

## Chapter 4 ■ Profits Tax

4.1	Legislation	196
4.2	Scope of the Tax	196
4.3	Liability to Profits Tax	198
	4.3.1 Persons chargeable	199
	4.3.2 Carrying on a trade, profession or business	202
	4.3.3 What constitutes trading	207
	4.3.4 Meaning of business	216
	4.3.5 Commencement of business	218
	4.3.6 Cessation of business	220
4.4	Source of Profits	220
	4.4.1 Statutory provisions	221
	4.4.2 Case law — general principles	222
	4.4.3 Case law — other issues	255
	4.4.4 Source of interest income	261
	4.4.5 IRD's practice	267
4.5	Ascertainment of Assessable Profits	276
	4.5.1 When income and profit arises	281
	4.5.2 Treatment of capital profits	288
	4.5.3 Other excluded profits	292
	4.5.4 Amounts deemed taxable	308
	4.5.5 Expenditure — general deductibility rules	326
	4.5.6 When expenditure is incurred	334
	4.5.7 Expenditure — capital v revenue	338
	4.5.8 Expenditure deemed deductible	347
	4.5.9 Deductibility of interest and related expenses	375

## 4.1 Legislation

Profits Tax has the greatest amount of legislation of the three income taxes, the main provisions being in Secs. 14 to 26A under Part IV of the IRO. Also directly relevant are Rules 2A to 2D of the IRR governing apportionment of allowable deductions, Rules 3 and 5 of the IRR governing the ascertainment of branch assessable profits and Part XB governing Provisional Profits Tax. The provisions governing depreciation allowances in Part VI are also primarily concerned with Profits Tax and are dealt with separately in Chapter 5.

The general provisions governing returns in Part IX, assessments in Part X, objections and appeals in Part XI, payment and recovery of tax in Part XII, double tax relief in Part VIII and penalties in Part XIV are also applicable to Profits Tax.

## 4.2 Scope of the Tax

Profits Tax is, in general, levied on the Hong Kong sourced profits derived by a person (as defined) from the carrying on of a trade, profession or business in Hong Kong. The source of profits is largely ascertained in accordance with case law principles. Additionally, however, the IRO contains a series of provisions which deem certain profits to have a Hong Kong source and, in some cases, as arising from a business carried on in Hong Kong, thereby rendering the amounts taxable where they would not otherwise be taxable under general principles.

Historically there was no distinction in the scope of the charge between residents and non-residents, but certain rules are laid down concerning dealings between residents and non-residents and the ascertainment of the assessable profits of a non-resident. In 2006, however, legislation was introduced (some aspects of which have retrospective application) which grants non-residents exemption from tax in specified circumstances on a range of transactions. This legislation was originally conceived to give exemptions in relation to the fund management industry in Hong Kong, but the final provisions have broader application. These provisions are examined in section 4.5.3.

There is a distinction between the rate of taxation of corporations and of other persons; for the 2012/13 year of assessment corporations are charged at 16.5% and others at 15%. Apart from this, however, there are few distinctions between the taxation of corporations and other persons.

In general, assessable profits are profits arrived at under generally accepted accounting principles, as adjusted to comply with the specific requirements of the IRO, e.g. a difference in depreciation rates for accounting and tax purposes, the exclusion of net profits from a source outside Hong Kong and adjustments to exclude capital expenditure and profits. In addition to the specified profits of non-residents referred to above, dividends and certain categories of interest and profits from qualifying debt instruments are specifically excluded from the charge to Profits Tax, as are certain profits of mutual fund corporations and unit trusts and other similar collective investment vehicles where specified requirements are met. Certain other types of profits, being profits arising on other specified categories of debt instruments and qualifying offshore reinsurance profits of insurance companies, are taxed at concessional rates.

Profits Tax is assessed on the basis of years of assessment ending on 31 March and assessable profits are ascertained on the basis of the accounting period ending in the year of assessment. There are provisions governing the basis of assessment which are applicable in the commencement and cessation years and also where there is a change of a previously established accounting date.

Losses are computed in the same way as profits and can be carried forward indefinitely against any source of profits liable to Profits Tax in the case of companies; in the case of individuals and partnerships, however, there are restrictions on the income or profits against which losses can be offset.

Partnerships are assessed as a single entity with no separate assessments on the individual partners. Normally, the manner in which partners share profits and losses is not of importance except where:

- (1) a company is a partner, in which case the corporate rate of Profits Tax will apply to its share of profits. Similarly, a company's share of losses may be treated differently;
- (2) a partner wishes to claim Personal Assessment; and/or
- (3) there are changes in the partners and losses are carried forward.

There are also provisions which allow for the basis of assessment to remain undisturbed notwithstanding the withdrawal or addition of a partner in a partnership.

Depreciation allowances are separately computed for tax purposes and are governed by the detailed rules in Part VI of the IRO.

In addition to the general rules for the ascertainment of assessable profits, the IRO recognises that certain types of business need special

rules for determining the source of profits and computing assessable profits and, in particular, contains specific provisions to deal with:

- (1) life insurance business;
- (2) other insurance business;
- (3) shipping and aircraft businesses; and
- (4) financial institutions.

Profits Tax is payable by direct assessment and incorporates a system of Provisional Profits Tax under which a provisional assessment is raised based on the assessable profits of the immediately preceding year of assessment. Where the date of payment falls due within the accounting period which will form the basis for the final assessment, the Provisional Profits Tax is payable in two instalments in order to reduce any element of payment in advance; the first such instalment is 75% of the liability and the second, which is payable about three months later, is the remaining 25%.

When the actual assessable profits for the year of assessment are agreed, a final assessment is issued and credit is given for the Provisional Profits Tax paid. Any excess of final liability over Provisional Profits Tax paid or vice versa is added to or subtracted from the first instalment of Provisional Profits Tax for the following year. Provisions exist for an application to be made for the Provisional Profits Tax or part thereof to be held over in a number of situations and, although it is at the discretion of the Commissioner whether the holdover is granted, it is exceptional for a holdover to be refused.

### 4.3 Liability to Profits Tax

Sec. 14 is the general charging section for Profits Tax and, under this provision, three conditions must be satisfied before a person can be liable for the tax. These are that the person:—

- (1) carries on a trade, profession or business in Hong Kong;
- (2) derives profits from that trade, profession or business, other than profits arising from the sale of capital assets; and
- (3) those profits arise in or are derived from Hong Kong (i.e. the profits have a Hong Kong source).

In addition to this provision, there are specific sections which deem the conditions for chargeability to be met in respect of certain items where those conditions would not otherwise be met. If a liability arises, tax is

charged on the profit as adjusted for tax purposes, at the rate (for the 2012/13 year of assessment) of 16.5% in the case of corporations and any share of a partnership's profits attributable to a corporation, and at the rate of 15% in respect of other persons.

Therefore, determining whether or not a liability to Profits Tax arises depends upon a consideration of a number of basic principles. The questions to be considered in any particular case are whether the "person" is chargeable to tax, whether he is carrying on a trade, profession or business in Hong Kong, whether profits arise from that trade, profession or business and, if so, what is the source of those profits. If, after dealing with these questions, it is found that a liability to Profits Tax does not exist, consideration must be given to the specific deeming sections of the IRO to determine if, notwithstanding that no liability exists under the general charging provision, a liability is created by such specific provisions. Similarly, if a liability is found to exist under general principles, consideration needs to be given to whether any specific statutory exemption applies. Finally, if a liability is found to exist, various provisions of the IRO must be examined to determine the quantum of the assessable profits. All of these matters are discussed in detail in the following sections of this chapter.

Although a number of factors need to be considered in determining chargeability to Profits Tax, it is important to note that unlike the position in most other jurisdictions, the place of residence or domicile of the person (and the place of incorporation in the case of a company) generally play no part in determining whether a liability exists and the quantum of any such liability although a specific exemption for certain profits of non-residents exists (see point (17) in section 4.5.3). Except where those provisions apply, non-residents are generally subject to Profits Tax in exactly the same way as residents and non-Hong Kong companies are taxed in the same manner as Hong Kong companies. Nonetheless, there are some provisions which deal with the quantification of the assessable profits of non-residents to overcome practical difficulties which may otherwise exist, and these are discussed in appropriate places in this chapter.

#### 4.3.1 Persons chargeable

Sec. 14 imposes Profits Tax on a "person," which is defined very widely in Sec. 2 as including a corporation, partnership, trustee, whether incorporated or unincorporated, or a body of persons. Further, a "corporation" is

## 7.1 Legislation

The law covering returns and information to be provided by taxpayers and others is contained in Part IX of the IRO, Secs. 51 to 58. Penalties in respect of returns, information and other matters are covered by Part XIV, Secs. 80 to 84.

## 7.2 Returns and Information

Most of the provisions in Part IX deal with returns and information in general in respect of all taxes covered by the IRO, but there are some provisions which deal specifically with only Salaries Tax or Profits Tax.

### 7.2.1 Returns — general

An assessor has the power to issue a return, in a form specified by the Board of Inland Revenue, to any person and to require him to complete and submit the return within a reasonable time as stated in the notice to him. This provision applies to returns in respect of each of the income taxes as well as composite tax returns covering all three taxes (Sec. 51(1)). The same powers apply in respect of returns required for Personal Assessment purposes (Sec. 51(2A)). Where a Personal Assessment return is issued to a married person, a notice is also required to be sent to that person's spouse and they are required to submit a return of their joint incomes (Sec. 51(2B)). However, since the introduction of composite tax returns from the 1993/94 year of assessment, there have been no separate Personal Assessment forms and, therefore, Secs. 51(2A) and (2B) have little practical application. Indeed, when composite tax returns were introduced, Sec. 51(2C) was added to the IRO which provides that compliance with a notice issued under Sec. 51(1) is to be deemed to be compliance with a notice issued under Sec. 51(2A) or Sec. 51(2B).

The form in which the return is to be made is laid down by the Board of Inland Revenue pursuant to Sec. 51AA and, if a statement purporting to be a return is submitted which does not conform in every material particular with the required form, it will be rejected and the taxpayer will be treated as if he had not made a return. In this regard, see *CIR v Mayland Woven Labels Factory* (HKTC 627).

Historically, returns were required to be made on printed paper forms. Nonetheless, provisions now exist for returns to be made in electronic form over the internet (Sec. 51AA(2)) or by telefiling (Sec. 51AA(3)). Because of the nature of these alternative methods of filing, there are

(currently at least) limitations as to the matters they can deal with. As such, these filing methods can only be adopted in cases specified by the Commissioner. The Commissioner is empowered by Sec. 51AA(5) to specify classes or descriptions of persons or returns permitted to be filed electronically or through the telefiling system by publication of a notice in the *Gazette*, which in fact has been done. The Commissioner, pursuant to Secs. 51AA(6) and (7) is also empowered to specify matters relating to, *inter alia*, attachments, digital signatures and passwords in relation to electronic filing and telefiling; nonetheless, it remains the Board of Inland Revenue's responsibility to specify the system, templates and information required to be provided for electronic filing (Secs. 51AA(2)(a) to (c)). Interestingly, in the case of telefiling the Board of Inland Revenue's responsibility is limited to specifying the information required to be provided by taxpayers. Note, however, that from the 2007/08 year of assessment the Commissioner has not specified any circumstances where telefiling is permitted; accordingly, this service is effectively no longer available.

In practice, one month is normally allowed for the submission of returns of income and, if a return has not been submitted by the due date specified on the return it is in default, in which case penalties become exigible unless the assessor has granted an extension; any extension granted has the effect of deferring the statutory due date to the new date specified in the extension notice. For individuals who choose to lodge their Salaries Tax returns on-line (eTax users), an automatic extension of one month is allowed (to 3 July 2011). For e-filers of sole proprietorship businesses, the deadline is extended from 3 August 2011 to 3 September 2011. In the case of Profits Tax returns, which are normally issued around 1 April each year, there is an automatic extension arrangement available to tax representatives provided they submit suitably detailed lists of affected clients when invited to do so. These arrangements recognize the fact that it is not possible for accountants to audit and present all of their clients' accounts by the end of April each year and, therefore, the period of extension varies with the proximity of the accounting date to the following April. The automatic extensions granted in respect of 2010/11 returns are as follows:—

- (1) for accounting periods ending in December, extensions are granted to 15 August 2012; and
- (2) for accounting periods ending between 1 January and 31 March, extensions are available on a proportionate basis to dates up to

15 November 2012 although for loss cases an extension until 31 January 2013 is available on application.

These extensions can, in some cases, themselves be further extended by individual application specifying good grounds, but such extensions are entirely at the discretion of the assessor and only granted exceptionally.

With effect from 1 April 2010, corporations and partnerships satisfying certain conditions specified by the Commissioner can also file their Profits Tax returns electronically under eTAX. To promote electronic filing a further extension of two weeks is available on application. The additional two weeks is counted from the day immediately after the extended due date given above or the normal due date whichever is the later.

Tax returns for individuals (i.e. composite tax returns) may also have their one month time limit extended by individual application. In the case of individuals who have appointed a tax representative, an automatic extension in respect of 2011/12 returns is granted to 3 July 2012 in cases where there is no sole proprietor business involved, or to 3 October 2012 where the individual does carry on a sole proprietorship business.

If the assessor is not satisfied with the extent of information contained in the return, even if it is properly completed within the specification, he can give notice by letter requiring fuller or further information within a reasonable time limit specified in the notice (Sec. 51(3)). There are penalties for failure to comply with this notice (see section 7.4.1).

It is not sufficient excuse for failure to report taxable income that no return form was received from an assessor. Any person chargeable to tax for a year of assessment is obliged to inform the Commissioner in writing that he is so chargeable within four months after the end of the basis period for the relevant year of assessment unless he has already received a specified return form, in which case he must, of course, comply with the due date of that return (Sec. 51(2)).

Similarly, when a person ceases to carry on a trade, profession or business within the charge to Profits Tax or ceases to own a source of income chargeable to Salaries Tax, Profits Tax, Property Tax or Personal Assessment, he must so inform the Commissioner within one month (Sec. 51(6)). There is also a requirement to notify change of address within one month (Sec. 51(8)).

Any person who is chargeable to Salaries Tax, Profits Tax or Personal Assessment who is about to leave Hong Kong for a period which will exceed one month must inform the Commissioner in writing at least one month before departure of his expected date of departure and return. This

does not, however, apply to an individual who must leave Hong Kong frequently in the course of his business or employment (Sec. 51(7)). The purpose of this is to enable the Commissioner to protect the Government from any loss of tax which could result from the departure of an individual.

### 7.2.2 Persons responsible

Where anything in the IRO requires a return, statement or form to be submitted by a person and it is in fact submitted in a manner whereby it purports to have been submitted or authorised by that person, it is deemed to have been so submitted or authorised unless the contrary is proved (Sec. 51(5)).

If, however, the person who is required to perform any act under the IRO is incapacitated or is a non-resident, the obligation falls upon the trustee of the incapacitated person or upon the Hong Kong agent of the non-resident person (Sec. 53). An agent for this purpose is defined by Sec. 2 as the agent attorney, factor, receiver or manager in Hong Kong or any person in Hong Kong through whom the non-resident receives any income or profits arising in Hong Kong. This, amongst other things, enables a duly appointed tax representative of a non-resident taxpayer to sign the non-resident's return on his behalf.

Similarly, Sec. 54 provides that the obligations of a deceased person fall upon his executor, who is also competent to be assessed to tax in respect of income accruing to the deceased before his death. In respect of a person who died before 11 February 2006, however, no proceedings or penalty imposed under Part XIV of the IRO, other than under Sec. 82A (see section 7.4.2), can be imposed upon the executor in respect of any act of the deceased. Furthermore, the ability to raise an assessment in respect of income accrued prior to the date of death is restricted to a period of one year from the date of death or one year from the date of filing the Estate Duty Affidavit, whichever is the later; however, this restriction does not apply to Sec. 82A additional tax assessments. In respect of a person who dies on or after 11 February 2006, no Estate Duty Affidavit is required (as Estate Duty was abolished from that date) and the time limit for raising an assessment (other than an assessment for additional tax under Sec. 82A) is three years after the end of the year of assessment in which the person died.

Where a partnership incurs an obligation under the IRO, the person answerable is the precedent partner and as to which partner this is, is a question of fact. Any person who has received any notice addressed to