17. **Three-tier audit system "Audit Trilogy"**

With effect from May 2002, the IRD implemented a 3-tier audit system, the "Audit Trilogy". Computer programmes are used to select cases for:

- assessing officers to conduct "Desk Audit";
- field auditors to conduct "Field Audit"; and
- investigators to carry out "In-depth Investigation".

VII Issue of Additional Assessment

18. Under Section 60(1), an assessor may issue assessment or additional assessment on a taxpayer if the assessor is of the opinion that the taxpayer has been assessed at less than the proper amount for a year of assessment. The assessment or additional assessment must be issued within 6 years after the expiration of the year of assessment concerned. For example, if an assessor wishes to raise an assessment or additional assessment on a taxpayer for the year of assessment 2008/09, the assessment or additional assessment must be issued before 31 March 2015 (i.e., the expiration of 6 years after the year of assessment 2008/09).

19. If the non-assessment or under-assessment is due to fraud or wilful evasion, the assessment or additional assessment may be made within 10 years after the expiration of that year of assessment under Section 60(1) proviso.

20. If tax has been repaid to a taxpayer by mistake, whether of fact or law, an assessor may issue assessment or additional assessment to recover the tax so wrongly repaid within 6 years after the expiration of the year of assessment related under Section 60(2).

21. Regarding the tax demanded on the estate of a deceased, no assessment or additional assessment, other than an assessment for additional tax under Section 82A, is to be made on the estate of a deceased after the expiry of three years immediately after the year of assessment in which the death occurred under Section 54(c).

22. Students are required to understand the difference between additional assessment issued under Section 60(1) and the additional tax assessment issued under Section 82A. What Section 60(1) refers to is an additional assessment on property income, salary income or business profits while what Section 82A refers to is a penalty imposed on a taxpayer when he or she omits or understates his or her income leading to an undercharge of tax.

VIII Issue of Notice for Payment of Provisional Tax

23. Assessments issued under Sections 59, 60 and 54 proviso (b) are commonly known as final assessments which are only issued to taxpayers after the end of the year of assessment concerned. For example, a profits tax assessment for the year of assessment 2013/14 can only be issued after 31 March 2014 except in the case of cessation of business or departure from Hong Kong.

24. Parts XA, XB and XC of the Inland Revenue Ordinance provide the issue of notice for payment of provisional tax for salaries tax, profits tax and property tax respectively. A notice of payment of provisional tax is issued within the year of assessment concerned, and it cannot be issued after the expiration of that year of assessment. For example, a notice of payment of provisional tax for the year of assessment 2014/15 has to be issued before the expiry of the year of assessment 2014/15, and it cannot be issued after 31 March 2015.

25. The amount of provisional tax payable is an estimated one and it is usually based on the amount of income or profits chargeable in the previous year of assessment for continuous employment or business.

26. **Payment of final tax for the previous year and provisional tax for the current year**

Final tax is paid in the following year while provisional tax is paid in the current year. Provisional tax is payable in two instalments. Generally, 75% of provisional tax is payable in the first instalment and 25% of provisional tax is payable in the second instalment.

Taking the profits tax return issued on 1 April 2014 as an example, the procedure for the issue and payment of 2014/15 provisional profits tax is as follows:

a. 2013/14 profits tax return is issued on 1 April 2014;

b. the taxpayer enters in the profits tax return with assessable profit for year ended 31 March 2014;

c. profits tax assessment is issued around November 2014;

d. 2013/14 final profits tax and 2014/15 provisional profits tax are payable in January 2015 and April 2015;

e. 75% of 2014/15 provisional profits tax is payable in 2014/15, i.e. 9 months after the profit has been earned;

f. 25% of 2014/15 provisional profits tax is payable after 31 March 2015 (i.e. in the year 2015/16).

27. **Illustration of interaction between final tax and provisional tax**

Example 2.1

A Ltd commenced business on 1 April 2012, and made assessable profits of $1,000,000 for the year ended 31 March 2013. The company received its profits tax return for the year of assessment 2012/13 and provisional payment 2013/14 in April 2013. A Ltd completed the profits tax return in September 2013, and received a composite profits tax assessment in November 2013. The profits tax is payable in two instalments with one payable on 15 January 2014 and the other payable on 15 April 2014.

A Ltd received its profits tax return for the year of assessment 2013/14 and provisional payment 2014/15 in April 2014. A Ltd completed the profits tax return in October 2014, and received a composite profits tax assessment with assessable profits of $1,200,000 in November 2014. The profits tax is payable in two instalments with one payable on 18 January 2015 and the other payable on 18 April 2015.

Answer

2012/13 Final & 2013/14 Provisional

Tax payable for the first instalment		Due Date
2012/13 Final ($1,000,000 x 16.5%)	$165,000	
Add: 75% of 2013/14 provisional tax (75% x $165,000)	$123,750	
Tax payable for the first instalment	$288,750	15/1/2014
Tax payable for the second instalment		
25% of 2013/14 provisional tax (25% x $165,000)	$41,250	15/4/2014

Year of Assessment 2012/13

Period spread over is 1.1.2013 – 31.3.2013 $720,000 × $\frac{3}{36}$ = $60,000

Year of Assessment 2013/14

Period spread over is 1.4.2013 – 31.3.2014 $720,000 × $\frac{12}{36}$ = $240,000

Year of Assessment 2014/15

Period spread over is 1.4.2014 – 31.3.2015 $720,000 × $\frac{12}{36}$ = $240,000

Year of Assessment 2015/16

Period spread over is 1.4.2015 – 31.12.2015 $720,000 × $\frac{9}{36}$ = $180,000

IV Property Tax Treatment on Rent Receivable

12. Section 5B(2) provides that the assessable value of an immovable property is the consideration *payable* in a year of assessment. The consideration is taxable on an accrual basis, not on a cash basis. Bad debt may arise if a tenant does not pay the rent as stipulated in the lease.

V Property Letting By an Individual Amounting to a Business

13. Generally, it does not matter whether an individual owner lets one immovable property or lets many immovable properties. The owner is chargeable with property tax. Sometimes, property letting by an individual may amount to carrying on a business. In that circumstance, that individual is chargeable with profits tax, not property tax.

14. Whether property letting by an individual amounts to carrying on a business is a question of fact, and it has to be decided according to the merits of each case. The CIR states the IRD's view in paragraph 24 of DIPN 14 that the following situations demonstrate strong indication of business:

a. the number of properties let is substantial and the owner has engaged some staff to handle tenancies and deal with the tenants;

b. the properties are of a special class such as ballrooms, cinemas or restaurants, and that additional services are provided by the landlord such as the landlord being the licencee of the ballroom, cinema or restaurant (see *Louis Kwan-nang KWONG & Carol Kwok-nang KWONG v. CIR*, (1989) 2 HKTC 541) [CACV16/1989];

c. letting by a property dealer, and the rents are regarded as income of the property dealing business;

d. the letting is incidental to and is therefore part of the trade or business as would be the situation of a trader who owns a property which he uses partly for his trade and lets that part which is surplus to his immediate requirements.

VI Property Letting By a Corporation

15. **Charge of property tax**

If a corporation owns a property situated in Hong Kong, and receives income from leasing that property, the income is chargeable with property tax as an owner of the property under Section 5 of IRO.

16. **Charge of profits tax**

Section 2 of IRO defines "business" to include the letting of a property by a corporation. The income derived from a property is reflected as a part of the income of the corporation in its income statement. As result, the income is also chargeable to profits tax.

17. **Exemption of a corporation from property tax**

In order to avoid the double taxation of the same income derived from a property under property tax and profits tax, Section 5(2)(a) allows a corporation to apply for exemption from property tax if that property income is assessable under profits tax. Such exemption is not applicable to a sole-proprietorship or a partnership.

18. **Harley case – Property Income Exempt from Profits Tax Assessable under Property Tax**

In *Harley Development Inc and Another v CIR* (1994), the taxpayer granted with a 30-year lease and received a lump sum premium. The taxpayer applied for exemption from property tax under Section 5(2)(a) at the first instance. Then, the taxpayer applied for exemption from profits tax on the ground that the lump income was a capital gain. CIR accepted the taxpayer's claim of capital gain under profits tax, and cancelled the profits tax assessment. Then the CIR issued property tax assessment on the premium received. The taxpayer objected to the property tax assessment on the ground of ultra vires.

The judges at the Court of Appeal dismissed the taxpayer's appeal, and ruled that the property tax assessment was valid as the property income would not be assessed under profits tax. Exemption from property tax would be granted only when the property income was included in the profits tax computation.

VII Double Payments of Property Tax and Profits Tax

19. **Set-off of property tax against profits tax payable**

As explained above, it is possible that a business may pay property tax and profits tax on the same piece of income derived from a property. In such situation, the taxpayer may apply to the property tax paid to set off against the profits tax payable under Section 25 of IRO. The relief of tax set-off applies to all types of business such as a sole-proprietorship, a partnership and a corporation.

VIII Taxation of Property Income Derived from Sub-letting（分租）

20. **Definition of "business"**

Section 2(1) defines "business" to include agricultural undertaking, poultry and pig rearing and the letting or sub-letting by any corporation to any person of any premises or portion thereof, and the *sub-letting* by any other person of any premises or portion of any premises held by him under a lease or tenancy other than from the Government.

Rental value before deduction of rent suffered (H × 10%)			I
Less: Rent suffered			
i.e. Rent refunded by employer		J	
Less: Rent paid by employee to landlord and employer		K	L*
Rental Value			M

* If L is larger than I, M becomes zero. (M cannot be negative.)

In case the notional rental value exceeds the rateable value of the accommodation provided, the taxpayer may elect the rateable value for the computation of taxable income.

The rent paid by an employee includes not merely the actual rent payable but also the rates and building management fee paid by the tenant.

17. **Example 9.5**

Mr. Lam is the chief accountant of a Hong Kong company, and he received an annual remuneration of $1,500,000 and a refund of rent of $30,000 each month from employer. Each month, he paid rent of $36,000 and building management fee of $4,000. Each quarter, he pays rates of $6,000. Compute Mr. Lam's assessable income for the year.

Salaries			$1,500,000
Rental value ($960,000 × 10%)		$150,000	
Less: Rent paid by employee	504,000 *		
Less: Rent refunded ($30,000 × 12)	360,000	144,000	6,000
Assessable income			$1,506,000

*$(36,000 + 4,000 + \frac{6,000}{3}) \times 12 = \$504,000$

18. **Calculation of rental value and rent suffered for non-Hong Kong employment**

For a non-Hong Kong source employment, the income is chargeable on a time-apportionment basis. The calculation of rental value is based on the reduced assessable income. However the rent suffered or rent contribution made by the employee for the full basis period is not apportioned, but fully deducted from the apportioned rental value.

19. **Example 9.6**

Mr. Pak is the regional sales manager of an American company. His employment is sourced outside Hong Kong. He received an annual remuneration of $2,000,000 and a monthly refund of rent of $50,000 from his employer. Each month, he paid rent of $60,000. During the year of assessment, he stayed in Hong Kong for 292 days. Compute Mr. Pak's assessable income for the year.

Salaries ($2,000,000 × $\frac{292}{365}$)			$1,600,000
Rental value ($1,600,000 × 10%)		$160,000	
Less: Rent paid by employee	720,000		
Less: Rent refunded ($50,000 × 12)	600,000	120,000	40,000
Assessable income			$1,506,000

20. **Rental refund (退還租金) v rental allowance (租金津貼)**

Rental refund (or rental reimbursement) is different from rental allowance in that:

a. under rental allowance scheme, rental allowance is a cash allowance, and the amount received by the employee from the employer is 100% chargeable to salaries tax;

b. under rental refund scheme, the amount received by the employee from the employer is not chargeable to salaries tax, but the benefit is chargeable to salaries tax in the form of rental value.

In considering whether an amount received is a rental allowance or a rental refund, all the circumstances have to be looked into. They are:

i. the employer's control over the use of the money by the employee on payment of rent,

ii. the size of the refund of rent in relation to rental payment by the employee, and

iii. the genuineness of the rental expenditure.

21. **Employer's control of use of money on payment of rent by the employee**

In the decision of *Peter Leslie Page v CIR* (2002), the judge pointed out that the following evidence might justify the existence of a rental refund scheme:

a. the rental refund benefit is stated in the employment contract,

b. employer's inspection of the stamped lease agreement, and

c. employer's inspection of monthly rental receipt before making payment to the employee.

22. **Peter Leslie Page v CIR (2002)**

In the case, although the rental benefit was stated in the employment contract, and there were a stamped lease agreement and monthly rental receipts, yet the employer did not examine the lease agreement or monthly rental receipts. The judge decided that in such circumstances, the employer did not exercise any control on the employee's payment of rent. As a result, the payment was a rental allowance in absence of inspection of all the available documents.

VII Receipts from a Non-Recognised Occupational Retirement Scheme (Non-RORS)

23. Any amount (other than a pension) received by an employee from a retirement scheme or provident fund, other than a RORS, is taxable to the extent that it represents the employer's contributions to the scheme – Section 9(1)(aa).

24. **Additional dependent parent allowance**

a. **Additional condition**

If a taxpayer resides with the parent, otherwise than for full valuable consideration, continuously throughout the year of assessment (i.e. for the full year of assessment), he or she is entitled to an additional dependent parent allowance.

b. **Amount of additional dependent parent allowance**

There are two categories of dependent parent allowance as follows:

i. parents who are aged 60 or over, or who, at any age, are eligible for an allowance under the Government's Disability Allowance Scheme (disability allowance), and

ii. parents who are at the age of 55 to 59 and not eligible for an allowance under the Government's Disability Allowance Scheme.

	2005/2006 – 2010/2011	2011/2012	2012/2013 – 2013/2014
Age 60 or above	$30,000	$36,000	$38,000
Any age eligible for disability allowance	$30,000	$36,000	$38,000
Age 55-59 without disability allowance	$15,000	$18,000	$19,000

25. **Table of dependent parent allowance (DPA) and additional DPA for 2012/2013 and 2013/2014**

	DPA	Additional DPA
Age 60 or over	$38,000	$38,000
Any age eligible for Government's Disability Allowance Scheme	$38,000	$38,000
Age 55 – 59 but *not* eligible for Government's Disability Allowance Scheme (effective from 2005/2006)	$19,000	$19,000

VI Dependent Grandparent Allowance（供養祖父母或外祖父母免稅額）

26. **General principle**

Under Section 30A, dependent grandparent allowance is granted to a person, if the person or his or her spouse, not being a spouse living apart from that person, maintains a grandparent or grandparent of his or her spouse in the year of assessment and that grandparent at any time in the year was:

a. ordinarily resident in Hong Kong; and

b. satisfying the age requirement:

i. 60 or over,

ii. no age limit if the parent is eligible to claim an allowance under the Government's Disability Allowance Scheme, or

iii. 55 to 59 not eligible for an allowance under Government's Disability Allowance Scheme (effective from 2005/2006 onwards).

27. **Definition of "grandparent or grandparent of his or her spouse"**

Section 2(1) defines "grandparent or grandparent of his or her spouse" to mean, in relation to any person:

a. a natural grandfather or grandmother of the person or his or her spouse;

b. an adoptive grandparent of the person or his or her spouse (whether an adoptive parent of a natural parent, adoptive parent or step parent of the person or his or her spouse, or a natural parent of an adoptive parent of the person or his or her spouse);

c. a step grandparent of the person or his or her spouse (whether a step parent of a natural parent, adoptive parent or step parent of the person or his or her spouse, or a natural parent of a step parent of the person or his or her spouse); or

d. in the case of a deceased spouse, a person who would have been the grandparent of the person's spouse by reason of any of the provisions of paragraphs (a) to (c) if the spouse had not died.

28. **Meaning of "maintaining a grandparent"**

Section 30A(4)(a) provides that "a grandparent is only treated as being maintained by a person or his or her spouse" if:

a. the grandparent resides, otherwise than for full valuable consideration, with that person and his or her spouse for a continuous period of not less than 6 months in the year of assessment; or

b. the person or his or her spouse contributes not less than $12,000 in money towards the maintenance of that grandparent in the year of assessment.

29. **No split of allowance for a grandparent**

A dependent grandparent allowance may be granted in respect of each grandparent satisfying the aforesaid requirements. If a taxpayer was married and has grandfather and grandmother who fall with the definition of dependent grandparent, the taxpayer may claim dependent grandparent allowance for the grandfather, and let his or her spouse claim dependent grandparent allowance for the grandmother. Alternatively, either the taxpayer or the spouse may claim dependent grandparent allowance for both the grandfather and the grandmother. However, there is no apportionment of individual dependent grandparent allowance. Take the year of assessment 2013/14 as an example, the dependent grandparent allowance of $38,000 cannot be apportioned between the spouses.

30. **No double claim for the same grandparent**

If two or more persons are entitled to claim dependent grandparent allowance in respect of their grandparent, only one person may claim the allowance. All duplicate claims lodged by a person and his or her brothers or sisters in respect of that grandparent are disallowed. They have to nominate one person to claim the dependent grandparent allowance.

31. **Amount of dependent grandparent allowance**

There are two categories of dependent grandparent allowance as follows:

a. grandparents who are aged 60 or over, or who, at any age, are eligible for an allowance under the Government's Disability Allowance Scheme (disability allowance), and

28. **Tax paid**

a. **Types of tax**

Generally, there are two types of tax. They are turnover tax and income tax.

b. **Turnover tax**

Turnover tax is a tax on transaction, and it is usually deductible as long as the expense is incurred in the production of chargeable profit. These include business tax, value added tax and consumption tax.

c. **Income tax paid under Inland Revenue Ordinance**

i. **Profits tax and property tax**

Income tax is paid after an income has been earned, and it is generally not deductible under profits tax under section 16(1). Thus, profits tax and property tax paid under Inland Revenue Ordinance are not deductible under profits tax. However, property tax paid may be used to set off against profits tax for the same year of assessment – Section 17(1)(g).

ii. **Salaries tax paid for employees and directors**

The business and the staff that the business employed are two different legal entities. The salaries tax paid for employees and directors are treated as additional remuneration, and the expense is deductible in the same manner as salaries or other benefits for the employees and director – Section 17(1)(g).

d. **Income tax paid in overseas countries**

i. **Overseas income tax paid for interest income earned**

Section 16(1)(c) specifically provides that the overseas income tax paid for the interest income taxable under Sections 15(1)(f), (g), (i), (j), (k) and (l) is deductible as an expense under profits tax.

ii. **Withholding income tax paid in overseas countries**

There are two ways to deal with this. One is to treat the tax as a deductible expense under Section 16(1), and explained DIPN 28 (no matter whether the overseas country has signed or not signed a double tax arrangement with Hong Kong). The other is to use the overseas income tax paid to set off against Hong Kong profits tax payable as tax credit if the tax is withheld by an overseas country having signed a double tax arrangement with Hong Kong. The tax credit set-off does not apply to an overseas country not signing a double tax arrangement with Hong Kong.

iii. **Income tax paid (not by withholding) in overseas countries**

The overseas income tax is not a deductible expense under Section 16(1). It the tax is paid to an overseas country having signed a double tax arrangement with Hong Kong, the overseas income tax may be set off against Hong Kong profits tax payable as tax credit. The tax credit set-off does not apply to an overseas country not signing a double tax arrangement with Hong Kong.

29. **Exchange difference**

a. **Introduction**

There are two elements involved under exchange difference. One is the question of "realised" or "unrealised". The other is revenue or capital. The issue of realised or

unrealised has been settled after the issue of DIPN 42 in 2005. The deduction of exchange loss is deductible even though it is not realised as long as it is of revenue nature. Exchange gain is treated in the same way.

b. **Revenue or capital nature**

The nature of exchange difference is similar to legal expenses. It is neutral for tax purposes. It depends on whether the transaction giving rise to the exchange difference is a revenue transaction or a capital transaction. If the transaction is of revenue nature, the exchange difference is also of revenue nature, and vice versa.

c. **Exchange differences derived from trading transactions**

The exchange differences derived from trading activities are of revenue nature. Exchange gain is taxable and loss is deductible. This includes purchase and sale of goods for resale, conversion of trade accounts receivable and accounts payable and inventory at the year-end. This applies to on-shore transactions. If the transactions are off-shore and the profit is exempt from profits tax, the exchange loss derived from such transactions is not deductible under Section 16(1). The exchange loss is not incurred in the production of assessable profits.

d. **Exchange differences derived from purchase of fixed assets**

The exchange differences derived from purchase and sale of fixed assets are of capital nature. Exchange gain is not taxable and loss is not deductible.

e. **Exchange differences derived from holding bank deposit**

i. **Deposit held by a company not a financial institution**

This depends on whether the deposit is held by a trader or by a bank. If the deposit is held by a trader as in the case of *CIR v Li & Fung* (HKTC 1193), it is of capital nature in the form of an investment. The exchange loss is not deductible. In that case, the company received a sum in foreign currency. The company did not convert it into Hong Kong dollar, but put it in a deposit account with a view that the currency would appreciate and would give rise to an exchange gain. However, it was an exchange loss. The court held that the nature of the sum had changed from trading nature to an investment when the sum was put in a bank as a deposit.

ii. **Deposit held by a financial institution**

Cash and deposit are trading assets of a financial institution. They are of revenue nature. The gain derived from such assets is taxable while the loss is deductible under profits tax. This view is supported by *CIR v Hang Seng Bank Ltd* (1972) (HKTC 583).

f. **Exchange differences derived from speculative activities**

If a company puts its money in foreign currency with a view to speculating a rise in the value of the currency, the gain is taxable and the loss is deductible. This is supported by *CIR v General Garment Manufactory (Hong Kong) Ltd* (1997).

In that case, at the beginning of 1989, the taxpayer found itself in the happy position of being awash with US dollars. Between 4 January 1989 and 31 March 1989, it used these dollars to purchase Japanese Yen worth HK$99.8m in more than 10 occasions. Unfortunately, the taxpayer took an exchange loss on these purchases. The court held that what is important is the intention at the time of acquisition. If that question is posed in the context of the present case, it is clear that the taxpayer's intention at the time of acquisition of Yen was to dispose of it quickly for a profit, not to acquire a permanent

24. **Example 18.11**

C Ltd. borrowed *$2,500,000* from Bank D at 9% interest rate p.a. The loan was used to finance:

a. onshore activities in the amount of $1,500,000, and

b. offshore activities in the amount of $1,000,000.

The loan was secured by a deposit of *$4,000,000* earning tax-free interest of 6% p.a. In the year of assessment, C Ltd. earned tax-free interest of $240,000 from the deposit and paid interest of $225,000 on the loan to Bank D.

Answer

The amount of interest expenses allowable for deduction will be reduced by $90,000, which is calculated as follows:

$$\text{Interest disallowed} = \text{Tax free interest} \times \frac{\text{Loan}}{\text{Deposit}} \times \frac{\text{Onshore loan}}{\text{Onshore loan + Offshore loan}}$$

$$= \$240{,}000 \times \frac{\$2{,}500{,}000}{\$4{,}000{,}000} \times \frac{\$1{,}500{,}000}{\$1{,}500{,}000 + \$1{,}000{,}000}$$

$$= \underline{\underline{\$90{,}000}}$$

Thus, the interest deductible under profits tax is reduced to $45,000 (i.e. $135,000 – $90,000).

[Note: Interest expense applicable to onshore activities = $1,500,000 × 9% = $135,000]

25. **Example 18.12**

C Ltd. borrowed *$2,500,000* from Bank D at 9% interest rate p.a. The loan was used to finance:

a. onshore activities in the amount of $1,500,000, and

b. offshore activities in the amount of $1,000,000.

The loan was secured by a deposit of *$2,800,000* earning tax-free interest of 6% p.a., and listed shares of a value of *$1,200,000*. In the year of assessment, C Ltd. earned tax-free interest of $168,000 from the deposit and paid interest of $225,000 on the loan to Bank D.

Answer

The amount of interest expenses allowable for deduction will be reduced by $63,000, which is calculated as follows:

$$\text{Interest disallowed} = \text{Tax free interest} \times \frac{\text{Deposit}}{\text{Deposit + Shares}} \times \frac{\text{Loan}}{\text{Deposit}} \times \frac{\text{Onshore loan}}{\text{Loan}}$$

$$= \$168{,}000 \times \frac{\$2{,}800{,}000}{\$4{,}000{,}000} \times \frac{\$2{,}500{,}000}{\$2{,}800{,}000} \times \frac{\$1{,}500{,}000}{\$2{,}500{,}000}$$

$$= \underline{\underline{\$63{,}000}}$$

Thus, the interest deductible under profits tax is reduced to $72,000 (i.e. $135,000 – $63,000).

[Note: Interest expense applicable to onshore activities = $1,500,000 × 9% = $135,000]

26. **How to avoid being caught by Section 16(2A)**

In order not to fall into the trap of Section 16(2A), when a person borrows money and a security is required for the loan, it is better to secure the loan in the form of a mortgage of property, shares or personal guarantee. If the loan is secured or guaranteed by a deposit or a loan, the deposit or the loan should be in the name of a company carrying on a business in Hong Kong. The deposit and the loan should not be in the name of an individual or an overseas company which does not carry on a business in Hong Kong.

V Interest Flow-back Test for Sections 16(2)(c), (d) and (e) – Section 16(2B)

27. **Interest flow-back test applicable to cases not involving listed debentures or marketable instruments**

a. **Statute**

Section 16(2B) provides that if arrangements are in place whether between the borrower and the lender or otherwise, whereby any sum payable by way of interest on the money borrowed or on any part of the money borrowed is payable whether directly or through any interposed person, to the borrower or to a person (other than the lender) who is connected with the borrower, the amount of interest deduction shall be reduced by an amount calculated in accordance with the following formula:

$$\text{Interest disallowed} = \frac{A}{B} \times C$$

Where:

A means the total number of days during the basis period of the borrower for the year of assessment concerned, at the end of each of which the principal in respect of the money borrowed or in respect of the relevant part of the money borrowed, as the case may be, is outstanding and the arrangement are in place;

B means the total number of days during the basis period of the borrower for the year of assessment concerned, at the end of each of which the principal in respect of the money borrowed or in respect of the relevant part of the money borrowed, as the case may be, is outstanding; and

C means the total amount of sums payable by the borrower by way of interest on the money borrowed or on the relevant part of the money borrowed, as the case may be, which, but for Sections 16(2A) and (2C), would have been deductible under Section 16(1)(a) for the year of assessment concerned.

b. **Explanation and interpretation**

i. If the interest received by the lender flows back to the borrower or an associate of the borrower, and the interest so received back by the borrower or its associate is not taxable in Hong Kong, the interest paid by the borrower may only be partially deductible or wholly not deductible under profits tax under Section 16(2B). This section applies to the situations in Sections 16(2)(c), (d) and (e), but does not apply to situations in Section 16(2)(f).

b. payments are made to any approved research institute, the object of which is the undertaking of research and development related to the class of trade or business to which the taxpayer's trade or business belongs; or

c. expenditure on research and development is related to the taxpayer's trade or business (including capital expenditure) except to the extent that it is expenditure on land or buildings.

9. **Definition of "approved research institute"**

An "approved research institute" means any university, college, institute, association or organisation which is approved in writing for the purposes of this section by the Commissioner as an institute, association or organisation for undertaking research and development which is or may prove to be of value to Hong Kong.

10. **Definition of "research and development"**

"Research and development" is defined in Section 16B(4)(a) to mean –

a. any activities in the fields of natural or applied science for the extension of knowledge;

b. any systematic, investigative or experimental activities carried on for the purposes of any feasibility study or in relation to any market, business or management research;

c. any original and planned investigations undertaken with the prospect of gaining new scientific or technical knowledge and understanding; or

d. the application of any research findings or other knowledge to a plan or design for the production or introduction of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of their commercial production or use.

11. **Capital expenditure on plant and machinery**

Research and development expenditure satisfying the conditions of Section 16B is deductible under profits tax, and capital expenditure on plant and machinery can be deducted *in full* in the year of assessment in which it was incurred.

12. **Capital expenditure on building**

Capital expenditure on land or buildings cannot be fully deducted in the year in which it was incurred, but industrial building allowance is granted to the cost of construction of the building or building structure used for research and development purposes.

13. **No apportionment of expenditure incurred in Hong Kong**

If the expenditure is made or incurred in Hong Kong, there is no requirement for apportionment, even if part of the profits derived from the research and development expenditure arises outside Hong Kong, and is not subject to profits tax. This is because the deduction criteria are related to a trade, profession or business and not to profits. However, if the expenditure is incurred outside Hong Kong, apportionment may be required if part of the profits is offshore – Section 16B(2).

14. **Significance of Section 16B**

The importance of Section 16B lies in Section 16B(1) that capital expenditure incurred for plant and machinery on research and development related to the taxpayer's trade, profession or business is wholly deductible in the year when the expenditure was incurred.

15. **Tax treatment of proceeds of sale of rights**

Section 16B(3A) provides that proceeds for the sale of rights in, arising out of, research and development the expenditure which has been allowed as a deduction under Section 16B is taxable notwithstanding the exclusion relating to the sale of capital assets contained in Section 14. However, the taxable amount is restricted to the amount of the deduction allowed under this section.

V Section 16C – Payment for Technical Education

16. Section 16C(1) provides that notwithstanding Section 17, where a person carrying on a trade, profession or business in Hong Kong makes any payment to be used for the purposes of technical education related to that trade, profession or business at any university, university college, technical college or other similar institution which is approved in writing for the purposes of this section by the Commissioner (being an amount which is not otherwise allowable as a deduction under this Ordinance), the payment shall be deducted as an expense in ascertaining the profits from that trade, profession or business for the year of assessment in the basis period of which the payment was made.

17. **Definition**

Section 16C(2) defines "technical education" must be technical education of a kind specially requisite for persons employed in the class of trade, profession or business to which that trade, profession or business belongs.

18. Conditions for granting deduction under Section 16C are as follows:

a. payment made to an approved education institution, and

b. technical education of a kind specially requisite for persons employed in the class of trade, profession or businesses, and

c. payment not deducted elsewhere.

VI Section 16D – Charitable Donation

19. A taxpayer chargeable to profits tax is entitled to a deduction for the aggregate of all approved charitable donations made in the basis period for the relevant year of assessment.

20. The conditions required for the deduction of charitable donation are:

a. the donation is made in cash;

b. the donation is made to an approved charitable institution;

c. the aggregate donation must be at least $100 for the year of assessment in which they are claimed for deduction;

Chapter 21
Unincorporated Business

Learning Objectives

After having studied this chapter, you would:

a. understand how to prepare a profits tax computation for a sole proprietor; and
b. understand how to prepare a profits tax computation for a partnership.

I Introduction

1. Unincorporated businesses include sole-proprietorship and partnership. They are different from incorporated business in that they do not have a separate legal entity, and all the drawings, remuneration including salaries, meal, interest on capital are treated as withdrawal of capital which are not deductible under Sections 17(1)(c) and 17(2). Such expenses have to be added back to the profits tax computation of a sole-proprietorship or a partnership There are also some different tax treatments between those of a sole-proprietorship and those of a partnership.

II Sole Proprietorship Business

2. **Characteristics of a sole proprietorship business**

There is no separate legal entity between a sole proprietorship business and its owner. As a result, the following expenses paid by the sole proprietorship business are not deductible under profits tax:

a. all private expenses of the sole proprietor (with the exception of the contribution to a mandatory provident fund in respect of the proprietor under Section 16AA – up to a certain limit);
b. all private expenses of the proprietor's spouses (including the contribution to a mandatory provident fund in respect of the proprietor's spouse – disallowed under Section 17(2));
c. all payments (such as salary, interest, rent, etc.) made to the proprietor by the business;
d. all payments (such as salary, interest, etc., with the exception of the payment of rent for the use of premises by the business) made to the proprietor's spouse

3. **Payment of rent by the business to the proprietor and the spouse**

The rent paid to the proprietor is not deductible under profits tax, and the rent is added back to the assessable profits of the business. No property tax is charged on the sole proprietor.

However, different treatment is made for the rent paid to the proprietor's spouse by the business. The rent paid to the spouse is deductible under profits tax. It is not required to add back the rent paid to the spouse to the assessable profits. On the other hand, the spouse is chargeable to property tax on the rent so received from the business.

4. **Issue of profits tax assessment**

The profits tax assessment is not merely issued in the name of the business but also in the name of the proprietor. For example, if Patrick Ho carries on a sole-proprietorship business called PH Consultancy Company, the Inland Revenue Department (IRD) will issue a profits tax assessment in respect of the business's profits tax liability in the name as "Patrick Ho trading as PH Consultancy Company. The consequence is that in case the PH Consultancy Company does not pay the profits tax, the IRD will chase Patrick Ho for the payment of the sole proprietorship's profits tax from his personal assets.

5. **No election of personal assessment by the proprietor**

If a sole proprietor does not elect for personal assessment, the IRD will issue a profits tax assessment with a demand note for payment of profits tax similar to that of a corporation. If the proprietor is not satisfied with the profits tax assessment, he may lodge an objection against the assessment to the CIR under Section 64.

6. **Election of personal assessment by the proprietor**

When a proprietor elects for personal assessment, both the business's assessable profits and profits tax paid are transferred to personal assessment section for further treatment. In order to reduce the administrative work with the refund of profits tax paid under personal assessment, it is the IRD's practice to issue a profits tax assessment without a demand note for the payment of profits tax. Although there is no profits tax liability demanded in the profits tax assessment, the proprietor is still required to lodge an objection within the one-month objection period in case he is not satisfied with the amount of profits assessed by CIR.

7. **Treatment of loss**

If a proprietorship business incurs a loss, the loss will be carried forward to set off against the future profit of the same business. The loss cannot be used to set off against the profit of other business held by that person under profits tax.

However, if the proprietor elects for personal assessment, the business loss will be transferred to the proprietor's personal assessment, and the loss will be used to set off against the other current year income of the taxpayer

8. **Example 21.1**

Mr. Wong carries on a retail business. The income statement of his business for the year ended 31 March 2014 is as follows:

	$	$
Gross profit on sales of goods		980,000
Bank deposit interest income with an overseas bank		200
Profit on sale of furniture		1,500
		981,700
Less: Salaries (Note 1)	380,000	
Contributions to mandatory provident fund (Note 2)	19,000	
Rent and rates (Note 3)	265,000	
Interest expenses (Note 4)	7,400	
Sundry expenses (including traffic fine of $500)	4,900	
Depreciation	73,000	749,300
Net profit for the year		232,400

Answers to Examination Questions on Profits Tax

1. The charge of profits tax is governed by Section 14 of the Inland Revenue Ordinance. Before a company is liable for profits tax, three conditions must be satisfied. They are:

   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 arisen from or derived from Hong Kong.

   All the three conditions must be fulfilled before the profits are chargeable to tax in Hong Kong.

   According to the judgment of the *Hang Seng Bank case*, the Lordship said that the source of gross profit resulting from a transaction is a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to the question of source of profit is to be determined. The Broad Guiding Principle is that "one looks to see what the taxpayer has done to earn the profit in question".

   There are two common tests employed for the determination of source of profit, namely contract conclusion test and operations test. Contract conclusion test is usually applied to trading transactions while operations test is usually applied to cases other than trading and money lending business. Operations test is usually applied to manufacturing business and those businesses which involve rendering physical services.

   Regarding proposal "a" for setting up a factory in China, the company would either purchase or rent property for establishing a factory thereon. The head office in Hong Kong would provide raw materials and supervision to the factory in China while the factory in China would employ local workers to manufacture toys. In this way, the manufacturing process is almost fully completed in China while the Hong Kong office would provide logistic support for the operation of the factory in China. In such circumstances, the Inland Revenue Department is of the view that the gross profits derived from the sale of the toys manufactured in China would be taxed on a 50% basis taking into consideration of the work required in both China and Hong Kong.

   Regarding proposal "b.i." for setting up a subsidiary in China for the purpose of purchasing raw materials from Hong Kong company, the subsidiary in China would take up its own manufacturing work for the production of toys, and then sell the finished toys to the Hong Kong company. There are two separate sets of purchases and sales. One is the Hong Kong company purchases raw materials from suppliers, and sells the raw materials to the subsidiary in China. After the completion of the toys in China, the Hong Kong company purchases finished goods from the subsidiary in China and then sells them to the Hong Kong company's own customers. What Mr. Chik concerns is the profits derived from the sales of finished goods.

In this situation, the Hong Kong company does not carry out any manufacturing process. Its nature of business is changed to trading. The source of profit for a trading business is governed by the rule set out in Inland Revenue Departmental Interpretation and Practice Note No. 21. The rule is that trading profits are exempt from profits tax only when both the contract for purchases and contract for sales are effected outside Hong Kong. If either one is effected in Hong Kong, then the whole trading profit is taxable, and there is no apportionment of profit.

Regarding proposal "b.ii." for setting up a subsidiary in China to carry out subcontracting process for the Hong Kong company, the Hong Kong company would deliver raw materials to the subsidiary in China with subcontracting fee. The subsidiary carries out processing work in China and delivers the finished goods to the Hong Kong company. This situation is different from setting up its own factory in China in that the manufacturing work is not done by its own workers, but by a subsidiary (which is a separate legal entity from the Hong Kong company). The 50% exemption of gross profit does not apply to subcontractor in this case. The subcontracting fee is allowed as a deductible expense in the computation of profit. The rule governing the source of profit is the same as that of a trading transaction.

2. According to the Inland Revenue Departmental Interpretation and Practice Note No. 21, trading profit of a company is taxable in Hong Kong if the purchase contract or the sale contract is effected in Hong Kong. The only possible situation that trading profit may be exempt from Hong Kong profits tax is when both the purchase contract and the sale contract are effected outside Hong Kong.

   There is no apportionment of trading profit. If either the purchase contract or the sale contract is effected outside Hong Kong while the other is effected in Hong Kong, the whole trading profit is taxable.

   The meaning of "effect" is widely interpreted, and it includes the negotiation and conclusion of a contract. If a Hong Kong company negotiates the terms of purchase or sale with an overseas customer through fax remitted from Hong Kong or by international telephone calls, the contract is partly effected in Hong Kong. In such circumstances, the profit from such a sale is in Hong Kong and taxable in Hong Kong.

   In this case, the suppliers are located in Switzerland. In order to effect purchase contract outside Hong Kong, Tak Sing Ltd. may send travelling executives to Switzerland to negotiate the terms of purchase with suppliers there, and sign purchase contracts with the suppliers on behalf of the Hong Kong company.

   Regarding the customers in Korea, Tak Sing Ltd. may send travelling executives to Korea to negotiate the terms of sales with customers there, and sign sale contracts with the customers on behalf of the Hong Kong company.

   The essence of such arrangement is that the travelling executives must have a general authority to sign contracts on behalf of the Hong Kong company in order to qualify the contracts as effected outside Hong Kong. If the travelling executives are required to seek approval before signing contracts, the contracts cannot be considered as effected outside Hong Kong.

22. The formula for the computation of assessable profits for a non-Hong Kong resident aircraft owner is similar to that of a Hong Kong resident aircraft-owner as follows:

$$\text{Assessable profit for aircraft owner} = \text{Total aircraft profit} \times \frac{\text{Relevant sum}}{\text{Total aircraft income}}$$

The meaning of "relevant sums" has a similar meaning to that under Section 23C except for the charter hire by demise extended to the whole aircraft. The sum to be included in the charter hire by demise extended to the whole aircraft is that *attributable to a permanent establishment maintained in Hong Kong* by a person deemed carrying on a business as an owner of aircraft in Hong Kong.

23. Section 23D(3) provides that an assessor may compute the assessable profits on the basis of a fair percentage of the relevant sums, but the non-resident aircraft owner is entitled to elect in writing at any time within two years from the end of the year of assessment that the assessable profit for the year be recomputed by the above formula.

24. Section 23D(5) provides that if the Commissioner is satisfied that the landing at any airport within Hong Kong of any aircraft owned by a non-Hong Kong resident aircraft owner is of a casual nature, and that further landings in Hong Kong by aircrafts owned by that person are improbable, the person shall be deemed not carrying on business as an owner of aircrafts.

VIII Depreciation Allowances for Ship and Aircraft Owners (Section 39E) and Limited Partnership (Section 22B)

25. Section 39E was first enacted in 1986, and was subsequently amended in 1989 and 1992 to prohibit aircraft and ship owners (both resident and non-resident) to make use of the huge amount of depreciation allowances to set off against the profit of their other businesses under Section 19C(5). Section 22B was introduced in 1992 to further restrict the amount of loss available for set off against the profit of each partner of aircraft or ship owners. (Please refer to Parts IX and XI of Chapter 29 and Part IX of Chapter 35 for further details.)

QUESTIONS to test your knowledge

a. Explain when a ship owner is deemed to carry on a shipping business in Hong Kong.

b. Explain how the assessable profit of a shipping business is computed.

c. Explain how the double tax relief with USA on shipping profits is operated.

d. Explain when an aircraft owner is deemed to carry on an aircraft business in Hong Kong.

e. Explain how the assessable profit of a Hong Kong aircraft owner business is computed.

f. Explain how the assessable profit of a non-Hong Kong aircraft owner business is computed.

Chapter 27
Clubs and Trade Associations

Learning Objectives

After having studied this chapter, you would:

a. understand the differences between a club and a trade association;

b. understand when the profit made by a club is exempt from profits tax; and

c. understand when the profit made by a trade association is chargeable to profits tax.

I Introduction

1. **Principle of mutuality**

Under the principle of mutuality, a person cannot make a profit from himself. Club and trade association are treated as mutuality associations. Under the general tax principle, the profit made among members is not chargeable to profits tax. Club and trade association are taxable on the profits made from transactions with non-members (i.e. outsiders). However, the statute breaks the general tax principles and deems club and trade association chargeable to profits tax under Sections 24(1) and (2). (Please also refer to Part V of Chapter 25 in connection with Mutual Insurance Corporations.)

2. **Difficulty in studying this chapter**

The definition of "club" and "trade association" and the chargeability easily cause confusion to students. The method of study in this area is to memorise by heart the deeming provisions of not carrying on a business and carrying on a business respectively under Sections 24(1) and (2).

II General Definition of a Club and a Trade Association

3. Before the application of Section 24(1) or (2), one must understand whether the institution falls within the general definition of a club or a trade association. The difference between a club and a trade association is that a club is an association formed not for a business purpose, and there is no financial advantage of its members.

4. In *Kowloon Stock Exchange v CIR* [1984] (2 HKTC 99) in which Kowloon Stock Exchange wished to claim itself as a club so that it would fall within the exemption of Section 24(1), and deemed not carrying on business in Hong Kong, thus all its income would not be subject to Hong Kong profits tax.

5. However, the Privy Council in that case approved the Court of Appeal's definition given in the same case:

"... a club was an association formed for other than business purposes. It was crucially important that the association should not exist for financial advantage of its members ... and a predominate intention to benefit members financially by itself was sufficient to prevent an association ranking as a club."

Thus, the claim of Kowloon Stock Exchange as being a club failed.