

CHAPTER 14

Scope of Charge

Learning Objectives

After having studied this chapter, you would:

- a. understand the scope of charge of profits tax;
- b. understand the meaning of "trade", "profession" and "business";
- c. understand when activities may amount to carrying on a trade in Hong Kong;
- d. understand when a business is carried on in Hong Kong by a non-resident; and
- e. understand when tax is required to be withheld at the time of making payment to a non-resident.

I Introduction

1. The charge of profits tax may involve many different sections under the IRO. The purpose of this chapter is to explain the first two limbs of Section 14, i.e. whether a trade, business or profession is carried on in Hong Kong, and whether the profits made from a sale of an asset amount to a capital gain. The source of profits is to be explained in the following chapter.

II Prerequisites for Profits Tax Liability

2. Statute

The charge of profits tax is governed by Section 14(1) which reads as follows:

"Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part."

3. Explanation and interpretation

Profits tax liability is chargeable under Section 14 of IRO when the following conditions are satisfied:

- a. a person carries on a trade, a profession or a business in Hong Kong,
- b. there are profits arising in or derived from such a trade, a profession or a business (excluding profits from the sale of capital assets), and
- c. the profits must be arising in or derived from Hong Kong.

It is only when all the three conditions are satisfied, the profit is taxable in Hong Kong.

4. The above criteria have the following implications:
- the place where a business is incorporated is irrelevant, and
 - the place where a business is carried on is not necessarily the same place where an income from that business arises.

III Whether a Trade is Carried on in Hong Kong

5. Definition of "trade"

- Section 2 defines "trade" (行業或生意) to include every trade and manufacture, and every adventure and concern in the nature of trade.
- The definition of "trade" is very wide. Any activities not falling within the normal meaning of trade or manufacture may still be treated as a "trade" under the IRO.

6. Badges of trade

In order to decide whether a trade is carried on, it usually relies on the six "badges of trade" as arrived at by the UK Royal Commission on the Taxation of Profits and Income in 1955 as follows:

a. Profit-seeking motive at the time of acquisition

If there is a profit-seeking motive at the time of purchase of the flat, it is interpreted by the IRD that there is a trading business. However, motive is subjective, and it has to be proved by objective evidence as shown below.

b. Subject matter of the commodity disposed

If the subject matter is able to provide enjoyment to the owner, such as accommodation or rental income, it is possible to prove that there is no intention of making a profit at the time of purchase of the property.

c. Length of ownership

Usually the longer the period of ownership, the less likely that the property is acquired for short-term profit.

d. Frequency of similar transactions

Usually the more similar transactions take place, the more likely that the taxpayer carries on a trading business.

e. Supplementary work done on the property

If the owner incurs heavy expenditure to make the property more marketable or exerts effort to promote the sale, it is likely that the property is acquired for sale.

f. Circumstances leading to the disposal

If the sale is due to compelling reasons not expected by the owner at the time of purchase of the property, e.g. sudden need of cash, the owner may be able to prove that the original intention for the purchase of the property does not aim for making a short-term profit.

7. **Balance of probability in the determination of the existence of a trade**

The most important factor is whether the taxpayer has any profit-seeking motive at the time of acquisition of the asset. If there is such a motive, the taxpayer is regarded as carrying on a trade. Since whether a person carries on a trade is a question of fact, none of the above badges is by itself conclusive evidence to arrive at the decision that a person is or is not carrying on a trade. Thus, all the relevant factors have to be considered, and the decision is usually arrived at on a *balance of probability*.

8. Two cases to demonstrate the determination of capital gain or existence of a trade for the sale of property or sale of shares.

a. ***Real Estate Investments (N.T.) Ltd. v CIR (2008) – Sale of property***

Issue:

Whether profit on disposal of landed properties should be assessed to tax when the properties were held for more than 16 years.

Facts:

The Taxpayer was a joint venture between the Chinachem group and the Sun Hung Kai group. The Taxpayer was the owner of a new building situated at No. 49 Conduit Road, Mid-Levels, Hong Kong [“the Property”] which it acquired in December 1979. The Taxpayer finished redeveloping in June 1996.

Court of Final Appeal Decision

- i. The stated intention of the Taxpayer was not conclusive and the Board had considered all the surrounding circumstances to come to its conclusion. There is no specifically identifiable error of law on the part of the Board.
- ii. The onus of proof cannot be shifted from the taxpayer to the Commissioner of Inland Revenue where section 68(4) of the Inland Revenue Ordinance places it, namely on a taxpayer who appeals against an assessment to show that it is excessive or incorrect.

Observation by the author

Although the length of ownership is 16 years and the holding period may be regarded as long enough for the characteristics of a capital asset, other factors have to be considered. Since the company is a joint venture and both shareholders are property developers, it is difficult to persuade others that the property was acquired as a long-term investment of producing a steady rental income. Therefore, no one factor is conclusive and all the facts have to be taken into account before coming to a decision of a capital asset or a trading asset.

b. ***Lee and Yeung v CIR (2008) – Sale of Hong Kong listed shares***

Issue:

The activities of the taxpayer in the purchases and sales of Hong Kong listed shares amount to the existence of a share-dealing business.

CHAPTER 25

Insurance Businesses

Learning Objectives

After having studied this chapter, you would:

- a. understand how the assessable profit of a life insurance corporation is computed;
- b. understand how the assessable profit of a non-life insurance corporation is computed;
- c. understand the special profits tax treatment applicable to a qualifying reinsurance business;
- d. understand how the assessable profit of a mutual insurance corporation is computed; and
- e. understand the special profits tax treatment on the gain of disposals of immovable properties and stock for insurance business

I Introduction

1. Insurance business is a special type of business, and its uniqueness is on the acceptance of an estimated amount, e.g., unexpired risk, in the calculation of assessable profits. Under the Inland Revenue Ordinance, the treatment of profits tax may be divided into four types:
 - a. life insurance business,
 - b. non-life insurance business,
 - c. qualifying reinsurance business (offshore risk), and
 - d. mutual insurance business

II Life Insurance Corporations

2. Section 23(9) defines "life insurance business" as business of the following classes:
 - a. life and annuity,
 - b. marriage and birth,
 - c. linked long-term, and
 - d. tontines,

and references to a "life insurance fund" is construed accordingly.

("Tontine" is a fund to which a group of persons contribute, and the benefits would finally go to the last survivor or those surviving after a specified period.)

3. There are two methods of ascertainment of the assessable profits, whether mutual or proprietary, of the business of life insurance:

- a. Section 23(1)(a) – 5% of the premiums from life insurance business in Hong Kong of the corporation during the basis period for that year; or
- b. Section 23(1)(b) – through the adjusted surplus method in accordance with Sections 23(2) to (7), profit is deemed to arise from the basis period for that year less any dividend received.

4. Section 23(9) defines “premiums from life insurance business in Hong Kong” as:

- a. all premiums received or receivable in Hong Kong from both residents and non-residents; and
- b. all premiums receivable outside Hong Kong from residents of Hong Kong where such premiums are in respect of policies the proposals for which were received by the corporation in Hong Kong.

5. Section 23(4) provides the “adjusted surplus method” to ascertain the assessable profit of a life insurance business. The adjusted surplus is arrived at by adding to or subtracting from the life insurance fund (after deducting the estimated liability of the corporation on the life insurance fund at the end of the period, in respect of which an actuarial report is made) the following items:

Additions	Subtractions
<ul style="list-style-type: none"> • Deficits of previous period • Expenses disallowable under Section 16 or 17 • Income (other than non-life insurance) not credited to the fund • Transfer to reserve from the fund • Balancing charge 	<ul style="list-style-type: none"> • Surplus of previous period • Allowable expenses not yet deducted • Payment to policy holders not yet charged • Transfer to the fund from reserve • Depreciation allowances

6. In calculating the adjusted surplus, the income items mentioned in Section 26A are not excluded from the adjusted surplus, unlike dividend which is specifically excluded by Section 23(1)(b). The reason is that the exemption under Section 26A applies to the calculation of assessable profit, and it does not apply to the calculation of adjusted surplus.

7. According to Section 23(6), if any insurance business is partly done within and partly done outside Hong Kong, adjusted surplus is to be apportioned as follows:

$$\text{Adjusted surplus} \times \frac{\text{Premiums received from life insurance business in Hong Kong}}{\text{Premiums received from the whole life insurance business}}$$

8. If the actuarial report covers more than one year, the adjusted surplus is to be apportioned to the amounts of premiums received in the relative years.