suggested answers as the basis for any decision. The examiners expressly disclaim all liability to any person in respect of any direct, indirect, incidental, consequential or any other damages relating to the use of the suggested answers.

1 Report to

To: Mr Man
From: Tax adviser
Date: 10 December 2015
Subject: Acquisition of SmartCake Ltd

We refer to our earlier meeting regarding the Hong Kong tax implications arising from your intended acquisition of SmartCake Ltd (SmartCake) as well as the business plans that follow. We provide our advice on the respective issues as follows.

(a) Acquisition of SmartCake Ltd

(i) Stamp duty

Under the Hong Kong Stamp Duty Ordinance (SDO), stamp duty is payable on instruments that give effect to the transfer of stocks and shares which need to be registered in Hong Kong (Head 2). SmartCake is a company incorporated in Hong Kong, which must have its register of members (i.e. shareholders) in Hong Kong, therefore, the shares in SmartCake are Hong Kong stock (s.2(1) of the SDO) and their transfer will be chargeable to stamp duty. The chargeable instrument for stamp duty is the contract note (comprising a bought note and a sold note) and stamp duty is payable at the rate of 0·2% (0·1% on each of the bought note and sold note) of either the stated consideration for the share transfer or the fair market value of the shares being transferred, if higher. The subsequent instrument of transfer is subject to a fixed duty of $5. In determining the consideration for a share transfer, any benefits or money's worth including debts assigned or assumed or waived, securities, commodities or services performed is included. So, the amount of the outstanding loan balance due by SmartCake to its former shareholder, being waived by that shareholder will need to be included in the amount of the consideration chargeable to stamp duty.

(ii) Additional funding

Following the acquisition you intend to inject additional funding into SmartCake, in the form of either an interest bearing loan or as equity. Interest income received by an individual is not taxable in Hong Kong, unless the loan is provided in the course of a money-lending business carried on by that individual. In the absence of any information indicating that you carry on a business as a money-lender, the interest income received by you, as an individual, on an interest bearing loan made to SmartCake will not be taxable under any of the tax regimes of salaries tax, property tax or profits tax. Alternatively, if the funding is injected in the form of equity, the return will be in the form of a dividend. Similar to interest income, dividend income arising from personal investment does not fall within the scope of any tax charges under the tax regime in Hong Kong.

From the perspective of SmartCake, if the funds are provided as an interest bearing loan, then the tax deductibility of the interest expense incurred will depend on:

- whether the loan interest is incurred in the production of assessable profits (s.16(1)); and
- whether the borrowing, being a loan from a person other than a financial institution generates interest income which is taxable in Hong Kong in the hands of that person. (s.16(2)(c)).

It is reasonable to assume that the additional funding you intend to provide to SmartCake will be applied in its operations that generate income taxable in Hong Kong, therefore the first condition is likely to be satisfied. However, the second condition will not be satisfied because (as stated above) as an individual not carrying on a money-lending business, you will not be taxed on the interest income you receive. There is however an alternative condition for interest deduction (s.16(2)(e)) whereby a tax deduction is allowed for interest incurred on a loan which is used to acquire machinery or plant or trading stock, but only if the lender is not an associated person. As the 100% shareholder of SmartCake, you are an associate of the company and so an interest deduction under s.16(2)(e) would also be denied.

Alternatively, if the additional funding is provided in the form of equity, SmartCake would distribute dividends to yourself when profits are earned. A dividend payment is not an expense or outgoing incurred in the generation of that income, but rather an appropriation of those profits. As a result, no tax deduction can be secured. In conclusion, SmartCake is unlikely to be able to claim any tax deduction for the cost (interest or dividends) of the additional funding you intend to provide.

(b) Sale and license back of the brandname

Following the sale of the brandname to Dutch Co, SmartCake will license it back from Dutch Co pursuant to a licence agreement, under which Dutch Co will receive a licence fee. Given that Dutch Co is not carrying on a business in Hong Kong, the profits tax charge which is imposed on any person carrying on a trade, profession or business in respect of income arising in or derived from Hong Kong (s.14(1)) will not apply to this fee. However, the licence fee will be deemed to be a receipt arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong because it is received for the use of, or the right to use, the brandname in Hong Kong (s.15(1)(b)) and Dutch Co will be chargeable to profits tax in accordance with this provision. The normal quantum deemed to be assessable is 30% of the fee, which will then be multiplied by the corporation tax rate of 16·5% to arrive at the profits tax payable by Dutch Co. However, there is an anti-avoidance provision whereby the deemed rate is increased to 100% if the brandname has previously been owned by any person carrying on a business in Hong Kong, and the fee is received by an associate of that person (s.21A). In this case, Dutch Co is an associate of SmartCake, and the brandname was previously owned by SmartCake before its transfer to Dutch Co. As a result, the deemed rate of 100% will apply and Dutch Co's Hong Kong profits tax liability will be 16·5% of the gross fee it receives from SmartCake.

This tax liability will be collected through a withholding mechanism, which obliges SmartCake, as the payer of the fee to comply with the following requirements:

– To file a tax return on behalf of Dutch Co reporting the amount of the licence fee paid and the amount of tax payable. SmartCake will be regarded as the agent of Dutch Co in this context.
– To withhold the calculated tax amount from the payment made, and only remit the net amount to Dutch Co.
– To forward the amount withheld to the Inland Revenue Department (IRD) upon receipt of the tax assessment.

(c) Closure of Shop 1

(i) **Deductibility of the termination payments made to staff**

The general rule for the deductibility of outgoings and expenses requires that they must be incurred in the production of profits chargeable to profits tax during the basis period for the year of assessment (s.16(1)), and must not be capital in nature (s.17(1)(c)). The Inland Revenue Ordinance does not define what a capital expense is, but the rules generated from common law would have to be observed.

In the case of redundancy payments made in accordance with the statutory requirement, it has been established in CIR *Cosmotron Manufacturing Company Limited* that, despite the payment being made at the time of cessation of a business, the payments represent the discharge of a statutory obligation incurred in the running of the business prior to its cessation. More importantly, since it is statutorily required, the liability to pay will have accrued as a cost of employing the staff from the time the staff is first employed, even though the liability does not crystallise until actual payment is made. For this reason, the redundancy payments made under the statutory requirement will be tax deductible to SmartCake.

The deductibility of the payment made to the chef for the restrictive covenant depends on whether the nature of the payment is one of capital or revenue. A deduction for the compensation payment will be denied if it is considered as capital in nature (s.17(1)(c)). Based on case law, in general, the tests to identify capital expenditures include: the 'fixed vs circulating capital' test, the 'once-and-for-all' test, and the 'enduring benefit' test. While an expenditure connected with fixed capital (such as fixed assets) is normally considered as capital in nature, an expenditure incurred on circulating capital (such as inventory) is generally regarded as revenue in nature. From another perspective, an expenditure that recurs year by year (such as office rent) is generally regarded as revenue in nature; and an expenditure which is incurred only once and for all (such as an incorporation fee) is normally regarded as capital in nature. The enduring benefit test is viewed from the perspective of the benefit created by the expenditure. If the expenditure gives rise to a benefit which is enduring in nature and lasting longer than normal revenue expenditure, it is likely that the expenditure will be regarded as capital in nature. In the case of the compensation payment, it is made by SmartCake for the purpose of securing a covenant from a leaving employee not to compete after he has left for a long time-span of five years. Therefore, the benefit is likely to be considered as long lasting and enduring and so the payment will be regarded as capital expenditure and not deductible for profits tax purposes.

(ii) **Taxability of the compensation payment received by the chef**

From the perspective of the chef, the taxability of the compensation depends on whether it is considered as income from employment (s.8(1)(a)) which includes a reward for services, or as compensation for the deprivation of rights. If the latter, the compensation would not be taxable under salaries tax. In the case of the chef, provided that documentary evidence exists to prove that the payment is to compensate him for the loss of his rights to join other competitors and the obligation to pay such compensation is not stated in his employment contract, then the compensation is not likely to be taxable.

(d) The chef of Shop 2

Based on the proposed arrangement as requested by the chef, it is likely that the IRD will regard Chef Ltd, the company established by the chef, as a Type I service company and apply the provisions of s.9A to determine whether the new appointment constitutes a contract for service (i.e. an independent contractor), or a contract of service (i.e. an employment). If s.9A applies, the arrangement will be 'looked through' such that the relationship between SmartCake and the chef will continue to be treated as an employer-employee relationship. Any payment made to Chef Ltd will be deemed as employment income of the chef, who will provide the services to SmartCake in return for the income. Salaries tax will continue to be imposed on the chef based on the total amount of the service fee which is paid by SmartCake to Chef Ltd.

For s.9A to be successfully applied, the following conditions must be satisfied:

(1) There is an agreement – in this case, the service contract between SmartCake and Chef Ltd will be the relevant agreement.

(2) There is a 'relevant person' – in this case, SmartCake will be the relevant person who carries on a business in Hong Kong and who will enter into a service contract with Chef Ltd.

(3) There is a 'relevant individual' – in this case, the chef will be the relevant individual who will provide the services to the relevant person (SmartCake) pursuant to the service contract.

(4) The remuneration for the relevant individual's services is paid to a service company which is under the control of the relevant individual – in this case, the remuneration for the services will be paid to Chef Ltd, which will be wholly owned and controlled by the chef.

As the above conditions will be satisfied, *prima facie* the arrangement will be regarded as a 'disguised employment' between the chef and SmartCake. However, s.9A can have no application to deem such an employer-employee relationship if ALL of the following criteria in relation to the appointment terms are satisfied:

(1) The remuneration for the services should not include any employment-like fringe benefits stipulated in s.9A(3)(a), one of which is annual leave. In this case, the chef will be entitled to 20 days annual leave in a year.

(2) The relevant individual (the chef) also carries out similar services for persons other than the relevant person (SmartCake). In this case, the chef is the designated individual to provide the services to SmartCake but it is not certain as to whether the chef will also provide similar services to other parties.

(3) The performance of any of the services by the relevant individual (the chef) is not subject to any of the control or supervision commonly exercised by an employer. (No information is given on this point.)

(4) The remuneration is not paid or credited periodically or calculated on a basis commonly used in employment contracts. In this case, the service fee will be payable on a bi-annual basis, which appears to be inconsistent with the regular basis used for employment remuneration.

(5) The relevant person (SmartCake) does not have the right to terminate the services of the relevant individual (the chef) as if it did this in the capacity of an employer. (No information is given on this point.)

(6) The relevant individual (the chef) is not held out to the public to be an officer or employee of the relevant person (SmartCake). In the case of the chef, he will continue to use his existing business card, which indicates that he will continue to represent himself as an employee of SmartCake even after the proposed arrangement.

Given that not all of the above criteria are satisfied, it is likely that the disguised employer-employee relationship between SmartCake and the chef will remain.

However, there is an 'escape clause' under s.9A(4), which allows a genuine service company to escape from the deeming provision. If the Commissioner of Inland Revenue is satisfied that in substance an individual is not holding an office or employment, the escape clause will apply. For this purpose, the common criteria (integration test, control test, and economic reality test) leading to the distinction between a contract of service (i.e. an employment) and a contract for service (i.e. an independent contractor) will be examined. In the absence of sufficient evidence that the chef will genuinely provide the services to SmartCake as an independent contractor, it is likely that a disguised employer-employee relationship will be deemed by the IRD and the chef will continue to be treated as an employee of SmartCake and subject to salaries tax.

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

End of Report

Tutorial note: *An arrangement which falls outside the scope of s.9A may nevertheless be charged to salaries tax by the IRD through the application of the general anti-avoidance provisions in s.61 and s.61A.*

2 Peter Chan

(a) Employment status

Salaries tax is charged on income from an employment, office and pension arising in, or derived from Hong Kong (s.8(1)). 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, the court ruled in the *Goepfert* case that the source of employment income should first depend on the source of the employment, which is where the employment is located. If the employment is sourced in Hong Kong, the employment income is potentially fully taxable unless the employee renders ALL his services outside Hong Kong (s.8(1A)(b)); or the employee provides his services during 'visits' to Hong Kong of not more than 60 days in the year of assessment (s.8(1B)). However, if the employment is sourced outside Hong Kong (i.e. it is a foreign employment), only the income derived from the services rendered in Hong Kong is chargeable to tax, and this is usually based on a time-in-time-out basis, with the exception that no tax will be charged if the employee only 'visits' Hong Kong for not more than 60 days in the year of assessment. Due to the different rules applicable to ascertaining the assessable income, it is critical to first identify the criteria leading to the source of employment.

Based on the *Goepfert* case, the Inland Revenue Department (IRD) takes the position in Departmental Interpretation & Practice Note No. 10 that an employment is located outside Hong Kong (i.e. it is 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, the first two factors become more important. However, when the employer is resident in Hong Kong (the second factor), the IRD tends to accept that the employment is Hong Kong-sourced. 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.

Peter is required to travel extensively in the region, but will stay in Hong Kong for about one-third of his time. Therefore, if he is under a Hong Kong employment, he will be subject to salaries tax on a 100% basis, for the reason that he performs some services in Hong Kong and his presence in Hong Kong will either be that of a 'non-visitor' or is likely to be more than 60 days. However, if he is under a foreign employment, he will only be assessed to salaries tax based on the time spent in Hong Kong. In the event that he is regarded as a 'visitor' and he stays in Hong Kong for not more than 60 days, he will be totally exempt from salaries tax. In the circumstances, it appears that if feasible, a foreign employment would be more advantageous.

Based on the *Goepfert* case stated above, it is advisable for Peter to continue to be employed by C Ltd. C Ltd is a Canadian-based company, listed in Canada, so provided C Ltd is managed and controlled in Canada and hence not resident in Hong Kong, the first and second factors of the *Goepfert* case would be satisfied. As regards the payment of his remuneration, as part of the remuneration would still be paid in Canada, the administrative arrangement to spin-off part of the payment to Peter's Hong Kong bank account should not be significant enough to affect his overall employment status. In the circumstances, it is likely that Peter's employment will be classed as foreign-sourced and he will be assessed to salaries tax based on the portion of his income attributable to the services he renders in Hong Kong (including a portion of his leave pay) according to the number of days that he is present in Hong Kong in the year of assessment.

The decision whether or not to move his entire family to Hong Kong is more relevant to determining whether Peter would be accepted as a 'visitor' by the IRD for the purpose of applying the 60-day rule. Under a foreign employment, if Peter is a visitor and he stays in Hong Kong for not more than 60 days, then no salaries tax will be payable. There is no definition of a 'visitor' but in general, the IRD will consider the location of the family base, the work base, and the social and economic ties of the employee. If Peter's family moves to Hong Kong and so establishes his family base in Hong Kong, it is possible that the IRD would not accept him as a visitor. Therefore, if Peter would like to rely on the 60-day rule to claim tax exemption, it is advisable for him not to establish a family base in Hong Kong. However, based on the facts given, as he is likely to stay in Hong Kong for more than 60 days in a year, the 60-day rule may not be relevant and the establishment of the family base in Hong Kong would not be a concern to Peter from a tax perspective.

In the event that Peter chooses to be employed by HK Ltd., his employment is likely to be Hong Kong sourced and he will be subject to salaries tax on his total employment income. However, his appointment as an associate regional director by C Ltd and the source of the director's fee received needs to be considered separately. The source of income from an office is determined by the location of the office, i.e. where the office legally exists. In general, this is usually the place where the company is centrally managed and controlled (*McMillan* v *Guest*). In the case of C Ltd, if the central management and control of C Ltd is in Canada, the office of the directorship is legally located in Canada. Therefore, the fee Peter receives from the directorship will be sourced outside Hong Kong and not taxable in Hong Kong.

(b) Allowances that may be claimed for family members

A taxpayer under salaries tax (or personal assessment) is entitled to various allowances, as prescribed under Part 5 of the IRO. In Peter's case, a basic allowance of $120,000 will be available, or a married person's allowance of $240,000, if Peter's wife does not have any chargeable income or if she does have income, and the couple elects for joint assessment to salaries tax or for personal assessment. Eligibility for the married person's allowance is not affected by whether Peter's wife is in Hong Kong or in Canada.

Child allowance of $70,000 will also be available for each child who is unmarried and maintained by Peter at any time during the year of assessment, and is either under 18 years of age or, over 18 but under 25, and receiving full-time education. Although Peter's son is over 18, the child allowance will still be available to him for the reason that the son is receiving full-time education and is under 25. The fact that the son is staying and studying in Canada does not affect Peter's eligibility to child allowance. No child allowance will be available for Peter's daughter, because she is over 18, and although under 25, she is not receiving full-time education. The fact that she will live together with Peter in Hong Kong and is maintained by him is not sufficient.

Dependent parent allowance of $40,000 (basic) is available for each parent (including parents-in-law) maintained by a taxpayer or his spouse, who is ordinarily resident in Hong Kong at any time during the year of assessment. However, if Peter's parents-in-law continue to stay in Canada, they will not be ordinarily resident in Hong Kong, so he will not be able to claim dependent parent allowance in respect of his parents-in-law regardless of the fact that he will continue to contribute to their living in Canada.

(c) Accommodation in Hong Kong

Accommodation benefit is a taxable benefit for salaries tax, as long as it represents a reward from employment or, if the employment is a foreign employment, for services rendered in Hong Kong. The taxable benefit is extended to cover accommodation provided by either the employer or an associated corporation (ss.9(1)(b) and (c)). Therefore, the accommodation provided by HK Ltd would remain assessable to salaries tax, irrespective of whether Peter is employed by HK Ltd or by C Ltd. This is also true regardless of whether the benefit is received in the form of a serviced apartment or a fixed sum housing subsidy. However, there is a difference in the calculation of the taxable value between the two choices.

If Peter chooses to live in the serviced apartment at a nominal rent, this would be regarded as a place of subsidised residence provided by his employer (or an associated corporation) (s.9(1)(c)). The taxable value will be calculated using the 'rental value', which is equivalent to 10% of Peter's assessable income from the employer (and any associated corporation) excluding any share option gain, retirement sum or terminal payment, but after deducting allowable outgoings, expenses and depreciation allowance. For the purpose of calculating the rental value for salaries tax purposes, the actual market value of the serviced apartment or the market rent is irrelevant. However, the rateable value of the property (according to the Rating Ordinance), if lower, can be substituted for the computed rental value. The nominal rent, equal to 3% of his salary, payable for the accommodation by Peter, can be deducted as 'rent suffered' from the 'rental value' calculated, and only the net balance will be the taxable value of the housing benefit. Where the total rent suffered exceeds the rental value calculated, any 'negative' value will be reduced to zero.

If Peter chooses to receive the fixed sum housing subsidy, which can be used at his full discretion without any restriction, the total amount of the subsidy received will be taxable income (s.9(1)(a)).

(d) Asset management in Canada

Under the Hong Kong tax regime, property tax is only imposed on the owner of land and/or a building situated in Hong Kong (s.5(1)). Therefore, as the property is located in Canada, Peter's rental income will not be subject to property tax in Hong Kong.

In respect of the share option, any gain arising from the exercise, assignment or release of a share option is deemed to be income from an employment or office (s.9(1)(d)). However, the gain must be sourced in Hong Kong before it can be assessed. There is no clear guideline on how to determine the source of the gain from a share option, but it is generally accepted that the nexus between the option and the employment at the time of grant should be examined. In Peter's case, the option was granted to him while he was employed by C Ltd (a foreign employment). Assuming that Peter did not render any services in Hong Kong in the year the option was granted to him, the option will generally be regarded as offshore-sourced. Therefore, even if Peter exercises the option in May 2016 after he moves to Hong Kong, any gain arising therefrom will not be taxable in Hong Kong. On Peter's subsequent sale of the shares any gain arising would also generally not be taxable in Hong Kong, because the shares will have been held by Peter as a personal investment, and he does not carry on a business as a dealer in securities.

3 Waterich Ltd (Waterich)

(a) Taxability of interest income

Any person carrying on a trade, profession or business in Hong Kong is chargeable to profits tax in respect of the profits derived from such trade, profession or business arising in or derived from Hong Kong (s.14(1)). Certain types of receipts, not otherwise taxable under s.14, are statutorily deemed as the Hong Kong-sourced trading receipts of a business carried on in Hong Kong and so taxable (s.15). Interest income earned by a corporation carrying on a business in Hong Kong is one of these deemed trading receipts (s.15(1)(f)), and is assessable to profits tax if the interest is derived from a Hong Kong source. In determining the source of interest income, the Inland Revenue Department's current practice is to apply the 'provision of credit' test (as stated in Departmental Interpretation & Practice Note No. 13), except in the case where the interest forms part of a trading transaction, a mortgage asset is involved, or a money-lending transaction is by itself a trade or business. Under the 'provision of credit' test, the loan interest is regarded as sourced in Hong Kong if credit for the loan is first made available to the borrower in Hong Kong.

(1) Loans to associated companies
The loans made by Waterich to associated companies within the group have an interest rate benchmarked with the market rate, so transfer pricing is assumed not to be an issue. Interest income earned from the loans, considered sourced in Hong Kong, will be taxable. In applying the provision of credit test, reference should be made to the place to which the loan moneys were remitted and first made available for drawing by the borrowing associated companies. Therefore, if the moneys were remitted to the Hong Kong bank accounts of the associated companies, the loans would be regarded as provided in Hong Kong. The interest deriving therefrom would be sourced in Hong Kong and so taxable to Waterich. On the other hand, the interest earned from the loans remitted to the bank accounts of associated companies outside Hong Kong would be regarded as offshore sourced and the interest therefrom, will not be taxable to Waterich.

(2) Loans to employees
The loans made to the employees were financed by Waterich's surplus cash, so no funding cost was incurred by Waterich and the fact that the lending was at a lower-than-market rate will not have any tax impact on Waterich. With regard to the interest income earned from the employee loans, this will be taxable to Waterich if it is sourced in Hong

Kong, i.e the loans were made available to the employees in Hong Kong. Given that all the employees are Hong Kong residents and all the loan moneys were used to acquire Hong Kong properties, it is reasonable to assume that the loan moneys were provided to the employees in Hong Kong. As a result, the interest income from the loans will be taxable to Waterich.

(3) Deposit with a Hong Kong bank

The nature of the bank deposit interest is similar to the interest earned from the loans made to the associated companies or employees, such that the provision of credit test still applies to determine the source of the interest income. If the deposit money was made available to the bank in Hong Kong, the interest will be considered as sourced in Hong Kong and taxable (s15(1)(f)). However, pursuant to the 1998 Exemption Order, interest earned on a deposit placed with a financial institution in Hong Kong is specifically exempt from profits tax, unless the deposit is used to secure any loan in respect of which interest is claimed as a deduction under s.16(2)(d). In Waterich's case, there is no indication that the deposit has been used to secure any loan. Therefore, the Exemption Order should apply and the interest earned from the bank deposit will be exempt from profits tax.

(4) Foreign currency trading

Waterich recorded two kinds of gain from the foreign currency trading, realised gains from trading during the year and unrealised gains from the revaluation of the year end balances based on the difference between their mark-to-market value and their cost. The act of trading in foreign currencies is obviously a trade because the trading activities were conducted with the purpose of profit-making. As such profits tax will apply to the realised gains earned from trading during the year under s.14(1) whereby tax is imposed on a person who carries on a trade, profession or business in Hong Kong in respect of the profits arising in or derived from Hong Kong.

As regards the unrealised gains arising from the mark-to-market valuation of the year-end balances, pursuant to the decision of *Nice Cheer Investment Ltd* v *CIR*, unrealised profits recognised in accordance with international accounting standards are not chargeable to tax for the reason that assessable profits should refer to actual and realised profits, not potential or anticipated profits. On the contrary, unrealised losses which are anticipated due to the diminution in value of the foreign currency balances (which are held as trading stock) and thus are duly provided for, would be tax deductible.

(b) Deductibility of staff loans written-off

Based on the general tax deduction rule, an expense or outgoing is tax deductible only if it is incurred in the production of assessable profits (s.16(1)). In the case of a claim for irrecoverable debt, a deduction for bad debts is allowable only where the debts have previously been included as a taxable trading receipt or the debts arise from money lent in the ordinary course of a money lending business (s.16(1)(d)(i)). In Waterich's case, despite the loan interest being returned as taxable, the interest did not represent a trading receipt to Waterich, nor did it arise from a money-lending business. As a result, the conditions for deduction are not satisfied and the losses resulting from the employees' default in repaying the staff loans will not be tax deductible to Waterich for profits tax purposes.

(c) (i) Taxability of the interest saving to staff

The benefit of the low-interest-rate on the loans is a benefit-in-kind from employment for the borrowing employees. However, the benefit comes in the form of a saving in interest payments, which is not convertible into cash. Moreover, no cost was involved to Waterich in providing the benefit since the loans were financed from its surplus funds. Therefore, the benefit of the interest saving would not be taxable to the employees. This tax position is not affected by the tax position taken by Waterich.

(ii) Deductibility of the interest paid to staff

As regards a deduction for the loan interest expense, if the borrowing employees apply the loan moneys to finance a property which is used as their primary place of residence in Hong Kong, they can claim the concessionary deduction for home loan interest against their assessable income from employment. A home loan obtained from an employer qualifies for this deduction as for any other loan borrowed for the same purpose. The maximum annual deduction is $100,000 and each taxpayer is entitled to such a deduction for 15 years in total, whether continuous or not. If the loan money is used to finance a property which is leased out for rental income, and the employee is subject to property tax, no deduction would be available for the loan interest incurred. However, if the employee elects for personal assessment and is assessed to tax on his aggregated income under personal assessment, the loan interest can be claimed as a deduction against their aggregated income. Unlike the home loan interest, there is no statutory limit, but the deduction is restricted to the net assessable value derived from the property. The eligibility to an interest deduction for the employee is not affected by the tax position taken by Waterich.

4 P Ltd, A Ltd and B Ltd

(a) Profit from the sale of shares in B Ltd

Where profits arise from a trade, profession or business carried on in Hong Kong and the profits so derived are sourced in Hong Kong, profits tax will be imposed, unless the profits arise from the sale of capital assets (s.14). Whether the $1 million profit from the sale of the B Ltd shares by A Ltd can be regarded as capital in nature and thus excluded from tax will depend on whether or not the sale is considered as constituting a 'trade' or an 'adventure in the nature of trade'. This issue is contentious and subject to the merits of each case. The Inland Revenue Department will usually examine the case by reference to the so-called 'badges of trade', as follows:

(1) Subject matter of the transaction – Shares may be held for long-term income-generating purposes, or for short-term speculation. A Ltd's principal line of business is trading in properties while B Ltd has carried on a business of trading in listed securities. Apparently holding the shares in B Ltd is a separate line of business for A Ltd.

(2) Length of the ownership period – The shorter the period of ownership, the more likely that the transaction is trading. A Ltd was the founding shareholder of B Ltd and has held the shares for more than ten years.

(3) Frequency of similar transactions – The higher the frequency, the more likely that the transaction is trading. Information is not provided as to whether A Ltd has undertaken any previous transactions in shares.

(4) Supplementary work done – If additional work has been performed to enable the asset to be sold at a better profit, a trading intention would be implied. Primarily no supplementary work has been done on the shares before they are sold.

(5) Circumstances leading to the sale – Whether due to an increase in share price or other non-profit making reason. The sale of the shares in B Ltd has been triggered by a commercial reason, i.e. the restructuring of the group.

(6) Motive – Any motive to make a profit from a resale would constitute a 'trading' purpose.

Judging from the facts of this case, it can be inferred that A Ltd might not have had a trading intention upon the acquisition of the shares in B Ltd, nor is there any information to indicate that such intention has changed during the period when the shares have been owned by A Ltd. Hence, the relevant shares would not be considered as the trading stock of A Ltd and so, the profit that will be derived from the sale of the shares should not be chargeable to profits tax.

(b) Valuation of trading stock

Upon liquidation, the properties held as trading stock by A Ltd at the date of cessation need to be valued for the purpose of computing the profits of A Ltd. The value of the trading stock should be the amount which would have been realised if the properties had been sold in the open market at the date of cessation (s.15C(b)).

(c) Stamp duty implications

B Ltd is a company incorporated in Hong Kong, hence its register of members should be kept in Hong Kong and the shares in B Ltd will be Hong Kong stock for the purposes of the Stamp Duty Ordinance (s.2(1)). The transfer of the shares in B Ltd is therefore, *prima facie* subject to stamp duty on the sale and purchase contract notes at 0·2% of the dutiable value and on the instrument of transfer at $5 (s.19(1); Heads 2(1) and 2(4) respectively). The dutiable value will be $100 million, since the consideration for stamp duty purposes includes debts waived or assigned (s.24(1)) and as part of the consideration for acquiring the shares, P Ltd will pay an additional amount of $20 million to settle the bank debt. Despite the $20 million not being received by the transferor, A Ltd, it is still a debt assumed by the transferee, P Ltd, and thus must be included in the consideration subject to stamp duty. If the market value of the shares is higher than $100 million, then stamp duty will be levied on the higher market value.

A transfer of stock within a corporate group where the transferor and transferee are associated corporations may be exempt from stamp duty (s.45). Two corporations are associated if one is the beneficial owner of not less than 90% of the other, or a third corporation is the beneficial owner of not less than 90% of each of the transferor and transferee. The fact that the parent, P Ltd, is incorporated outside Hong Kong does not mean that the exemption does not apply. In this case, A Ltd is 100% held by P Ltd. Therefore, A Ltd and P Ltd are associated, and stamp duty exemption may be available. Adjudication by the Collector is required (s.45(3)).

However, the exemption under s.45 will not be available if as part of the arrangement, the transferor and transferee cease to be associated by reason of a change in the percentage of the issued share capital of the transferee held by the transferor or a third corporation. Even if such an arrangement is not in existence at the time of the transfer, if the transferor and transferee cease to be associated within two years for the same reason, the stamp duty exemption previously granted will be 'clawed back' and stamp duty becomes payable.

As a result of A Ltd's liquidation, P Ltd will no longer hold any shares in A Ltd and thus strictly speaking, A Ltd and P Ltd will no longer be associated. However, a disqualification of the s.45 exemption is made by reference to a change in shareholding by the transferee, i.e. P Ltd. Thus, any change in the shareholding of the transferor, i.e. A Ltd, should not affect the s.45 exemption.

Therefore, on an application under s.45, the restructuring should not give rise to any stamp duty liability and the subsequent liquidation of A Ltd should not impact this stamp duty exemption. Further, although the payment of the $20 million to the bank strictly breaches the pre-condition under s.45 which prohibits payment to parties outside the corporate group, by concession the Stamp Office does not treat payments made in this manner as rendering s.45 not applicable.

Finally, upon liquidation, the liquidator will distribute all the properties held by A Ltd in specie to its only shareholder, P Ltd. Because it lacks any valuable consideration, such a distribution would normally be deemed to be a voluntary disposition *inter vivos* (s.27(4)) and the instrument of transfer effecting such a transaction would have been chargeable to stamp duty (Head 2(3)). However, a distribution in specie of A Ltd's assets to its shareholder, P Ltd, will not involve any change of beneficial interest in the properties transferred: see *Wigan Coal & Iron Co Ltd* v *IRC* [1945] *1 All ER 392*. As such, the instrument of transfer will be exempt from a charge to stamp duty (s.27(5)).

5 Ms Princess

(a) Chargeability to Hong Kong tax

Under the Hong Kong tax law, any person deriving profits from a source in Hong Kong by carrying on a trade, profession or business in Hong Kong is chargeable to profits tax in Hong Kong (s.14). By carrying out her performance for profit in Hong Kong, Ms Princess will be regarded as carrying on a business in Hong Kong and deriving the profits from Hong Kong. Hence she will be chargeable to profits tax in Hong Kong on such profits.

A non-resident entertainer, such as Ms Princess, is chargeable to Hong Kong tax notwithstanding that the relationship between her/him and the payer is on a principal-to-principal basis (s.20B). For this purpose, 'entertainer' means a person, other than a corporation, who gives a performance in the character of an entertainer in any kind of entertainment, including any activity of a physical kind which the public may be permitted to see or hear (s.20B(4)). The taxable sum includes amounts paid for any appearance made in connection with the promotion of a commercial occasion or event; and any participation by the entertainer in sound recording, films, videos, radio, television or similar transmissions, whether live or recorded (s.20B(1)(b)).

(b) Determination of the tax payable and the collection thereof

When a payment is made to a relevant overseas entertainer, the entertainer is chargeable to tax in respect of the payment in the name of the person in Hong Kong who paid or credited the payment to them or to any other non-resident (s.20B(2)). In Ms Princess' case, even though Queens Ltd is strictly not an agent representing her, it is by law chargeable to tax on her behalf in respect of the payment made. The relevant payment in this case is the fee of $10 million payable by Queens Ltd to Ms Princess, not the sum of $11 million payable by Kings Ltd to Queens Ltd.

As a result, Queens Ltd is empowered to deduct at the time of payment or credit, a sum sufficient to meet the tax due (s.20B(3)). It is correct that Hong Kong does not operate on a self-assessment system, so tax will only be demanded and paid upon the issuance of an assessment. Thus, Queens Ltd must retain the amount deducted, until an assessment calling for the tax payment is received from the Inland Revenue Department (IRD). Queens Ltd is indemnified against any person in respect of the sum deducted to meet the tax liability (s.20B(3)).

It should be noted that the withholding obligation under s.20B(2) is imposed on any person in Hong Kong who pays or credits the performance fee to Ms Princess, a non-resident. Therefore, as Kings Ltd is paying a resident person, Queens Ltd, it has no withholding obligations. Similarly, Mr Prince, assuming he will not be in Hong Kong, has no withholding obligations.

In deciding the amount to be withheld for the payment of tax, the IRD accepts that one-third of the fee payable can be allowed as deductions for expenses. In other words, two-thirds of the fee would be treated as assessable profits (Departmental Interpretation & Practice Note (DIPN) No. 17, paragraph 14). This arrangement has legal support under s.21 which enables the assessable profits of a non-resident to be computed on a percentage of turnover. Given the applicable profits tax rate for an unincorporated person is 15%, this is the basis for the 10% (1 x 2/3 x 15%) suggested by Queens Ltd for the agreement. The amount to be withheld will, therefore, be $1,000,000 (10,000,000 x 2/3 x 15%).

It is certainly permissible for Ms Princess to make a claim for deductions in respect of her actual expenses if they are in excess of the deemed one-third portion. In these circumstances, a tax return would have to be lodged together with the full particulars and supporting evidence for the expenses claimed.

(c) Incorporation of a Hong Kong company

If a new Hong Kong company is set up purely to receive the payment from Queens Ltd on behalf of Ms Princess, the overall tax position of Ms Princess will not change. In this situation, when the new Hong Kong company makes a payment to Ms Princess overseas, it will also become chargeable to tax on her behalf under s.20B in the same way as did Queens Ltd. However, Queens Ltd will no longer have any withholding obligation as it will be paying a person in Hong Kong, i.e. the new Hong Kong company.

(d) Tax overpaid by Queens Ltd

Where a non-resident person has been assessed in the name of another person (under s.20A or s.20B) and the tax so assessed has been paid by that other person, either the other person or the non-resident, but not both, may claim repayment of any tax overpaid (s.79(3)). The term 'another person' covers both an 'agent' (as referred to in s.20A) and 'any person in Hong Kong' (as referred to in s.20B) (DIPN No. 17, paragraph 15).

Therefore, if tax is overpaid by Queens Ltd, either Ms Princess or Queens Ltd, but not both, may claim repayment of the tax overpaid.

				Available	*Maximum*
1	**(a)**	**(i)**	Transfer of HK stock dutiable (Head 2)	0·5	
			Shares of HK company registered in HK are HK stock	0·5	
			Transfer of stock attracts stamp duty at 0·2% plus $5	1	
			Higher of consideration and fair value	0·5	
			Consideration includes value of waived loan balance	1	
				3·5	3
		(ii)	Interest income not taxable unless he is a money-lender	0·5	
			Not taxable under any tax regime	0·5	
			Dividend also not taxable under any tax regime	0·5	
			Interest is deductible if incurred in the production of assessable profits	0·5	
			And interest income is taxable	0·5	
			If loan is used for operations, condition 1 is satisfied	0·5	
			Condition 2 is not satisfied as he is not taxed	0·5	
			S.16(2)(e) not satisfied because he is an associate	1	
			Dividend is not an expense or outgoings, not deductible	1	
				5·5	5
	(b)		S.14(1) does not apply as DutchCo does not carry on business in HK	0·5	
			S.15(1)(b) applies	1	
			30% deemed as profits and taxed at 16·5%	1	
			100% is deemed as profits as DutchCo is an associate	1	
			Brandname has been owned by a company carrying on business in HK	0·5	
			SmartCake to file a tax return on behalf of DutchCo as its agent	0·5	
			SmartCake to withhold tax amount from payment	0·5	5
	(c)	**(i)**	S.16(1) general rule for deductibility	0·5	
			S.17(1)(c) capital expenses disallowed	0·5	
			Statutory redundancy is a discharge of a statutory obligation incurred in running the business	0·5	
			Liability accrues from the start of the employment	0·5	
			Liability crystallises upon payment	0·5	
			Redundancy payment is deductible	0·5	
			Compensation for restrictive covenant – capital or revenue	0·5	
			Fixed vs. circulating capital test	1	
			Once-and-for-all test	1	
			Enduring benefit test	1	
			Conclusion: restrictive covenant is enduring, not deductible	0·5	
				7	6
		(ii)	Income from employment vs for deprivation of rights	0·5	
			Not taxable if for deprivation of rights	0·5	
			Compensation for loss of rights to join competitors	0·5	
			If not in contract, not taxable	0·5	2

		Available	Maximum
(d)	Type I service company	0·5	
	Contract for service vs. contract of service	0·5	
	Employer-employee relationship	0·5	
	Deemed as employment income	0·5	
	An agreement	0·5	
	A relevant person (SmartCake)	0·5	
	A relevant individual (the chef)	0·5	
	Remuneration paid to a service company	0·5	
	Chef Ltd under the relevant individual's control	0·5	
	Deemed as disguised employer-employee relationship	0·5	
	Six criteria for s.9A not to be applied	3	
	Escape clause: Commissioner's discretion	1	
	Integration test, control test, economic reality test	1·5	
	Conclusion: salaries tax will continue to apply	0·5	
		11	10
	Appropriate format and presentation	1	
	Logical development	1	
	Effectiveness of communication	2	4
			35

			Available	*Maximum*
2	**(a)**	**Scope of charge under s.8**	1	
		HK employment potentially fully taxable	0·5	
		Unless all services rendered outside HK	0·5	
		Or during visits of not more than 60 days	0·5	
		Offshore employment taxes only income from services in HK	0·5	
		No tax if visits HK for not more than 60 days	0·5	
		Source of employment under the *Goepfert* rule (3 criteria)	2	
		If he has a HK employment, likely fully taxable	0·5	
		If he has a foreign employment, likely taxed on time basis	0·5	
		Foreign employment is more advantageous	0·5	
		Advisable to be employed by C Ltd	0·5	
		Goepfert principles 1st and 2nd factors satisfied	0·5	
		Partial payment in HK does not affect the status	0·5	
		Time apportionment applies	0·5	
		Family move is relevant to ascertain if a 'visitor' or not	0·5	
		Family base, work base, social and economic ties	1	
		If family base in HK, likely not a visitor	0·5	
		60-day rule not applicable if he is not a visitor	0·5	
		If he stays for more than 60 days, family base is not relevant	0·5	
		If he is employed by HK Ltd his total employment income is taxable	0·5	
		Director's fee is taxable if sourced in HK	0·5	
		Source of a director's office	1	
		If director's office is in Canada, fee is offshore and not taxable	0·5	
			14·5	12
	(b)	Eligibility for basic and married person's allowance	1	
		Not affected by whether his wife is in HK or in Canada	0·5	
		Eligibility for child allowance	1	
		Child allowance for son, but not daughter	1	
		Eligibility for dependent parent allowance	1	
		No allowance for parents-in-law as not ordinarily resident in HK	0·5	
			5	4
	(c)	Accommodation benefit is taxable	0·5	
		Provided by employer or an associated corporation	0·5	
		Regardless of whether he is employed by HK Ltd or by C Ltd	0·5	
		If serviced apartment, rental value assessed	0·5	
		10% of assessable income excluding share option, retirement, terminal payment, after deducting outgoings, expenses and depreciation allowance	1	
		Actual market value or rent is irrelevant	0·5	
		Rent suffered (i.e. 3%) is deductible from the rental value	0·5	
		If negative, reduced to zero	0·5	
		Subsidy's usage without restriction	0·5	
		Taxable in full	0·5	
			5·5	5
	(d)	HK property tax only imposed on owners of property in Hong Kong	0·5	
		Rental from Canada property is offshore Hong Kong	0·5	
		Not taxable in Hong Kong	0·5	
		Share option is income from employment	0·5	
		Source of share option depends on time of grant	0·5	
		Option granted while under a foreign employment	0·5	
		If no services in HK in the year of grant, option is offshore-sourced	0·5	
		Gain from exercising the option is not taxable in HK	0·5	
		Gain from sale of shares not taxable as from personal investment	1	
			5	4
				25

				Available	Maximum
3	**(a)**		Interest income is a deemed trading receipt (s.15)	0·5	
			Assessable if sourced in HK	0·5	
			Provision of credit test	1	
			Except trading transaction, mortgage loan or money-lending business	1	
			Loan to associates benchmarked to market, no transfer pricing	0·5	
			If remitted to associates in HK, taxable	0·5	
			If remitted outside HK, not taxable	0·5	
			Loan to employees at no cost to company; no tax impact	0·5	
			Loans are provided in HK to HK employees for buying HK properties	0·5	
			Interest on staff loans is taxable	0·5	
			Deposit with a bank in HK, HK sourced	0·5	
			1998 exemption order	0·5	
			Except where deposit is used to secure a loan under s.16(2)(d)	0·5	
			Deposit interest is exempt	0·5	
			Trading in foreign currencies had a profit making purpose	0·5	
			Taxable under s.14	0·5	
			Realised gains are taxable	0·5	
			Unrealised gains not taxable	0·5	
			Assessable profits do not include potential or anticipated profits	0·5	
			Unrealised loss due to diminution in value is tax deductible	0·5	
				11	10
	(b)		General tax deduction rule under s.16(1)	0·5	
			Irrecoverable debt deductible only if a trade receipt or from money-lending	1	
			Write-off is not deductible	0·5	2
	(c)	**(i)**	Benefit-in-kind from employment	0·5	
			Saving in interest	0·5	
			Not convertible into cash by employees	0·5	
			No cost to employer	0·5	
			Interest rate differential is not taxable to employees	0·5	
			Tax position not affected by the company's tax position	0·5	3
		(ii)	If used as a primary place of residence	0·5	
			Home loan interest can be claimed	0·5	
			Home loan from employer qualifies	0·5	
			$100,000 per annum	0·5	
			Maximum 15 years, not necessarily consecutive	0·5	
			If used for leasing, subject to property tax	0·5	
			No interest deduction	0·5	
			Unless personal assessment is elected	0·5	
			No statutory limit but deduction limited to net assessable value	1	
			Tax position not affected by the company's tax position	0·5	
				5·5	5
					20

			Available	Maximum
4	(a)	Profit on the sale of capital assets not taxable	0·5	
		'Trade' or 'adventure in the nature of trade'	0·5	
		Consideration of badges of trade	5·5	
		Conclusion: no trading intention	1	
		not taxable	0·5	
			8	7
	(b)	On cessation trading stock valued for computing profits	1	
		Valued at open market value at date of cessation	1	2
	(c)	Shares of HK company are HK stock	0·5	
		Rates of duty payable; 0·2% and $5	0·5	
		Dutiable value is $100m	0·5	
		Consideration includes debts waived or assigned	1	
		Stamp duty on market value if higher	0·5	
		Section 45 exemption for associated corporations	1	
		90% holding required	0·5	
		A Ltd and B Ltd are associated	0·5	
		P Ltd being incorporated overseas not relevant	0·5	
		Adjudication required	0·5	
		Exemption not available if cease to be associated within two years	1·5	
		Effect of the liquidation of A Ltd on s.45 exemption	1·5	
		Concession re $20m paid to bank	0·5	
		Conclusion	0·5	
		Distribution of properties in specie deemed a voluntary disposition	1	
		But no change of beneficial interest, hence not chargeable	1	
			12	11
				20

			Available	Maximum
5	(a)	Charge to profits tax – s.14	0·5	
		Performance in HK chargeable to profits tax	0·5	
		Tax treatments for overseas entertainers – s.20B	1	
		Definition of an entertainer	1	
		Taxable sums	1·5	
			4·5	4
	(b)	Non-resident entertainer chargeable in the name of the person in HK who paid or credited the entertainer	1	
		Queens Ltd, even though not an agent of Ms Princess	1	
		Taxable sum is $10m, not $11m	1	
		Withholding obligation on Queens Ltd	1	
		Tax demanded and paid upon issuance of the assessment	1	
		Queens Ltd entitled to be indemnified	0·5	
		No withholding obligation on Kings Ltd, with reason	1	
		No withholding obligation on Mr Prince, with reason	1	
		Deemed profit – two-thirds	1	
		Deemed profit under s.21 as a percentage of turnover	0·5	
		Explanation of 10% to be withheld	1	
		Calculation of withholding tax	0·5	
		Can claim deduction for actual expenses, if more	1	
		Needs to file a tax return with supporting evidence	1	
			12·5	11
	(c)	No change in tax position of Ms Princess	1	
		HK company chargeable to tax on Ms Princess' behalf	1	
		But no withholding obligation on Queens Ltd	1	3
	(d)	Tax overpaid/withheld by Queens Ltd can be reclaimed	0·5	
		By either Ms Princess or Queens Ltd	1	
		But not both	0·5	2
				20