remuneration as a holiday allowance. He was not required to produce any documentary evidence to claim the allowance. The taxpayer reported his salary and holiday allowances in his tax returns but claimed deductions for his holiday expenses against the assessable income. The Board rejected the Commissioner's argument that the holiday allowances did not qualify for exemption under s 9(1)(a)(ii), notwithstanding the fact that the taxpayer was free to spend the allowances in any manner. Accordingly, the holiday allowances received by the taxpayer were exempted from salaries tax. See also *Case* R33 (2008) HKRC ¶81-251 (*D9/08* IRBRD Vol 23).

From the year of assessment 2003/04 onwards, pursuant to s 9(1)(a) and 9(2A)(c), exemptions for holiday warrant and transportation allowance of a taxpayer's personal effects in connection with holiday warrant or passage are also removed (see ¶2-1630).

COMMON LAW INCOME PRINCIPLES

¶2-1100 Common law income principles

As the *Inland Revenue Ordinance* does not provide an exhaustive definition of "income" (see ¶2-0300), reference is made to common law principles which have been developed by the courts. Under common law, a payment is most likely to qualify as "income" if it fulfils the following criteria:

- it was derived beneficially by the recipient (see ¶2-1150);
- it was in money or money's worth (see ¶2-1200);
- it was a reward for services rendered (see ¶2-1250); and
- it had the qualities of periodicity, recurrence and regularity (see ¶2-1300).

Fulfilment of only one of the criteria is not normally decisive, and the weight attached to each element varies from case to case.

¶2-1150 Beneficial receipt

To be "income" a payment must "come in" to the recipient taxpayer. The receipt should be a realised gain derived beneficially.

In other words, according to ordinary concepts and usages, income is "what comes into (the) pocket" (*Tennant v Smith* (1892) AC 150). Normally, a payment which does no more than save the taxpayer from incurring expenditure is not regarded as income because

income is what "comes in" and not what is saved from going out (*Federal Commissioner of Taxation v Cooke & Sherden* 80 ATC 4140).

An amount of money does not need to be paid over to a taxpayer in order for it to "come in" as assessable income. It is enough if a payment is dealt with as the taxpayer directs (*Cooke & Sherden*).

The requirement that a gain must be derived *beneficially* in order to constitute "income" means that the amount must be received for the taxpayer's own benefit rather than being held by the taxpayer for the benefit, or on behalf, of another (*The Countess of Bective v FC of T* (1932) 47 CLR 417). For example: if Ms A received $500 to be disposed of as she wished then, all else being equal, the amount would have been derived beneficially by Ms A and would be taxable "income." If, however, Ms A was paid $500 on condition that she invests it and pays the proceeds to Mr B, then the income would not have been derived beneficially by Ms A. She could not treat the amount as her own and dispose of it as she wished. The amount would not then be "income."

¶2-1200 Money or money's worth

To constitute "income" at common law, there must have been a receipt of money or something capable of being turned into money.

It is not necessary for income to be received in the form of money. It is sufficient if the item is in a form which can be converted into money or money's worth (*Cross v London & Provincial Trust Ltd* (1938) 1 All ER 428).

In *Federal Commissioner of Taxation v Cooke & Sherden* 80 ATC 4140, taxpayers were awarded a free holiday as part of a sales incentive scheme. The holiday could not be sold or transferred. There could be no cash payment in lieu of the trip. According to the Court, as the benefit could not be converted into money or money's worth, it was not "income" and, therefore, was not assessable.

Free air tickets obtained through a frequent flyer program (with points obtained as a result of business travel) were not "income" because they were not money and could not be turned into a pecuniary account according to the Australian Federal Court in *Payne v FC of T* 96 ATC 4407. The tickets could be used only by the member of the program or by his or her appointed nominee. They were not transferable and, if sold, were subject to cancellation. The taxpayer was not taxable on the value of the tickets.

A taxpayer's right to be reimbursed by his or her employer for dental fees, which he or she had incurred and paid, was a benefit or

extent that it represents his or her employer's contributions to the scheme in excess of the "proportionate benefit" prescribed under s 8(5) (s 9(1)(ab)(ii)).

- any payment received by an employee, in accordance with an order under s 57(3)(b) of the *Occupational Retirement Schemes Ordinance* to the extent that it is attributable to the employer's contributions to the occupational retirement scheme in respect of which the judgment was given (s 9(1)(ac)) (s 57(3) of the *Occupational Retirement Schemes Ordinance* allows the Court to determine the amount of any shortfall in the funding of a beneficiary's vested benefits under a scheme and to make an order against the employer for that shortfall);
- so much of the accrued benefit that an employee has received, or is taken to have received from a mandatory provident fund scheme other than on retirement, death, incapacity or termination of service, as is attributable to his employer's contributions to the scheme (s 9(1)(ad)); and
- so much of the accrued benefit that an employee has received, or is taken to have received from a mandatory provident fund scheme upon termination of services, as is attributable to his or her employer's voluntary contributions to the scheme which exceeds the proportionate benefit calculated in accordance with s 8(5) (s 9(1)(ae)).
- An "occupational retirement scheme" is a scheme which:
  - (i) is comprised in one or more instruments or agreements; and
  - (ii) provides, or is capable of providing, benefits in the form of pensions, allowances, gratuities or other payments on the termination of service, death or retirement, to a person under a contract of service in any employment (s 2(1) of the *Inland Revenue Ordinance*; s 2(1) of the *Occupational Retirement Schemes Ordinance*).

Insurance contracts under which benefits are only payable upon the death or disability of an insured do not qualify as occupational retirement schemes.

A "recognised occupational retirement scheme" means an occupational retirement scheme which:

- is registered under s 18 of the *Occupational Retirement Schemes Ordinance*;

- is exempt from registration by virtue of s 7(1) of the *Occupational Retirement Schemes Ordinance*;
- is operated by an employer who is either a foreign government, or any agency or undertaking of a foreign government not operated for the purpose of gain; or
- is established by or contained in any other Hong Kong Ordinances other than the *Mandatory Provident Fund Schemes Ordinance*.

A mandatory provident fund scheme is a scheme registered under the *Mandatory Provident Fund Schemes Ordinance*. Mandatory provident fund schemes commenced on 1 December 2000. Mandatory contributions are calculated on the basis of 5% of an employee's relevant income (subject to the current minimum and maximum income levels of $7,100 and $30,000 respectively), with the employer matching the employee's contribution. Self-employed persons also have to contribute 5% of their relevant income.

In addition to the mandatory contributions, employers, employees and self-employed persons can also choose to make voluntary contributions to a mandatory provident fund scheme.

A "recognised retirement scheme" is a collective term for the two types of retirement schemes that may enjoy tax benefits and means either a recognised occupational retirement scheme or a mandatory provident fund scheme (DIPN No 23 (Revised), para 10).

Retirement schemes previously approved by the Commissioner of Inland Revenue

The Registrar of Occupational Retirement Schemes assumed responsibility for the registration of retirement schemes from 19 November 1993. Previously, approval was granted to retirement schemes for taxation purposes by the Commissioner of Inland Revenue under the former s 87A of the *Inland Revenue Ordinance*.

The *Occupational Retirement Schemes Ordinance* provided a two-year transitional period during which it was not necessary for retirement schemes to be registered or exempted from registration. During this transitional period, any retirement schemes which had received the Commissioner's approval under s 87A before its repeal were regarded as "recognised occupational retirement schemes" for tax purposes. The transitional period expired on 15 October 1995. Accordingly, any retirement scheme that is neither operated by a foreign government, nor established under a Hong Kong Ordinance, is now required to be registered or exempted from registration

necessarily incurred in the production of assessable income (s 12(1)(a); see ¶2-4950ff);

- depreciation and other capital allowances for plant and machinery calculated under Pt VI of the Ordinance (s 12(1)(b); see ¶2-6100);
- the taxpayer's losses carried forward to the year of assessment (s 12(1)(c); see ¶2-6150);
- any losses of the taxpayer's spouse carried forward to the year of assessment (s 12(1)(d); see ¶2-6150); and
- self-education expenses, up to a maximum of $80,000 (s 12(1)(e); see ¶2-5300).

Also, for the purposes of ascertaining a taxpayer's net assessable income, his or her assessable income is increased by the amount of any balancing charge made under Pt VI for machinery or plant used in the production of the assessable income.

See further ¶2-6200.

GENERAL DEDUCTIBILITY OF OUTGOINGS AND EXPENSES

¶2-4950 Requirements for deductibility

Outgoings and expenses must satisfy a number of requirements in order to qualify as allowable deductions. First, they must *not* constitute domestic, private or capital expenditure (see ¶2-5000) and then:

- they must have been "incurred" (see ¶2-5150);
- they should have arisen wholly and exclusively in the production of assessable income (see ¶2-5050, ¶2-5200); and
- they must have been necessary for the production of assessable income (see ¶2-5100) (s 12(1)(a)).

The outgoings and expenses which may be deducted under s 12 are limited as a result of the restrictive nature of these requirements. The onus of establishing a claim is upon the taxpayer.

¶2-5000 Domestic, private or capital expenditure

The first step in determining whether expenses or outgoings are deductible is to determine whether they are of a domestic, private

or capital nature. Only when it is decided that they are *not* of such a nature will other criteria for deductibility be considered.

Domestic or private expenses

Australian authority suggests that the test to be applied to determine whether expenses or outgoings are of a domestic or private nature is one of degree. That is, expenditure which is "essentially" of such a nature will not be an allowable deduction. Expenditure which has the "essential character" of a business expense is deductible (*John v Federal Commissioner of Taxation* 89 ATC 4101).

Items of expenditure which are likely to be disallowed as being of a private or domestic nature include:

- living expenses;
- normal travel to and from work;
- entertainment costs; and
- household insurance.

A taxpayer's personal medical expenses are normally non-deductible. A taxpayer who was required to undergo regular dialysis treatment, for example, was denied a salaries tax deduction for his expenses in *Case* E18 (1995) 1 HKRC ¶80-315 (*D33/94* IRBRD Vol 9). Note, however, that the High Court has acknowledged, in a profits tax case, that medical expenses might be deductible in some very rare cases. A reimbursement of an insurance premium received by the taxpayer from his employer was a private expense and was subject to salaries tax (*Case* T21 (2010) HKRC ¶81-290 (*D37/09* IRBRD Vol 24)).

For more on "domestic or private expenses", refer to ¶6-6040.

Interest expenses incurred by a taxpayer so that he or she can purchase a home are of a domestic or private nature and, up to 31 March 1998, were therefore non-deductible (*Case* A97 (1991) 1 HKRC ¶80-097 (*D66/90*)). However, from the 1998/99 year of assessment, a taxpayer can claim a special concessionary deduction in respect of mortgage interest payments of up to $100,000 per year of assessment for five years of assessment under s 26E–26F. Under the *Revenue Ordinance 2004*, the number of years of assessment has been increased from five to seven, with retrospective effect from 1 April 2003. Time limit has been extended from seven to ten years of assessment under the *Revenue Ordinance 2006*, with retrospective effect from 1 April 2005, and to fifteen years of

those of an unmarried couple in exactly the same situation. The Commissioner, on the contrary, argued that the assessments were raised by following the mechanics laid down by the *Inland Revenue Ordinance* and that he had no discretion to produce a result that was desired by the taxpayers.

The taxpayers appealed to the Court of First Instance after the case was rejected by the Board. The Court held that the taxpayers had misunderstood the meaning of equity in its legal sense and had wrongly equated it with the general notion of fairness and justice. It pointed out that the legal meaning of equity was much narrower and that there should not have been any room for giving any taxing statute an "equitable construction" as suggested by the taxpayers.

The Court of First Instance observed that it was a question of tax policy for the legislature as to whether a married couple should have been treated as a single tax unit under certain circumstances. As the consequences applied across the board to all married taxpayers, the Court of First Instance held that the *Inland Revenue Ordinance* was not in contravention of Art 25 of the *Basic Law* and that the taxpayers had not been discriminated by reason of their family status. The Court of First Instance also held that the Commissioner had no discretion to permit separate assessments for the taxpayers once they had elected for personal assessment.

The decision of the Court of First Instance was upheld in the Court of Appeal in *Wong Tai Wai, David v Commissioner of Inland Revenue* (2004) HKRC ¶90-134.

ELIGIBLE TAXPAYERS

¶4-1200 Eligible taxpayers

A taxpayer is eligible to elect personal assessment if he or she is:

- 18 years of age or over; and
- a permanent or a temporary resident in Hong Kong, or his or her spouse is a permanent or a temporary resident (s 41(1)).

A taxpayer who is under 18 years of age is eligible to elect personal assessment if both of his or her parents are deceased.

Age requirement

A taxpayer whose parents are alive becomes eligible to elect personal assessment in the year that he or she turns 18. If an election is made

in that year, the taxpayer is personally assessed on his or her total income for the full year. Personal assessment is not limited to the income which the taxpayer received after reaching 18 years of age. There is no provision for the apportionment of income in this manner.

The requirement that a taxpayer must be 18 years of age to be eligible to elect personal assessment prevents adults from reducing their own tax liability by causing children under that age to become joint property owners with them or partners in their business. The age requirement prevents multiple personal assessment claims being made to the benefit of an adult.

Residency requirement

Whether a taxpayer is a resident of Hong Kong is an issue of fact for the Commissioner to determine. The *Shorter Oxford English Dictionary* defines the word "reside" as follows:

> "To dwell permanently or for a considerable time, to have one's settled or usual abode, to live in or at a particular place."

This definition was cited with approval in *Levene v IRC* (1928) 13 TC 486.

A "permanent resident" is defined as an individual who ordinarily resides in Hong Kong (s 41(4)). The meaning of "ordinarily resides", however, is not provided in the *Inland Revenue Ordinance*. British case law has addressed the issue of what is meant by "ordinary residence." It has been held to connote continuity or habitual residence.

The following factors may be taken into consideration to determine where an individual resides:

- **Physical presence.** If an individual is physically present in Hong Kong for a considerable amount of time during an assessment year, the inference may be that he or she resides in the territory;
- **Taxpayer's history.** The history of the taxpayer's residences and movements may be taken into account when determining where he or she resides;
- **Visit details.** When an individual is a visitor to a country, the frequency, regularity, purpose and duration of the visits may be an influential factor in determining whether he or she has resided in that country in the relevant year (*Lysaght v IRC* (1927) 13 TC 511);
- **Reason for absences.** When an individual has been outside a country for part of a year, the purposes for the absence may be

co-operative society or trade union (s 2(1)). A "body of persons" is any body politic, corporate or collegiate or any company, fraternity, fellowship or society of persons whether corporate or not corporate (s 2(1)).

A trustee is subject to profits tax on its own profits arising from the provision of trustee services and will not be personally liable to tax in respect of the chargeable profits of the entity for which it acts. When a trustee is involved in a profitable transaction, the profit must be looked at to determine whether it belongs to the trustee or some other person (*Case* D20 (1994) 1 HKRC ¶80-270 (*D37/93* IRBRD Vol 8)).

In *Case* D20 (*D37/93*), a trustee which had purchased and sold a property as trustee for an unrelated company (Company X) was not chargeable to profits tax on the sale proceeds. The purchase price for the property had been paid directly to the vendor by Company X, and Company X had directly received the sales proceeds. The Board of Review said that there was no way that the profit belonged to the trustee for tax purposes. Company X had been carrying on business for its own account and only used the trustee as its nominee. The trustee had done nothing. It made no decisions, did not provide capital and did not receive sale proceeds. The profit was profit of Company X.

DEFINITION OF TRADE

¶6-0350 Definition of trade

"Trade" is defined in the Ordinance as including:

(i) every trade and manufacture; and

(ii) every adventure and concern in the nature of trade (s 2(1)).

This definition, however, is of limited practical assistance for determining whether a taxpayer has been engaged in trade. Consequently, courts tend to look at the established characteristics or identifying features of trade which are reflected in earlier cases and assess whether the transaction in question displays any of those characteristics (*Griffiths (Inspector of Taxes) v JP Harrison (Watford) Ltd* (1963) AC 1). The various characteristics or "badges of trade" are discussed at ¶6-0500.

Whether a person is, or has been, engaged in trade is a question of fact, not law (*IRC v Scottish Automobile and General Insurance Co* (1932) 16 TC 381). The question therefore turns to the circumstances of the

relevant case, which must be examined in their entirety. In *Erichsen v Last* (1881) 4 TC 422, the Master of Rolls said:

> "There is not, I think, any principle of law which lays down what carrying on trade is. There are a multitude of things which together make up the carrying on of trade, but I know no one distinguishing incident, for it is a compound fact made up of a variety of incidents."

Furthermore, the fact that one or all of the usual "badges of trade" is or are absent does not negate the existence of an adventure in the nature of trade (see ¶6-0500).

CHARACTERISTICS OF TRADE

¶6-0500 Badges of trade

The basic characteristics of trade have been established through case law. In particular, six identifying features have emerged which are normally taken into consideration when determining whether a taxpayer is, or has been, engaged in trade. These "badges of trade", as they have become known, are:

(i) the subject matter of the transaction/s (see ¶6-0540);

(ii) the length of ownership (see ¶6-0580);

(iii) whether there have been successive or frequent similar transaction/s (see ¶6-0620);

(iv) whether supplementary activities have been performed to make the asset/s marketable or to attract purchasers (see ¶6-0660);

(v) the reasons for the disposal or realisation of the subject matter (see ¶6-0700); and

(vi) the taxpayer's motive (see ¶6-0740).

The badges of trade substantially originated from the case of *Leeming v Jones* (1930) 15 TC 333. They were specifically identified and enunciated by the United Kingdom Royal Commission on the Taxation of Profits and Income (Comd. 9474) in 1955.

In addition to the general badges of trade, there are two other significant features to which courts attach considerable weight. They are:

(i) the taxpayer's intention to trade (see ¶6-0780); and

(ii) the existence of a commercial purpose in the taxpayer's transaction/s (see ¶6-0820).

resident. In such cases, the Inland Revenue Department will allow the Hong Kong company to deduct the foreign withholding tax paid from the service fee charged. Therefore, the Hong Kong company is effectively assessed on the service fee received net of withholding tax. This is in accordance with DIPN No 28 — Deductibility of Foreign Taxes (see ¶6-5100) which deals with the deductibility of foreign taxes charged on foreign earnings, regardless of whether a profit is made or not (DIPN No 21 (Revised), paras 51 and 52).

In *Case* K4 (2001) HKRC ¶80-735 (*D8/00* IRBRD Vol 15), a taxpayer in the stockbroking business argued that the corporate finance and underwriting income generated from services provided by its network of offshore offices should be apportioned between onshore and offshore activities using the same basis as the onshore/offshore brokerage income. However, the Board found that there was insufficient evidence to show that the income was sourced outside Hong Kong.

Subsequently, the Commissioner and the taxpayer appealed to the Court of First Instance against the Board's findings (*Commissioner of Inland Revenue v Indosuez WI Carr Securities Ltd* (2002) HKRC ¶90-117). The Court made an order for the Board to reconsider its ruling on the source of profits (see ¶6-1980).

¶6-2060 Royalties

When considering the source of royalties, one may refer to the guidance from the Privy Council's decision in *Commissioner of Inland Revenue v HK-TVB International Limited* (1992) 1 HKRC ¶90-064, in which the taxpayer had derived profits from sub-licensing film rights which were only exercisable outside of Hong Kong.

The taxpayer argued, before the Privy Council, that the sub-licensing fees it had received were derived from exploiting property assets which were only capable of being used outside Hong Kong. An analogy was drawn between the letting of real property and the licensing of intellectual property rights. The Privy Council found, however, that this was a false analogy as it presupposed that intellectual property rights have a *situs* similar to immovable property.

The Privy Council said that although profits accruing from the sale of immovable property located outside Hong Kong are likely to arise in the country where the property is situated (see ¶6-2180), it by no means follows that intellectual property rights exercisable only in one country can be equiparated to immovable property in that country.

The Privy Council found that the transactions which produced the profits in the *HK-TVB* case were: the acquisition of the exclusive rights of granting sub-licences; and the actual granting of the sub-licences, both of which were carried on in Hong Kong. Hence the profits, or royalties, were chargeable.

See ¶6-1740 for more on the *HK-TVB* case.

In certain circumstances, royalties which do not otherwise fall within the charge to profits tax under s 14 are deemed to be Hong Kong-sourced trading profits under s 15(1) (see further ¶6-2260). DIPN No 49 also provides the Inland Revenue Department's view on locality of royalties derived from licensing of intellectual property rights. Broadly speaking, where the intellectual property right is created or developed by the licensor carrying on business in Hong Kong, the royalties so derived will generally be regarded as Hong Kong sourced; where a taxpayer purchases an intellectual property right and licenses that right to another party for use outside Hong Kong, the royalties so derived will generally be regarded as non-Hong Kong sourced; in a case where a taxpayer only obtains a licence to use an intellectual property right (ie the taxpayer is not the owner of the right) and then sub-licenses the right to another party for use outside Hong Kong, the Inland Revenue Department will take the place of acquiring and granting the licence as the place for ascertaining the source of income (DIPN No 49, paras 72–76).

See ¶6-2180 for the Inland Revenue Department's view, as set out in DIPN No 21 (Revised), on the locality of royalties other than those deemed chargeable under s 15(1)(a) or (b).

Lam Soon Trademark Limited v Commissioner of Inland Revenue (2004) HKRC ¶90-137 involved an appeal to the Court of First Instance against a decision by the Board of Review in *Case* N46 (2004) HKRC ¶81-022 (*D45/03* IRBRD Vol 18) in holding that the royalty income of the taxpayer was sourced in Hong Kong and assessable to profits tax. The taxpayer formed part of the well-known Lam Soon Group of Companies and its controlling company was Lam Soon Hong Kong Limited ("LSHK"). The taxpayer had directors in Hong Kong, Singapore and the Cook Islands. It was decided during a management meeting held in Hong Kong that LSHK's trademarks should be transferred to an offshore company to be incorporated. The taxpayer,

which is exposed to a risk of change in value or changes in future cash flows. Application of hedge accounting is permitted under HKAS 39 if certain strict criteria are met.

There are three types of hedging relationships:

(a) fair value hedge;

(b) cash flow hedge; and

(c) hedge of a net investment.

The Inland Revenue Department considers that the tax treatment for hedging relationship should follow its accounting treatment. Some of the accounting treatments specified in para 37 of DIPN No 42 are:

(a) In a fair value hedge, the profit or loss from remeasurement is recognised immediately in the profit and loss account while at the same time, the carrying amount of the hedged item is adjusted and the change is also recognised immediately in the profit and loss account.

(b) In a cash flow hedge, the portion of the profit or loss on the hedging instrument that is an effective hedge is recognised directly in equity and is recycled to the profit and loss account when the hedged cash flows affect the profit.

(c) Any hedge ineffectiveness is recognised in the profit and loss of the current period.

If the hedging relationship is qualified for hedge accounting under HKAS 39 and is accounted for as such, the Inland Revenue Department considers that the hedged item and the hedging instrument should not be considered separately. The nature of the profit or loss arising from the hedging instrument will depend on the nature of the hedged item (DIPN No 42, para 38).

If the hedging relationship is not accounted for under hedge accounting, the hedged item and the hedging instrument will be accounted for separately in the accounts. The tax treatments for the hedged item and the hedging instrument will be considered separately. An exception to this is where the hedging instrument is as a matter of fact a hedge against the hedged item even though hedge accounting is not or cannot be adopted (DIPN No 42, para 39).

For enterprises that control their group financial activities through a central treasury unit, the norm is for the central unit to execute a hedge with an external third party and pass on the terms and conditions of that hedge to a subsidiary through an internal hedge. The Inland Revenue Department holds the view that hedge accounting should

normally be available to internal or centralised hedging activities with "matched external transactions" that are entered into on a one-for-one basis (DIPN No 42, para 40).

Embedded derivatives

An embedded derivative is a component of a hybrid instrument that contains a non-derivative host contract and is one single instrument in legal form (DIPN No 42, para 41).

For tax purposes, the locality of the profit and loss of a hybrid instrument and whether it is capital or revenue in nature are determined on the basis that the embedded derivative and the host contract is one single instrument. Therefore, the same tax treatment will be applied to the embedded derivative and the host contract despite the fact that they are required to be accounted for separately under certain circumstances (DIPN No 42, para 42).

Where the accounting treatments of changes in the carrying amounts of the embedded derivative and the host contract differ, according to DIPN No 42, the Inland Revenue Department was only prepared to accept the accounting treatment under HKAS 39 as the tax treatment so far as timing of assessment was concerned. The Inland Revenue Department did not accept that the entire gain will only be taxed in the year the hybrid instrument is sold (DIPN No 42, para 43). However, pursuant to the Court of Final Appeal's decision in *Nice Cheer Investment Limited v CIR* (2013) HKRC ¶90-252 (see ¶6-3030), such gain may only be taxed upon realisation of the gain, ie when the hybrid instrument is sold.

¶6-3335 Imputed interest on interest-free loans and non-arm's length loans

After the issuance of DIPN No 42, the Inland Revenue Department posted Frequently Asked Questions (FAQs) in its website to state its position on imputed interest on interest-free loans and non-arm's length loans.

Under HKAS 39, imputed interest will be measured in respect of interest-free loans or loans bearing above or below market interest rate and recognised accordingly. Notwithstanding the accounting treatment, the Inland Revenue Department has confirmed that only the actual interest income/expenses based on the contractual rate (zero rate for interest-free loans) will be assessed/allowed for tax purposes. Similar taxation treatment will also be applied to the imputed interest involved in those loans bearing off-market interest rates.

- any partner with the partnership in any other partnership, and if that partner is a partnership, any partner of that partnership;
- any relative of such partner;
- a corporation controlled by the partnership, or by a partner or any relative of that partner;
- a director or principal officer of such a corporation; and
- a corporation of which any partner is a director or principal officer.

An "associated corporation" in relation to a borrower is either: a corporation over which the borrower has control; a corporation which has control over the borrower; or a corporation under the same control as the borrower (s 16(3)). "Control", in relation to a corporation, means the power of a person to ensure that the affairs of the corporation are conducted in accordance with his or her wishes. This may be achieved by holding shares or possessing voting power in the corporation or any other corporation; or through powers conferred by the articles of association or other documents regulating the corporation or any other corporation (s 16(3A)).

A person who is not a corporation is also regarded as being controlled by another person if he or she is accustomed or under an obligation to act in relation to his or her investment or business affairs, in accordance with the directions, instructions or wishes of that other person.

Condition 6: The borrower is a corporation and the deduction is for interest payable on the following (s 16(2)(f)):

(i) debentures listed on a stock exchange in Hong Kong or on any other stock exchange recognised by the Commissioner;

(ii) on instruments (other than debentures described above):

(a) issued *bona fide* and in the course of carrying on business, which is marketed in Hong Kong or in a major financial centre outside Hong Kong; or

(b) issued pursuant to any agreement or arrangement, where the issue of an advertisement, invitation or document in respect of the agreement or arrangement has been authorised by the SFC under s 105 of the *Securities and Futures Ordinance (Cap 571)*, and the advertisement, invitation or document has been issued to the public; or

(iii) on moneys borrowed from an "associated corporation" (see above), where the moneys in the hands of the associated corporation arose entirely from the proceeds of an issue of debentures or an issue of an instrument described in (i) or (ii), in an amount not exceeding the interest payable by the associated corporation to the holders of such debentures or instruments.

In order to satisfy this condition, the debt instruments that qualify for interest deduction must be actually marketed in Hong Kong or a major financial centre recognised by the Commissioner. Some conditions which indicate that the instruments have been marketed are conducting road shows or meetings with potential investors before the issue of the instrument, publishing research reports on the issuer by major market participants, and having the instrument rated by reputable credit rating agencies (DIPN No 13A, para 17).

This condition is subject to restriction under s 16(2C) of the IRO (see below).

In recent years, there has been an increase in aggressive tax avoidance schemes, including the use of tax planning tools such as trust, alienation of interest income, and the artificial issue of debentures on overseas stock exchanges. In this regard, ss 16(2)(d), 16(2)(e) and 16(2)(f) have been amended under Ordinance No 12 of 2004 in order to combat these tax avoidance schemes between associated companies which seek to create allowable interest deduction where the corresponding interest income is not taxable. For this purpose, ss 16(2A) to 16(2G) have also been introduced at the same time and became effective on 25 June 2004.

Section 16(2A) — the Secured-Loan Test

Under s 16(2A), even though the condition for the application of s 16(1)(a) is satisfied under conditions 3, 4 or 5 mentioned above, full deduction of interest may not be obtained and shall be reduced by an amount calculated in the most reasonable and appropriate basis in the circumstances of the case if:

- the payment of any sum payable by way of principal or interest in respect of the money borrowed is secured or guaranteed, whether wholly or in part and whether directly or indirectly, by a deposit or loan made by the borrower or an associate of the borrower with or to:

(i) the lender or an associate of the lender;

Example

X Ltd transacts life insurance business in Hong Kong. The actuarial report submitted to the Commissioner covered two taxation basis periods (A and B). Of the total premiums received by X Ltd during the period covered by the report:

- 40% were received during basis period A; and
- 60% were received during basis period B.

X Ltd's adjusted surplus would be apportioned between the basis periods using the same proportions:

- 40% of the adjusted surplus would be allocated to basis period A for tax assessment; and
- 60% of the adjusted surplus would be allocated to basis period B for tax assessment.

Deficit and loss

If the adjustments made to a corporation's surplus result in a deficit, the deficit is deemed to be the loss sustained by the corporation during the period for which the relevant actuarial report is made (sec 23(7)). Only deficits or losses incurred in connection with the conduct of business in Hong Kong can be carried forward for deduction in future assessment years (sec 19C(4); see ¶6-6500 for the treatment of losses generally).

An adjusted deficit or loss is apportioned between basis periods in the same way that an adjusted surplus would be under sec 23(7) (see above).

NON-LIFE INSURANCE CORPORATIONS

¶6-7500 Assessment of non-life insurance corporations

The assessable profits of a non-life insurance corporation are calculated by taking the gross premiums from the insurance business in Hong Kong and adding:

- interest or other income arising in or derived from Hong Kong; and
- balancing charges made under Pt VI (see Chapter 7; ¶7-5000ff).

The following amounts are deducted:

- premiums returned to the insured;
- corresponding reinsurance premiums;
- any increase in the provision for unexpired risks as provided in the accounts (a decrease would be added to gross premiums);
- actual losses less amounts recovered through reinsurance;
- agency expenses in Hong Kong;
- a fair proportion of the expenses of the head office; and
- depreciation and other capital allowances (refer to Chapter 7 at ¶7-0100ff) (sec 23A(1)).

Section 23A exclusively deals with the taxation of non-life insurance companies and is not subject to other provisions of the Ordinance (D51/88, IRBRD Vol 3, 456; *Commissioner of Inland Revenue* v *Carlingford Life and General Assurance Company Limited* (1990) 1 HKRC ¶90-025).

Any interest income which accrues to an insurance corporation but which does not have a Hong Kong source is not assessable to tax under sec 23A.

The phrase "premiums from insurance business in Hong Kong" is narrower in scope for the purposes of calculating the assessable profits of non-life insurance corporations (sec 23A) than it is for the purpose of calculating the assessable profits of life insurance corporations (sec 23). For the former purpose the phrase is defined to include:

- all premiums in respect of contracts of insurance, other than life insurance, made in Hong Kong; and
- all premiums on contracts of insurance other than life insurance, the proposals for which were made to a corporation in Hong Kong (sec 23A(3)).

Non-life insurance corporations are corporations which carry on insurance business other than "life insurance business" (see ¶6-7380). Corporations which transact household, motor vehicle, medical and other various types of insurance are therefore covered by sec 23A.

With effect from the year of assessment 2005/06, income arising from a business under retirement scheme management categories I and II (classified as Classes G and H under the *Insurance Companies Ordinance*) will be assessable under sec 14 rather than sec 23A of the *Inland Revenue Ordinance*. This reflects the position that a contract for a retirement scheme under Class G or Class H is not a contract of

legal, financial and commercial characteristics of the relationship must be taken into consideration (sec 20AA(5)).

However, sec 20AA(5) does not provide that an adviser is to be necessarily recognised as acting in an independent capacity where the specified characteristics point to such an arm's length relationship. Other factors may be present which indicate to the contrary, though such a situation would presumably be unusual.

Therefore, in a situation where the investment adviser can readily ascertain that there is a profits tax liability and make arrangements for the payment of the tax, the Department will not accept that the requirement specified in sec 20AA(3)(g) is satisfied (DIPN No 30 (Revised), para 16).

Definitions of "associate" and "associated corporation"

"Associate"

The term "associate", in relation to a non-resident person, means:

- If the person is a natural person:
  - a relative of the person;
  - a partner of the person, or a relative of that partner;
  - a partnership in which the person is a partner;
  - a corporation controlled by the person or by any of the persons listed above; or
  - a director or principal officer of such a corporation.
- If the person is a corporation:
  - an associated corporation (see below);
  - a person who controls the corporation, or a partner of such person, or a relative of the controller or partner;
  - a director or principal officer of the corporation (or any associated corporation), or a relative of that director or officer; or
  - a partner of the corporation, or a relative of a partner.
- If the person is a partnership:
  - any partner, and if a partner is a partnership, any partner of that partnership;
  - any partner with the partnership in any other partnership, and if that partner is a partnership, any partner of that partnership;

  - any relative of any partner;
  - a corporation controlled by the partnership, or by a partner or any relative of a partner;
  - a director or principal officer of such a corporation; and
  - a corporation of which any partner is a director or principal officer (sec 20AA(6)).

"Associated corporation"

An "associated corporation", in relation to a person, is either a corporation over which the person has control; a corporation which has control over the person; or a corporation under the same control as the person (sec 20AA(6)). "Control", in relation to a corporation, means the power of a person to ensure that the affairs of the corporation are conducted in accordance with his or her wishes. This may be achieved by holding shares, or possessing voting power in the corporation or any other corporation; or by virtue of powers conferred by the articles of association or other documents regulating the corporation or any other corporation (sec 20AA(6)).

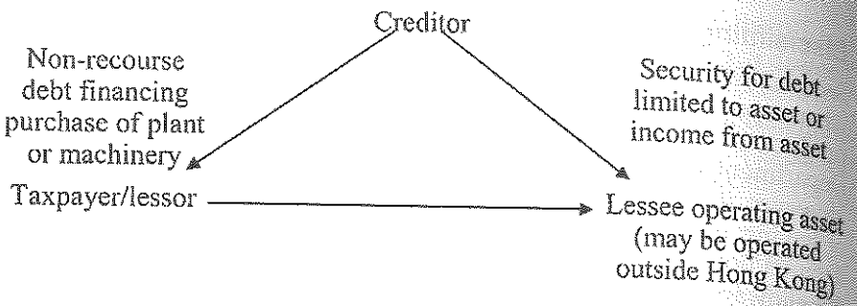
¶6-8380 Assessment of non-resident in name of person making payments

A non-resident who receives royalties or licence fees from Hong Kong, or who is an entertainer or sportsperson who performs in Hong Kong, is assessed to profits tax in the name of any person who pays or credits him or her with payments in Hong Kong (sec 20B(2)). This provision was inserted into the Ordinance so that any person who makes payments to a non-resident on a principal to principal basis, and is therefore not an agent of the non-resident, can nevertheless be charged to profits tax on the non-resident's behalf (DIPN No 17 (Revised), para 4–6).

Application of section

Section 20B applies when a non-resident is liable to tax on:

- sums received or accrued from the exhibition or use in Hong Kong of cinematographic or television film or tape, any sound recording, or any connected advertising material (such sums are deemed assessable under sec 15(1)(a); see ¶6-2260);
- sums received or accrued for the use of (or right to use) a patent, design, trademark, copyright material, secret process,



As the legal owner of the machinery or plant, a taxpayer/lessor, but for the operation of s 39E, would be entitled to substantial capital allowances despite the fact that:

(i) the taxpayer may have contributed only a small amount of money towards acquiring the relevant asset, having financed the acquisition under a non-recourse debt; or

(ii) the asset may be used or operated outside Hong Kong so that it makes no significant economic contribution to the territory.

Under s 39E, however, taxpayers who have incurred capital expenditure on machinery or plant are denied initial and annual allowances in those circumstances.

Machinery or plant (other than ships or aircraft)

Neither an initial allowance nor annual allowances are available for any machinery or plant (excluding a ship or aircraft) acquired under a transaction entered into after 12 March 1992 if the relevant asset is subsequently leased and one of the following conditions applies:

(i) it is wholly or principally used outside Hong Kong, during the period of the lease, by a person other than the taxpayer; or

(ii) its acquisition or construction was financed wholly or predominantly by a non-recourse debt (see ¶7-4500) (s 39E(1)(b)).

The restriction on the availability of allowances in such circumstances first applied in relation to machinery or plant acquired under contracts entered into after 13 March 1986. For machinery or plant acquired before 12 March 1992, both conditions set out above must exist before allowances can be disallowed by the Department.

Whether machinery or plant is "wholly or principally" used outside Hong Kong is a question of fact which must be determined having regard to the particular circumstances. Factors relevant to the issue include:

- the place where the machinery or plant is physically located;

- the nature of the asset (eg whether it is movable);
- the nature of the lessee's trade or business; and
- the location where the asset is designated for use according to the terms of the lease (DIPN No 15 (Revised), para 17).

When a leased asset is used both within and outside Hong Kong, the Department will look at the use of the asset for each year of assessment separately. If in a particular year the asset is not used wholly or principally within Hong Kong, no allowances will be granted. However, for the purpose of determining the written-down value of the item to be carried forward, the notional amount of allowances which could have been granted will be deducted from the written-down value brought forward (DIPN No 15 (Revised), para 18). Any balancing adjustments on the sale of the item will be calculated on a pro-rata basis.

Contract processing arrangements with a Mainland enterprise, where a Hong Kong company is required to provide machinery or plant for the use of the Mainland enterprise, is a lease defined in s 2. The Inland Revenue Department as a concession is prepared to allow 50% of the depreciation allowances on the leased machinery or plant on the condition that the profits from manufacturing activities of the Hong Kong company are assessed on a 50:50 basis. This concession will not apply where the Hong Kong company has ceased to be the owner of the machinery or plant, eg machinery or plant injected as a share of equity into a foreign investment enterprise in the Mainland (DIPN No 15 (Revised), para 19). The concession also does not apply to import processing arrangements even if the profits earned by the Hong Kong company from the arrangement are wholly chargeable to Hong Kong profits tax.

Ships or aircraft

Neither an initial allowance nor annual allowances are available for a ship or aircraft acquired under a transaction entered into on or after 15 November 1990 if the relevant asset is subsequently leased and one of the following conditions applies:

(i) the person holding rights as a lessee of the asset is not an operator of a Hong Kong ship or aircraft; or

(ii) the asset's acquisition or construction was financed wholly or predominantly by a non-recourse debt (see ¶7-4500) (s 39E(1)(c)).

Provisional salaries tax is calculated at the tax rates specified in the Second Schedule of the Ordinance. The amount of provisional tax imposed, however, must not exceed the amount which would have been chargeable if the standard tax rate (set down in the First Schedule) had been applied to the whole of:

- the net assessable income for the preceding year of assessment as reduced by concessionary deductions allowed under Pt IVA; or
- in the case of spouses who have elected personal assessment, the aggregate of their net assessable incomes for the preceding year of assessment reduced by concessionary deductions allowed under Pt IVA (see ¶2-6400ff).

Concessionary deductions allowed under Pt IVA are approved charitable donations, elderly residential care expenses, home loan interest, and contributions to recognised retirement schemes.

For more on Pt IVA, refer to ¶2-6400ff in Chapter 2.

For current tax rates, see ¶2-7700. For tax rates applicable to past assessment years, see ¶320.

When a taxpayer has commenced or ceased to derive income during a year of assessment (ie for a period less than twelve months) the taxpayer's assessable income for provisional salaries tax purposes may be estimated by the Assessor (s 63C(2) and (3)). This is usually done on a pro rata basis, that is, by extrapolating an estimate of twelve months' assessable income based on the actual income of the taxpayer for the lesser period.

Provisional profits tax

Provisional profits tax for a year of assessment is calculated on the taxpayer's assessable profits for the preceding year reduced by any loss which is available for set off (s 63H(1), (2)). For individuals and partnerships without corporate partners, the tax is calculated at the standard tax rate set down in the First Schedule. For corporations, provisional profits tax is payable at the rate prescribed in Sch 8 (s 63H(1A)).

See ¶6-9100 for current tax rates, and ¶330 for tax rates applicable to past assessment years.

An assessor may estimate the taxpayer's provisional profits tax liability if the assessable profits for the preceding year were calculated for a period of more or less than one year, or if the taxpayer commenced a trade and became chargeable during the year of assessment (s 63H(3) and (4)). Estimates are usually made on a pro rata basis.

Provisional property tax

Provisional property tax is calculated on the net assessable value of the taxpayer's land and/or buildings for the preceding year of assessment. The provisional tax is calculated at the standard tax rate set down in the First Schedule (s 63M(1)).

For the current rate, see ¶5-8500. For the rates applicable to past years, see ¶310.

An assessor may estimate a taxpayer's provisional property tax liability if the assessable value of the taxpayer's property for the preceding year was calculated for a period of less than one year, or if the taxpayer became chargeable to tax during that year of assessment (s 63M(2) and (3)). Estimates are usually made on a pro rata basis.

¶8-8500 Assessment and notification of liability

When a taxpayer is liable to pay provisional tax, an assessor will normally assess or estimate the amount payable as soon as possible after the lodgement of the taxpayer's annual tax return (see ¶8-0500) (s 63C(4), 63H(5), 63M(4)). An assessment to provisional tax may also be made at any other time if the assessor believes that the taxpayer is about to leave Hong Kong or if it is expedient to make an assessment for any other reason (s 63C(5), 63H(6), 63M(5)).

When provisional tax is payable, the Commissioner must give a notice to the taxpayer indicating the amount payable and the due date for payment (s 63C(6), 63H(7), 63M(6)). A notice for payment may be included in a normal notice of assessment, or issued separately (s 63D, 63I, 63N).

APPLICATION AGAINST TAX LIABILITY

¶8-8700 Application of provisional tax against final tax liability

When a taxpayer who has paid provisional tax for an assessment year is assessed to salaries tax, profits tax and/or property tax for

to enable him or her to give evidence. In practice, the Commissioner rarely summons anyone to give evidence.

A person who fails to comply with the Commissioner's request commits an offence and may be liable to a fine (see ¶11-0900). A Court may order the person to comply with the request within a specified time. The Commissioner is empowered to compound the offence (s 80).

For more on offences and penalties, see ¶11-0200ff.

¶10-1850 Consequences of failure to object

When a taxpayer fails to object to (or appeal against) an assessment which has been raised against him or her, that assessment becomes final and conclusive (s 70). The policy of the law is to force the taxpayer's hand (*Mok Tsze-fung* (1962) 1 HKTC 166).

When a taxpayer fails to submit an acceptable return and fails to object to an estimated or additional assessment, the assessment becomes final and conclusive (s 70). Even if the taxpayer would not have been liable to tax if a proper return had been furnished to the Department, an estimated assessment raised against him or her will become final and conclusive if a valid objection is not made. For example, a company which did not furnish a profits tax return because it was not liable to profits tax, became liable to profits tax calculated from an estimated assessment because it failed to make an objection to that assessment in *Sun Yau Investment v Commissioner of Inland Revenue* (1984) 2 HKTC 17.

For more on the finality of assessments, see ¶10-7000.

OBJECTION TO PERSONAL ASSESSMENT

¶10-2100 Limitations on objections to personal assessment

When a taxpayer elects personal assessment, his or her property, employment and business incomes are aggregated. An election for personal assessment may be made within two years after the end of the relevant assessment year, or within one month after any assessment of income, which is to be included in the personal assessment, has become final and conclusive, whichever is later (see ¶4-2700).

As personal assessments are often made after assessments to other taxes have become final, taxpayers are restricted in the scope of their objections. When a taxpayer objects to a personal assessment, no revision will be made to any part of his or her total income which has been the subject of an assessment which has become final and conclusive (s 64(7); *Case* A131 (1991) 1 HKRC ¶80-131 (*D93/89* IRBRD Vol 6, 342)). A taxpayer is permitted, however, to make an objection to a personal assessment on the grounds that an amount included in his or her total income as a share of the profits or losses of a partnership has not been appropriately determined under s 22A (see ¶6-7220) (proviso to s 64(7)).

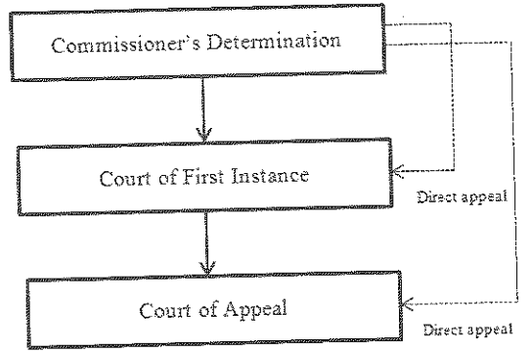
APPEALS

¶10-3000 Overview

A taxpayer who is dissatisfied with the Commissioner's determination of an objection (see ¶10-1100) may appeal to the Board of Review (s 66; see ¶10-3500). The appeal usually will be heard by the Board (see ¶10-3250). In certain circumstances, however, an appeal may be transferred directly to the Court of First Instance (see ¶10-5000). A taxpayer who is dissatisfied with a decision made by the Board may appeal to the courts (see ¶10-5250).

The new appeal flowchart after the enactment of Inland Revenue (Amendment)(No. 3) Ordinance 2015

Under the new simplified tax appeal mechanism, which involves the appeal on a questions of law, the steps of appeal may be demonstrated as follows:



The maximum fixed fine for the late submission of returns is a level 3 fine (see ¶600). Increasingly, however, substantial additional tax penalties are being imposed upon recalcitrant taxpayers. The Board of Review has indicated that a penalty equal to approximately 5% to 10% of the tax involved is reasonable in cases where there are no aggravating circumstances (*Case* X31 (2015) HKRC ¶81-419 (D45/13); *Case* X36 (2015) HKRC ¶81-414 (D35/13); *Case* W1 (2013) HKRC ¶81-364 (*D10/12*); *Case* N37 (2004) HKRC ¶81-013 (*D25/03*); *Case* L18 (2002) HKRC ¶80-819 (*D15/01*); *Case* K54 (2001) HKRC ¶80-785 (*D96/00*); *Case* J5 (2000) HKRC ¶80-673 (*D41/99*); *Case* F7 (1996) HKRC ¶80-385 (*D38/95*); *Case* E64 (1995) 1 HKRC ¶80-361 (*D11/95* IRBRD Vol 10, 132); *Case* E59 (1995) 1 HKRC ¶80-356 (*D1/95* IRBRD Vol 10, 71)).

In more serious cases, however, the Commissioner may impose, and the Board of Review is likely to uphold higher levels of additional tax penalties, particularly in cases involving taxpayers who persistently file late returns. For example, in *Case* G45 (1997) HKRC ¶80-483 (*D63/96* IRBRD Vol 11, 641), as the taxpayer was not a first offender, an additional tax penalty equal to 19.9% (ie double the rate of the last offence) was not outrageous, excessive or unacceptable. In *Case* I48 (1999) HKRC ¶80-617 (*D125/98* IRBRD Vol 13), the Commissioner submitted that the IRD's internal guideline had set a range of additional tax of up to 10% for the first offence and up to 20% for the second offence. This guideline for additional tax assessment was held by the Court as not excessive. Accordingly, as the taxpayer in this case was a second offender, an additional tax penalty equal to 14.4% was not excessive. In *Case* E48 (1995) 1 HKRC ¶80-345 (*D68/94* IRBRD Vol 9, 379), an additional tax penalty equal to 48% of the tax involved was imposed on a taxpayer who had a five-year history of filing late returns.

In *Case* I62 (1999) HKRC ¶80-631 (*D150/98* IRBRD Vol 13), an additional penalty equal to 26.31% of tax involved was imposed on a taxpayer who had a five-year history of filing tax returns late.

In *Case* K50 (2001) HKRC ¶80-781 (*D89/00* IRBRD Vol 15), the Board confirmed the penalties, averaged 80% of the tax undercharged, imposed on the taxpayer for persistently filing its tax returns late for the six years of assessment.

The fact that the authorities are taking a stern view of taxpayers who have a history of late filing is evident in cases such as *Case* F12 (1996) HKRC ¶80-390 (*D43/95* IRBRD Vol 10) in which the taxpayer filed his profits tax returns just over two weeks late. The Commissioner ordinarily would only issue a warning letter in such cases in the past.

However, in *Case* F12, because the taxpayer had been repeatedly late in filing its returns, a 5% additional tax penalty was imposed. In *Case* I70 (1999) HKRC ¶80-639 (*D177/98* IRBRD Vol 14), the taxpayer filed its profits tax return just over 25 days late. It had a good compliance record for prior years. A 2.47% additional tax penalty, not a token fine, was imposed.

Failure of deemed employer to comply with notice requirements

A person who is deemed to be an employer of an individual under s 9A of the Ordinance, because he or she pays remuneration for services provided by the individual to a service company or trust controlled by the individual (see ¶2-0500), is required to comply with the notice requirements of s 52(4)–(7). In certain circumstances, however, a person may be unsure as to whether the provisions of s 9A apply to a particular service company or trust remuneration arrangement. To cater for such cases, s 80(1AA) allows the relevant person to presume, in certain circumstances, that the notice requirements do not apply. According to s 80(1AA), it is a defence, in proceedings against a person for failure to comply with s 52(4), (5), (6) or (7), that the person relied upon a statement in writing by the relevant individual (in the form specified by the Commissioner):

- that the company or trust to which the remuneration is paid or credited is not a corporation or trust in relation to which s 9A applies; or
- that the individual falls within one of the escape provisions so that s 9A does not apply, and it was reasonable for him or her to rely upon that statement (DIPN No 25 (Revised), paras 50–54; Appendix C).

An individual who makes a false or misleading statement commits an offence and is liable on conviction to a fine at level 3 (s 80(1AB)).

¶11-1600 Failure to keep proper business records

A taxpayer who, without a "reasonable excuse", fails to keep and maintain proper business records as required under s 51C (see ¶8-4500) commits an offence (s 80(1A)) and is liable on conviction to a fine at level 6 (see ¶600). The Court may also order a convicted taxpayer to rectify his or her business records so that they fulfil the requirements of s 51C.

Moreover, a taxpayer cannot apply for an advance ruling on a matter which is the subject of a tax return whose due date has passed. It is also noted that an application for a ruling is not an acceptable ground for delaying the submission of a return (DIPN No 31 (Revised), para 9).

Other circumstances in which the Commissioner must not make a ruling are (Sch 10, Pt I, s 3):

- where a tax audit is presently being undertaken involving the same provision/s of the Ordinance and a similar arrangement to that which is the subject of the ruling application;
- where the Commissioner considers that the applicant has not provided sufficient information; and
- where the Commissioner considers that it would be unreasonable to make a ruling in view of the resources available to the Commissioner (DIPN No 31 (Revised), para 14).

When Commissioner may decline to make a ruling

In certain circumstances, the Commissioner has the discretion to decline to make a ruling (Sch 10, Pt I, s 2). Such circumstances include:

- when the Commissioner would be required to determine or establish a question of fact (for example, whether the gain arising from the disposal of a property is chargeable to tax or not) (DIPN No 31 (Revised), para 11);
- when the correctness of the ruling would depend on the Commissioner making assumptions regarding future events or other matters (DIPN No 31 (Revised), paras 11 and 38);
- when the matter on which the ruling is sought is the subject of an objection or appeal (involving either the applicant or any other person) (DIPN No 31, para 11); and
- when the matter on which the ruling is sought is the subject of a return which has been lodged or is due to be lodged with the Inland Revenue Department (DIPN No 31, para 11).

Other situations where Commissioner will generally decline to make a ruling

In addition to the situations given above, the Commissioner will also generally decline to make a ruling if:

- the matter on which a ruling is sought is the same in character as a completed transaction entered into by the applicant in an earlier year of assessment and the tax effect of the earlier transaction is the subject of discussions with the applicant, or is subject to an objection or appeal, whether in relation to the applicant or any other person;
- the central issue concerns a matter which is before a board, a tribunal or the courts or, if a judgment has been issued, an appeal is under consideration;
- the request contains alternative proposals or courses of action on the part of the applicant;
- the matter is primarily one of fact, and the circumstances are such that all the pertinent facts cannot be established at the time of the application for the ruling;
- the ruling requires an opinion about generally accepted accounting principles or commercial practices;
- the matter is the law concerned with the administration of the tax system; or
- the issue involves the interpretation of a foreign law (DIPN No 31 (Revised), para 12).

¶12-0500 Advance ruling cases related to corporate amalgamation

The IRD published three advance ruling cases regarding court-free amalgamation in January 2016. These cases involved utilization of tax losses and the tax treatment of fixed assets succeeded upon amalgamation.

In Advance Ruling Case No. 55, the directors of Company A had planned to put Company A into liquidation. Company A later on transferred most of its business to a third party in a restructuring exercise. Company A and Company B will be amalgamated with Company B as the amalgamated company.

It was ruled that the general anti-avoidance provision section 61A may be applied where the un-utilized loss of Company A sustained prior to the amalgamation will not be allowed for setting off against the assessable profits of Company B, the amalgamated company as there is no commercial justification for the Amalgamation except an attempt to obtain tax benefits.

In Advance Ruling Case No. 56, four companies incorporated in Hong Kong are wholly-owned by four holding companies and all of which are held by a single ultimate holding company. All the four holding companies and the ultimate company were incorporated

Company B, which were outside the scope of the transaction; hence, the director's fees were correctly assessed to tax.

In *Case* N78 (2004) HKRC ¶81-054 (*D109/03*), the sale of land to the taxpayer by its parent company was considered as a scheme of tax avoidance by the Commissioner because the price of the land would be deductible by the taxpayer but free of tax in the hands of its parent company. This was so for the following reasons:

(i) The parent company was not a trader in land and its land was part of its capital. Any income from the sale of land would not be profits arising from its trade.

(ii) The taxpayer was in the business of developing and selling land and any land it acquired for the purpose of this trade was part of its trading stock and its cost was deductible from receipts in calculating its taxable profits.

The Board considered that the Commissioner adopted an incorrect approach by considering factors (a) to (f) in s 61A(1) without addressing the issue of whether the impugned transaction would give rise to a tax benefit. Unless there was a tax benefit, s 61A would not be relevant or the subject matter of consideration. The Board found that s 61A would not be relevant in the present case as the impugned transaction did not have, and would not have had but for s 61A, the effect of conferring a tax benefit on the taxpayer. The Board also considered that the impugned transaction was realistic from a business or commercial point of view and was not entered into with the sole or dominant purpose of obtaining a tax benefit.

The Court of First Instance overturned the Board's decision in *Case N78* in *Commissioner of Inland Revenue v Tai Hing Cotton Mill (Development) Limited* (2005) HKRC ¶90-150. The Court ruled that the Sale and Purchase Agreement entered into between the taxpayer and the parent company for the acquisition of land lots did have the effect of conferring a tax benefit on the taxpayer. In addition, the Court considered the seven matters in s 61A(1)(a) to (g) and held that the main objective of the Sale and Purchase Agreement was to interpose the taxpayer to effect a sale and purchase of the land between the parent company and the taxpayer so that the land cost was structured in such a way that a significant portion of the proceeds of the redevelopment could be converted into a purported item of expenditure. As such, the dominant purpose of the Sale and Purchase Agreement was to enable the taxpayer to obtain a tax benefit in the form of reduction in the amount of tax.

The Court of Appeal subsequently overturned the decision of the Court below and ruled for the taxpayer in *Commissioner of Inland Revenue v Tai Hing Cotton Mill (Development) Limited* (2006) HKRC ¶90-181. The Court of Appeal did not see any legitimate reason for denying the taxpayer the ability to take the consideration into account when ascertaining its profits. The judge stated that as the Board considered that from a business and commercial point of view, the consideration paid by the taxpayer to the parent company under the Sale and Purchase Agreement was not excessive and was realistic, the consideration paid and sought to be deducted as a legitimate expense was therefore a perfectly proper amount.

With respect to s 61A, the Court considered that the question of whether the sole or dominant purpose was to obtain a tax benefit was a question of fact to be decided by the Board after taking into consideration all the relevant evidence of the case. As the Board concluded that the sole or dominant purpose in this case was not the obtaining of a tax benefit, a higher court could not properly interfere with that decision nor have any basis to overturn that decision unless the Board's decision could be said to be perverse. The Court was thus satisfied that there was no tax benefit in the present case.

The Commissioner further appealed to the Court of Final Appeal in *Commissioner of Inland Revenue v Tai Hing Cotton Mill (Development) Ltd* (2008) HKRC ¶90-198 and its appeal was successful. The Court considered that the parties were plainly not dealing at arms' length as they were parent and subsidiary, being the same enterprise under the same direction in economic terms, and the land was simply being passed from one pocket to another. The objective of the parties was also plain upon the face of the agreement, being to transfer as large a portion of the taxpayer's profits as possible tax free to the parent company. The Court had considered the form and substance of the transaction under s 61A(1)(b) and considered it unnecessary to further consider the various matters listed in s 61A as these matters would not affect the conclusion that the price formula adopted in determining the consideration of the land was chosen for the sole or predominant purpose of securing a tax benefit.

In two other cases which were heard together, the Court of Appeal ruled for the taxpayer and remitted the matter to the Board for reconsideration of s 61A. *HIT Finance Ltd v Commissioner of Inland Revenue* (2006) HKRC ¶90-185 and *Hongkong International Terminals Ltd v Commissioner of Inland Revenue* (2006) HKRC ¶90-186 were two appeals from *Case* O48 (2005) HKRC ¶81-104 (*D97/04*) and *Case* O49 (2005) HKRC ¶81-105 (*D98/04*) directly to the Court of Appeal.

¶13-5580 Allowance for misused stamps

When an instrument has been stamped or issued with a stamp certificate but is not chargeable with stamp duty, or an instrument has been inadvertently stamped or issued with a stamp certificate for a greater value than required, the stamp may be cancelled and allowed as spoiled, and an allowance may be made by the Collector under s 48 (see ¶13-5500). The person who first executed the relevant instrument must apply to the Collector for the allowance within two years after the date of its execution (s 49).

An application in respect of a stamp certificate inadvertently issued shall be made by the person who can prove to the satisfaction of the Collector that the stamp duty to which the stamp certificate relates was paid by him or her.

¶13-5660 Allowance for unwanted adhesive stamps

The Collector may, upon application, make an allowance for adhesive stamps purchased from the Collector's office and returned unused, provided that the stamps are not spoiled or rendered useless (s 50). An allowance is only made if:

- the adhesive stamp is delivered to the Collector; and
- the Collector is satisfied that the adhesive stamp was purchased at the Collector's office no more than two years earlier with the *bona fide* intention that it would be used (s 50(a) and (b)).

¶13-5740 Making allowance for spoiled, misused or unwanted stamps

Where an allowance is made for stamps, adhesive stamps or stamp certificates, the Collector, may:

(a) give in lieu of the stamps, adhesive stamps or stamp certificates:
- money to the value of such stamps, or to the amount of stamp duty denoted on such stamp certificates;
- other stamps of the same denomination or value; or
- stamps of any other value or denomination to the same value or issue a stamp certificate denoting the same amount if it is considered proper.

(b) use a combination of any of the ways as listed above to effect the allowance (s 51(1)).

An allowance made by the Collector lapses one year after it is made (s 51(2)).

ADJUDICATION AND APPEAL

¶13-6000 Adjudication by Collector

The Collector, when required, adjudicates on whether an instrument is chargeable with stamp duty, and in the case of chargeable instruments, on the amount of duty payable. Subject to certain exceptions listed in the *Stamp Duty (Amendment) Ordinance 2000* (see ¶13-6200), an adjudication fee of $50 per instrument applies, and only executed instruments can be submitted for adjudication (s 13(1)). The Collector does not adjudicate on the duty payable on the basis of a draft or partly executed instrument.

Power to call for abstract and evidence

When making an adjudication on the chargeability of an instrument to stamp duty, the Collector is empowered to call for an abstract of the instrument and any other evidence which is regarded as necessary (s 12). The Collector may require a statutory declaration to be made. Such a declaration, however, can only be used against the person who makes it in an enquiry into the stamp duty payable on the instrument to which the declaration relates (s 13(5)).

¶13-6080 Stamping after adjudication

Non-chargeable instruments

When the Collector decides that an instrument is not chargeable with duty, it is stamped with a stamp denoting that it is not chargeable.

Chargeable instruments

When the Collector decides that an instrument is chargeable with duty, the duty payable is then assessed by the Collector. The instrument is then stamped:

- if, at the time of adjudication, the instrument had already been stamped for the amount of duty assessed, the Collector may endorse it to the effect that it is duly stamped; and
- if the instrument was unstamped at the time of adjudication, then, provided that the duty is paid within time, it is stamped upon payment. The duty must be paid by the time