A number of basic principles which a Court may consider when deciding whether a voluntary payment qualifies as "income" were set out in the *Moorhouse* case:

(i) The test of liability to tax on a voluntary payment is whether, from the standpoint of the person who receives it, it accrues as a reward for services).

(ii) If the taxpayer's contract of employment entitles him or her to receive the payment, there is a strong ground for holding that the payment accrues by virtue of the employment and is therefore income.

(iii) The fact that a voluntary payment is of a periodic or recurrent character affords a further, though less cogent ground for the same conclusion. (The element of non-recurrence was one of the more important factors taken into consideration in deciding that bonuses paid to a World Cup winning English football team were not emoluments of their employment in *Moore v Griffiths* (1972) 3 All ER 399.)

(iv) If the payment is made in circumstances which show that it is given by way of a gift or testimonial on grounds personal to the recipient — eg a collection made for a person because he or she is poor, or a benefit for a professional cricket player in recognition of his long and successful career — then the proper conclusion is likely to be that it is not a reward for services and therefore non-taxable.

In *Payne* v *FC of T* 96 ATC 4407, the value of free tickets obtained under a frequent flyer program was not taxable as income from employment. The taxpayer had joined the frequent flyer program independently but had earned the requisite frequent flyer points from business travel and accommodation paid for by her employer. The Federal Court ruled that the provision of free travel resulted from a personal contractual entitlement of the taxpayer. According to the Court, the free tickets were provided by the airline, not because of the taxpayer's employment, but because the taxpayer was entitled to it under the airline's own scheme.

Payments made by an employer under a settlement package to the employees as full and final settlement in connection with the employees' claim for rest days, statutory holidays, public holidays and overtime worked were found to be taxable. The sums were offered and paid to the employees in return for their having acted as employees on their rest days, statutory holidays, public holidays and overtime. The sums were not paid as damages but even if they were, the employment contracts were still the source of the payments (*Case* S7 (2009) HKRC ¶81-260 (*D31/08* IRBRD Vol 23)).

See *Case* N71 (2004) HKRC ¶81-047 (*D98/03* IRBRD Vol 18).

Pre-commencement payments

It is not a prerequisite of chargeability to salaries tax that the taxpayer must have actually commenced his or her employment at the time that a payment is received. A payment made even before an employee commences to perform services for an employer may be regarded as assessable employment income.

A lump sum payment made by a Hong Kong employer to a taxpayer at the commencement of his or her employment was characterised as assessable income from the employment in *Case* B44 (1992) 1 HKRC ¶80-205 (*D19/92* IRBRD Vol 7). The lump sum paid to the taxpayer, who had previously been employed in the United Kingdom, was offered as an inducement for the taxpayer to take up Hong Kong employment: it was made at least in part to recompense the taxpayer for removal expenses.

The taxpayer's view was that since the lump sum was not a reward for services actually rendered it was not chargeable to salaries tax. According to the Board of Review, however, the source of the lump sum payment was the taxpayer's employment with the Hong Kong employer. It was not unrelated to the taxpayer's employment and was certainly not a gift. The Board pointed out that nothing in s 8 or 9 limits taxable payments to remuneration for services rendered or to be rendered. As the payment arose directly

from the employment which the employer had offered to the taxpayer, it was assessable to salaries tax.

A similar employment inducement payment was found to be a taxable perquisite in *Case* C12 (1993) 1 HKRC ¶80-221 (*D36/92* IRBRD Vol 7). The payment was paid by the taxpayer's new employer as a contractual obligation. The source of the payment was the employment of the taxpayer; the payment was therefore chargeable to salaries tax.

United Kingdom authority

United Kingdom authority holds that an inducement payment is taxable as an emolument from employment (*Glantre Engineering Ltd* v *Goodhand* 56 TC 165). The Board of Review, citing the *Glantre* case, has stated that "emolument" corresponds with "income" in s 8 and 9 of the *Inland Revenue Ordinance* such that an inducement sum is taxable as income from employment (*Case* D42 (1994) 1 HKRC ¶80-292 (*D3/94* IRBRD Vol 9)).

The Board in *Case D42* also referred to the United Kingdom case of *Shilton* v *Wilmshurst* (1991) STC 88 as authority for the principle that the payment of a sum of money by a third party, who was not the employer, to a taxpayer as an inducement to enter a contract of employment with the employer was taxable as an emolument "from employment" because it was an emolument "from becoming an employee". In the Board's view this principle applies to payments from an employer as well as from a third party. Accordingly, the Board held that the phrase "income from employment" in the *Inland Revenue Ordinance* means "income from being or becoming an employee".

Termination payments

When considering whether a termination payment qualifies as taxable "income" it is essential to determine why it was made. A payment made out of personal esteem, for instance, is not regarded as "income" (*Seymour*). A payment made simply to discharge a personal obligation and not connected with the taxpayer's employment is also non-taxable. A taxpayer who was promised by his employer that his previous employment with another company would be taken into account when his severance pay was calculated was not assessed to salaries tax on the part of his severance payment which apparently related to his former employment (*D24/88* IRBRD Vol 3, 289). According to the Board of Review, the payment was not income from the taxpayer's employment. The payment represented a discharge of the director's personal obligation to the taxpayer and, therefore, was not a payment for services.

A termination payment constitutes taxable "income" only if it relates to the services rendered by the taxpayer during his or her employment. A termination payment which has been pre-arranged as part of the terms of employment may be regarded as a deferred payment for services rendered and, therefore, taxable income (*Henry v Foster* 16 TC 605 see also *Case* U13 (2011) HKRC ¶81-319 (*D31/10* IRBRD Vol 25); *Case* N42 (2004) HKRC ¶81-018 (*D36/03* IRBRD Vol 18); *Case* N30 (2004) HKRC ¶81-006 (*D12/03* IRBRD Vol 18); *Case* K10 (2001) HKRC ¶80-741).

The Court of First Instance in *Fuchs, Walter Alfred Heinz v Commissioner of Inland Revenue* (2008) HKRC ¶90-209 adopted the following approach in determining the taxability of the termination payments:

(i) Look at the contract as a starting point — if a payment had been made upon premature termination which was not a contractual entitlement, it would be *prima facie* not income from employment ie not assessable.

(ii) On the other hand, payment made pursuant to the contract as an entitlement on early termination would be *prima facie* "income arising in or derived from the office…".

[¶2-2250] "Rent-free" accommodation

The value of accommodation is taxable income if the accommodation is provided to a taxpayer free of charge by his or her employer or if the taxpayer pays rent to an independent landlord and is later refunded or reimbursed. In both instances the accommodation is regarded as having been provided "rent-free" and its "rental value", as calculated under the Ordinance (see ¶2-2150), is included as part of the taxpayer's "income" for salaries tax purposes (s 9(1)(b) and 9(1A)(b)).

If a residence is regarded as having been provided "rent-free" because the taxpayer's employer has paid or refunded all or part of the payable rent, the payment or refund actually received does not constitute part of the taxpayer's income. It is only the "rental value" which is taken into account in the computation (s 9(1A)(a)).

Example

If, during a year of assessment, Ms X's employer refunded $80,000 in rent which was paid by Ms X for her flat, and Ms X's annual salary was $300,000, her income for that year would be calculated as follows:

		$
Salary		300,000
PLUS		
Rental value (10% × 300,000)	+	30,000
EQUALS		
Income	=	330,000

The $80,000 refund is not income.

Rent-free accommodation v rent allowance

The tax treatment of rent-free accommodation is significantly different from the tax treatment of a rent allowance. While it is only the "rental value" (calculated as a percentage of remuneration under s 9(2)) that is taxable in the case of rent-free accommodation, a rent allowance paid to a taxpayer is taxable in full according to the general definition of "income" provided in s 9(1)(a) (see ¶2-0300) (*Case* H15 (1998) HKRC ¶80-523 (*D33/97* IRBRD Vol 12); *D16/83* IRBRD Vol 2, 54)..

Proper control over housing benefit essential

An employer must exercise proper control over the provision of a housing benefit if it is to be accepted as the provision of rent-free accommodation rather than the payment of a fully taxable rent allowance. Such control would include the review of lease agreements and rental receipts to ensure that rent payments or refunds are used for their designated purpose.

Labelling income as "rent refund" not enough

In *Case* L5 (2002) HKRC ¶80-806 (*D140/00*), an employer provided its employees with a "tax effective remuneration program" for "housing refund". The taxpayer's employment contract did not refer to any provision of housing benefit. The Board held that the disputed amounts were not rent but salary. His employer had tried to implement fringe benefits tax planning with hindsight after the end of each year of assessment. The company had retrospectively altered the nature of the income accrued by, and paid to, the taxpayer in the form of a base salary to a reduced salary plus rent. The so-called tenancy agreements entered into between the taxpayer and his employer were "artificial".

Test of intention

The Commissioner in the case of *Commissioner of Inland Revenue v Peter Leslie Page* (2003) HKRC ¶90-123 appealed successfully to the Court of First Instance against the Board of Review's decision that certain housing benefit payments made by the employer to the taxpayer were rental refunds. The taxpayer received $410,010 as a housing benefit payment and was assessed to salaries tax. This was assessed to salaries tax in the year of assessment 1998/99.

There was a Resident Site Staff Agreement (the staff agreement) under which the payment was made. The Commissioner argued that the terms of the staff agreement indicated that payment in any form and not just rental refund was envisaged. The Court of First Instance agreed with this interpretation. The Court held that the real test of determining the nature of the payment was the intention of the parties at the time the payment was made. Here the Court disagreed with the Board of Review's view that the intention of the parties at the time that employment contract was entered into was relevant (*Case* M30 (2003) HKRC ¶80-895 (*D141/01* IRBRD Vol 17)). Looking at the conduct of the parties, the Court held that the terms of the staff agreement were varied and the employer intended to pay the taxpayer a sum of money regardless of whether rental had actually been incurred by the taxpayer. The taxpayer also admitted this was so.

In *Roger Jesse Robertshaw* v *Commissioner of Inland Revenue* (2006) HKRC ¶90-184, where the taxpayer appealed against the Board's decision in *Case* P10 (2006) HKRC ¶81-162 (*D3/06* IRBRD Vol 21), the Court ruled for the Commissioner and held that the Board had applied the correct test laid down in the *Page* case. The real test for determining the true nature of the payments was the intention of the parties at the time of the payment of the money by the employer. It was clear from the Board's findings that:

(i) the explicit intention of the employer was that it would only provide financial assistance and not rental assistance to those employees who occupied a boat or property owned through a company in which they had an interest as director or shareholder. The taxpayer was within this category.

(ii) there was ample evidence to conclude that with effect from 1 April 2001, only those employees who had no relevant interest in his or her corporate landlord were intended and treated by the employer as being entitled to rental assistance. The taxpayer did not fall into this rental assistance category.

The Court thus held that the sums in questions were allowances chargeable to salaries tax in terms of s 9(1)(a) and not refunds of rent within the meaning of s 9(1A)(a)(ii).

In *Case* O63 (2005) HKRC ¶81-119 (*D23/05* IRBRD Vol 20), the Board found that the intention of the employer throughout the years of assessment 2001/02 and 2002/03 was for it to pay and for the taxpayer to receive housing assistance to acquire a boat and not rental refund. Based on the evidence available, the Board considered that the intention of the parties when the amounts in dispute were paid was for the employer to pay to the taxpayer assistance to acquire a residence by helping to finance the costs of the relevant mortgage. As such, the Board concluded that the employer at all relevant times provided cash allowances to the taxpayer which were subject to salaries tax and they were not refunds of rent for the purposes of s 9(1)(c), 9(1A)(c) and 9(1A)(a)(ii).

See also *Case* P28 (2006) HKRC ¶81-180 (*D27/06* IRBRD Vol 21).

Legally binding tenancy agreement with employer

In *Case* K61 (2001) HKRC ¶80-792 (*D105/00*), the taxpayer reported that he had received a refund of rent from his employer, in respect of the property jointly owned by himself and his wife. The assessor regarded the full sum as assessable income but the taxpayer submitted that his employer had provided him with a rent-free residence, hence the housing benefit should be assessable to him only at 10% of his salary.

Labour Tribunal award

The components of a Labour Tribunal award are regarded as having accrued on the date that the taxpayer was entitled to claim them.

For example, in *Case* E35 (1995) 1 HKRC ¶80-332 (*D51/94* IRBRD Vol 9), the taxpayer's employment had been wrongfully terminated and he had received a Labour Tribunal award comprised of pay in lieu of notice, arrears of wages, compensation, holiday pay and a pro-rata bonus. The taxpayer was assessed to tax on the award for the year of assessment in which his employment had been terminated despite the fact that the award had not been received by him until the following year.

The Board of Review ruled that the taxpayer had the right to claim the income emoluments and bonus due to him for services rendered prior to his dismissal in the year of assessment in which his employment was terminated. Therefore, the arrears of wages, compensation, holiday pay and pro-rata bonus all accrued to the taxpayer in that year of assessment even though they were not received by the taxpayer until the following year.

[¶2-4700] Receipt of income

Income which has accrued but has not been received by a taxpayer is not included in his or her assessable income (s 11D(a)). Income only becomes assessable when it is received. At that time an additional assessment may need to be raised for the income.

To be deemed "received", income must have either been:

- made available to the taxpayer to whom it has accrued; or
- dealt with on the taxpayer's behalf, or according to the taxpayer's directions (s 11D(a)).

The time of payment is not relevant to the question of receipt. For example, if a payment is posted it is not deemed to have been received while it is in the post even though the employer has executed payment.

If an employee directs an employer to deal with his or her income in a certain way, such as instructing the employer to pay a third party, that income will have been dealt with on the employee's behalf and is deemed to have been received (*Case* E13 (1995) 1 HKRC ¶80-310 (*D22/94*)).

In *Case* E46 (1995) 1 HKRC ¶80-343 (*D65/94* IRBRD Vol 9), an employee's contributions to a pension fund which were deducted directly from his salary could not be excluded from his assessable income as claimed by the employee. The income from which the contributions had been deducted had accrued to the taxpayer and the amounts of the contributions had been "received" by the taxpayer as they had been dealt with on his behalf.

Payments made to a third party *on behalf* of a taxpayer must be distinguished from payments made to a third party in place of the taxpayer. A taxpayer cannot be assessed to tax on income which he was never entitled to receive. This was demonstrated in *Case* E4 (1995) 1 HKRC ¶80-301 (*D11/94*) in which it was found that a taxpayer who had arranged for a substitute worker to take over his duties when he left his employment was not assessable to salaries tax on the income which was paid to the substitute worker. When the taxpayer left his employment the substitute worker was paid the salary which would have been paid to the taxpayer. The substitute worker was employed and paid directly by the employer. The taxpayer was not entitled to receive any payment from the employer during the period that the substitute worker was employed; he did not employ the substitute, nor did he exercise any control over him. The taxpayer was not liable to pay tax on money which had been paid to the substitute not on behalf of, but in place of, the taxpayer.

Income received but not accrued

Just as income which has accrued but has not been received by a taxpayer is not assessable to salaries tax (see ¶2-4650), income which has been received but which has not accrued to the taxpayer is not regarded as assessable income. A Hong Kong government contract officer was paid a gratuity four days before the date on which he became legally entitled to it in *BR 13/74* IRBRD Vol 1, 159. It was found that the gratuity did not accrue, and was therefore not chargeable to salaries tax, on the date it was received.

A taxpayer who refunded her final month's salary to her employer in lieu of notice was assessed to salaries tax on the refunded sum in *D15/88* IRBRD Vol 3, 223. She claimed that the sum was not chargeable to salaries tax because it should have been treated as if she had never received it. However, the Board found that the sum was assessable. It did not matter whether the amount was paid and then refunded or if there was a set-off and the taxpayer physically received one month's less salary. The set-off implicitly involved receipt of the month's salary which would therefore be chargeable to tax.

[¶2-4750] Spreading back lump sum payments

A lump sum paid to a taxpayer upon the cessation of his or her employment can be spread back over the period of employment (s 11D(b)(i)). The following payments can be related (or spread) back and regarded as income which has accrued during an employee's period of service:

- a lump sum payment or gratuity paid upon retirement from or termination of an office or employment;
- a lump sum payment or gratuity paid upon the termination of any contract of employment; or
- a lump sum payment of deferred pay or arrears of pay.

The spreading back provision does not apply to leave payments (*D21/84* IRBRD Vol 2).

Lump sum gratuities received other than upon retirement or termination, ie while a taxpayer is still employed, are not permitted to be spread back under s 11D even though they may relate to previous years of service (*Case* E19 (1995) 1 HKRC ¶80-316; (*D39/94* IRBRD Vol 9)).

When an employment contract is renewed, a lump sum which was paid upon the conclusion of the original contract can be spread back. Spreading back a marriage gratuity paid to an employee upon retirement has been allowed although the employee was subsequently re-employed on month-to-month terms (*BR 17/76* IRBRD Vol 1).

Time limit for spreading back payments

Payments may only be spread back over a maximum of three years. If the employee's period of service exceeds three years, the payment is regarded as income accruing at a constant rate over the three years up to either the date on which the employee was entitled to claim the payment or the final day of employment, whichever was earlier.

The opportunity to spread back a lump sum payment is available irrespective of whether the payment is paid to a taxpayer during his or her employment or after the employment has ceased.

Application for spreading of payment

A taxpayer must apply in writing within two years of the end of the year of assessment in which a lump sum was paid in order to claim the advantage of spreading back.

- any child in respect of whom the taxpayer is entitled to a child allowance (see ¶3-3500); or
- any brother or sister in respect of whom the taxpayer is entitled to a dependent brother or dependent sister allowance (see ¶3-3000) (s 31A(4)).

[¶3-5400] Apportionment between eligible taxpayers

Where two or more taxpayers, other than a husband and wife living together, are entitled to claim a disabled dependant allowance for the same child, the allowance is apportioned between them. The apportionment is carried out on the same basis as the apportionment of any child allowance granted in respect of the child (see ¶3-4100) (s 31A(2)).

[¶3-5600] Claim by husband and wife

When a husband and wife are not living apart and are both eligible to claim a disabled dependant allowance in respect of the same child, only one spouse may claim the allowance. The allowance must be claimed by the same spouse who claims any child allowance for the child (see ¶3-4300) (s 31A(3)).

SINGLE PARENT ALLOWANCE

[¶3-6000] Eligibility and calculation

A taxpayer is granted a single parent allowance, which is deductible from his or her net assessable income (see ¶2-4900), if, at any time during a year of assessment, he or she had the sole and predominant care of a child for whom he or she was entitled to a child allowance (see ¶3-3500) (s 32(1)).

The amount of the single parent allowance for the 2015/16 year of assessment is $120,000 (Sch 4, Item 8). The allowance is only granted for a taxpayer's first child. A taxpayer is not entitled to claim the single parent allowance for his or her second child or for any subsequent children (s 32(2)(c)).

The single parent allowance is not granted if at any time in the relevant year of assessment the claimant taxpayer was married and living with his or her spouse (s 32(2)(a)). The taxpayer in *Case* L47 (2002) HKRC ¶80-848 (*D42/01*) who was estranged from her husband was denied a single parent allowance claim as the separation was considered as unlikely to be permanent. She was still living under the same roof with her husband, and they took certain holidays together. They were trying to save their marriage. Under s 2(3), a person shall be deemed to be living apart from his or her spouse in such circumstances as the Commissioner is of the opinion the separation is likely to be permanent.

The allowance will also not be granted simply because the taxpayer made contributions to the maintenance and education of his or her child during the assessment year (s 32(2)(b)). This is confirmed in the Court of First Instance (*Sit Kwok Keung v Commissioner of Inland Revenue* (2002) HKRC ¶90-113) and by the Board of Review (*Case* L7 (2002) HKRC ¶80-808 (*D144/00* IRBRD Vol 16)). The decision was upheld by the Court of Appeal (*Sit Kwok Keung v Commissioner of Inland Revenue* (2002) HKRC ¶90-121 and *Sit Kwok Keung v Commissioner of Inland Revenue* (2005) HKRC ¶90-145). See also *Case* K16 (2001) HKRC ¶80-747 (*D38/00* IRBRD Vol 15).

In *Case* M27 (2003) HKRC ¶80-892 (*D140/01* IRBRD Vol 17), the Board of Review held that whether a parent can be considered to have predominant care of his child is a question of fact. The fact that the taxpayer did not have sole custody was not conclusive if, on the fact, he could show that he had predominant care of the child for part of the time. A sole custody order is common in divorce and related proceedings; however, to provide stability for the child, parental care and control over the child can be shared.

The taxpayer in this case had predominant care of the child for at least 30% of the time during the relevant year of assessment, although the taxpayer's wife had sole custody of the child. The Board of Review held that the single parent allowance should have been apportioned and 30% of the allowance was granted to the taxpayer.

Example — Deduction of dependent grandparent allowance

Mrs S earned $500,000 in the 2015/16 year of assessment, after the deduction of allowable outgoings. Mrs S also made charitable donations of $500 in 2015/16. Mrs S is a single parent, having sole continuous care of her two children, both of whom are under the age of 18 years. The following indicates how personal allowances would be deducted from Mrs S' income for 2015/16 for salaries tax purposes:

		$
Net assessable income (assessable income less allowable deductions)		500,000
LESS		
Concessionary deductions:		
Approved charitable donations	–	(500)
LESS		
Basic allowance (see ¶3-0500)	–	(120,000)
LESS		
Single parent allowance	–	(120,000)
LESS		
Child allowance		
First child	–	(100,000)
Second child	–	(100,000)
EQUALS		
Net chargeable income	=	59,500

[¶3-6200] Apportionment between eligible taxpayers

When more than one taxpayer is entitled to claim a single parent allowance for the same child, in the same year of assessment, the allowance is apportioned between them (s 32(3)). When determining the basis of apportionment, the Commissioner has regard to the periods for which each person had the sole or predominant care of the child during the year (s 32(3)(a)). If, in the Commissioner's opinion, those periods are uncertain, a basis of apportionment which the Commissioner regards as just is applied.

RESTRICTIONS ON ELIGIBILITY

[¶3-7000] Where two or more taxpayers entitled to allowance for same dependent person

There are two situations in which duplication of allowances may arise:

(i) where two or more taxpayers are eligible to claim the same allowance for the same dependent parent, grandparent, brother, sister or child; and

(ii) where two or more taxpayers are eligible to claim different allowances for the same dependent person (for example, where the son and grandson of a dependent person are eligible to claim, respectively, a dependent parent allowance and a dependent grandparent allowance).

One-off transactions

The term "business" was defined in *CIR v Marine Steam Turbine Co Ltd* (1920) 1 KB 193 as "an active occupation or profession continuously carried on". However, "business" also has been held to encompass not only passive conduct but also one-off transactions (*Re Abenheim* (1913) 109 LT 219; *George Hall & Son v Platt (Inspector of Taxes)* (1954) 35 TC 440).

CHARACTERISTICS OF A PROFESSION

[¶6-1250] Characteristics of a profession

The term "profession" is not defined in the Ordinance. It has been held, however, to connote work requiring purely intellectual skill, or manual labour dependent upon purely intellectual skill (*IRC v Maxse* (1919) 1 KB 647). In the *Maxse* case the Court of Appeal said that:

> "… a profession in the present use of language involves the idea of an occupation requiring either purely intellectual skill, or of any manual skill, as in painting and sculpture, or surgery, skill controlled by the intellectual skill of the operator, as distinguished from an occupation which is substantially the production, or sale, or arrangement for th e production or sale of commodities. The line of demarcation may vary from time to time."

Membership of a professional body may point to a taxpayer carrying on a profession (*Currie v IRC* (1921) 12 TC 245) but is not a conclusive factor on its own.

If a person practises a profession but is an employee (for example: an in-house lawyer), he or she is not considered to be carrying on a profession for the purposes of profits tax but will be assessed to salaries tax. To determine whether a professional person is an employee assessable to salaries tax, it must be determined whether that person is in a master/servant relationship (see further ¶2-2850).

The term "business" is interpreted so widely that it encompasses most professions. If what the taxpayer does, however, is to fulfil a series of engagements by moving from one to another, and there is no such thing as occupying a position and staying in it, the taxpayer will be treated as carrying on a profession. In *Davies v Braithwaite* (1931) 18 TC 198 the taxpayer was an actress who accepted and fulfilled different and various engagements as long as her professional qualifications equipped her to do so. In a year she acted in various stage plays in the UK and the USA under different contracts, performed on the BBC and performed for record companies. It was held that she was carrying on a profession and not earning income as an employee.

Profit from professional activity

When a taxpayer carries on a profession in Hong Kong, only those profits which arise out of or are derived from the taxpayer's professional activities are assessable (s 14(1)). In each case the circumstances must be considered in full to determine whether a professional's receipts are in consideration of professional services rendered and accordingly assessable to profits tax.

Interest earned by a firm of solicitors from clients' accounts has been found to be assessable professional income (*Commissioner of Inland Revenue v Lau & Ors* (1990) 1 HKRC ¶90-028). The solicitors argued that the interest was not profit arising from their profession as it did not represent a charge levied by them against their clients. The High Court found, however, that in view of agreements made between the solicitors and clients, entitling the former to the interest, there was no doubt that the solicitors had received the interest in consideration of professional services rendered.

COMMENCEMENT AND CESSATION OF TRADE, BUSINESS OR PROFESSION

[¶6-1400] Commencement

Since profits tax is only charged for the period for which a trade, business or profession is carried on, it is important to determine with precision when a trade, business or profession commences (and when it ceases; see ¶6-1440).

The time at which a business commences is a question of fact and degree (*O'Kane & Co v IRC* (1922) 12 TC 303). A business ordinarily commences with the beginning of commercial production or current operations. The activities signifying the commencement of business do vary, however, according to the nature of the business involved.

It cannot be assumed that a business only commences when the first sale is made or the first receipt received. It has been held, for example, that the business of a property developer commences when it first buys the land to develop, even though resale may not occur for several years (*D3/86* IRBRD Vol 2, 231). The Board found that the date of commencement is the date upon which the taxpayer's intentions begin to translate into an activity which can be characterised as trading.

Preparatory activities

The commencement of a trade, business or profession must be distinguished from activities which are merely preparatory or preliminary. When a taxpayer has carried on activities which go no further than allowing business to commence, the activities are not regarded as constituting "business activities".

In *Softwood Pulp and Paper Ltd v FC of T* 76 ATC 4439 a firm conducted preliminary investigations into the viability of a paper mill. The project was abandoned with no progress having been made. The Court held that the firm's activities had not constituted the commencement of a business. All that had happened, it said, was that certain investigations had been made. Nothing had been done which could have pointed to a business having commenced.

See also *Birmingham and District Cattle By-Products Co Ltd* v *IRC* (1919) 12 TC 92 and *Vallambrosa Rubber Co Ltd* v *Farmer (Surveyor of Taxes)* (1910) 5 TC 529 per Lord Johnston.

[¶6-1440] Cessation

The question of whether a business has ceased is significant because profits tax is only charged on a taxpayer for the period during which business was carried on. It is important to determine precisely when the business ceased, as special arrangements apply to profits received and payments made after that time (see below).

The questions of whether and when a business has ceased are questions of fact and degree. A variety of factors may be taken into consideration including:

- the intention of the business' controllers;
- the nature of the business; and
- the reason for the cessation of activities.

For example, if the cessation of a taxpayer's activities is due to a temporary adversity, which the taxpayer's controllers are actively trying to overcome, this would suggest that the business has not been terminated (*AGC (Advances) Ltd v FC of T* 75 ATC 4057).

The fact that a taxpayer had an outstanding claim against the Government for compensation for resumed land was regarded as a decisive reason for deeming the taxpayer's business

The issues for the Board were:

(i) whether the taxpayer was a trader of the Property or an underwriter in the sale of the Property;

(ii) irrespective of the nature of the transaction, whether part of the sale proceeds from the sale of the units in Hong Kong that accrued to the taxpayer was taxable in Hong Kong.

The taxpayer argued that in essence, it was a trader of foreign property rather than an underwriter. It submitted two sets of documents. The first set was an underwriting contract between the taxpayer and the Developer in which the taxpayer was the underwriter. The second set comprised purchase agreements in respect of the Property and an Agency Agreement appointing the Developer to sell the Property. The taxpayer reiterated its argument that the Property being offshore, no profits tax was payable on the sale of the units. Further, the taxpayer submitted that it was Company G, the Hong Kong agent, who marketed and sold the Property in Hong Kong.

On the other hand, the Revenue argued that the taxpayer was an underwriter and the profits were earned in Hong Kong through the marketing of the units through its agent, Company G, or through the crediting of the sale profits to the taxpayer.

The Board held by a majority decision that the nature of the transaction between the Developer and the taxpayer was that of underwriting, and not the marketing and sales activities. The legal owner of the Property had been, throughout the whole episode up to the issue of the certificate of ownership of individual units, the Developer. There was no real commercial explanation for the two conflicting sets of documents.

The Board held that the taxpayer's underwriting profits were earned outside Hong Kong as it had assumed risk in China, where the underwriting agreement was signed and where the subject matter of the underwriting agreement was situated.

However, on appeal to the Court of First Instance (*Commissioner of Inland Revenue* v *Kwong Miles Services Ltd (in members' voluntary winding up)* (2002) HKRC ¶90-122), the Commissioner argued that there was an error in law in that the Board of Review wrongly identified that what the taxpayer had done to earn its profits was the assumption of the risk and had wrongly shuttled out the relevant evidence of the marketing and sales activities in Hong Kong by the taxpayer (through its agent). What was done to produce the profits was significant and the risk assumed by itself did not produce profits. What produced the profits was the marketing and sale of the property. The Board of Review was wrong to assume that the marketing and sales activities were not directly relevant to the production of the taxpayer's profits from the underwriting arrangement.

On the other hand, the taxpayer argued that no error in law had been made as the correct legal test as to the source of profits had been applied and the conclusion was a reasonable conclusion on the facts. The taxpayer further submitted that what the taxpayer did was to exploit foreign immovable property via the underwriting agreement, and the test for the source of profits was the situs of the property and not the operations of the taxpayer.

The Court held in favour of the Commissioner. It held that the profit producing activities were the marketing and sales activities carried on in Hong Kong through the taxpayer's agent in Hong Kong. Based on this causal connection between the marketing activities in Hong Kong and the profit arising from or derived from the assumption of the risk, the only reasonable conclusion was that the profit from the underwriting arose or derived from those activities in Hong Kong. The guiding principle in determining the source of profits is that one looks at what the taxpayer has done to earn the profit in question and where he has done it. There is no simple, single, legal test of essence of business or place of contract or location of property.

The taxpayer appealed to the Court of Appeal against the Court of First Instance's decision (*Kwong Miles Services Ltd (in members' voluntary winding up)* v *Commissioner of Inland Revenue* (2003) HKRC ¶90-127). The taxpayer's counsel relied on what Lord Bridge said in the *Hang Seng Bank* case and argued that the subject income was non-taxable as it arose from an immovable property which was located in Guangzhou.

The Court of Appeal upheld the decision made by the Court of First Instance and concluded that the Board had erred in law in ignoring the marketing and sales activities of the taxpayer in Hong Kong. The Court of Appeal considered that the example of exploitation of property given by Lord Bridge in the *Hang Seng Bank* case only highlighted the application of the guiding principle in determining the source of profits. It did not mean that the situation or location of a property would necessarily determine the source of profits arising from buying and selling of property. The Court of Appeal held that it was the operations of the taxpayer in Hong Kong which generated the subject income and the fact that the property situated in Guangzhou was not the determinative factor. The Court of Appeal also held that the Board erred in law in taking the assumption of risk in underwriting into account to the exclusion of other matters.

The Court of Appeal considered the three conditions set out by Lord Bridge in the *Hang Seng Bank* case, ie:

(1) The taxpayer must carry on a trade, profession or business in Hong Kong.

(2) The profits to be charged must be "from such trade, profession or business".

(3) The profits to be charged must be "profits arising in or derived from" Hong Kong.

On the facts, the first two conditions were met. On the third condition, the Court of Appeal noted that the first stage was to ascertain what the taxpayer had in substance done to earn the profits in question. The Court of Appeal considered that even though the profits would not have been derived by the taxpayer if it had not undertaken the assumption of risk under the underwriting agreement, the existence of the underwriting contract would be of no use in the generation of the profits without the operations carried out by the taxpayer in Hong Kong. The Court of Appeal then determined where the taxpayer performed those activities which led to the subject profits and it concluded that the relevant activities had taken place in Hong Kong. The Court of Appeal therefore held that all of the three requirements set out in the *Hang Seng Bank* case were met and the taxpayer was liable to profits tax on the subject profits.

The decisions of the courts below were upheld by the Court of Final Appeal in *Kwong Miles Services Ltd (in members' voluntary winding up)* v *Commissioner of Inland Revenue* (2004) HKRC ¶90-135. Mr Justice Bokhary PJ held that:

"What the Taxpayer did in the Mainland was to assume an underwriting risk … All that the Taxpayer acquired by assuming this underwriting risk was an opportunity to earn the profits by its exertions. What actually earned the profits for the Taxpayer were its exertions in the form of its activities in marketing the Property. And those activities took place in Hong Kong … I respectfully share the view taken by all the learned judges in the courts below that the true and only reasonable conclusion to be drawn from the primary facts found by the Board of Review is that the Taxpayer earned the profits by marketing the Property here. So the profits arose in or were derived from Hong Kong, and are chargeable to Hong Kong profits tax."

DEEMED HONG KONG-SOURCED TRADING RECEIPTS

[¶6-2200] Receipts deemed to have arisen in or been derived from Hong Kong

Certain gains are assessable to profits tax because they are deemed to be receipts, arising in or derived from Hong Kong from a trade, profession or business carried on

In *Case* M86 (2003) HKRC ¶80-951 (*D51/02* IRBRD Vol 17), the taxpayers which were group companies claimed that a property was purchased in a joint venture for long-term investment purposes. The Board held that it was nonsensical for the original purchaser of the property (ie one of the taxpayers) to bring in its group companies as they were in deficit and did not have the financial means to assist the purchaser to complete the acquisition. There was also no commercial sense for the taxpayers to borrow 70% of the purchase price at an annual interest rate of 8.25% which would only generate a rental return of 6.9% per annum.

Ability to carry out intention

To prove his or her intention to hold an asset as a long-term investment a taxpayer must be able to prove that at the time the asset was acquired he or she could have reasonably expected to be able to carry out that intention (*Case* A125 (1991) 1 HKRC ¶80-125 (*D16/91* IRBRD Vol 6, 24)). If the feasibility of the intention was never explored, or if it is impossible or unlikely that the taxpayer was financially capable of carrying it out, the intention will not be established (*Case* I78 (2000) HKRC ¶80-647 (*D10/99*)); *Case* I77 (2000) HKRC ¶80-646 (*D9/99*); *Case* I56 (1999) HKRC ¶80-625 (*D137/98*); *Case* H44 (1998) HKRC ¶80-552 (*D102/97*); *Case* H34 (1998) HKRC ¶80-542 (*D80/97*); *Case* H14 (1998) HKRC ¶80-522 (*D31/97*); *Case* F10 (1996) HKRC ¶80-388 (*D41/95*); *Case* C40 (1993) 1 HKRC ¶80-249 (*D8/93*); *D8/88* IRBRD Vol 3, 161).

The ability of the taxpayer to carry out his or her intention does not need to be proved in absolute terms. Proof of a reasonable expectation of ability is sufficient. Allowances can be made, for instance, if the intention has been frustrated by events beyond the taxpayer's control such as that shareholders of the taxpayer were busy handling their own affairs, a surging or declining property market, deterioration of the business relationship with directors, or changes in the law (*Case* J32 (2000) HKRC ¶80-700 (*D123/99* IRBRD Vol 14); *Case* G54 (1997) HKRC ¶80-492 (*D77/96* IRBRD Vol 11); *Case A12*; *Case* A44 (1991) 1 HKRC ¶80-044 (*D83/89* IRBRD Vol 6); also see the *Simmons* case)..

To determine the financial capability of a taxpayer to accomplish a claimed investment intention, it is not enough to simply look at the taxpayer's cash position. The availability of funding options may support the taxpayer's claim by establishing that the alleged investment intention was not merely wishful thinking (see *Case* G3 (1997) HKRC ¶80-441 (*D116/95* IRBRD Vol 11, 254)).

In *Case* V8 (2012) HKRC ¶81-334 *(D7/11* IRBRD Vol 26), the Board found that the taxpayer did not have the financial ability to acquire and hold a residential property and an office unit as investment properties. The taxpayer arguments failed on the facts of the case. In this case, the acquisitions of the two properties were funded wholly by loans. It was found that the appellant was financially unable to fund the acquisition of or hold the two properties as investment property on a long term basis. The only reason given for the sale of the investment property was the termination of the tenancy agreement by the tenant and that for the office unit was the attractiveness of the offer from the buyer. Considering all the circumstances of this case, it was held that the appellant acquired the two properties as trading stock.

In *Commissioner of Inland Revenue v Common Empire Limited* (2006) HKRC ¶90-174, the Court found that the lack of evidence of the taxpayer's financial ability suggested that its intention to hold the lots as investment was not realistic and not realisable. The Court also found the following:

- the sale of the lots in question which was at the heart of the taxpayer's land was inconsistent with any long-term redevelopment plan in respect of the lots, while the sale of the lots within four months of their acquisition was consistent with the acquisition being a trading transaction than capital investment.

- the lack of progress in carrying out the alleged redevelopment, the failure to build the houses after certificates for exemption were granted and the inexplicable refusal to provide redevelopment plans to the District Lands office all indicated a lack of genuine intention to redevelop the lots into resort houses.

Change of intention

A taxpayer may change his or her intention from investment to trading and convert investment assets into trading stock (or vice versa). When a change of intention is alleged, however, the circumstances of the case are always carefully considered. There must be clear and unequivocal evidence that a change of intention occurred; a self-serving statement of intention (or changed intention) is not, by itself, sufficient evidence *(D16/88* IRBRD Vol 3, 225).

Change of intention from investment to trade

A change of intention from investment to trade will not be inferred simply because an investor sells off investment assets or takes steps to realise his or her investment advantageously. An investment does not turn into trading stock simply because it is sold (*Simmons v IRC* (1980) 2 All ER 798). Whether a change of intention has occurred depends on the facts.

A taxpayer who subdivided and sold land on which it had carried out its operations for many years, was not regarded as having begun trading in The *Scottish Australian Mining Co Ltd v Commr of Taxation* (1950) 9 ATD 135. The Court found that the taxpayer was simply realising its assets in the most effective, advantageous way. In *Case* A79 (1991) 1 HKRC ¶80-079 (*D19/90* IRBRD Vol 5), however, a property investor who entered into an agreement for the development and sale of property but claimed that it was no more than the means whereby it had chosen to realise its capital asset was found to have been trading. The Board of Review said that on the facts of the case the development agreement had gone far beyond the mere realisation of a capital asset so that the profits arising from it were of a trading nature and assessable. The same argument also failed in *Case* A73 (1991) 1 HKRC ¶80-073 (*D35/90* IRBRD Vol 5) in which the facts showed that the taxpayer had commenced the trade of development for sale after it was purchased by a joint venture and its new directors decided that its property would be sold.

Similarly, in *Case* I49 (1999) HKRC ¶80-618 (*D126/98* IRBRD Vol 13), the fact that the taxpayer sold the subject property to its subsidiary was treated as part of the whole arrangement for it to participate in the joint venture scheme for developing the area.

Also, in *Case* K1 (2001) HKRC ¶80-732, the Board held that the change of intention from investment to trading has happened when the taxpayer recovered vacant possession of the property from a related company and the sub-division plan could be implemented. This trading intention did not subsequently change back to an investment one even when the taxpayer treated the unsold or vacant units as investment assets in the financial statements. This is because the unsold units which were rented out, were still available for sale. In view of the sub-divided units being trading assets, the taxpayer was not entitled to claim rebuilding allowances in respect of the sub-divided units.

In *Case* M65 (2003) HKRC ¶80-930 (*D21/02* IRBRD Vol 17), the Board held that the annual report and accounts of the taxpayer's immediate and ultimate holding companies provided documentary proof of the taxpayer's intention to change the properties from capital assets to trading stocks. The evidence in this case which pointed to the taxpayer's alleged intention of holding the properties as capital assets was not sufficient to displace the view that the Board had reached on the totality of the evidence.

In *Church Body of the Hong Kong Sheng Kung Hui v Commissioner of Inland Revenue* (2010) HKRC ¶90-224, the Court of Appeal held that entering into an irrecovable agreement, like a joint venture agreement in this case, is an indication of change of

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 who are not excepted persons (see below).

For the purpose of this section, reference to "any sum payable by way of interest on the money borrowed or on any part of the money borrowed" should be construed as including a reference to any sum payable by way of principal or interest in respect of any other loan, where the payment of such sum is:

- secured or guaranteed, whether wholly or in part and whether directly or indirectly, by any sum payable by way of principal or interest in respect of the money borrowed or in respect of any part of the money borrowed; or
- conditional, whether wholly or in part and whether directly or indirectly, on the payment of any sum payable by way of principal or interest in respect of the money borrowed or in respect of any part of the money borrowed (s 16(2E)(a)).

If any sum construed in accordance with the above is payable, whether directly or through any interposed person, to a trustee or a trust estate or a corporation controlled by such a trustee, such sum would be deemed to be payable to each of the trustee, the corporation and the beneficiary under the trust (s 16(2E)(b)).

As explained in DIPN No 13A para 29, apportionment of interest expenses is allowed by this section in two ways:

(i) The provision applies to arrangements that cover interest payable on a part of a loan, and this allows apportionment of interest in the case where only part of the loan in question is subject to an arrangement under which the interest payable will be reverted back to the borrower or his or her connected person.

(ii) Where the arrangement is in place for only part of the basis period during which the loan interest is incurred, the interest expenses can be apportioned on a time basis. This means that only the portion of interest attributable to the period of time during which the arrangement is in place will be disallowed from deduction.

Example

Company L borrowed a loan of $10 million from Bank M at the interest rate of 10% p.a. At its inception, $7 million of the loan was sub-participated by Company N, an associate of Company L. The repayment by Bank M to Company N of the principal and interest of the $7 million loan was made conditional to or secured by the repayment of principal and interest of the $10 million loan made by Company L to Bank M. In a year of assessment Company L paid interest of $1 million to Bank M, and correspondingly Bank M paid interest in the amount attributable to the $7 million loan to Company N.

Only $7 million of the total loan was sub-participated by a person connected with the borrower (Company L). Thus only the interest attributable to the sub-participated portion, that is the amount of $700,000 ($1 million × 7/10), is subject to the adjustment under s 16(2B). As this part of the loan was participated for the whole period during which interest was incurred, the full amount of the $700,000 interest would be disallowed by s 16(2B). The interest on the remaining part of the loan which was not sub-participated by the borrower or a person connected to him (ie $300,000) would be deductible.

Example

If in Example 4, the loan of $7 million (C) was sub-participated by Company N for only 6 months (A) during the basis period of the year of assessment (B) concerned, the operation of s 16(2B) will be as follows:

	$ million
Interest payable on the portion of loan which was sub-participated to Company N	0.7
Deduct: by the amount (A/B × C) (183 days/365 days × $0.7 million)	0.35
Interest on sub-participated loan deductible	0.35
Add: Interest on the portion of the loan that is not sub-participated ($3 million/$10 million × $1 million)	0.3
Total interest deduction	0.65

Section 16(2C) — Interest Flow-Back Test on Debt Instruments

Under s 16(2C), even though the condition for the application of s 16(1)(a) is satisfied under condition 6 mentioned above, the amount of interest deduction shall be reduced by an amount calculated in accordance with a formula specified under this section if arrangements are in place whereby any sum payable by way of interest on the debentures or instruments concerned or on any interest in the debentures or instruments concerned is payable, whether directly or through any interposed person, to the borrower or to a person who is connected with the borrower that is not an excepted person.

For the purpose of this section, reference to "any sum payable by way of interest on the debentures or instruments concerned or any interest in the debentures or instruments concerned" should be construed as including a reference to any sum payable by way of principal or interest in respect of any other loan, where the payment of such sum is:

- secured or guaranteed, whether wholly or in part and whether directly or indirectly, by any sum payable by way of principal or interest in respect of the debentures or instruments concerned or in respect of any interest in the debentures or instruments concerned; or
- conditional, whether wholly or in part and whether directly or indirectly, on the payment of any sum payable by way of principal or interest in respect of the debentures or instruments concerned or in respect of any interest in the debentures or instruments concerned (s 16(2F)(a)).

If any sum construed in accordance with the above is payable, whether directly or through any interposed person, to a trustee or a trust estate or a corporation controlled by such a trustee, such sum would be deemed to be payable to each of the trustee, the corporation and the beneficiary under the trust (s 16(2F)(b)).

As explained in DIPN No 13A para 33, apportionment of interest expenses is allowed by this section in three ways:

(i) The provision applies to arrangements in relation to interest expenses payable on any debentures or instruments within an issue. This allows for apportionment of interest expenses when only some of the debentures or instruments issued are held by the borrower or a connected person of the borrower.

(ii) The provision also applies to arrangements that cover interest expenses payable in the interest on any debentures or instrument concerned. This allows apportionment of interest expenses in the case where the beneficial interest in a debenture or an instrument is shared among a number of persons, and only some of the persons are connected with the issuer.

(iii) Where the arrangement is in place for only part of the basis period of the issuer during which the loan interest claimed for deduction was incurred, the interest expenses can be apportioned on a time basis. This means that only the portion of interest expenses attributable to the period of time during which the arrangement was in place will be disallowed from deduction.

[¶6-7340] Alteration of partnership

Normally, when a change of partners occurs in a partnership that partnership is regarded as dissolved and a new partnership commences. For tax purposes, however, it is provided that if at least one partner continues to carry on the trade, business or profession as a partner after the change then the original partnership is treated as continuing and the tax payable is computed as if no change has occurred (s 22(3)). This provision applies when a partnership changes as a result of:

- the retirement or death of a partner;
- the dissolution of the partnership by one or more partners;
- the admission of a new partner;
- the admission by a sole proprietor of a partner; or
- any other change which results in only a sole proprietor being left.

The same or a similar trade, profession or business must be carried on by the "new" partnership, otherwise the former partnership is regarded as having ceased and the "new" partnership is assessed according to s 18C as a commencing business (see further ¶6-8740).

LIFE INSURANCE CORPORATIONS

[¶6-7380] Assessment of life insurance corporations

A life insurance corporation is a corporation which carries on "life insurance business". The Ordinance specifies that "life insurance business" means business of the following classes, as specified in the *Insurance Companies Ordinance* (Cap 41) (First Schedule; Pt 2):

(A) Life and annuity;

(B) Marriage and birth;

(C) Linked long-term; and

(D) Tontines.

There are two methods of ascertaining the assessable profits of a life insurance corporation. Under the first method, which applies automatically, the assessable profits are deemed to be a percentage of the premiums received during the relevant basis period (s 23(1)(a); see ¶6-7420). Under the second alternative method, which may be elected by the taxpayer, the assessable profits are determined by reference to the adjusted surplus of the corporation (s 23(1)(b); see ¶6-7460). The IRD has published an advance ruling case (No 9) in respect of Class C (ie linked long-term).

Section 23 applies whether the life insurance corporation is mutual or proprietary (s 23(1)).

[¶6-7420] Calculating assessable profits — primary method

Using the first method, the assessable profits of a life insurance corporation for any year of assessment are deemed to be 5% of the premiums from the corporation's life insurance business in Hong Kong during the basis period for that year (s 23(1)(a)). This method applies automatically if the taxpayer does not elect the alternative method (see ¶6-7460).

"Premiums from life insurance business in Hong Kong" include:

- all premiums received or receivable in Hong Kong from residents and non-residents; and

- all premiums receivable outside Hong Kong from residents of Hong Kong in relation to policies for which proposals were received in Hong Kong.

Any premiums returned to the insured, and any corresponding premiums paid on reinsurance, must be deducted from the premiums receivable (s 23(9)).

[¶6-7460] Calculating assessable profits — alternative method

A life insurance corporation may elect to have its assessable profits calculated by the alternative method set out in s 23(1)(b). Using that method, the life insurance corporation's assessable profits are taken to be:

- that part of its "adjusted surplus" which is deemed to arise in the basis period for the year; less
- any dividend received by the life insurance corporation from any other corporation which is chargeable to profits tax (such dividends are required to be excluded by virtue of s 26(a); (see ¶6-3400).

Electing the alternative method

There is no time limit, as such, on when an election must be made by a corporation. However, an election is only effective if a certified true copy of the latest abstract of the corporation's actuarial report is submitted to the Commissioner (s 23(2)), and the actuarial report must not be submitted later than two years after the end of the period for which it was made (s 23(3)). Once a corporation elects the alternative method the election is irrevocable and is deemed to apply to all future assessment years (s 23(1)).

An "actuarial report", which is required by the Commissioner of Inland Revenue, is a copy of the latest abstract of the report of the corporation's actuary which is submitted to the Insurance Authority under s 18 of the *Insurance Companies Ordinance* (Cap 41) (s 23(9) and (2)). When a corporation falls under s 52(3) of the *Insurance Companies Ordinance* (Cap 41), the Commissioner must receive a copy of the latest abstract submitted under that section. Section 52(3) applies to an insurer which carries on business in the United Kingdom and has been granted an authorisation to carry on certain businesses in Hong Kong.

An actuarial report usually covers a period of two years. In order that this may not delay collection of tax, assessments are provisionally raised under the first method of calculating assessable profits (see ¶6-7420). When the actuarial report is complete, and if the corporation so elects, the assessments can be reopened and adjusted in accordance with the alternative method (s 23(3)).

Adjusted surplus

The alternative method involves determining the corporation's *adjusted surplus* and dividing and allocating it to basis periods of assessment years.

The *surplus* of a life insurance corporation is the amount by which the life insurance fund exceeds the estimated liability of the corporation on the life insurance fund at the end of the period for which an actuarial report is made (s 23(4)). The *adjusted surplus* for the period is calculated by taking the surplus and adding:

- any deficit of a previous period which was included in the actuarial report;
- outgoings or expenses charged against the life insurance fund which are not deductible under s 16 (see ¶6-4600ff for allowable deductions);
- expenses, disbursements or losses charged against the life insurance fund which are not deductible by virtue of s 17 (see ¶6-6000ff);

[¶7-1300] Qualifying capital expenditure

"Capital expenditure" for which an allowance may be granted under s 33A includes any interest paid and any commitment fees incurred in connection with a loan made for the purpose of financing a commercial building or structure (s 40(1)). Specifically excluded from the definition of "capital expenditure" are grants, subsidies or any other financial assistance paid to the taxpayer who incurred the expenditure, and any amount already deductible under the profits tax provisions of the Ordinance (s 40(1)).

The definition of capital expenditure which is provided in s 40(1) is not exhaustive. Attention must also be paid to general principles.

See ¶6-6120 for more on identifying capital expenditure.

Expenditure incurred on construction

To qualify for an annual allowance under s 33A, a taxpayer must have incurred capital expenditure on the construction of a commercial building or structure. Expenditure incurred on the acquisition of land, or rights in or over land, is not capital expenditure incurred on construction (s 40(3)). Just as the cost of acquiring a site to build on cannot be included in computing an initial allowance, neither can the costs of demolishing a building already located on the site.

Expenditure incurred on ordinary work done in preparation for the laying of foundations, or in the laying of drains, sewers and water mains for a building may be included in the taxpayer's capital expenditure (DIPN No 2 (Revised), paras 16 and 37).

Case R13 (2008) HKRC ¶81-231 (*D21/07*) was a case which involved the determination of the cost of construction. In that case, the taxpayer deducted commercial building allowances on four properties based on one-half of the costs incurred on the acquisition of the properties. The Assessor viewed that the commercial building allowance should be based on the capital expenditures incurred on construction of the properties and estimated that the costs of construction should not be more than one-half of the first assignment prices of the properties. In the absence of any evidence adduced by the taxpayer on the actual cost of construction, the Board agreed with the Commissioner's submission that taking half of the first assignment price as the deemed cost of construction was fair, reasonable and appropriate. The Commissioner added that it had been the practice of the Inland Revenue Department for many years to determine the cost of construction based on the first assignment price. The logic was explained as follows:

(i) the acquisition cost incurred on a property comprised three elements (1) construction cost, (2) land cost, and (3) appreciation or depreciation in value over time. The first two elements were static historical costs whereas the third element would vary depending on the market conditions;

(ii) the first assignment price of a newly completed property comprised the first two elements and a profit margin for the developer. It would be unlikely to be on the low side to estimate the first element by taking it as half of the first selling price;

(iii) with inflation and a buoyant property market, the acquisition cost would be substantially higher than the original construction cost over the years. The appreciation in turn comprises the upsurge in the land value and the profits of the subsequent sellers. Over time, the third element would far exceed the other two elements but only the first element would qualify for rebuilding allowance or commercial building allowance. Taking half of the acquisition cost incurred by the taxpayer in the 1990s as the cost of construction of the properties would be a gross over-estimate of the cost of construction by merging the big appreciation in value of the properties over time with it.

[¶7-1400] Purchaser's entitlement to annual allowance

When the "relevant interest" (see ¶7-1200) in a building or structure which has been used at any time before the sale as a commercial building structure or otherwise is sold, the purchaser is entitled to an annual allowance for wear and tear based on the residue of expenditure immediately after the sale (s 33A(2)). The "residue of expenditure" consists of the amount of the capital expenditure incurred in the construction of the building or structure reduced by any initial, annual or balancing allowances that have already been granted, or any notional amounts written off (see below), and increased by any balancing charges made when the building or structure was used previously as an industrial or commercial building or structure (see ¶7-5100) (s 40(1)).

For the purpose of determining the residue of expenditure which a purchaser inherits when buying the relevant interest in a building, a notional amount is written off for any year in which no annual allowance was made (s 40(1)). The notional amount equals 4% of the capital expenditure.

The rate of the annual allowance available to a purchaser is determined using the following formula:

$$\text{Residue of expenditure} \times \frac{1}{\text{Number of years of assessment from the basis period in which the sale takes place, to the 25th year after first use.}}$$

In cases where rebuilding allowances had been claimed for the relevant commercial building or structure prior to the introduction of the annual allowance in the 1998/99 year of assessment, the rate of annual allowance allowed would be determined by the following formula:

$$\text{Residue of expenditure} \times \frac{1}{\text{Number of years of assessment from the basis period in which the sale takes place, to the 25th year after the 1998/99 year of assessment (in which the annual allowance scheme commenced).}}$$

[¶7-1500] Rebuilding allowance (pre-1998/99)

In the years of assessment preceding the 1998/99 year of assessment, commercial buildings or structures were not eligible for the same annual allowance as industrial buildings for capital expenditure incurred on their construction.

Instead, up to the basis period for the year of assessment 1997/98, where a taxpayer was entitled to a "relevant interest" (see ¶7-1200) in a commercial building or structure at the end of the basis period of a year of assessment, he or she was entitled to a rebuilding allowance for that year. The amount of the rebuilding allowance granted to a taxpayer was equal to 2% of the capital expenditure incurred on the construction of the building or structure (s 36).

For more on qualifying capital expenditure, see ¶7-0600.

BUILDINGS AND STRUCTURES BOUGHT UNUSED

[¶7-2000] Entitlement to allowances

The initial allowance for capital expenditure on industrial buildings or structures is normally granted to the person who incurred the expenditure (s 34(1)). When, however,