Answers

Professional Level – Options Module, Paper P6 (HKG)
Advanced Taxation (Hong Kong) **December 2011 Answers**

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

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1 Report to Ms Mi

To: Ms Mi
From: Tax Advisor
Date: 9 December 2011
Subject: Raising finance for H Ltd

I refer to our discussion in respect of the potential financial consequences for H Ltd as a result of your husband's withdrawal of his personal guarantee for the bank loan currently extended to H Ltd. Two proposals as suggested by your father (Papa), together with another proposal, have been discussed. As promised, I have reviewed these proposals from a Hong Kong tax perspective, and the key issues are summarised below for your consideration:

(a) Tax effectiveness of the current structure

Under the current funding structure, a bank loan is obtained by H Ltd under a personal guarantee from your husband (Hubby). Loan interest is incurred by H Ltd to the bank. The bank loan money was used by H Ltd to acquire the shareholding in K Ltd. Under the Inland Revenue Ordinance (IRO), interest payable to a bank is tax deductible if the following conditions are fulfilled:

(i) the bank interest is incurred in the production of assessable profits (s.16(1));
(ii) the bank borrowing is not secured by any deposits or loans which derive non-taxable income in Hong Kong ('secured loan' test) (s.16(2A)); and
(iii) there is no arrangement in place such that the interest payment is ultimately paid back to the borrower or any connected person ('interest flow-back' test) (s.16(2B)).

Under the current structure, the only potential income of H Ltd from its investment in K Ltd will be dividend income. Dividends from K Ltd, a company chargeable to profits tax by virtue of holding properties in Hong Kong as trading stock, are specifically exempt from tax in Hong Kong (s.26(a)). Hence, the bank interest cost incurred by H Ltd will not be regarded as incurred in the production of assessable profits; and thus will not be tax deductible. Therefore, the current loan structure is not tax effective.

(b) Proposal 1

(i) Profits tax implications for H Ltd

Proposal 1 seeks to replace Hubby's personal guarantee by a deposit placed by Papa with the bank's associate in China, with a new bank loan being extended to K Ltd to replace the existing bank loan to H Ltd. From the perspective of H Ltd, no further interest cost will be incurred after the restructuring; and thus there is no tax implication for H Ltd.

(ii) Profits tax implications for K Ltd

Under Proposal 1, K Ltd will obtain a new bank loan from the bank and on-lend the loan money to H Ltd, interest free. Bank interest will be incurred by K Ltd on this new loan, which is secured by a deposit placed by Papa with the bank's associate in China. It is intended that the deposit will generate interest income at the same rate as that paid by K Ltd on the new bank loan, minus a small percentage.

From a profits tax perspective, K Ltd may encounter difficulty in claiming a tax deduction for the bank loan interest incurred on the new loan, because the interest is not incurred in the production of assessable profits. The Inland Revenue Department (IRD) may argue that the loan money has been on-lent to H Ltd and no interest will be earned from H Ltd. As a result, s.16(1) is not satisfied. Moreover, a tax deduction for the bank loan interest will also be denied on the basis that the loan is secured by a deposit which generates interest that is not taxable in Hong Kong. So the 'secured loan test' under s.16(2A) will not be satisfied. The 'interest flow-back' test under s.16(2B) is also not satisfied, because the interest payment from K Ltd to the bank will, ultimately, be paid back in its majority to Papa. In conclusion, similar to the current structure, Proposal 1 is also not tax effective for K Ltd.

(c) Proposal 2

(i) Share issue by H Ltd to P Ltd

Under this proposal, P Ltd will hold a 50% shareholding in H Ltd. Assuming that the additional shareholding is acquired by way of a share issue by H Ltd directly to P Ltd, there will be no profits tax implication to H Ltd. Neither does the share issue give rise to any profits tax implication for P Ltd, as any dividend subsequently distributed from H Ltd will not be taxable in the hands of P Ltd pursuant to the IRO. There is also no stamp duty implication as a share issue does not trigger a charge to stamp duty in Hong Kong.

Tutorial note: *If there is a need to increase the authorised capital of H Ltd, capital duty of 0·1% would be payable (capped at $30,000 per increase) but capital duty is not within the syllabus of this paper.*

(ii) Share disposal by Ms Mi to P Ltd

Under this alternative, P Ltd will acquire a 50% shareholding in H Ltd directly from you. If the share disposal gives rise to any profits, you may be subject to profits tax in respect of this profit if you are regarded as carrying on a 'trade' or 'business' in respect of the holding and the selling of the 50% shareholding in H Ltd.

The word 'trade' is defined to include 'every trade and manufacture and every adventure in the nature of trade' (s.2). While it is difficult to determine the nature of an isolated transaction, it is always essential to look at the 'intention' of the person at the time of acquiring the asset and its subsequent disposal. The usual criteria are known as the 'badges of trade', which include 'subject matter', 'length of ownership', 'frequency of similar transactions', 'supplementary work done', 'circumstances leading to the realisation' and 'motive'. Other factors may also be relevant, including the method of financing the initial acquisition and the utilisation of the sale proceeds. In your case, the short period of holding, only one year, would be most vulnerable to challenge by the IRD as an indication of trading. However, the most valid argument is that the share disposal is not driven by a profit-making motive but by the need to raise funds for H Ltd to repay the bank loan. To prove this, all or at least the majority of the proceeds from the share disposal should be on-lent to H Ltd for bank loan repayment purposes.

You have concern as to whether your tax position will be affected by the property trading intention of K Ltd. There is a possible risk that the IRD may seek to import the trading intention of K Ltd with regard to its properties into your intention as shareholder. Based on the information given, the properties held by K Ltd are accounted for as trading stock and revenue trading assets. The issue that follows is whether or not your shareholding in K Ltd as well as H Ltd should also be regarded as trading assets rather than capital assets. It has, however, been decided that the trading motive of companies holding trading property should not be assumed to be imported into the share transactions of their shareholders (see *Beautiland Co Ltd* v *CIR* and *CIR* v *Quitsubdue Ltd*).

In conclusion, if the IRD is convinced that there is no trading intention in your share disposal, any profits from the disposal will not be taxed.

In terms of stamp duty, the disposal of your shares would trigger stamp duty at the rate of 0·2% on each transaction (i.e. 0·1% each on the bought and sold notes), on the basis that the shares are Hong Kong stock. The instrument of transfer will also incur a further fixed amount charge of $5. The stampable value is based on the net asset value of the shares, if this is higher than the consideration paid on disposal. Moreover, although the shares are disposed of to P Ltd which is held by your father, the group relief under s.45 of the Stamp Duty Ordinance will not apply to exempt the transaction from stamp duty, since this exemption only applies to a corporate group, i.e. where both the transferor and transferee are associated corporations. In your case, you, the transferor of the shares, is an individual.

Tutorial note: *For shares in a private company holding investment properties, the market value of the shares is, in practice, usually taken to be the net asset value of the shares.*

(iii) Sale of two properties at cost from K Ltd to P Ltd

The sale of two properties from K Ltd to P Ltd will be regarded as a transfer between associated enterprises as defined under the double tax arrangement between Hong Kong and China (the DTA). K Ltd and P Ltd are associated on the basis that P Ltd 'participates directly or indirectly in the management, control or capital of K Ltd'. Under the arm's length principle provided by the DTA, transactions of independent enterprises should be used as a benchmark for the intra-group transfer price, and profits and expenses should be allocated accordingly for the transactions between the associated enterprises. If there is any distortion, the profits tax charged or payable should be adjusted to reflect the position which would have existed if the arm's length principle had been applied, instead of the actual price transacted between the enterprises (DIPN 45 and 46).

In the case of K Ltd, as the properties are held as trading stock, any sale at a price below the market value will cause the taxable profits of K Ltd to be understated. Under Article 9 (Associated Enterprises) of the DTA between Hong Kong and Mainland China, if conditions are made or imposed between the two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, the IRD has the right to adjust upwards the profits of the Hong Kong enterprise. In exercising its right to adjust upwards the profits of K Ltd, the IRD may raise an additional profits tax assessment on K Ltd based on the market price of the property, thereby seeking to tax the profits as if the profits are earned from an arm's length transaction. Alternatively, the IRD may consider applying the anti-avoidance provisions of s.61 or s.61A if it considers that the sale of property constitutes a scheme to obtain a tax benefit.

In terms of stamp duty, a conveyance of property is subject to stamp duty at *ad valorem* rates, ranging from $100 to 4·25% for consideration above $20,000,000. The stampable value is based on the higher of the market value of the property free from any encumbrance, at the date of the sale and purchase agreement, and the stated value. In this case, the group relief under s.45 is also not available to exempt the transaction from stamp duty, for the reason that the requirement of not less than a 90% shareholding relationship is not fulfilled. K Ltd and P Ltd are associated by way of 50% only.

(d) Proposal 3

Under this proposal, K Ltd will change its strategy and intention of holding the properties from one of trading stock held for sale to one of capital assets held for investment purposes. Thereafter, it will seek to assign its rights to the future stream of rental income for a consideration to enable H Ltd's bank loan to be repaid. Two issues are involved.

Firstly, the change of intention by K Ltd may trigger the crystallisation of a profits tax charge. Based on the *Sharkey* v *Wernher* rule, where trading stock is appropriated to some other use including as a fixed asset in the business, it is to be treated as a sale at open market value at the time of the change of intention. Although there is uncertainty on the applicability of this rule in Hong Kong, it is generally the practice of the IRD to deem the asset as being sold at the time of the change of intention, and to seek to tax the profits, albeit notional, based on the difference between the cost of the asset and the market value at that time. In the case of K Ltd, it is likely that the change of usage of the properties from trading stock to investment assets held for leasing purposes would be deemed as a notional sale and taxed accordingly.

Apart from the above risk, if the right to the future stream of income is to be assigned in return for a consideration, such consideration will be deemed a trading receipt under s.15(1)(m), even though the consideration can be capital in nature. In the case of K Ltd, this tax position would likely be the same as if property lease income was earned and taxed each year. However, K Ltd will have the commercial benefit of the immediate cashflow derived from the assignment.

I trust that the above addresses the major profits tax and stamp duty implications arising from the various proposals. Should there be any questions, please feel free to discuss.

End of Report

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Xxx Tax advisors
[Firm's address]

[Date]

Mr Kelvin King
[Address]

Dear Mr King,

Thank you for engaging us to review your tax position. You asked us to advise on the Hong Kong salaries tax position of the draft package and how you could best structure your affairs and remuneration package to ensure that your salaries tax liability is minimised. Based on the information you supplied, we outline our advice as follows:

(a) Hong Kong salaries tax position of the current structure

Since the Company is resident in Hong Kong, your employment will be regarded as a Hong Kong employment and, thus, any remuneration representing a reward for your employment is within the scope of salaries tax. In general, s.9(1)(a) of the Inland Revenue Ordinance provides that taxable remuneration includes any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite or allowance, regardless of whether it comes from the employer or from some other person. The tax treatment of certain specific benefits are provided in the law, including benefits that are capable of being converted into cash by the employee and those amounts that represent the assumption by the employer of an employee's personal liability. In certain circumstances, case law needs to be referred to in order to ascertain the taxability of an item of income.

Under the current draft package, the total remuneration of $3,120,000 is taxable under salaries tax. Your salary is obviously taxable as it represents a reward for your employment. Your bonus is also taxable as a reward for your employment.

In respect of the contract gratuity, it is a kind of termination payment that is made by the employer upon the completion or expiration of the contract. Whether a termination payment is taxable or not depends on the circumstances leading to the payment. If a payment merely represents a discharge of a personal obligation and is not connected with the employment, it may be non-taxable. However, a contract gratuity which is pre-arranged as part of the terms of employment is considered as part of the payment for employment, but the income does not accrue to the employee until the contract ends. On this basis, your gratuity is taxable. However, under s.11D(b)(i), you are eligible to elect to relate back the contract gratuity over the two-year contract period or thirty-six months (whichever is shorter) for the purposes of assessing the gratuity. The election has to be made within two years after the end of the year of assessment in which the lump sum payment is received.

As regards the incentive for acceptance of the offer, this has been held as assessable income in *D44/92* in Hong Kong, with reference made to a UK case: *Glantre Engineering Ltd* v *Goodhand 56 TC 165*. As the inducement payment will be made by the Company in order to encourage you to take up their offer and render services for the Company, the payment is related to the new employment as a contractual obligation once the offer is accepted.

If you choose to live in the Company's quarter, the provision of accommodation at a rent is regarded as a taxable benefit to you for salaries tax purposes. However, the taxable value will be calculated by the rental value, which is 10% of your other taxable emoluments (excluding certain payments such as share option gains and severance payments), but you may elect to have the rateable value of the premises substituted for the rental value at 10% if this is lower, minus any rental deducted from your salary.

The medical insurance scheme provided by the Company is a contractual obligation between the Company and the insurance company, and thus the annual premium paid by the Company is discharging its own liability rather than yours. Thus, both the premium and any benefit for the services are not taxable.

As regards the share options and share awards, both benefits are taxable as they are received in compensation for the employment services provided to the Company. However, the timing of assessment and value to be assessed may be different depending on the circumstances.

In the case of the share option benefit, the taxability is governed by s.9(1)(d). An option benefit is taxed on the gain realised through the exercise, assignment, or release of the option. For this purpose, the option right is taxed if it is granted at a time when you are holding a Hong Kong employment or as a result of a Hong Kong employment. It is not relevant whether or not you are still employed by the Company at the time the option is exercised, released or assigned. The taxable gain is the difference between the market price of the shares at the time of exercise, or the consideration received for the assignment or release, and the cost paid for the option and the shares. Any gain arising from the subsequent sale of the shares is considered as a return from investment rather than employment, and thus is disregarded.

In the case of the share award benefit, the taxability is governed by the general charging provision of s.9(1)(a) as a perquisite. As such, the timing of taxing the award would depend on the timing at which the perquisite accrues to you. For the share award which has no vesting period, that is you are entitled to the shares and will have your name registered upon being granted the shares, the time of assessment is at the time of the grant. This approach is regarded as the ‘upfront approach’ by the IRD under Departmental Interpretation and Practice Notes No. 38. The taxable value of this award will be based on the market value of the shares at the time of the grant. For the share award which is granted with a vesting period and you are not fully entitled to ownership of the shares until the end of the vesting period, the time of assessment will be based on the time at which the vesting period is completed. In contrast with the ‘upfront approach’, this is regarded as the ‘back-end approach’. The taxable value will therefore be the market value of the shares at the time when all the conditions for the grant are fulfilled.

If you choose the share option and you plan to exercise it after you return to Canada, the option will still be taxable as it is granted as a result of a Hong Kong employment, although the timing for assessing the gain will depend on the timing of the exercise of the option. Section 11D(b)(ii) which deems any taxable income paid by an employer after the cessation of employment to accrue on the last day of employment does not apply in the case of a share option gain, because the gain is not a payment made by the employer. Therefore, if you make a gain from exercising the option on or after 1 April 2014, the gain will be assessed under salaries tax for the year of assessment 2014/15. However, you may elect to have your tax liability ascertained based on a notional exercise of the option on any day within seven days before the day when the return for the final assessment for 2013/14 is submitted. If the return is submitted after your departure, such election shall be made within three months from the date of your departure; which will be taken as the date of the notional exercise for the purpose of calculating the gain. On the other hand, if the share price is not expected to rise significantly, you should not make a notional exercise election, and should exercise the option after 1 April 2014, so that any gain from the exercise will fall within the year of assessment 2014/15, as a full year of statutory personal allowance will be granted before tax is charged.

(b) Restructuring of the remuneration package

The following items may be considered as means to restructure your remuneration package in a more tax efficient manner:

(i) Payment for restrictive covenant

You are restricted from working for another company engaged in the same business or industry for 12 months after the contract ends. This is a deprivation of rights and it is not uncommon for a compensation to be paid for this deprivation of rights. Such a payment is usually made in a lump sum upon the completion of the contract and is referred to as payment for a restrictive covenant. Since the payment is not received for employment or past services but as compensation for the deprivation of rights, it is not taxable. Therefore, you should consider asking the Company to attribute part of the total remuneration package to such compensation.

(ii) Accommodation benefit

If you are likely to rent your own accommodation, you may consider asking the Company to reimburse all or part of the rent paid by you to your landlord, or to pay the rent to your landlord directly, as part of your total remuneration package. The amount reimbursed or paid by the Company will not be taxable on you but, instead, you would be taken to have received a taxable benefit equal to the ‘rental value’ of the premises rented or provided, as applicable, as your place of residence, and as stated above, this is normally calculated as 10% of your other taxable emoluments (excluding certain payments such as share option gains and severance payments) or upon your election the rateable value of the premises. For this purpose, the rental payment can include not only rent, but also management fees and rates with respect to the accommodation which you are obliged to pay under your lease. If the rental value is less than the total rental reimbursed or paid by the Company, your total assessable income will be reduced.

However, the IRD will stringently monitor the situation to ensure that the Company’s obligation to make such rental payments or reimbursements is clearly set out in your contract of employment, and that you do in fact incur the rental expenses so provided for. Your contract should specifically require that you use such payments to pay rent, as otherwise the whole of the payment will be taxable as an ordinary salary payment.

In order to satisfy the IRD that the Company is carefully monitoring how such funds are expensed, the Company would be required to obtain a copy of the stamped lease agreement entered into by you, as well as copies of the monthly rental receipts given to you by the landlord. The procedures can be simplified if the Company were to enter into the lease agreement directly with the landlord and to make all payments direct to the landlord itself.

(iii) Contract gratuity

Depending on the related employment law, you may consider choosing to receive severance pay as provided under the Employment Ordinance instead of the contract gratuity. Whilst a contract gratuity is taxable, under the current practice, severance pay calculated in accordance with the Employment Ordinance is not taxable. However, you should be aware that if the IRD has evidence that the severance payment is effectively a gratuity, or in situations where the actual payment is substantially in excess of the statutory amount payable under the Employment Ordinance, the IRD may challenge the true nature of the payment and choose to impose tax on the entire amount, or the excess.

If you have any queries in relation to this advice, or if I can be of further assistance, please do not hesitate to contact me.

Yours sincerely,

For and behalf of Xxx

Xxx

3 (a) The arrangement involves a sum payable in respect of the performance in Hong Kong by a non-resident entertainer (the US pop star) in connection with a commercial occasion or event. A withholding obligation is imposed on a resident person who pays or credits a non-resident (not necessarily the one who is chargeable) sums which are derived from a performance given in Hong Kong by a non-resident entertainer in connection with a commercial occasion or event: s.20B. The relevant sum in this case is the fee of $3 million payable by CD Ltd to Mr X, not the sum of $3·3 million payable by AB Ltd, nor the sum of $2·7 million receivable by the non-resident entertainer.

Mr X, the non-resident person, is chargeable to tax in respect of the fees in the name of the resident person who pays or credits the fee to him, which in this case is CD Ltd: s.20B(2). CD Ltd is obliged, at the time it pays or credits the fee to Mr X, to deduct from the fee a sum sufficient to pay the tax on the fee and CD Ltd is indemnified against any person in respect of its deduction of such sum: s.20B(3).

It should be noted that the withholding obligation under s.20B(2) is imposed on Hong Kong residents making payments to non-residents. Therefore, as AB Ltd is paying a resident person, CD Ltd, it has no withholding obligations. Similarly, Mr X, being a non-resident, has no withholding obligations.

In deciding the amount of the sum to be withheld for the payment of tax, the IRD accepts that one-third of the fee payable to Mr X can be allowed as deductions for expenses. In other words, two-thirds of the fee would be treated as assessable profits: DIPN 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. However, Mr X is entitled to make claims for deductions of more than one-third of the fee by producing sufficient evidence.

The amount to be withheld by CD Ltd is the tax payable. This means CD Ltd has to apply the appropriate tax rate to the deemed assessable profits, which in this case is 15%, as the non-resident, Mr X, is an individual. The amount to be withheld is therefore $3,000,000*2/3*15% = $300,000.

(b) The important point to note is that the lease in this case constitutes a hire purchase agreement, which term is defined in s.2 to mean 'an agreement for the bailment (i.e. the lease) of goods under which the bailee (i.e. the lessee) may buy the goods ….' The existence of a hire purchase agreement brings into play the provisions of s.37A which provides that, where a lessee incurs capital expenditure under a hire purchase agreement, then the lessee shall be entitled to claim depreciation allowances with respect to the leased machinery or plant. It therefore appears that KK Ltd is entitled to claim depreciation allowances.

As KK Ltd does not pay upfront the entire cost of the motor vehicle, it follows that, each year, the lease payments made by KK Ltd must be divided into notional capital and interest portions, and only the former amount would be entitled to the benefit of depreciation allowances each year. The latter would be deductible outright as a normal interest charge under s.16(1). The condition for interest deduction under s.16(2)(e) is satisfied as the interest is incurred on money borrowed to finance capital expenditure incurred on the provision of machinery or plant used in producing the company's profits and qualifying for depreciation allowance, and the lender (the leasing company) is unrelated to KK Ltd.

Initial allowances at 60% will be granted on the capital element of the hire-purchase instalments paid in the relevant basis periods: s.37A(1) and s.37A(1A). Annual allowances will also be granted on a reducing balance basis on the full cash cost (i.e. excluding interest) of the motor vehicle less any initial allowances and previous annual allowances granted: s.37A(3). The motor vehicle is not to be 'pooled' together with other assets qualified for depreciation allowance during the period of the hire purchase agreement. It will be so 'pooled' in the year following the year in which ownership of the motor vehicle passes to KK Ltd: s.39C(1) and (2).

In the absence of any other information, the capital and interest portions in the 'lease' payments are computed on a straight-line basis. The capital portion in each payment is therefore computed as $840,000/24, i.e. $35,000; and the depreciation allowance for the year of assessment 2010/11 is calculated as follows:

	$
Cash cost	840,000
Initial allowance (840,000/24*2*60%)	(42,000)
	798,000
Annual allowance at 30%	(239,400)
Written down value carried forward	558,600

Capital expenditure incurred under a hire-purchase agreement cannot be deducted as 'specified capital expenditure' under s.16G(6).

The interest portion of the 'lease' payments, i.e. $10,000 per month, is deductible as revenue expenses under s.16(1). The amount deductible for 2010/11 is $20,000.

4 **(a)** Under the Hong Kong IRO, the salaries tax position of the five specialist staff members would depend on the location of their employment and whether all of the employment income arises in or is derived from Hong Kong. In the case given, the five staff members are employed by MRS (HK) Ltd (MRS-HK) which is a Hong Kong resident company carrying on business in Hong Kong. All the staff members are residents of Hong Kong and, presumably, they provide all their services in Hong Kong, except for the two weeks on the China project. Accordingly, it is reasonable to assume that the *situs* of their employment is Hong Kong.

In the case of a Hong Kong employment, all remuneration for services under that employment would be subject to Hong Kong salaries tax, regardless of the place where the services are rendered. The only exception to this general rule is where all the services are rendered outside Hong Kong (s.8(1A)(b)). In determining whether all services are rendered outside Hong Kong, any service rendered during visits of up to 60 days in Hong Kong will be ignored. However, this 60-day rule only applies to an employee who is a 'visitor' during his stay in Hong Kong. In the case of the staff members of MRS-HK, since all of them are residents of Hong Kong, it is unlikely that they will be regarded as 'visitors' of Hong Kong. As a result, the 60-day rule does not apply to them, and so 100% of their employment income, including the portion attributable to their services rendered in China, would be fully taxable in Hong Kong.

(b) For the purposes of applying the double tax agreement (the DTA) between Hong Kong and the PRC, in the case of MRS-HK's staff members, the term 'One Side' refers to Hong Kong, and the term 'the Other Side' refers to China.

Pursuant to Article 14 of the DTA, the specialist staff's remuneration relating to their services rendered in China would be exempt from China tax if ALL of the following conditions are fulfilled.

The first condition is that the aggregate number of days that the staff member stayed in China in any 12-month period did not exceed 183 days. According to the information given, the staff members only stayed in China for two weeks, which would not exceed 183 days during any 12-month period. This condition should be considered as being fulfilled.

The second condition is that the remuneration of these staff members is paid by an employer who is not a resident of China. As the staff members are employees of MRS-HK, their remuneration would obviously be paid by MRS-HK which is not a resident of China. This condition is also fulfilled. The fact that the hotel bills were settled by MRS (China) Ltd (MRS-China) is not relevant in this context.

The third condition is that the payment of the staff remuneration is not to be borne by any permanent establishment which the employer, MRS-HK, has in China. To fulfil this condition, either none of the staff remuneration is to be recharged by MRS-HK to MRS-China; or even with the recharge, the China tax authority is convinced that MRS-China is NOT the 'permanent establishment' of MRS-HK in China. With regard to this latter issue, uncertainty arises as to whether this condition is to be interpreted strictly to include any 'establishment in China' associated with MRS-HK for this purpose.

Based on DIPN 44 (revised), paragraph 114(2), it is mentioned that if a Hong Kong resident renders services both in the Mainland and in Hong Kong, income 'paid or borne by the Mainland establishment' will be chargeable to individual income tax in the Mainland, implying that the exemption under the DTA is not available. This seems to denote that the condition in the DTA applies to cover any establishment in China. In view of the uncertainty, it would be advisable that MRS-HK does not recharge the remuneration to MRS-China at all, as in the absence of the recharge, this condition will be fulfilled without doubt.

If all the three conditions are fulfilled, the staff remuneration will be exempt from China individual income tax. However, if any of the three conditions is not fulfilled, China tax may be imposed on the staff remuneration, subject to the local applicable law. If the objective is to avoid China tax being imposed, no recharge should be made by MRS-HK.

(c) Assuming that the staff members are subject to both Hong Kong salaries tax and China individual income tax, they can either rely on the Hong Kong IRO (s.8(1A)(c)) to exclude that part of the income doubly taxed for Hong Kong salaries tax purposes, or refer to Article 21 of the DTA to claim the China tax as a credit against the Hong Kong tax payable on the same income (DIPN 44 (revised)).

Under s.8(1A)(c) of the IRO, if a taxpayer is chargeable to tax in a country outside Hong Kong in respect of the income from services rendered in that country, and the tax is of substantially the same nature as salaries tax in Hong Kong, provided that the tax has been paid, the taxpayer can seek to exclude that part of the income on which the offshore tax has been paid, for the purpose of calculating the assessable income under the Hong Kong salaries tax regime. In the case of the five staff members, to be eligible for this tax exclusion, evidence must be available to prove that China tax has been paid. In the event that the proof for the China tax payment is only available after the issuance of the Hong Kong salaries tax assessment, the staff member can apply to have the tax assessment revised accordingly: s.70A of the IRO.

Alternatively, Article 21 of the DTA provides for the double taxation to be eliminated by way of a tax credit. In ascertaining the basis for granting the tax credit under the HK-China DTA, only tax paid in China can be allowed as a credit, and the applicant must be resident in Hong Kong during the year of assessment in which the income is earned: s.50 of the IRO. Based on DIPN 44 (revised), the amount of China tax to be eligible for credit against Hong Kong tax is not necessarily the same amount as the China tax paid. Due to the different tax rates applicable in China and Hong Kong, the effective portion of the China tax needs to be ascertained by reference to the Hong Kong effective tax rate applicable to the taxpayer for that year. The effective portion of the China tax as calculated would then be used to reduce the Hong Kong tax payable. If there is any portion of the China tax not allowed as a tax credit, the shortfall can be deducted from the assessable income for Hong Kong salaries tax purpose.

5 **(a)** For the purpose of revising his 2005/06 profits tax return to take into account the omitted staff cost, Mr Look is entitled to lodge a claim under s.70A to have the 'error or omission' corrected in respect of the year of assessment 2005/06. A s.70A claim must be made in writing within six years after the end of the year of assessment or within six months after the service of the notice of assessment, whichever is later. In the case of Mr Look, the error occurred during the year ended 31 December 2005 and the relevant year of assessment is 2005/06, which ends on 31 March 2006. Six years after 31 March 2006 would be 31 March 2012. The latest date for Mr Look to lodge a s.70A claim is, therefore, 31 March 2012.

The claim will be accepted only if it can be established to the satisfaction of the IRD that the assessment is excessive by reason of:

(i) an error or omission in a return or statement submitted; or
(ii) 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. Whether the tax treatment is a prevailing practice or not is a question of fact, and it is normally distinguished from the basis which is made according to the stipulated law. Based on case law, a taxpayer must demonstrate the existence of an error or omission in a return or statement, and an 'error' for the purpose of s.70A generally refers to only inadvertent error, and would not extend to deliberate error. Evidence as to how the error would have come to be made would need to be established.

In the case of Mr Look, he would be required to produce evidence to explain the cause of the omission of the staff cost from his business accounts. He is also required to provide evidence to substantiate the hiring of the staff and the payment of the cost. The hiring of staff must be incurred in the production of his assessable profits, and thus details of the services provided by the staff would also be reviewed. In this connection, the review may be extended to ascertain whether Mr Look has fully complied with the reporting obligations as an employer during the period the staff was hired. In the event that such reporting was absent, Mr Look should be prepared to give explanations and, if appropriate, may be subject to a penalty for non-compliance. Such non-compliance may also add doubt to the validity of the s.70A claim as to whether the omission of the staff cost was an advertent error or a deliberate act. In the latter case, the s.70A claim would not be accepted, and the assessment would not be revised. However, provided that it can be established to the satisfaction of the IRD that the under-reported expense was a genuine 'error' or 'omission', his s.70A claim would be approved and the profits tax assessment for 2005/06 would be revised accordingly.

(b) Property tax is charged for each year of assessment on the owner of land and/or buildings situated in Hong Kong at the standard rate on the net assessable value of such land and/or buildings: s.5(1). In so far as common parts are concerned, 'owner' in respect of any land and/or buildings is defined to include a corporation registered under s.8 of the Building Management Ordinance. Therefore, the Assessor is empowered to issue a 2010/11 property tax return to the 'Incorporated Owner of Regent Court'; and the incorporated owner is required, on behalf of all owners of the building, to report the income and pay the tax.

'Land and/or buildings' includes piers, wharves and other structures, and 'buildings' includes any part of a building: s.7A. The assessable value of a property for each year of assessment shall be the consideration, in money or money's worth, payable in that year to, to the order of, or for the benefit of, the owner in respect of the right of use of that property: s.5B(2).

In the present case, the roof is part of a building; and the licence fee falls within the definition of assessable value, namely, the consideration paid by the company for the use of the roof to erect an advertising neon sign thereon. Even though the licence fee is not paid directly to the owners of the common parts, it is used for the purpose of meeting the management expenses. The licence fee can therefore be regarded as having been paid to the order of, or for the benefit of, the owners. As such, the owners will be chargeable to property tax in respect of the licence fee for the year of assessment 2010/11.

Professional Level – Options Module, Paper P6 (HKG)
Advanced Taxation (Hong Kong) **December 2011 Marking Scheme**

			Available	Maximum
1	**(a)**	**Current structure's effectiveness**		
		Interest expense deductible if incurred in the production of profits	0·5	
		Secured loan test	0·5	
		Interest flow-back test	0·5	
		Dividends from K Ltd not taxable	0·5	
		H Ltd's interest not tax deductible	0·5	
			2·5	2
	(b)	Proposal 1		
	(i)	H Ltd incurs no further interest cost	0·5	
		No profits tax implications to H Ltd	0·5	1
	(ii)	K Ltd incurs interest on new bank loan	0·5	
		Loan money is on-lent to H Ltd interest free	0·5	
		Interest not incurred in production of profits	0·5	
		Secured by a deposit which does not generate interest taxable in HK	0·5	
		Secured loan test failed	0·5	
		Majority of interest paid back to Papa	0·5	
		Interest flow-back test failed	0·5	
		No interest deduction/not tax effective to K Ltd	0·5	4
	(c)	Proposal 2		
	(i)	No profits tax implication to H Ltd	0·5	
		No profits tax implication to P Ltd	0·5	
		No stamp duty implication to either	1	2
	(ii)	Mi may be subject to profits tax if a trade is carried on	1	
		Definition of trade	0·5	
		Intention when acquiring and disposing of the asset	1	
		Badges of trade	3	
		Other factors, e.g. method of financing and uses of proceeds	1	
		Short period of holding the shares	1	
		Sale is driven by the need to raise funds, rather than profit-making motive	1	
		Evidence of utilisation of proceeds	1	
		Risk of property trading intention of K Ltd to affect Mi	0·5	
		Shareholder's intention not associated with intention of company	1	
		If no trading intention of Mi, no profits tax arises	1	
		Stamp duty at 0·2% (bought and sold notes) + $5	2	
		Stampable value is net asset value, if higher than consideration	1	
		Group relief under s.45 not applicable because not corporate group	1	
			16	15
	(iii)	Transfer is between associated enterprises	1	
		Definition of 'associates' under DTA	0·5	
		Arm's length principles	1	
		Transactions of independent enterprises as a benchmark	1	
		Actual price not used/profits adjusted	0·5	
		K Ltd's sale at cost is subject to challenge	0·5	
		Profits adjustment by the IRD under the DTA	1	
		Application of s.61 or s.61A	0·5	
		Stamp duty at *ad valorem* rates from $100 to 4·25%	1	
		Stampable value is market value	0·5	
		Group relief under s.45 not applicable because less than 90% shareholding	1	
			8·5	8

		Available	Maximum
(d)	**Proposal 3**		
	Change of intention from trading to capital	1	
	Deemed sale of property	1	
	Market price at the time of change of intention	0·5	
	Notional profit taxable	0·5	
	Sale of future stream of rental income taxable as deemed trading receipts	1	4
	Appropriate format and presentation	1	
	Effectiveness of communication	1	2
			38

			Available	Maximum
2	**(a)**	**Salaries tax position of current structure**		
		General principles of s.9(1)(a)	1	
		Convertible into cash	0·5	
		Discharging personal liability	0·5	
		Tax treatment of		
		Salary and bonus	0·5	
		Contract gratuity and relating back	2	
		Incentive for acceptance of offer	1	
		Company quarter	1	
		Medical insurance scheme	1	
		Share options and share awards		
		Both are taxable employment income	0·5	
		Share option taxable under s.9(1)(d)	0·5	
		Timing of assessment – Hong Kong employment	1	
		Taxable gain calculation basis	1	
		Disposal gain disregarded	0·5	
		Share award taxed as perquisite	0·5	
		Timing based on when ‘accrued’	1	
		If no vesting period, at time of grant	1	
		‘Upfront approach’	0·5	
		Value based on market price at time of grant	1	
		If vested, at time when vesting period ends	1	
		‘Back-end approach’	0·5	
		Value based on market price when conditions fulfilled	0·5	
		If share option chosen		
		Timing for taxing the share option	2	
		Advise deferral of exercise of option to 2014/15, with reasons	2	
			21	20
	(b)	**Restructuring of the remuneration package**		
		Payment for restrictive covenant	2	
		Accommodation benefit		
		Reimbursement of rent or rent directly paid to landlord not taxable	1	
		Taxed on rental value	0·5	
		Meaning of rent	0·5	
		Benefit set out in employment contract	1	
		Control by employer	0·5	
		Severance payment to replace contract gratuity	1·5	
			7	6
		Appropriate format and presentation	1	
		Effectiveness of communication	1	2
				28

			Available	Maximum
3	(a)	Non-resident entertainer performing in Hong Kong: s.20B	1·5	
		Taxable sum – $3m paid to Mr X	1	
		Withholding obligation on CD Ltd	1	
		No withholding obligation on AB Ltd	0·5	
		No withholding obligation on Mr X	0·5	
		Deemed profit 2/3	1	
		Can claim deduction for actual expenses, if more	0·5	
		Deemed profit under s.21	0·5	
		Amount withheld is tax payable	0·5	
		Tax rate 15%	0·5	
		Calculation of withholding tax	0·5	8
	(b)	Hire purchase agreement	1	
		Definition of hire purchase	0·5	
		Entitled to claim depreciation allowances	0·5	
		Lease payments divided	0·5	
		Interest portion deductible under s.16(1) and s.16(2)(e)	1	
		Conditions for deducting interest satisfied	1·5	
		Treatment of depreciation allowances under hire purchase	1	
		When a hire purchase asset to be pooled	1	
		Calculation of IA and AA for 2010/11	1	
		Calculation of allowable interest expense for 2010/11	1	
		Expenditure under HP cannot be deducted as specified capital expenditure	0·5	
			9·5	9
				17
4	(a)	Source of employment	0·5	
		All income arises in Hong Kong	0·5	
		Employer is Hong Kong company	0·5	
		All staff are Hong Kong residents	0·5	
		Presumably Hong Kong employment	0·5	
		All remuneration subject to Hong Kong salaries tax	0·5	
		Except where all services rendered outside Hong Kong	0·5	
		</= 60 days in Hong Kong ignored	0·5	
		Definition of 'visitor'	0·5	
		Staff with Hong Kong base not 'visitors'	0·5	
		60 days rule does not apply	0·5	
		100% of income taxable in Hong Kong	0·5	6
	(b)	Exempt from China tax if all conditions under Article 14 fulfilled	1	
		</= 183 days fulfilled	1	
		Remuneration paid by employer, MRS-HK, not resident in China – fulfilled	1	
		Payment of hotel bills, etc by MKS-China not relevant	0·5	
		Remuneration not borne by PE in China if no recharge to MRS-China	1	
		Or if MRS-China not regarded as a PE of MRS-HK	1	
		Uncertainty of interpretation/DIPN 44	1	
		Advised not to recharge	0·5	
			7	6
	(c)	Can exclude doubly taxed income from assessable income under s.8(1A)(c)	0·5	
		Overseas tax substantially of the same nature as salaries tax	0·5	
		Overseas tax must have been paid	0·5	
		Evidence of tax payment required	0·5	
		Alternatively, can claim credit under Article 21 of DTA	0·5	
		Only tax paid in China is creditable	0·5	
		Applicant must be Hong Kong resident	0·5	
		Tax credit amount not necessarily the same as overseas tax paid	0·5	
		Effective portion of China tax calculated by reference to effective tax rate of Hong Kong tax	0·5	
		Shortfall of tax not credited can be claimed as deduction	0·5	5
				17

			Available	Maximum
5	**(a)**	Section 70A claim to correct error or omission	1	
		Made in writing within six years after the end of 2005/06	0·5	
		Or within six months after the service of the notice of assessment	0·5	
		Whichever is later	0·5	
		Due date for Mr Look is 31 March 2012	1	
		Assessment is excessive by reason of error or omission in return	0·5	
		Or arithmetical error or omission in the calculation of assessable profits or tax charged	0·5	
		Cannot be re-opened for a prevailing practice	0·5	
		Error is an inadvertent error, not a deliberate error	0·5	
		Mr Look to produce evidence of omission of staff cost	0·5	
		Explain why the cost is omitted	0·5	
		Staff cost incurred in the production of assessable profits	0·5	
		Reporting obligations for staff fully complied with	0·5	
		If not, penalty	0·5	
		May also raise doubt as to whether the error is deliberate	0·5	
		If genuine error or omission, 2005/06 tax assessment will be revised	0·5	9
	(b)	Property tax charged on net assessable value of land and/or buildings	0·5	
		Owners include incorporated owners	1	
		Assessor empowered to issue property tax return to the incorporated owner	1	
		Incorporated owner required to report the income and pay the tax	1	
		Meaning of land and/or buildings	0·5	
		Meaning of assessable value	0·5	
		Roof is part of a building	1	
		Licence fees are consideration for the use of the roof	1	
		Licence fees regarded as having been paid to the owners	1	
		Therefore, owners chargeable to property tax	0·5	8
				17