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Scope of Charge and Sources of Income

Learning Objectives

After having studied this chapter, you would:

- a. understand how property tax is levied;
- b. understand the meaning of "owner" under property tax;
- c. understand how income derived from an immovable property is taxed on an individual;
- d. understand how income derived from an immovable property is taxed on a corporation;
- e. understand what types of income are taxed under property tax;
- f. understand how premium and rent are taxed under property tax;
- g. understand when property letting by an individual may amount to carrying on a business;
- h. understand how sub-letting income is taxable; and
- i. understand the obligations of a property owner under Inland Revenue Ordinance.

I Introduction

1. Charge of property tax

Property tax (物業稅) is charged for each year of assessment on every person being the owner of any land (土地) or buildings (建築物) or land and buildings (土地連建築物) wherever situated in Hong Kong. It is computed at the standard rate on the net assessable value (應評稅淨值) of such land or buildings or land and buildings for each year of assessment – Section 5(1) of the IRO.

2. Territorial principle

In other words, only income derived from an immovable property situated in Hong Kong is taxable under property tax. It does not matter whether the owner is a Hong Kong resident or a foreigner. If a Hong Kong resident earns income from an immovable property situated outside Hong Kong, the income is exempt from Hong Kong property tax even though the income is received in Hong Kong.

3. Definition of "owner"

"Owner" (擁有人) in respect of land or buildings or land and buildings, is defined in Section 2(1) to *include* the following persons:

- a. a person holding directly from the Government (直接從政府名下持有的人),
- b. a beneficial owner (實益擁有人),
- c. a tenant for life (終身租客),
- d. a mortgagor (按揭人),
- e. a mortgagee in possession (管有承接人),
- f. a person with adverse title to land (擁有相逆土地業權) receiving rent from buildings or other structures erected on that land,
- g. a person who is making payments to a co-operative society (合作社) registered under the Co-operative Societies Ordinance (Cap. 33) for the purpose of the purchase thereof,

- h. a person who holds land or buildings or land and buildings subject to a ground rent (地租) or other annual charge (年費),
- i. (in so far as common parts are concerned) a corporation registered under Section 8 of the Building Management Ordinance (Cap. 344) or a person who, on the person's own behalf or on behalf of another person, receives any consideration, in money or money's worth, in respect of the right of use of any common parts solely or with another,
- j. an executor of the estate of an owner (遺產的遺囑執行人).

4. Definition of "land or buildings"

"Land or buildings or land and buildings" is defined in Section 7A to include piers, wharves and other structure.

5. Property income earned by a corporation

Income derived from an immovable property owned by a corporation may be charged with property tax or profits tax. Since the rental income of a corporation is included and reflected in its profit and loss account, as a matter of administrative convenience, a corporation's immovable property income is assessable under profits tax.

6. Property income earned from sub-letting

Property tax is only charged on a person who is an owner of an immovable property. As a result, income received from the sub-letting of an immovable property is assessable under profits tax (not property tax).

II Types of Income Chargeable under Property Tax

7. Computation of property tax

Property tax is charged at the standard rate on the net assessable value of an immovable property situated in Hong Kong.

8. Assessable value (應評稅值)

a. Definition of "assessable value"

Section 5B(2) provides that the assessable value of an immovable property is the consideration, in money or money's worth, payable in a year of assessment, to the order of, or for the benefit of, the owner in respect of the right of use of that immovable property.

b. Definition of "consideration"

The word "consideration" (代價) is defined in Section 5B(6) to include any consideration payable in respect of the provision of any services or benefits connected with or related to the right of use.

c. Elements of assessable value

DIPN 14 (revised in February 2005) provides, in paragraph 9, examples of sums *received or receivable* to be included in the assessable value as follows:

- i. rent,
- ii. payments for the right of use of premises under licence,
- iii. lump sum premium,
- iv. service charges, management fees etc. paid to the owner who provides the service, and
- v. owner's expenditure, e.g. repairs, borne by the tenant.



d. Exclusion of building management fee (大廈管理費) from assessable value

- i. The “building management fee” here is different from the “management fee” mentioned in paragraph 8(c)(iv) above. The “management fee” mentioned in that paragraph is the fee paid to the landlord for the provision of services to the tenant directly through his staff. The “building management fee” mentioned in this paragraph is the service provided by the Incorporated Association of Owners (大廈業主立案法團) of the building in which the landlord owns one or more flats out of many flats in the building. The Incorporated Association of Owners provides building management services to all the units of the building such as cleaning and handling of sewage services etc.
- ii. Paragraph 13 of DIPN 14 states that such building management fee received by the landlord from the tenant may not be chargeable to property tax as the landlord may merely act as an agent for the tenant for the payment of building management fee to the Incorporated Association of Owners. This is obvious if it is provided in the tenancy agreement that the tenant is responsible for the payment of building management fee, the fee so paid should not be included as consideration payable for the use of the immovable even though it is payable through the landlord.
- iii. Paragraph 14 of DIPN 14 further explains that where the tenancy agreement is silent on who is responsible to pay for the building management fee, but the established fact shows that the landlord is accustomed to paying the building management fee to the management service provider out of the lump sum that he received monthly from the tenant and that he has no right to claim a repayment from the tenant, only the net sum received by the landlord (as reduced by the building management fee paid by him) should be included as consideration payable for the use of the leased immovable property. In such situation, it is assumed that the tenant is responsible for the payment of the building management fee.
- iv. The treatment of building management fee elaborated in DIPN 14 recognises the fact that some tenancy agreements provide that building management fee is payable by the tenant while some tenancy agreements provide that building management fee is payable by the landlord. DIPN 14 allows an equitable and fair treatment for the building management fee differently provided in various tenancy agreements.

III Property Tax Treatment on Lump Sum Premium (整筆使用權費)

9. Spread over the premium (分攤整筆使用權費)

- a. Under Section 5B(4), a lump sum premium payable by a tenant for the right of use of an immovable property is deemed to be payable in equal monthly instalments during the period of the right of use or during a period of 3 years commencing at the start of the period of the right of use to which the consideration relates, whichever is the shorter.
- b. **Lease period – 3 years or less**
Premium is spread over the lease period.
- c. **Lease period – more than 3 years**
Premium is spread over 3 years (i.e. 36 months) from the date of commencement of the lease. In other words, premium is charged on the first three to four years of assessment of the lease period.

10. **Example 6.1: lease not more than 3 years**

Mr. Lau owns a flat and lets the flat to a person for a period of 2 years commencing on 1 June 2016 at a premium of \$600,000. Compute the premium to be spread over and assessable in each relevant year of assessment.

The premium is spread over 24 months (i.e., from 1 June 2016 to 31 May 2018) and assessable in the following years of assessment:

Year of Assessment 2016/17	
Period spread over is 1.6.2016 – 31.3.2017	$\$600,000 \times \frac{10}{24} = \underline{\underline{\$250,000}}$
Year of Assessment 2017/18	
Period spread over is 1.4.2017 – 31.3.2018	$\$600,000 \times \frac{12}{24} = \underline{\underline{\$300,000}}$
Year of Assessment 2018/19	
Period spread over is 1.4.2018 – 31.5.2018	$\$600,000 \times \frac{2}{24} = \underline{\underline{\$50,000}}$

11. **Example 6.2: lease more than 3 years**

Mr. Hui owns a flat and lets the flat to a person for a period of 5 years commencing on 1 January 2016 at a premium of \$720,000. Compute the premium to be spread over and assessable in each relevant year of assessment.

The premium is spread over 36 months (i.e., from 1 January 2016 to 31 December 2018) and assessable in the following years of assessment:

Year of Assessment 2015/16	
Period spread over is 1.1.2016 – 31.3.2016	$\$720,000 \times \frac{3}{36} = \underline{\underline{\$60,000}}$
Year of Assessment 2016/17	
Period spread over is 1.4.2016 – 31.3.2017	$\$720,000 \times \frac{12}{36} = \underline{\underline{\$240,000}}$
Year of Assessment 2017/18	
Period spread over is 1.4.2017 – 31.3.2018	$\$720,000 \times \frac{12}{36} = \underline{\underline{\$240,000}}$
Year of Assessment 2018/19	
Period spread over is 1.4.2018 – 31.12.2018	$\$720,000 \times \frac{9}{36} = \underline{\underline{\$180,000}}$



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 licensee 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 derives income from a property that it owns in Hong Kong, the corporation is chargeable with property tax as a property owner under Section 5.

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 a 30-year lease to a tenant for a lump sum premium. Initially, the taxpayer applied for exemption from property tax under Section 5(2)(a). After the exemption of property tax was granted, the taxpayer applied for exemption from profits tax on the ground that the premium was paid for the whole economical life of the property, and this would constitute the sale of a capital asset. Thus, the income should be exempt from profits tax under Section 14. 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 to the taxpayer on the premium received. The taxpayer objected to the property tax assessment on the ground of ultra vires as CIR had already exempt the taxpayer from property tax.

The judges at the Court of Appeal dismissed the taxpayer's appeal that the property tax assessment was valid. The judges ruled that exemption from property tax would be granted only when the property income was included in the profits tax computation and assessed under profits tax.

VII Double Payments of Property Tax and Profits Tax

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

If a business pays property tax and profits tax on the same piece of income derived from a property, the taxpayer may set off the property tax paid against the profits tax payable under Section 25. 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.

21. **Sub-letting income chargeable to profits tax**

Property tax is levied on the owner of an immovable property. If a person is not the owner of an immovable property, but sub-lets the whole or a part of the property to another person, the income so derived from that property is treated as income derived from a business. Thus, the income derived from sub-letting is chargeable to profits tax, not property tax.

Learning Objectives

After having studied this chapter, you would:

- understand when profits are regarded as arising in or derived from Hong Kong;
- understand how trading profits are taxable in Hong Kong;
- understand how manufacturing profits are taxable in Hong Kong;
- understand how income from services rendered is taxable in Hong Kong;
- understand how interest income is taxable in Hong Kong;
- understand how royalty income is taxable in Hong Kong;
- understand how income received from qualifying debt instruments is taxed in Hong Kong; and
- understand how profits received from qualifying reinsurance business are taxed in Hong Kong.

I Profits Arising in or Derived from Hong Kong

1. General principle

According to the judgment of the *CIR v Hang Seng Bank* (1990), the Lordship said that in the determination of the source of profits, the following items are relevant:

- It is the gross profit of a transaction, not the net profit of a company, to be considered.
- The determination of source of profit is a question of fact, and all the factors have to be considered before a conclusion can be arrived at.
- In view of the different nature of businesses carried on by various enterprises, it is not possible to lay down precise rules of law by which the answer to the question of source of profit is to be determined.
- The Law Lords provided a Broad Guiding Principle for the determination of the source of profit, and it is that "one looks to see what the taxpayer has done to earn the profit in question, and where he has done it".

2. New approaches after DIPN 21 (Revised 2009)

The Commissioner revised DIPN 21 in December 2009 to replace the old DIPN 21 issued in 1998. In view of the decisions of new cases in the past ten years, the CIR introduced two new approaches on the determination of source of profit. They are:

- antecedent activities and incidental activities, and
- agency principle.

3. Antecedent and Incidental Activities

When deciding the source of profit, judges will look at the immediate cause that give rise the profit. What is done before the activities causing the profit, they are known as antecedent activities. Activities done after the activities giving rise the profit are known as incidental activities. Antecedent and incidental activities do not give rise the profits, and they are not relevant in the determination of source of profit. The Commissioner used 3 paragraphs (paragraphs numbers 14 to 16 of DIPN 21) to explain how these two types of activities were different from profit-causing activities (or profit-generating activities).

In *Macquarie Securities Ltd v CIR* (2007) [also known as Baring Securities (HK) Ltd and ING Baring Securities Ltd], the judges decided that the management of Hong Kong customers' portfolio in Hong Kong was antecedent activities and did not give rise the profit. It was the activities of execution of orders by overseas brokers on behalf of Hong Kong taxpayer that gave rise the profit. Thus, the profit was source outside Hong Kong.

4. Agency principle

Under the agency principle, what is done by an agent on behalf of a principal outside Hong Kong is equivalent to the Hong Kong principal carrying out the same activities outside Hong Kong. If those activities done by an agent outside Hong Kong earn income or profit for a Hong Kong company, the Hong Kong company is treated as carrying out the same activities outside Hong Kong to earn the income or profit. Therefore, that income or profit is sourced outside Hong Kong.

In *Macquarie Securities Ltd v CIR* (2007) mentioned above, as the overseas brokers executed orders for purchase and sale of overseas listed stock on overseas stock exchange, the commission earned by the Hong Kong taxpayer from its Hong Kong customers for monitoring the purchase and sale of overseas stock was treated as earned by the activities carried out by overseas brokers outside Hong Kong. Thus, the commission was wholly exempt from Hong Kong profits tax.

In *CIR v Orion Caribbean Limited (In Voluntary Liquidation)* (1997), the taxpayer was an overseas incorporated company carrying out lending and borrowing activities. The taxpayer did not carry out any work in Hong Kong to earn the interest income. It was the taxpayer's Hong Kong parent company to carry out all the activities in Hong Kong to locate the borrowers and the fund providers for lending money to those borrowers (clients). Based on the agency principle, as the Hong Kong parent company did all the things in Hong Kong to secure the loans, and earned the interest income for the taxpayer, the judges held that the loan interest was sourced in Hong Kong and derived from the activities done by the parent company in Hong Kong. The taxpayer was chargeable to profits tax on such income earned.

5. Common source rule tests

There are five common types of tests applied for the determination of source of profits as follows:

a. Contract effected test

This is usually applied to trading transactions.

b. Operations test

This is usually applied to cases other than trading transactions and money lending business. These cases usually involve performance of duty or rendering physical services. When considering the "operations test", the following questions are usually asked:

- i. What is the originating cause of the income?
- ii. Did the originating cause take place in Hong Kong?

c. Provision of credit test

This is usually applied to the lending of money.

d. Development test

This is applied to intellectual property and payment of royalty.

e. Assumption of risk test

This is applied to guarantee or undertaking service.



II Determination of the Source of Trading Profit

6. Principles applicable to determination of trading profit

a. Contract effected test and the totality of facts approach

According to DIPN 21, it is the view of the CIR that the contract effected test is the most important principle in the determination of the source of trading profits, but sometimes the principle of "totality of facts" may be relevant.

b. Contract effected test

According to the contract effected test, the source of trading profits is outside Hong Kong only when both the purchase contract and the sales contract are effected outside Hong Kong. If either one of them is effected in Hong Kong, the whole trading profit is taxable in Hong Kong. There is no apportionment of trading profit for taxation. It is either fully taxable or fully exempt.

"Effected" is interpreted as not merely executing or signing a contract. "Effected" includes the process of negotiation to the conclusion of the contract. If any part of the effected process is done in Hong Kong, the trading profit is sourced in Hong Kong.

Purchase Contract Effected	Sales Contract Effected	Taxability / Exemption
In Hong Kong	In Hong Kong	100% taxable
In Hong Kong	Outside Hong Kong	100% taxable
Outside Hong Kong	In Hong Kong	100% taxable
Outside Hong Kong	Outside Hong Kong	100% exempt

c. Totality of facts approach

i. Overseas selling efforts much more significant than local purchase efforts

In *CIR v Magna Industrial Co. Ltd.*, the selling efforts through overseas stationed sales managers done outside Hong Kong were much more significant than those of purchase efforts done in Hong Kong. The judges ruled that the source of trading profit derived from the sales of such goods was arising outside Hong Kong. The judges ignored the contract effected test, but applied the totality of facts approach in arriving at the decision. The judges commented that this was a rare and extreme case, and the decision was arrived at on its own facts.

ii. Place of arrangement of finance for the trading transactions

In *Consco Trading Co. Ltd. v CIR*, the Board of Review was of the view that place of the arrangement of finance for trading transactions was also relevant in the determination of the source of profit. If the finance is arranged in Hong Kong, the trading profit may be sourced in Hong Kong.

7. Leading cases in this area are as follows:

a. ***CIR v Hang Seng Bank Ltd. (1990) 3 HKTC 351***

This is a case appealed to the Privy Council. In that case, Hang Seng Bank asked its associated company in Singapore to carry out the purchase and sale of certificates of deposit on behalf of Hang Seng Bank. The instruction of purchase or sale of certificates of deposit was given by officers in Hong Kong and the Singapore associates would conclude the transactions in Singapore. The point at issue is whether the location where the instruction was given for the purchase or sale or where the dealing was concluded would determine the source of profit. It was decided by the Privy Council that the place of conclusion of the trading contract was important, and where the instruction was given is not relevant. (Please also refer to Part VII of Chapter 16 about the different treatments applicable to financial institutions and non-financial institutions.)

b. ***Exxon Chemical International Supply SA v CIR (1989) 3 HKTC 57***

This is a High Court case involving trading transactions. The judge took the view that as the taxpayer obtained purchase orders from overseas affiliated companies in Hong Kong, and placed its own purchase orders to overseas suppliers in Hong Kong, the profit from the trading transactions was derived from Hong Kong.

c. ***Euro Tech (Far East) Ltd. v CIR (1995)***

This is a High Court case involving trading transactions. This case is similar to the Exxon Chemical case and the decision was that the source of trading profit was derived from Hong Kong.

d. ***CIR v Magna Industrial Co. Ltd. (1996)***

This is a case about the determination of source of profits for a trading transaction. In this case, the taxpayer effected sales contracts with overseas customers outside Hong Kong. For the purpose of not letting the customers know the actual source of the goods, the taxpayer used a related company to purchase the goods from the original supplier of goods. This related company then sold the goods to the taxpayer at a cost-plus basis. In this way, very little work was done by the taxpayer in the purchase of goods from its related company. The Board of Review decided that although both the effort made by the taxpayer in the purchase of goods and sale of goods had to be considered, the purchase work was not significant in this case. The Board relied on the work done for the sale of the goods to decide the source of the profit derived from the trading transactions. Since the sale contract was effected outside Hong Kong, the source of profit was outside Hong Kong. (BRD10/95)

CIR appealed against the Board's decision to the High Court which gave its decision in May 1996. The judge overruled the decision of the Board, and maintained that the part involved in the purchase contract could not be ignored, and this was also important in deciding the source of trading profit. Since the taxpayer took effort to use a related company to conceal the real supplier, the work done between the taxpayer and the related company, "the pretended supplier", had an important part in the course of trading of the company. Thus, its effort could not be ignored. The judge decided that the source of profit was in Hong Kong.



The taxpayer appealed against the High Court's decision to the Court of Appeal which gave its decision in December 1996 allowing the appeal. The judges said that the question to be considered was "Was the Board correct in holding that the relevant profits did not arise in or derive from Hong Kong?" The judges concluded that the answer was "yes". The judges said that that case fell within the extreme limits of the spectrum, and the Board's conclusion is, in their view, sustainable in law. Thus, the taxpayer won the case. The CIR did not lodge an appeal to the Privy Council.

e. **Consco Trading Co. Ltd. v CIR (2004)**

This case was heard on 19 November 2003, and judgment was delivered on 12 May 2004. The taxpayer lost the case.

The taxpayer was a trading company, and the Board of Review adopted "the totality of facts" approach to decide this case. The place where the contract of sale and purchase was made is an important factor to be considered, but not the only or the determinative factor.

In this case, five activities were identified:

- i. the pre-contract negotiations,
- ii. the making of contracts of purchase,
- iii. the making of contracts of sale,
- iv. the post-contract performance such as arrangement for finance, preparation of shipping documents, delivery of goods and effecting and receipts of payments, and
- v. the making of processing agreements with a Beijing company and effect payments thereunder.

The Board was aware that some of the contracts for sale and purchase orders for raw material were signed in Hong Kong but some were not, and it must have considered all these before it reached the conclusion that the profits arose or were derived from Hong Kong. The Board also considered that other factors, such as finance arrangement, payment of raw material and processing fees, arrangement for receipt of payment from purchase of the finished product and pre-contract negotiations were also relevant. The finding that the profits were derived from Hong Kong is a finding of fact, which the Court may not interfere.

8. **Principles applicable to determination of re-invoicing profit**

In the old DIPN 21, the CIR accepted that re-invoicing might be exempt from profits tax if the arrangement satisfied some requisite conditions. However, in the revised DIPN 21 issued in December 2009, the CIR did not accept the exemption of profits tax for re-invoicing activities. Instead of applying the contract effected test to re-invoicing activities, the CIR applies operations test to such activities and terms it as a re-invoicing centre.

9. The CIR provides an example in the DIPN 21 to explain why the profit derived from re-invoicing activities is chargeable to profits tax as follows.

"Example 1

Company A, incorporated in Hong Kong, is a re-invoicing centre of a group of companies with a holding company incorporated in the United States, as more particularly described below. It manages in Hong Kong all foreign currency exposures from intra-company trade, guarantees the exchange rates for future orders and manages intra-affiliate cash flows, including lead and lags of payments. Manufacturing affiliates in Mainland China sell goods to Company A, which in turns resells to the distribution affiliates in North America and Europe. Company A resells at cost plus a mark-up for its services. The mark-up covers the cost of the re-invoicing centre and a reasonable return on the services provided.

The profits accrue to Company A are service income derived from Hong Kong. The mark-up earned by Company A, which acts as a re-invoicing centre, is chargeable to profits tax."

III Determination of the Source of Manufacturing Profits

10. Manufacturing profit – in general

The basic source rule for the source of manufacturing profit is operations test. The two questions commonly asked in the "operations test" are:

- a. What is the originating cause of the income? and
- b. Did the originating cause take place in Hong Kong?

According to the Inland Revenue DIPN 21, there are four common types of manufacturing processes (but actually from the view point of taxation, some may belong to trading activities). They are:

- a. goods wholly manufactured in Hong Kong,
- b. goods manufactured by Hong Kong entity in the mainland (called "contract processing"),
- c. goods manufactured through import processing, and
- d. goods manufactured by sub-contractors situated outside Hong Kong.

11. Goods wholly manufactured in Hong Kong

If all the manufacturing processes are done in Hong Kong for the production of goods, the profit derived from the sale of such goods is sourced in Hong Kong based on operations test. The selling profit is fully taxable in Hong Kong. It makes no difference whether the goods are sold to Hong Kong customers or overseas customers. In other words, the place of effecting the purchase contract and the sales contract are not relevant in this situation.

12. Goods manufactured by Hong Kong entity in the mainland (contract processing)

This is referred to as "contract processing". If a Hong Kong company operates its own factory or signs a processing / assembling agreement with a party in the mainland of China for establishment of a cooperative joint venture, and produces goods in the mainland, the manufacturing profit is regarded as partly derived in Hong Kong, and partly derived in the mainland.

The CIR's rationale is that in such situation, on the one hand, the Hong Kong company is required to provide plant and machinery and supporting services such as administrative, accounting and finance to the factory in the mainland from Hong Kong. On the other hand, the Hong Kong company is treated as heavily involved in the manufacturing process in the mainland with its plant and machinery located in the mainland. Thus, the profit is partly derived in Hong Kong, and partly derived outside Hong Kong.

In order to avoid any dispute on the exact portion of the profit being derived in Hong Kong, CIR would take 50% of the selling profit as onshore and 50% as offshore no matter whether the goods are sold to Hong Kong customers or overseas customers.

The characteristics of contract processing are as follows:

- a. Hong Kong company provides raw materials to the mainland entity.
- b. Hong Kong company provides the mainland entity freely with its own plant and machinery and its supervisors to assist the manufacturing work in the mainland.
- c. Hong Kong company pays the mainland entity a fee for the use of factory and local labour force provided by the mainland entity.



- d. The mainland entity provides factory and local labour force for carrying out the manufacturing process.
- e. The mainland entity transports the finished goods back to the Hong Kong company.

13. **Goods manufactured through import processing**

This is referred to as "import processing". In this situation, the Hong Kong company sells its raw materials to the mainland entity which manufactures the goods according to the instructions of the Hong Kong company. At the same time, the Hong Kong company provides the mainland entity freely the use of the Hong Kong company's plant and machinery transported to the mainland entity. The Hong Kong company may also provide supervisory staff to the mainland entity for assisting the manufacturing work done by the mainland entity. After completion of the processing, the mainland entity sells the finished goods to the Hong Kong company.

The above description shows that the legal title of the raw materials has been changed, and not belonged to the Hong Kong company. Thus, the Hong Kong company does not carry out any manufacturing work on its own goods, but assists the other party to manufacture the goods belong to another party (i.e. the mainland entity). As a result, the Hong Kong company's activities are not manufacturing activities but trading activities of sale of raw materials, purchase of finished goods and the sale of finished goods.

The source of profit is governed by the contract effected test. In order to qualify for the exemption from Hong Kong profits tax, the contract for the purchase of finished goods and the contract for the sale of finished goods must be both effected outside Hong Kong.

The characteristics of import processing are as follows:

- a. Hong Kong company sells raw materials to the mainland entity.
- b. Hong Kong company provides the mainland entity freely with its own plant and machinery and its supervisors to assist the manufacturing work in the mainland.
- c. Hong Kong company purchases finished goods from the mainland entity.

14. **Goods manufactured by sub-contractors situated outside Hong Kong**

This is referred to as "sub-contracting processing". If a Hong Kong manufacturer does not operate its own factory, but pays sub-contracting fees to entities in the mainland to manufacture goods on its behalf. After processing, the finished goods are transported back to the Hong Kong company. In this situation, the Hong Kong company has little involvement in the manufacturing processes in the mainland.

As a result, the Hong Kong company's activities are not manufacturing activities but trading activities of purchase of raw materials and the sale of finished goods.

The source of profit is governed by the contract effected test. In order to qualify for the exemption from Hong Kong profits tax, both the contract for the purchase of raw materials and the contract for the sale of finished goods must be both effected outside Hong Kong.

The characteristics of subtracting processing are as follows:

- a. Hong Kong company provides raw materials to the mainland entity.
- b. Hong Kong company pays the mainland entity a fee for the manufacturing work done by the mainland entity.
- c. The mainland entity transports the finished goods back to the Hong Kong company.

15. Comparison of the characteristics of different processing arrangement

	Contract Processing	Import Processing	Sub-contracting Processing
Free provision of raw materials from HK to PRC	Yes	No	Yes
Sale of raw materials from HK to PRC	No	Yes	No
Purchase of finished goods from PRC to HK	No	Yes	No
Free provision of machines and staff from HK to PRC	Yes	Yes	No
Fee payment	Yes	No	Yes
Activity carried out by HK Co.	Manufacturing its own goods	Not manufacturing its own goods	No manufacturing activity by HK Co.
Tax nature of service of HK Co.	Manufacturing	Trading	Trading
Source rule	Operations test	Contract effected test	Contract effected test
Charge of HK profits tax	50% taxable / 50% exempt	100% taxable / 100% exempt	100% taxable / 100% exempt

16. Summary of the determination of source of different manufacturing profit

Activity / Arrangement	Nature of Activities	Taxability / Exemption
Goods wholly manufactured in Hong Kong	Manufacturing	100% taxable
Contract processing	Manufacturing	50% taxable and 50% exempt
Import processing	Trading	100% taxable or 100% exempt
Sub-contracting processing	Trading	100% taxable or 100% exempt

17. Two import processing tax cases wishing to get contract processing 50% exemption

a. *Datatronic Limited v CIR (2009)*

i. Issue

The issue of this case is whether 50:50 apportionment of profit would be allowed for import processing (as in the same way where the IRD allows for 50:50 apportionment for contract processing only).

IV Determination of Source of Profit Derived from Services Rendered

18. Services rendered

When a person earns his income through rendering services, the principle governing the source of profit is "operations test". The source of such income is the place where the person carries out his services. The place of effecting or signing the contract is generally not relevant.

19. Leading cases in this area are as follows:

a. *CIR v Hong Kong & Whampoa Dock Co. Ltd. (1960) 1 HKTC 85*

In this case, although the acceptance of the order for sending out a tug to salvage a ship outside Hong Kong took place in Hong Kong, all the work of refloating and repairing the ship was done outside Hong Kong. Thus, based on operations test, the profit was sourced outside Hong Kong.

b. *CIR v International Wood Products Ltd. (1971) 1 HKTC 551*

This case involved the receipt of commission income. In this case, the taxpayer was appointed by an overseas principal to sell logs. The taxpayer then appointed overseas sub-agents who sourced orders from buyers outside Hong Kong, and the taxpayer received commission from the principal in accordance with the volume of the orders obtained by sub-agents. The court held that the activities of the overseas sub-agents took place outside Hong Kong and the source of commission was outside Hong Kong. The court was also of the view that the mere existence of a business in Hong Kong did not indicate that the profit was derived from Hong Kong.

c. *Li & Fung (Trading) Ltd. v CIR (2012)*

i. Issue

Whether the 6% commission earned by the taxpayer through its agents' effort performed outside Hong Kong is chargeable to profits tax.

ii. Facts

The taxpayer (LFT) provided services to its customers in connection with the manufacture, sale and purchase of goods. Such services included finding suppliers to manufacture and then sold goods to LFT's customers as buyers. LFT managed the sourcing and manufacturing processes to ensure that satisfactory goods were supplied to its customers. Upon delivery of the finished goods to its customers, LFT was paid a commission of 6% of export sales.

Most of LFT's services were provided outside Hong Kong through local offices. The local offices usually had their own staff. In most cases, the local offices were LFT affiliates. LFT engaged or acted through these local affiliates or sourcing companies in performing the services which LFT had contracted to provide to its customers. In consideration for an affiliate's services, LFT paid the latter a percentage (say 4%) of the FOB value of total export sales by LFT's customer.

LFT took the view that the commission earned on orders from overseas customers which were handled by non-Hong Kong based LFT affiliates was foreign source income and so not chargeable to Hong Kong profits tax.



iii. **Decision of Court of Appeal**

Source of commission income was outside Hong Kong at the place where overseas agents carried out their services.

iv. **Reasons**

In this case, what generated LFT's gross commission of 6% were sourcing and agency activities which LFT carried out through overseas local affiliates outside Hong Kong. Without those activities (in particular, the successful delivery of merchandise to LFT's customer), no commission of 6% could have been earned.

V **Determination of Source of Profit Derived from Brokerage Business**

20. There are four cases involved in the determination of source of profit of brokerage business. The situations of three cases are quite similar, but their decisions are different. The situation of the fourth case is different from those of the other three. The crux of all the four decisions is what were the activities that gave rise to the brokerage income.
21. For the three similar cases, they all involved Hong Kong clients giving instructions to a Hong Kong brokerage firm to purchase and sell stock in overseas markets. The Hong Kong brokerage firm (i.e. the taxpayer in the case) instructed their associates in the overseas market to execute the customers' orders there.

a. ***CIR v Wardley Investment Services (Hong Kong) Ltd. (1992)***

In this case, Wardley Investment Services (Hong Kong) Ltd. (the taxpayer) managed investment portfolio for its Hong Kong clients. In order to execute orders in the overseas markets, the taxpayer employed overseas brokers to execute the orders for its Hong Kong clients in those overseas markets. The taxpayer signed an agreement with its clients that the taxpayer might receive rebates of commission from the aforesaid overseas brokers.

The taxpayer argued that the rebate income was sourced from the services provided by the overseas brokers outside Hong Kong, and the income should not be chargeable to Hong Kong profits tax.

However, the Court of Appeal ruled that although the rebates of commission were paid by overseas brokers for orders executed in overseas stock markets, the rebates were derived from the management agreement signed between the taxpayer and its Hong Kong clients allowing the taxpayer to receive the rebate. Thus, the rebates were treated as additional remuneration paid to the taxpayer for the performance of its duties stated in the management agreement. It did not matter whether the rebates were paid by Hong Kong brokers or overseas brokers.

b. ***Macquarie Securities Ltd. v CIR (2007)***

In this case, Macquarie Securities Ltd. (the taxpayer), also formerly known as ING Baring Securities (HK) Ltd. and Baring Securities (HK) Ltd., received three types of income from its clients. These included agency brokerage commission, placement and marketing income received from Hong Kong clients for stock purchased and sold in overseas stock markets.

The judge of the Court of First Instance decided that all the income received by the taxpayer from its Hong Kong clients was derived outside Hong Kong. The overseas brokers were agents of the taxpayer executing the taxpayer's clients' orders outside Hong Kong. Based

on the agency principle, when the brokers acted on behalf of the taxpayer executing the orders outside Hong Kong, this meant that the taxpayer itself also carried out the services of execution of the clients' orders outside Hong Kong. Thus, the commission that the taxpayer received from its clients would be sourced outside Hong Kong.

In June 2006, the CIR lodged an appeal against the decision to the Court of Appeal which allowed the CIR's appeal. The taxpayer lodged an appeal to the Court of Final Appeal which decided against the CIR and retained the decision of the Court of First Instance in October 2007. Thus, the final decision is that all the commission income received from all three types of transactions was sourced outside Hong Kong.

c. ***Indosuez W I Carr Securities Ltd. v CIR (2008)***

In this case, Indosuez W I Carr Securities Ltd. (the taxpayer) signed agreements with its clients to manage their overseas investment portfolio. The taxpayer asked its overseas brokers to effect the orders of its clients for purchase and sale of stock in overseas stock markets. The taxpayer claimed that all the brokerage income should be sourced outside Hong Kong as a result of the work done by the overseas brokers. The IRD claimed that the situation of the taxpayer was very similar to that of the case of *Wardley Investment Services Ltd. v CIR* (1992). In that case, the CIR issued an assessment taking the whole brokerage income assessable.

At the end, the judge of the Court of First Instance (January 2002) ruled that it was possible to apportion the brokerage income between the part derived in Hong Kong and the part derived outside Hong Kong. The judge said that Section 14 did not prohibit the apportionment of onshore and offshore profit. The judge remitted the case to Board of Review for clarification of some of the facts, with his recommendation that the income might be 60% sourced in Hong Kong and 40% sourced outside Hong Kong.

The Board heard the case the second time in November 2003, but the CIR did not agree with the Board's decision that the apportionment was 50:50 (not 60:40 as recommended by the judge). The CIR asked the Board to state a case for the purpose of lodging an appeal against the Board's second decision to the Court, but the Board refused to do so.

The CIR successfully applied for a judicial review against the Board's refusal to state a case in January 2006. The taxpayer lodged an appeal against the decision of the Court of Appeal, but the Court of Appeal dismissed the taxpayer's appeal in April 2007. The taxpayer lodged an appeal to the Court of Final Appeal against the decision of the Court of Appeal.

When the time for the hearing of the case by the Court of Final Appeal is still pending, the decision of *Macquaire Securities Ltd v CIR* came to light. Finally, the parties agreed to the finalisation of the case on the basis of the BOR decision handed down after the case had been remitted to the BOR with the opinion of the Court of First Instance by an order dated 30 January 2002 and a further order dated 24 April 2003. Since the taxpayer had lodged an appeal to the Court of Final Appeal against the Court of Appeal's decision through the judicial review, the Court of Final Appeal endorsed the compromised decision made by the parties.



d. Summary of the three brokerage income cases

Taxpayer	Result	Level of Court	Year of Decision
Wardley case	100% taxable	Court of Appeal	1992
Macquaire case	100% exempt	Court of Final Appeal	2007
Indosuez W I Carr case	Apportionment	Court of Final Appeal	2008

Important Note:

Although the decision of *Indosuez W I Carr Securities Ltd. v CIR* was made in 2008 by the Court of Final Appeal to endorse the compromised decision between the CIR and the taxpayer, it was not a decision actually carried out by the Court of Final Appeal. Thus, the better view is still that of *Macquaire Securities Ltd. v CIR* in 2007.

In other words, the current view is that for those kinds of income mentioned for stock brokerage income, the source is outside Hong Kong.

e. **Kim Eng Securities (Hong Kong) Ltd. v CIR (2007)**

In this case, Kim Eng Securities (Hong Kong) Ltd. (the taxpayer) carried on the business of a stockbroker in Hong Kong; and was not a member of any foreign stock exchange. At one time the taxpayer had been a wholly-owned subsidiary of Kim Eng Securities (Private) Ltd. ("KES"), a company incorporated under the laws of Singapore and a member of the Singapore Stock Exchange.

At that time, Singapore Stock Exchange imposed minimum commission rates for individual customers. In Singapore, stockbrokers were allowed to give rebates to foreign stockbrokers, but not individual customers. Where a customer sourced by KES traded on the Singapore Stock Exchange through KES, the customer must pay the minimum commission and no rebate was allowed. However, where a foreign (in relation to Singapore) broker (e.g. the taxpayer) came into the picture, KES was allowed to grant the foreign broker (e.g. the taxpayer) a rebate. The major issue of the dispute is whether the rebate given by KES to the taxpayer would be taxable in Hong Kong.

In such circumstances, the taxpayer (i.e. as a foreign broker) took part in two (or more) transactions, introducing its own clients to KES, and its own clients making orders direct with KES afterwards. The taxpayer would get a rebate from KES for business done by the clients.

The taxpayer argued that the rebate was earned from services rendered by brokers in Singapore and the income should not be taxable. The IRD argued that in substance the taxpayer earned its actual share of commission income for its work done in Hong Kong while the foreign stockbroker and source company earned their own income for the work which they performed abroad on their own behalf.

The Court of Final Appeal delivered its judgment in March 2007 and held that the services rendered by the taxpayer in Hong Kong could not be ignored, and held that the rebate income was sourced in Hong Kong.

VI Interest Income in General

22. Types of interest income

There are four common types of interest income. They are:

- interest income derived from overdue trade debts,
- interest income derived from clients' trust money,
- interest income derived from a loan, and
- interest income derived from a deposit placed with a financial institute.

23. General principle – provision of credit test

The source of interest income is generally determined by the "provision of credit" test. It means that the source of interest income is at the place where the money is *first* made available to the borrower. *Commissioner of Inland Revenue (NZ) v. NV Philips Gloeilampenfabrieken*, 10 ATD 435 and *CIR v. Lever Brothers & Unilever Ltd* (1946), 14 SATC 1.

If the provision of credit is first situated in Hong Kong, the source of the interest income is in Hong Kong, irrespective of the currency in which the loan is denominated, the place of residence of the debtor or the place where the debtor employs the capital.

The provision of credit test may be demonstrated by the three different situations shown in the following table. In all the three situations, the lenders are located in Hong Kong while the borrowers are located in the USA.

Situation	Provision of Credit	Source of Income	Taxability
a. The lender remits the money from his own bank account in Hong Kong to the borrower's bank account in Hong Kong.	The money is available to the borrower in Hong Kong	Hong Kong	Taxable
b. The lender remits the money from his own bank account in Hong Kong to the borrower's bank account in USA.	The money is available to the borrower in USA	USA	Exempt
c. The lender remits the money from his own bank account in USA to the borrower's bank account in USA.	The money is available to the borrower in USA	USA	Exempt

24. Interest income derived from overdue trade debts

Since the interest due on overdue accounts forms an integral part of a trading transaction, the interest income is treated as a part of the trading profit. Thus, if the trading profit is onshore, the interest income due from account receivable is also onshore and chargeable to profits tax, *BR 20/75, IRBRD, vol. 1, 184*. The location of the debtor is not relevant.



25. **Interest income derived from client's trust money**

Many professional firms, such as consultants, receive retainer fee or custody money from their clients for the provision of services at a later date. These funds are kept in a separate trust account maintained in a deposit account with a financial institution in the name of the professional firm as a trustee for its clients. The beneficial owners of such account are the clients. Interest is derived from such trust account, and it is not often that the professional firms will refund the interest to their clients in view of small amount from the angle of individual client. At certain intervals, the professional firms will transfer the interest "unclaimed" by the clients to the profit and loss account of the professional firm.

Although the interest, at all material times, does not belong to the professional firms, yet it is credited to their profit and loss accounts. The issue is whether the professional firm is chargeable to profits tax on such interest income. Based on the decision of *CIR v. Lau, Wong & Chan, Solicitors*, (1984) 2 HKTC 470, such interest income forms a part of the income of the professional firm as a trade practice, thus the interest income is chargeable to profits tax.

[Author's comment: The issue here is not the source of interest income, but whether the interest income belongs to the taxpayer (the legal firm) or the legal firm's customers. In the above case, the judges ruled that although the interest income originally did not belong to the legal firm, yet the legal firm got the interest income as a matter of trade practice. Thus, the interest income was treated as a part of the normal income of the legal firm. In the above case, the clients' trust account was kept in Hong Kong, the interest income was sourced in Hong Kong, and chargeable to profits tax. However, if the clients' trust bank account was kept in an overseas bank account, then the source of interest income would be sourced outside Hong Kong, and not chargeable to profits tax.]

VII Interest Income Derived from a Loan

26. **Interest income derived from a loan in general**

There are four possible different treatments on source of interest income derived from a loan. They are:

- a. interest income received by an individual,
- b. interest income received by a company which is not a money lender,
- c. interest income received by a money lender which is not a financial institution,
- d. interest income received by a financial institution, and
- e. interest income received by a qualifying corporate treasury centre (QCTC).

27. **Interest income received on a loan by an individual**

In order to be chargeable to profits tax, a person must carry on a business in Hong Kong. An individual is generally not regarded as carrying on a business in Hong Kong unless he carries on repetitive activities in earning interest income through lending money to others. Thus, if an individual lends money to his friends not on a frequent basis, he will not be treated as carrying on a business, and the interest income is not chargeable to profits tax.

28. **Interest income received on a loan by a company (not a money lender)**

A company is established for making money. Thus, interest income earned by a company carrying on a business in Hong Kong is chargeable to profits tax on its interest income derived from Hong Kong under Section 15(1)(f). The source of interest income is determined by provision of credit test.

29. **Interest income received by a money lender (not a financial institution)**

In the case of a money lending business, the taxpayer's business would normally encompass a broader range of activity, including the borrowing and/or lending of money. For this type of business, the IRD will apply the operations test instead of the provision of credit test in determining the source of the interest income. After the decision of Orion case and the issue of DIPN 13, this becomes a two-tier approach for determination of source of interest income for money-lender which is not a financial institution.

a. **The initial step – provision of credit test**

If the provision of credit is in Hong Kong, the loan interest income is wholly chargeable to profits tax, and IRD will not take any further action but charge profits tax on the interest income. If the provision of credit is outside Hong Kong, the IRD may apply operations test to determine the source of interest income.

b. **The second step – operations test**

IRD will look at activities such as the evaluation of the loan and the decision of approval for the application of the loan. If any one of such activities is carried out in Hong Kong, the interest is sourced in Hong Kong, and the interest income will be fully chargeable to profits tax.

30. ***CIR v Orion Caribbean Limited (In Voluntary Liquidation) (1997)***

a. **Facts**

The taxpayer was a Cayman Islands company, and it was a wholly owned subsidiary of a Hong Kong company, called Orion Royal Pacific Ltd. The taxpayer's main business was to consider and approve the loan participations recommended by its parent company. The taxpayer borrowed money in foreign currencies from the parent company and on-lent the money to borrowers outside Hong Kong. The parent company negotiated and serviced the loan for the taxpayer's approved, and raised funds for the loans approved by the taxpayer. The parent company also provided management, administrative and accounting services for the loans approved by the taxpayer.

b. **Board of Review decision**

The Board of Review found that based on "provision of credit test", the source of interest income was derived outside Hong Kong. However, the Board treated the taxpayer as a financial institution, thus all the interest income was subject to Hong Kong profits tax under Section 15(1)(i).

c. **Decision of Court of Appeal**

The taxpayer appealed directly to the Court of Appeal, and the Court overruled the decision of the Board. The Court found out that the taxpayer was a money lender, but not a financial institution as defined in Section 2 of the IRO, and Section 15(1)(i) did not apply. As a result, the interest was ruled with a source outside Hong Kong based on the principle of "provision of credit test". The interest income was not chargeable to profits tax.



d. Decision of Privy Council

The CIR appealed to the Privy Council (which was the Court of Final Appeal before 1 July 1997). The Privy Council ignored the provision of credit test, but applied operations test for the determination of interest income in this case. The Privy Council also introduced the concept of agency in this case. The Privy Council decided that all the services of the taxpayer were provided by the parent company in Hong Kong. As the parent company performed all the services for the taxpayer in Hong Kong, based on agency principle, the profit derived by the taxpayer would be subject to Hong Kong profits tax.

[Author's observation: In view of the new application of operations test to the source of interest income, the CIR, after the decision of Orion case, issued a revised DIPN13, and applied operations test for the determination of source of interest income received by a money lender.]

31. Interest income received on a loan by a financial institution

There are two approaches for charging loan interest income earned by financial institutions. They are the statutory approach under Section 15(1)(i) and the concessionary treatment in practice (i.e. the compromised package).

a. Statutory approach – Section 15(1)(i)

Section 15(1)(i) provides that interest income earned by a financial institution is chargeable to profits tax on a worldwide basis. No matter whether a financial institution earns its interest income in Hong Kong or outside Hong Kong, it is by law that all the interest income is chargeable to profits tax.

This approach is to prevent financial institutions making use of electronic systems to arrange artificially the money first made available to borrowers (its clients) outside Hong Kong. If the provision of credit test is accepted for determination of source of interest income of financial institutions, IRD will not be able to charge any profits tax on financial institutions.

b. In practice – compromised package

In order to relieve the harsh treatment on the bank industry, the CIR has an agreement with the banking industry that the loan interest income will not be taxable on a worldwide basis. This is called the “compromised package”.

Two factors are considered in the compromised package:

- i. where the loan is initiated, negotiated, approved and documented; and
- ii. where the loan is funded (i.e. where funds are raised and loaned to the borrower).

There are three possible outcomes:

- i. if both factors are in Hong Kong – 100% taxable
- ii. if either one factor is in Hong Kong – 50% taxable
- iii. if both factors are outside Hong Kong – 100% exempt

32. Interest income received on a loan by a qualifying corporate treasury centre (QCTC)

Section 14D(1) provides that the interest income on lending transactions of a QCTC is chargeable to profits tax at one-half of the profits tax rate (i.e. 8.25%). However, interest income is chargeable on worldwide basis under Section 15(1)(ia).

33. **Summary of taxation of interest income earned from a loan**

Nature of Business of the Recipient	Source Rule
Received NOT by a money lender	Provision of credit test
Received by a money lender (but NOT a financial institution)	Provision of credit test
	Operations test
Received by a financial institution	Worldwide taxable — S.15(1)(i)
	Compromised package — 2 factors
Received by a qualifying corporate treasury centre	Worldwide taxable — S.15(1)(ia)

VIII Interest Income Derived from a Deposit34. **Interest income derived from a deposit in general**

There are three possible different tax treatments on source of interest income derived from a deposit placed with a financial institution. They are:

- interest income received on a deposit by an individual,
- interest income received on a deposit by a company which is not a financial institution, and
- interest income received on a deposit by a financial institution.

35. **Interest income received on a deposit by an individual**

As an individual is not treated as carrying on a trade or business by a passive act of putting deposit with a financial institution, the deposit interest income is not chargeable to profits tax.

36. **Interest income received on a deposit by a company not a financial institution**

Based on the provision of credit test, the deposit interest income is sourced at the place where the deposit is placed. This part may be divided into two parts as follows:

a. **Deposit placed with a financial institution outside Hong Kong**

Since the deposit is placed with an overseas financial institution, the deposit interest income is sourced outside Hong Kong. The interest is *exempt from profits tax*.

b. **Deposit placed with a financial institution in Hong Kong**

Since the deposit is placed with a financial institution in Hong Kong, the deposit interest income is sourced in Hong Kong. The interest is chargeable to profits tax. However, as a result of the Interest Income Exemption Order 1998, the interest income may not be liable for payment of profits tax.

- Deposit not used as a security for a loan – the interest income is *exempt from payment of profits tax*. This means that although the interest income is chargeable to profits tax, yet the Interest Income Exemption Order exempts the recipient of interest income from payment of profits tax.
- Deposit used as a security for a loan – the interest income is chargeable to profits tax as usual (since it is an onshore interest income).



37. **Distinction between exempt from profits tax and exempt from payment of profits tax**

“Exempt from profits tax” means that the income is sourced outside Hong Kong, and not chargeable to profits tax. “Exemption from payment of profits tax” means that the income is chargeable to profits tax, but the law allows the CIR not to collect the profits tax from the taxpayer. Nevertheless, the exemption from payment of profits tax may be uplifted, and then taxpayers have to pay profits tax on such chargeable income

38. **Interest income received on a deposit by a financial institution**

Under Section 15(1)(i), the interest income is chargeable no matter whether the interest income is sourced in Hong Kong or sourced outside Hong Kong. Readers have to be careful that the compromised package as in the case of interest income received from a loan by a financial institution does not apply to interest income derived from a deposit received by a financial institution. Such deposit interest income is always wholly chargeable to profits tax.

39. **Summary of taxation of interest income earned from a deposit**

Recipient	Place of Deposit and Use of Deposit		Chargeability
Not a financial institution	In Hong Kong	Deposit pledged for a loan	Taxable
		Deposit NOT pledged for a loan	Exempt from payment of profits tax
	Outside Hong Kong		Exempt from profits tax
Financial institution	In Hong Kong		Taxable
	Outside Hong Kong		Taxable

IX Royalty Income Received by a Business Carried on in Hong Kong

40. **Types of royalty income**

If a business carried on in Hong Kong receives royalty income, it is chargeable to profits tax under Section 14. There are three different methods of acquisition of an intellectual property. They are:

- a. development of intellectual property in Hong Kong,
- b. purchase of the proprietary right of an intellectual property, and
- c. licence of the right to use an intellectual property.

Intellectual property includes copyright, trademark, patent for a design and patent for a secret process.

41. **Development of intellectual property**

If an intellectual property is developed in Hong Kong, the source of royalty income derived from the use of that intellectual property is governed by development test. The royalty income is wholly chargeable to profits tax no matter where the intellectual property is used. For example, if an author writes a book in Hong Kong, and receives royalty income from a publisher for books sold overseas, that royalty income is fully chargeable to profits tax.

42. ***CIR v HK-TVB International Ltd. (1992)***

HK-TVB International Ltd. acquired films in Hong Kong, and granted sub-licences to overseas parties for the distribution of films outside Hong Kong. The Privy Council confirmed that the test used in the case for the determination of the source of profit on royalty income received was operations test. The source of profit was the place where the films were acquired, where the rights in the films were exploited, and where the films rights were granted. Where the films were distributed was not relevant.

43. **Purchase of the proprietary right of an intellectual property**

In this situation, the locality of the royalty income is at the place where the intellectual property is used. It is stated in paragraph 74 of DIPN 49 that if a person has purchased the proprietary interest of an intellectual property right (IPR) and licenses that IPR to another party for use outside Hong Kong, the royalties so derived will generally be regarded as non-Hong Kong sourced income and hence will not be subject to Hong Kong tax.

44. **Licence of the right to use an intellectual property**

According to paragraph 45(g) of DIPN 21 (revised in 2012) and paragraph 75 of DIPN 49 (issued in 2012), the locality of source of royalty income other than those deemed chargeable under Section 15(1)(a), (b) or (ba) is at the place of acquisition and granting of the licence or right to use. This applies to a person who merely obtains a licence to use from an owner. The source of profit is governed by operations test.

If a person only obtains a licence to use an IPR from its owner (i.e. the taxpayer has not obtained the proprietary interest of the IPR) and then sub-licenses the IPR to another party for use outside Hong Kong, the IRD will, generally, take the place of acquiring and granting the licence as the source of the income so received. IRD's view is that if either one is in Hong Kong, the royalty income is wholly chargeable to profits tax.

This is in line with the decision of *CIR v HK-TVB International Ltd. (1992)* 3 HKTC 301 and *Lam Soon Trademark Ltd. v CIR (2005)*.

45. ***Lam Soon Trademark Ltd. v CIR (2005)***

Lam Soon Trademark Ltd. was incorporated in the Cook Islands and was a part of the Lam Soon Group of Companies. Its principal activities were the acquisition of trademarks and the granting of licences to its related companies to use the trademarks in return for royalty income. The assessor raised profits tax assessment on the royalty income so received from the grant of licences for use of trademarks as the contracts took place in Hong Kong.

c. **Application of Section 15(1)(ba)**

If the profits derived from the sales of goods bearing the intellectual property (such as trademark) are chargeable to profits tax, the royalty expense will likely be deductible. In such situation, the royalty income received by the non-resident owner is chargeable to profits tax under Section 15(1)(ba). If the selling profit is offshore, and not chargeable to profits tax, the royalty income will not be caught by Section 15(1)(ba), and not chargeable to profits tax.

50. **Meaning of use of an intellectual property**

It was decided in *Emerson Radio Corporation v CIR* (1999) that the place of use of trademark and patent was the place of manufacturing of goods bearing such trademark or using such design or process. Thus, if goods bearing a brand name are produced outside Hong Kong, the intellectual property is used outside Hong Kong. As a result, the royalty income received may be sourced outside Hong Kong.

51. **Emerson Radio Corporation v CIR (1999)**

In that case, Emerson Radio Corporation (the taxpayer) owned trademarks and entered Royalty Agreement with its Hong Kong subsidiary called Emerson Radio (Hong Kong) Ltd ("Emerson HK") providing Emerson HK with the use of "Emerson" trademark on products sold to US customers. Emerson HK gave instructions to manufacturers in Hong Kong, China and South-east Asian countries to manufacture goods bearing "Emerson" name. All the goods were sold by Emerson HK to department stores outside Hong Kong. No goods were sold to Hong Kong customers.

It was decided in the Court of Final Appeal that the royalty income would be divided into two parts as follows:

- a. The royalty income received for the goods manufactured in Hong Kong was chargeable to profits tax under Section 15(1)(b).
- b. The royalty income received for the goods manufactured outside Hong Kong was not chargeable to profits tax as it was outside the charging scope of Section 15(1)(b).

After the decision of the case, Inland Revenue Ordinance was amended with the insertion of Section 15(1)(ba) to assess royalty income received for an intellectual property used outside Hong Kong if the royalty is a deductible expense of the payer under profits tax. The new law took effect on 25 June 2004.

52. **Determination of assessable profits for royalty received – Section 21A**

If royalty income is chargeable under Section 15(1)(a), (b) or (ba), the whole royalty is assessable under Section 21A if the following two conditions are *both* satisfied:

- a. the payer and the recipient are associated, and
- b. the intellectual property was once owned in Hong Kong.

If the aforesaid two conditions are not satisfied or only one condition is satisfied, the assessable profits are merely 30% of the royalty income accrued. [For royalty income accrued on or before 31 March 2003, the rate was 10%.]



XI Commission Arising from Provision of Guarantee Services

57. Different types of guarantee commission income

There are two types of guarantee commission income:

- a. Passive guarantee commission income
- b. Active guarantee commission income

58. Passive guarantee commission income — assumption of risk test

In such situation, the guarantor is not required to take any physical activity to earn the income. The mere promise of providing a guarantee, such as a repayment of money on loan through an undertaking, belongs to such category. If the guarantor receives a commission on the provision of such guarantee service, the source of the commission income is governed by the assumption of risk test.

If the loan being guaranteed arises in Hong Kong or the undertaking for repayment of loan is signed or enforceable in Hong Kong, the assumption of risk is in Hong Kong. Thus, the guarantee commission so received is chargeable to Hong Kong profits tax.

59. Active guarantee commission income — operations test

If the situation is that the guarantor has to do something to ensure that the success of the guarantee, the source of the commission income is governed by operations test. The source of guarantee commission is at the place where the guarantor provides activities to make the guarantee successful as in *Kwong Mile* case.

60. *Kwong Mile Services Limited v CIR (2004)*

In this case, the taxpayer provided a guarantee service to a development project in Guangzhou. It guaranteed the sales proceeds of the flats to a certain amount. Although the project was in Guangzhou, all the purchasers were Hong Kong residents, and all the advertisement was done in Hong Kong to promote the sale.

The main issue in this case is whether the source of income arising from such transactions is derived from:

- a. the location of the property which is the subject matter being provided with guarantee service, or
- b. the place where the advertisement and promotion of sale activities are carried out to achieve the level of earnings being guaranteed.

The Board of Review decided (by a majority of 2:1) that the source was derived from the place where the property being guaranteed situated. The CIR lodged an appeal to the Court of First Instance, and the judge ruled in favour of the CIR. The judge's reason was that the commission income was derived from the marketing activities carried out in Hong Kong. In the absence of such activities, the taxpayer would not be able to earn the commission.

The taxpayer lodged an appeal to the Court of Appeal which also ruled in favour of the CIR. The taxpayer then lodged an appeal to the Court of Final Appeal which upheld the decision of the Court of Appeal.

XII E-commerce

61. Tax neutrality for e-commerce transactions

The Commissioner issued DIPN 39 in July 2001 explaining the IRD's viewpoint on the taxation of electronic transactions. The theme of the DIPN is that electronic transactions or internet transactions are merely a means of communication, and it is neutral to the chargeability of tax on electronic transactions.

62. Traditional source rules applicable to electronic transactions

What the IRD looks for in the determination of source of profit derived from electronic transactions is the substance that is being manufactured, traded or provided with services. IRD would rely on the traditional principles to determine the source of profit done through internet. The proper approach is to ascertain what the taxpayer has done to earn the profit and where he has done it. In other words, it is required to ascertain what activities are done by the taxpayer to give rise to the profit.

Products manufactured in Hong Kong but sold to overseas customers via internet are taxable in Hong Kong. The source of profits on goods sold through internet depends on the work done to initiate and completion of the sales including the procurement of goods, the supply of information for the server, the storage of goods, the physical delivery of goods, the answering of customers' enquiries and the operational controls of the virtual shop-front.

XIII Qualifying Debt Instruments – Section 14A

63. Section 14A was enacted on 24 May 1996 and revised in 1998 and 2003. The section provides a preferential profits tax treatment on sums (including interest, gain on disposal, redemption on maturity or presentment of the debt instrument) received in respect of medium term qualifying debt instruments by taxing the gain (after deducting outgoings and expenses) at half of the standard rate or corporate rate as the case may be. For long term debt instrument (maturity period not less than 7 years) issued on or after 5 March 2003, the income is fully exempt under Sections 26A(1)(h) and (i).

64. Definition of "debt instrument"

Section 14A(4) defines "debt instrument" to mean an instrument that –

- a. has been lodged with and cleared by the Central Moneymarket Unit operated by the Monetary Authority;
- b. is issued by a person with a credit rating acceptable to the Monetary Authority;
- c. has –
 - i. where it is issued before 1 April 1999, a minimum denomination of \$500,000 or its equivalent in a foreign currency; or
 - ii. where it is issued on or after 1 April 1999, a minimum denomination of \$50,000 or its equivalent in a foreign currency;
- d. is issued to the public in Hong Kong.

Industrial Building

Learning Objectives

After having studied this chapter, you would:

- understand the definition of “industrial building”;
- understand how to determine the cost of construction, initial allowance and annual allowance for industrial building;
- understand how to compute the balancing allowance and balancing charge for industrial building;
- understand how to compute annual allowance for second-hand acquired industrial building; and
- understand how to distinguish the different tax treatment on capital expenditure incurred on improvement and refurbishment.

I Introduction

- The depreciation allowance in respect of plant and machinery is not applicable to a building or structure of a building. The major distinction between “plant and machinery” and “building or structure of a building” is that plant and machinery is movable while a building or structure is not movable. The depreciation allowance applicable to plant and machinery is more generous than that applicable to a building or structure.
- There are two kinds of depreciation allowance applicable to a building or structure, namely industrial building allowance (工業建築物折舊免稅額) and commercial building allowance (商業建築物折舊免稅額). Industrial building allowance is applicable to an industrial building (as defined in Section 40) or structure attached to that building. Commercial building allowance is applicable to a building or structure of a building not entitled to industrial building allowance. Therefore, commercial building allowance is also applicable to domestic or residential buildings. For example, the cost incurred for construction of quarters for a company’s employees or directors is entitled to commercial building allowance.
- The major distinction between industrial building allowance and commercial building allowance is that both initial allowance and annual allowance are granted under industrial building allowance while only annual allowance is granted under commercial building allowance.

II Industrial Building Allowance

- The grant of industrial building allowance depends on the following three factors:
 - the building is used for the purpose of producing chargeable profits as required under Section 18F(1),
 - the nature of the trade carried on in the property – Section 40, and
 - the amount of cost of construction incurred.



III Building Qualified for Industrial Building Allowance

5. Definition of "industrial building"

Section 40(1) defines an "industrial building" as any building or structure or part of it used:

- a. for the purposes of a trade carried on in a mill, factory or other similar premises; or
- b. for the purposes of a transport, tunnel, dock, water, gas or electricity undertaking or a public telephonic or public telegraphic service; or
- c. for the purposes of a trade which consists of the manufacture of goods or materials or the subjection of goods or materials to any process; or
- d. for the purposes of a trade which consists in the storage –
 - i. of goods or materials which are to be used in the manufacture of other goods or materials; or
 - ii. of goods or materials which are to be subjected in the course of a trade to any process; or
 - iii. of goods or materials on their arrival into Hong Kong; or
- e. for the purposes of the business of farming; or
- f. for the purposes of research and development related to any trade, profession or business.

6. Definition of "structure"

IRO does not define the meaning of "structure", but "structure" usually includes the following:

- a. walls,
- b. bridges,
- c. dams,
- d. fish-ponds,
- e. banks around paddy fields,
- f. constructed parking grounds,
- g. roads,
- h. boreholes and wells,
- i. sewers,
- j. water mains and tunnel linings,
- k. wharves,
- l. acoustic tile ceiling (installed as an integral part of a building),
- m. ceiling light points,
- n. cocklofts,
- o. formica wall panelling (installed as an integral part of a building),
- p. telephone cable and wiring (installed as an integral part of a building), and
- q. wiring and electrical fixtures and fittings (installed as an integral part of a building).

7. Structure not qualified for industrial building allowance

Section 40(1) provides that "industrial building or structure" does not include any building or structure or part of any building or structure used for the following purposes:

- a. dwelling house (other than as a dwelling house for the housing of manual workers),
- b. retail shops,
- c. showroom,
- d. hotel, or
- e. office.

8. 10% rule on non-qualifying part of industrial building

- a. If the non-qualifying part for the use as an industrial building does not exceed one-tenth of the industrial building, the expenditure incurred on the non-qualifying part is still entitled to industrial building allowance.
- b. If the non-qualifying part exceeds one-tenth of the industrial building, the cost of construction will be divided into two parts. One part is granted with industrial building allowance while the remaining non-qualifying part is granted with commercial building allowance.

IV Determination of Cost of Construction and Initial Allowance

9. Initial allowance (首年折舊免稅額 或 初期折舊免稅額)

- a. When a person incurs capital expenditure on the construction of a building or structure which is to be an industrial building (i.e. within the definition of "industrial building" as defined in Section 40), he or she is entitled to an initial allowance of 20% on the cost of construction for the year of assessment in the basis period in which the expenditure was incurred – Section 34(1).
- b. Initial allowance is granted no matter whether the building is in use or not in use during the basis period of that year of assessment.

10. Definition of "cost of construction" (建築成本)

- a. Capital expenditure does not only mean the actual construction cost, but interest expense etc. incurred before the completion of the building. Section 40(1) defines capital expenditure to:
 - i. *include* interest paid and commitment fees incurred in respect of a loan made for the sole purpose of financing the provision of an industrial building or structure or commercial building or structure or machinery or plant; but
 - ii. *not include* expenditure which is reimbursed by way of or attributable to any grant, subsidy or similar financial assistance.



- b. Cost of construction does not include the following expenses:
 - i. cost of land,
 - ii. demolition of the old building erected on the site, and
 - iii. cost of levelling the ground.

11. Payment of capital expenditure by instalments (not mortgage loan)

- a. When the cost of construction is paid by instalment, initial allowance is granted in accordance with the amounts actually due for payment in a year of assessment.
- b. Readers have to pay attention to the distinction between payment by instalments and payment financed by a mortgage loan. If the purchase consideration or cost of construction of a building or structure is financed by a bank mortgage loan, the building or structure is treated as having been acquired for cash by the purchaser, and initial allowance of 20% on the whole consideration is granted to the purchaser in the year of acquisition. The mortgage interest is included as part of the cost of construction if the building or structure is not yet in use. If the building is in use, the interest expenses are deductible from the assessable profits.

12. Purchase of an unused industrial building

- a. When a company incurs capital expenditure on the construction of an industrial building, it is entitled to initial allowance of industrial building allowance. However, if the company sells the building to another person without using that building, the initial allowance granted to the seller will be withdrawn, and an additional assessment is issued to recover the initial allowance granted.
- b. The purchaser of an unused industrial building is deemed to have incurred capital expenditure equal to the amount of the construction expenditure incurred by the seller for the construction of the building or the net price paid by the purchaser, whichever is the less.

13. Purchase of unused industrial building from a seller who is a developer (發展商)

- a. Section 35B(b)(i) provides that when a person purchases an unused industrial building or a flat in an industrial building from a company which is carrying on a business of a property developer, the purchaser is not only entitled to the capital expenditure actually incurred by the seller but the profit made from the sale of the building or flat for the purpose of industrial building allowance, or the net price paid by the purchaser, whichever is the less. Nevertheless, the cost of land and profits attributable to the land are still excluded from the cost of construction which is entitled to industrial building allowance.

b. Example 30.1

A Ltd. purchased an industrial flat from a developer at a price of \$2,400,000. The developer incurred building cost and land cost of \$800,000 and \$700,000 respectively.

REQUIRED:

Compute the cost of construction which A Ltd. is entitled for industrial building allowance purposes.

Solution

As A Ltd. purchased the flat from a developer, it is entitled to the share of profit attributable to the cost of construction for claiming industrial building allowance.

$$\begin{aligned}\text{Cost of construction} &= \$2,400,000 \times \frac{\$800,000}{\$800,000 + \$700,000} \\ &= \underline{\underline{\$1,280,000}}\end{aligned}$$

Note: Although the actual cost of construction incurred by the developer is \$800,000 only, A Ltd. is entitled to cost of construction for \$1,280,000 (including the developer's share of profit in the flat) because A Ltd. purchased the flat from a developer.

14. **Purchase of unused industrial building from a seller who is not a developer**

a. Section 35B(b)(ii) provides that when a person purchases an unused industrial building or a flat in an industrial building from a company which is *not carrying on a business of a property developer*, the purchaser is entitled to the capital expenditure *actually* incurred by the seller for the purpose of industrial building allowance, or the net price paid by the purchaser, whichever is the less.

b. **Example 30.2**

B Ltd. is a toy manufacturer which employed a contractor to construct an industrial building for the expansion of its business. It incurred \$100,000,000 for the construction of the industrial building. After the completion of the construction of the building, B Ltd. decided to move its production lines to the Mainland. B Ltd. sold the whole industrial building to C Ltd. at a price of \$180,000,000 out of which one-third was the cost of the land on which the industrial building was erected.

REQUIRED:

Compute the cost of construction which C Ltd. is entitled for industrial building allowance purposes.

Solution

As C Ltd. did not purchase the industrial building from a developer, it is not entitled to the share of profit of \$20,000,000 (i.e. \$180,000,000 \times $\frac{2}{3}$ - \$100,000,000) attributable to the actual cost of construction for claiming industrial building allowance. C Ltd. is entitled to the cost of construction of \$100,000,000 only (i.e. the actual cost of construction incurred by B Ltd.).

15. **A series of sales and purchases before the building is in use (一連串的買賣)**

a. Section 35B(b) proviso (a) provides that in the event that there has been more than one sale before the building is first in use, only the final purchaser who actually uses the building for a qualifying purpose is entitled to industrial building allowance. The capital expenditure is equal to either the net price paid on the first sale or the net price paid by the purchaser, whichever is the less.



b. **Example 30.3**

D Ltd. is a developer which constructed an industrial building. It sold an industrial flat to E Ltd. at a price of \$2,000,000. Before the building was put into use, E Ltd. sold the flat to F Ltd. at a price of \$2,200,000. Again before the building was put into use, F Ltd. sold the building to G Ltd. at a price of \$2,300,000. G Ltd. put the building for industrial use. Assume that half of the prices for all the transactions are attributable to the cost of construction.

REQUIRED:

Compute the cost of construction which G Ltd. is entitled for industrial building allowance purposes.

Solution

The cost of construction paid for the first sale, E Ltd.	<u>\$1,000,000</u>
The cost of construction paid by the ultimate user, G Ltd.	<u>\$1,150,000</u>
The cost of construction G Ltd. is entitled to	<u>\$1,000,000</u>

Note: The cost of construction that the ultimate user is entitled to the lower of the price paid for the first sale from the developer and the price paid by the ultimate first user, and \$1,000,000 is the lower figure.

c. **Example 30.4**

Facts are same as those of Example 30.3 except that F Ltd. sold the building to G Ltd. at a price of \$1,800,000.

REQUIRED:

Compute the cost of construction which G Ltd. is entitled for industrial building allowance purposes.

Solution

The cost of construction paid for the first sale, E Ltd.	<u>\$1,000,000</u>
The cost of construction paid by the ultimate user, G Ltd.	<u>\$900,000</u>
The cost of construction G Ltd. is entitled to	<u>\$900,000</u>

Note: The cost of construction that the ultimate user is entitled to is the lower of the price paid for the first sale from the developer and the price paid by the ultimate first user, and \$900,000 is the lower figure.

16. **Withdrawal of initial allowance**

In case a person incurred capital expenditure on an industrial building or structure and was granted with initial allowance on industrial building, but the building was sold to another person before it was in use, the IRD will withdraw the initial allowance so granted, and issue an additional assessment to recover the tax – Section 34(1) proviso (b).

17. **Cost of construction incurred by a tenant (租客支出建築費用)**

- a. If a tenant, carrying on a qualifying trade or business under Section 40(1), incurs capital expenditure on the decoration or improvement of an industrial building or a flat in an industrial building, the tenant is entitled to industrial building allowance on the capital expenditure on which he or she incurred although he or she is not the owner of the industrial building or flat. However, the tenant is not entitled to the capital expenditure incurred by the owner of the industrial building or flat.

b. **Example 30.5**

On 1 May 2013, H Ltd. purchased an unused industrial flat from a developer at a price of \$3,000,000 (one-third of the price is attributable to the cost of land). Before putting the building into use, H Ltd. leased the flat to K Ltd. The tenant, K Ltd., incurred \$250,000 on the decoration and fixture on the industrial flat on 1 July 2013. Both companies close their accounts on 31 March each year.

REQUIRED:

Compute the cost of construction that H Ltd. and K Ltd. are entitled for industrial building allowance purposes.

Solution

- i. H Ltd. is entitled to cost of construction of \$2,000,000 ($\$3,000,000 \times \frac{2}{3}$).
- ii. K Ltd. is entitled to cost of construction of \$250,000.

V Annual Allowance (每年折舊免稅額) on Cost of Construction

18. When a person owns a building or structure which is used as an industrial building or structure at the end of the basis period for a year of assessment, he or she is entitled to an annual allowance for the year of assessment, which is equal to 4% on the cost of construction of the building – Section 34(2)(a). The annual allowance of 4% is on a straight line basis, not on a reduced balance as that of plant and machinery.

19. **Example 30.6**

L Ltd. purchased an unused industrial flat from a developer at a price of \$2,400,000 (one-third of the price is attributable to the cost of land). Before putting the building into use, L Ltd. incurred \$180,000 on the decoration and fixture on the industrial flat.

REQUIRED:

Compute the industrial building allowance that L Ltd. is entitled.

Solution

The cost of construction paid by L Ltd.

$(\$2,400,000 \times \frac{2}{3})$	\$1,600,000
Add: Cost of decoration and fixtures	<u>180,000</u>
The cost of construction L Ltd. is entitled to	<u>\$1,780,000</u>
Initial allowance $\$1,780,000 \times 20\%$	<u>\$356,000</u>
Annual allowance $\$1,780,000 \times 4\%$	<u>\$71,200</u>



20. **Example 30.7**

Following the facts of Example 30.5, the industrial building allowance for the landlord (H Ltd.) and tenant (K Ltd.) for the year of assessment 2013/14 are as follows:

Solution

	<u>Landlord</u>	<u>Tenant</u>
Cost of construction	\$2,000,000	\$250,000
Initial allowance	\$400,000	\$50,000
Annual allowance	\$80,000	\$10,000

21. If, in any year of assessment, the owner is not qualified for an annual allowance under industrial building allowance (e.g., the building is not used as an industrial building nor as a commercial building at the end of the basis period), a notional allowance calculated at 4% on the cost of construction of the building is deducted from the written down value – Section 40(1).

VI Balancing Allowance / Balancing Charge

22. **Disposal of an industrial building**

- a. Section 35(1) provides that where a building or structure is sold, demolished, destroyed or ceased altogether to be used while it is an industrial building or structure, it results with a balancing allowance or a balancing charge as the case may be.

b. **Balancing allowance**

If the written down value exceeds the sale, insurance, salvage or compensation money received, a balancing allowance will appear. The taxpayer may deduct the balancing allowance from the assessable profits.

Written down value – Sales proceeds = Balancing allowance

(If there is no sales proceeds, the balancing allowance is equal to the written down value.)

c. **Balancing charge**

- i. If the sale, insurance, salvage or compensation money received exceeds the written down value, a balancing charge will appear. The taxpayer is assessable on the balancing charge.

Sales proceeds – Written down value = Balancing charge

(If the written down value is zero, the balancing charge is equal to sales proceeds.)

- ii. Section 35(3)(b) provides that the balancing charge cannot exceed the industrial building allowance and commercial building allowance granted under Sections 33A and 34.

23. **Example 30.8**

Sunny Textiles Ltd. constructed a factory at a cost (excluding site) of \$30,000,000. It was completed and brought into use in March 2013. The building contract provided that instalments should be paid monthly, on an architect's certificate, and \$6,000,000 was due and paid before 31 December 2012 while the remainder was paid in February 2013.

Sunny Textiles Ltd. has carried on a qualifying trade since 1964, and makes up accounts to 31 December each year.

The factory is sold to Bright Ltd. who has been carrying on a qualifying trade for some years, on 31 July 2016, for \$100,000,000 including site. Bright Ltd. makes up accounts to 30 June each year. The value of the site as at 31 July 2016 was \$38,000,000.

REQUIRED:

Compute the industrial building allowance that Sunny Textiles Ltd. may claim.

Solution

Industrial Building Allowance		\$
Cost on instalment		6,000,000
Less: Initial allowance for 2012/13 ($\$6,000,000 \times 20\%$)		1,200,000
(No Annual allowance because the building was not in use in 2012/13)		<u>4,800,000</u>
Cost on the remainder	24,000,000	
Less: Initial allowance for 2013/14 ($\$24,000,000 \times 20\%$)	<u>4,800,000</u>	19,200,000
		<u>24,000,000</u>
Less: Annual allowance for 2013/14 to 2015/16 ($\$30,000,000 \times 4\% \times 3$)		3,600,000
Written down value		<u>20,400,000</u>
Sale price in 2016/17 ($\$100,000,000 - 38,000,000$)		62,000,000
Excess		<u>41,600,000</u>
Balancing charge in 2016/17 (restricted to allowance given)		<u><u>9,600,000</u></u>

24. **Balancing allowance for a tenant on the termination of a lease**

If a tenant terminates a lease, and incurred capital expenditure at the time of commencement or during the term of the lease, the tenant is entitled to a balancing allowance on the written down value of the capital expenditure so incurred unless the tenant receives compensation money which exceeds the aforesaid written down value.

25. **Example 30.9**

Data are the same as in Examples 30.5 and 30.7. K Ltd. terminated the lease on 30 June 2017, and moved out from the flat without receiving any compensation money for the removal.

REQUIRED:

Compute the industrial building allowance for H Ltd. and K Ltd. for the year of assessment 2017/18.

Solution

H Ltd.

Annual allowance = \$80,000 in the capacity of the landlord



K Ltd.

Capital expenditure (cost of construction)		\$250,000
Less: Initial allowance (\$250,000 × 20%)	\$50,000	
Annual allowance (\$250,000 × 4% × 4)	40,000	90,000
Balancing allowance (= written down value)		<u>\$160,000</u>

[For K Ltd., capital expenditure was incurred in the year of assessment 2013/14, and the disposal was in the year of assessment 2017/18. Thus, annual allowance is for four years, from 2013/14 to 2016/17 (no annual allowance in the year of disposal).]

VII Purchase of Second-hand Industrial Building

26. Under Section 34(2)(b), if a building or structure (which was first used after the year of assessment 1964/65) is sold while it is used as an industrial building or structure, the purchaser is entitled to an annual allowance only (but not initial allowance), which is calculated as follows:

$$\text{Annual allowance} = \text{Residue of expenditure} \times \frac{1}{\text{No. of years from the first year that the purchaser is entitled to IBA to the 25}^{\text{th}} \text{ year after the year of first use of the building}}$$

$$\text{Residue of expenditure} = \text{Written down value} + \text{Balancing charge} \\ \text{(or less Balancing allowance)}$$

$$\text{Year of first use} = \text{The year of assessment (i.e., counted from 1 April to the following 31 March) in which the building or structure was first in use}$$

27. Residue of expenditure for industrial building (工業建築物開支剩餘額)

- With effect from the year of assessment 2004/05, the annual allowance of industrial building and commercial building are merged in the calculation of residue of expenditure.
- Sections 35 and 40 were amended in June 2004. Before that, the calculation of annual allowance and residue of expenditure of industrial building allowance and those of commercial building allowance were under two completely separate schemes. In order to avoid the confusion on the calculation of annual allowance when a building was used for industrial purpose and commercial purpose at different periods, with effect from 2004/05, the annual allowance granted under commercial building allowance is also taken into account in the calculation of residue of expenditure purpose. In this way, the balancing allowance may be reduced while the balancing charge may be increased.

- Section 40(1) defines "residue of expenditure" in relation to an industrial building or structure as follows:

"the amount of the capital expenditure incurred on the construction of the building or structure reduced by –

- the amount of any initial allowance made under Section 34(1) in respect of any year of assessment commencing on or after 1 April 1998;
- the amount of any annual allowance made under Section 33A or 34(2) in respect of any year of assessment commencing on or after 1 April 1998;
- the amount of any balancing allowance made under Section 35,

and **increased** by the amount of any balancing charge made under Section 35:

Provided that in computing the residue of expenditure, there shall be written off, in respect of any **year** in which no allowance fell to be made under Section 33A or 34, an amount of one-**twenty**-fifth of the capital expenditure, and for the purposes of this proviso "year" means the **period** which would have comprised a year of assessment commencing on 1 April 1998 or any **subsequent** year of assessment in respect of which an annual allowance would have fallen to **be** made under Section 33A if the building or structure had been in use as a commercial **building** or structure."

- d. In **simple** terms, residue of expenditure for industrial building or structure is calculated as follows:

Capital expenditure (cost of construction)		A	
Less: Initial allowance granted under IBA	B		
Annual allowance granted under IBA & CBA	C	D	
Written down value		E	
Less: Balancing allowance		F	
		G	
Add: Balancing charge		H	
		I	

In each case, either balancing allowance or balancing charge exists, not both.

28. Example 30.10

Data are the same as in Example 30.8, and you are required to calculate the industrial building allowance that Bright Ltd. may claim.

Written down value	\$20,400,000
Add: Balancing charge	\$9,600,000
Residue of expenditure	\$30,000,000

Year of first use (March 2013) = 2012/13
 25th year after year of first use = 2037/38 (a)
 First year of allowance to Bright Ltd. = 2017/18 (b)
 (i.e., year ended 30 June 2017)

Number of years between (a) and (b) inclusive = 21

Annual allowance for 2017/18 onwards = $\frac{\$30,000,000}{21} = \underline{\underline{\$1,428,571 \text{ p.a.}}}$

Final year of allowance is 2037/38, and the annual allowance for that year
 = $\$30,000,000 - (\$1,428,571 \times 20) = \underline{\underline{\$1,428,580}}$



29. The key to success in this type of industrial building allowance question is to find out the following items step by step:
- a. the written down value,
 - b. the residue of expenditure,
 - c. the year of first use of the building,
 - d. the 25th year after the year of first use,
 - e. the first year that the purchaser is entitled to industrial building allowance,
 - f. the number of years between the first year that the purchaser is entitled to industrial building allowance and the 25th year after the year of first use of the building (both years are inclusive).

VIII Distinction of Capital Expenditure Incurred on Improvement and Refurbishment to an Industrial Building or Structure

30. **Improvement (改進方面的開支) to an industrial building or structure**

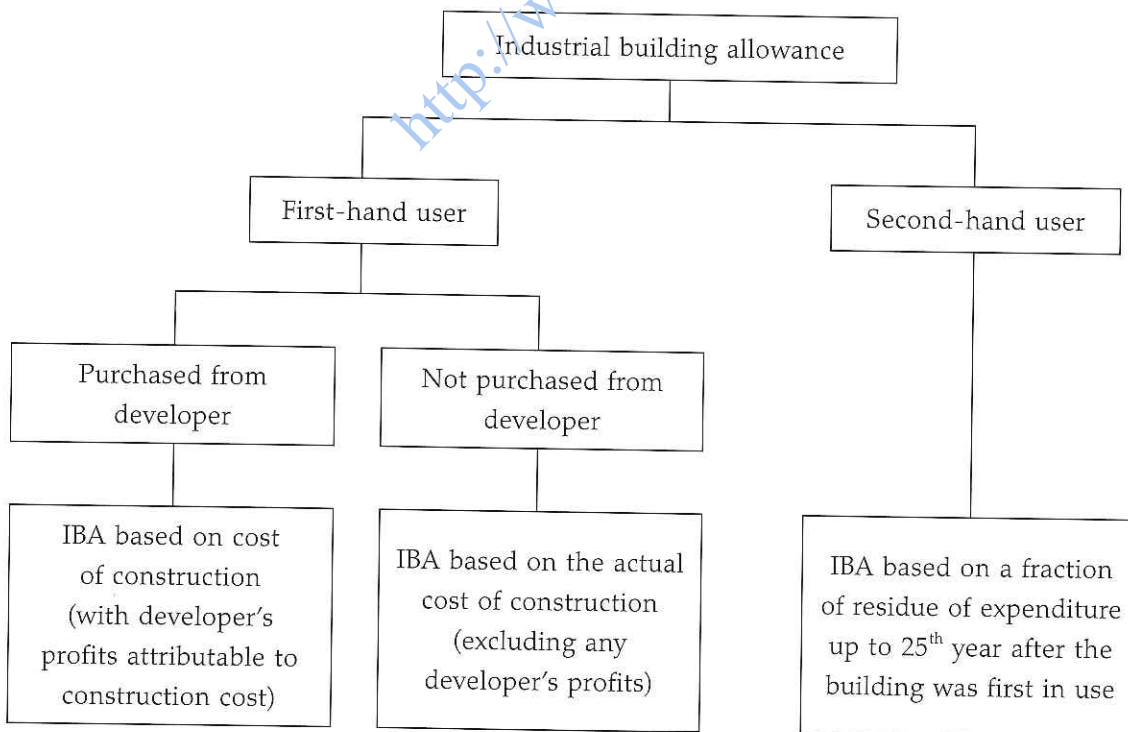
Improvement expenditure to an industrial building or structure is of capital nature, and only industrial building allowance is granted for such expenditure.

31. **Refurbishment (翻修建築物的開支) to an industrial building or structure**

The tax treatment of refurbishment is different from that of improvement. Although refurbishment is a capital expenditure, it is deductible in five equal annual instalments under Section 16F. Such treatment is much more beneficial to the grant of industrial building allowance.

IX Concept Map

Distinction between First-hand User and Second-hand User





Questions to test your knowledge

- a. Explain the definition of "industrial building".
- b. Explain how to determine the cost of construction, initial allowance and annual allowance for industrial building.
- c. Explain how to compute the balancing allowance and balancing charge for industrial building.
- d. Explain how to compute annual allowance for second-hand acquired industrial building.
- e. Explain how to distinguish the different tax treatment on capital expenditure incurred on improvement and refurbishment.

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