[¶1-2500] Provisional tax

Any taxpayer chargeable to property tax, salaries tax or profits tax, is liable to pay provisional tax. The amount of provisional tax payable is calculated by reference to the taxpayer's net chargeable income, assessable profits or, in the case of provisional property tax, the net assessable value of his or her property, in the previous year.

For more on provisional tax, refer to Chapter 9 (¶9-8000ff).

[¶1-2700] Personal assessment

Although taxation in Hong Kong is levied under three distinct and separate headings, an individual who is either a temporary resident or ordinarily resides in Hong Kong may elect for "personal assessment" (see ¶4-0200). When a taxpayer elects to be assessed under personal assessment, his or her total income (ie from salary, property, etc) is subject to a sliding scale of taxes.

Apart from the advantages of the graduated scale of taxation which applies under personal assessment, the taxpayer will be able to claim personal allowances which may not otherwise be available. For example, a taxpayer in receipt of income subject only to profits tax will not be entitled to claim these family allowances if he or she does not elect for personal assessment.

Calculation of "total income"

The taxpayer's "total income" is calculated by aggregating:

- net assessable value subject to property tax;
- net assessable income subject to salaries tax; and
- assessable profits liable to profits tax (see 4-3500ff).

Deductions are available for the following items:

- *Concessionary deductions*. Prescribed under Pt IVA of the Ordinance, deductions are available for: charitable donations (see ¶2-6450); elderly residential care expenses (see ¶2-6550); home loan interest (see ¶2-6700); and contributions to recognised retirement schemes (see ¶2-6900). With effect from the year of assessment 2019/20, deductions are also available for: health insurance premiums (see ¶2-7000); qualifying annuity premiums (see ¶2-7020); and tax deductible MPF voluntary contributions (see ¶2-7030).

  For details of the scope of deductions available refer to the paragraphs indicated in Chapter 2.

- *Interest*. Interest payable on money borrowed for the purpose of producing income subject to property tax, provided that the amount of such interest has not been permitted as a deduction in arriving at the net chargeable income subject to profits tax (see ¶4-5000).

- *Losses*. Any loss or share of a loss incurred in the course of carrying on any trade, business or profession is deductible. To the extent that losses exceed the taxpayer's total income, the amount of the loss may be carried forward and set off against income in future years (see ¶4-5500).

- *Allowances*. A taxpayer making an election for personal assessment is entitled to various personal allowances (see ¶4-6500).

For more on personal assessment, refer to Chapter 4 (¶4-0200ff).

Preservation of business records

A taxpayer must retain all records relating to any trade, profession or business carried on in Hong Kong for a period of not less than seven years after the completion of the transactions. The Commissioner may consent to a shorter retention period in special circumstances (see ¶9-4500).

For more on the Ordinance's provision of information requirements, see ¶9-0100ff.

[¶1-3300] Duties of "representatives"

Incapacitated persons

When a taxpayer is incapacitated, the trustee of the taxpayer is responsible for fulfilling the requirements of the Ordinance on behalf of the taxpayer (see ¶9-3800).

Non-residents

The primary obligation to comply with the provisions of the Ordinances rests with the non-resident but an agent of a non-resident is also liable to ensure compliance by his or her non-resident principal (see ¶9-3800).

Executors

An executor of a deceased's estate is liable in his or her capacity as executor, but is not personally liable, to discharge any liability to tax which the deceased may have incurred prior to the date of death. Furthermore, an executor is obliged to ensure compliance with the Ordinance in exactly the same way as the deceased would be if he or she were alive (see ¶9-3900).

Partnerships

The "precedent partner" of any partnership is primarily responsible for ensuring that the provisions of the Ordinance are complied with (see ¶9-4000).

Corporations

The responsibility for observance of the various statutory requirements rests on all the officers of the corporation, including the secretary, manager, any director or, in appropriate circumstances, a liquidator. If none of these office bearers are ordinarily resident in Hong Kong, the corporation is obliged to inform the Commissioner of the name of a "resident" who is responsible for ensuring compliance with the Ordinance (see ¶9-4200).

Joint/Co-owners

Where there is more than one owner of land or building, all persons appearing on the records maintained at the Land Registry are responsible for discharging the liabilities and obligations imposed by the Ordinance (see ¶9-4100).

[¶1-3500] Objections and appeals

A taxpayer who is dissatisfied with an assessment, and who wishes to object to that assessment, must lodge a notice of objection (which must be in writing) to the Commissioner within one month after the date of the notice of assessment. The Commissioner has power to extend this time period when he is satisfied that circumstances beyond the taxpayer's control (eg sickness or absence from Hong Kong) prevented an objection from being lodged within the prescribed period. The taxpayer's notice must clearly state, in as much detail as possible, the grounds upon which the objection is based.

In considering any objection, the Commissioner has power to call for further information and may compel any person who is able to give any useful evidence in respect of the assessment to attend for examination. The taxpayer lodging the objection has the right

United Kingdom authority

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

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

Termination payments

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

A termination payment constitutes taxable "income" only if it relates to the services rendered by the taxpayer during his or her employment. A termination payment which has been pre-arranged as part of the terms of employment may be regarded as a deferred payment for services rendered and, therefore, taxable income (*Henry v Foster* 16 TC 605).

The Court of First Instance in *Fuchs, Walter Alfred Heinz v Commissioner of Inland Revenue* (2009) HKRC ¶90-209 adopted the following approach in determining the taxability of the termination payments:

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

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

(iii) However, if it could be shown that the payment was truly compensation for loss of office or damages for breach of contract, it would not be assessable.

(iv) Damages for breach would logically not be provided for in the contract.

The taxpayer's appeal to the Court of Final Appeal in *Fuchs, Walter Alfred Heinz v Commissioner of Inland Revenue* (2010) HKRC ¶90-234 was dismissed. The Court held that the payments to the taxpayer were paid in satisfaction of the rights which accrued to the taxpayer under a clause in the employment contract and were plainly amounts derived from his employment. They were not sums paid in consideration of the abrogation of the taxpayer's rights under the employment contract.

The taxpayer's employment was terminated by a letter dated 12 January 2001 ("Termination Letter") and the taxpayer was offered severance payment equal to 12 months base salary ("Sum A"). The Termination Letter required the taxpayer to sign a "Severance Agreement and Release" ("Severance Agreement") agreeing to certain restrictive covenants, including to refrain from recruiting or soliciting any customers and employees of the Company. Any breach of the covenants may result in the cessation of payments to the taxpayer and the recovery of payments made previously by the employer.

The majority of the Board took the view that Sum A under the Employment Letter was only payable if there was termination of the taxpayer's assignment and if there were not any reassignment of the taxpayer within the AC Nielsen Group. Consequently, the majority of the Board held that the taxpayer's entitlement of Sum A was wholly dependent on the cessation of his employment with AC Nielsen. Further, the Severance Agreement did not impose any obligation on the taxpayer to render any service in favour of AC Nielsen.

The Court of First Instance considered that the Board had not expressly dealt with the more pertinent question of whether Sum A was an inducement to the taxpayer entering into employment. Although it was correct that Sum A would not be payable unless the employment was terminated and no reassignment offered, the taxpayer may also be entitled to such payment as *an insurance policy for peace of mind* which may act as an inducement for the taxpayer to enter into employment.

In determining what part of Sum A was income chargeable subject to salaries tax, the Court of First Instance examined more closely the "insurance policy for peace-of-mind" and found that it was the offer of reassignment of Sum A at the option of the employer ("the offer"). Thus, if there was an inducement to enter into employment, it was not Sum A, but rather the offer. Further, the taxable amount was the value of the offer to the taxpayer as an inducement and not Sum A itself. The Court noted that placing a monetary value on the offer was difficult. It was necessary to apportion Sum A and for this purpose, the Court needed to put a value on the offer as the inducement. Taking all circumstances from the Employment Letter to the actual payment of Sum A into consideration, the Court concluded that a reasonable value would be 10% of Sum A as the inducement to enter into employment. It was common ground that this would be subject to further apportionment depending on the number of days of service performed in Hong Kong during the taxpayer's employment.

Another case where the termination payment was not accepted as fully non-taxable was *Commissioner of Inland Revenue* v *Elliot* (2005) HKRC ¶90-170). In this case, the taxpayer was entitled to an Incentive Compensation Plan ("ICP") under an employment agreement where he was to be awarded 5,000,000 ICP units following to the effective date of the employment agreement. He would also be entitled up to 3,000,000 ICP units two years after the effective date of the employment agreement.

On 12 June 1997, the taxpayer was requested to resign and a termination agreement dated 12 June 1997 ("the Termination Agreement") was signed. Under the Termination Agreement, the taxpayer agreed, among other things, to the cancellation of his ICP units for a payment of US$11 million ("the Sum") to be paid no later than 12 July 1997.

The Court of First Instance found that the 5M Units formed part and parcel of the taxpayer's remuneration package under the employment agreement. The 5M Units would entitle the taxpayer to annual payments or a lump sum payment in lieu and as such, the 5M Units were an inducement to the taxpayer to enter into the employment agreement. The Court agreed with the Board's finding that one portion of the Sum was attributed to the cancellation of the 5M Units and the other was for the abrogation of his rights to the Future Units.

The Court, however, further found that the sum which was attributable to the cancellation of the 5M Units included a sum representing the value of the inducement, which was

employees are responsible for getting themselves to their place of employment and that the expenses incurred to do so are private expenses which are not the employer's concern (*Case* C11 (1993) 1 HKRC ¶80-220 (*D35/92*) referring to *Commissioner of Inland Revenue* v *Humphrey* (1970) 1 HKTC 451). Travel expenses that have been incurred in the performance of duties are only deductible if they have been incurred as a practical necessity rather than as a matter of convenience (*D25/87* IRBRD Vol 2, 400).

If vehicle expenses are claimed by a taxpayer, regard is to whether the amount claimed is reasonable considering the available alternatives (eg public transport). When vehicle expenses are partly incurred for the taxpayer's employment, and partly for the taxpayer's private or domestic use of the vehicle, only the former is deductible.

The onus is on the taxpayer to prove the quantum of the travel expenses claimed for deduction. Rough estimates are not acceptable. The taxpayer must be able to provide, with reasonable precision, details of the expenditure claimed for deduction. Taxpayers should keep contemporaneous records of their travelling expenses as well as retaining vouchers in order to verify deduction claims (*Case* D33 (1994) 1 HKRC ¶80-283 (*D59/93* IRBRD Vol 8); *Case* C13 (1993) 1 HKRC ¶80-222 (*D37/92* IRBRD Vol 7); *D25/87* IRBRD Vol 2).

Where a taxpayer has been paid a mileage allowance for using his or her own car for business purposes he or she may not be entitled to any deduction for vehicle expenses, depending upon the scope of the allowance. A taxpayer who received an allowance which was calculated to take into account all of the costs that he would incur in using his car for business (eg depreciation, insurance, petrol, and maintenance costs) was denied a salaries tax deduction for vehicle expenses in *Case* D9 (1995) 1 HKRC ¶80-306 (*D18/94* IRBRD Vol 9). Since the taxpayer had agreed with his employer upon the amount of the mileage allowance the Board of Review held that he could not then claim higher expenses, for the use of the car, from the Inland Revenue Department. If the mileage allowance had been calculated on a different basis which did not take into account all of the costs involved in using the car for business, the Board would likely have allowed the taxpayer a deduction for additional expenses provided that they fulfilled the "wholly, exclusively and necessarily" criteria.

[¶2-5500] Use of residential premises

When it is necessary for a taxpayer to work at home because, for instance, his or her employer does not provide office facilities, only the additional costs of heating and lighting are normally deductible. If, however, the nature of the taxpayer's employment is such that it is necessary for a separate part of his or her residence to be used solely for employment purposes, an appropriate proportion of the rent, rates and other similar expenses incurred by the taxpayer is deductible.

[¶2-5550] Clothing expenses

Expenditure incurred by a taxpayer on clothing is only deductible if the taxpayer has purchased or replaced special clothes required by the nature of his or her employment (DIPN No 9 (Revised), para 13).

Expenditure incurred by a solicitor on clothing did not qualify for deduction in *Case* C16 (1993) 1 HKRC ¶80-225 (*D41/92* IRBRD Vol 7, 411) because, according to the Board of Review, the expenditure was incurred for the dual purpose of allowing the taxpayer to keep up appearances at work and for the personal reason of providing the clothing needed by the taxpayer as a human being. The expenses had not been incurred "wholly" and "exclusively" or "necessarily" in the production of assessable income.

When joint assessment is elected, each spouse is required to file a salaries tax return.

Joint assessment is also explained in DIPN No 18 (Revised).

[¶2-7150] When to elect joint assessment

Unabsorbed allowance situation

Joint assessment may be elected when one spouse is entitled to concessionary deductions under Pt IVA and personal allowances under Pt V, which, in aggregate, exceed his or her net assessable income, and the other spouse continues to be chargeable to tax (s 10(2)(a)).

Example

For the 2019/20 year of assessment, Mr and Mrs A both have income which is subject to salaries tax. Mr A's net assessable income is $800,000. Mrs A's net assessable income is $60,000. They have two children and maintained Mr A's dependent father aged over 60. Compare the following tax assessments:

Separate Assessment			*Joint Assessment*	
	Mr A	Mrs A	Mr & Mrs A	
	$	$		$
Net assessable income	800,000	60,000	Net assessable income	860,000
Less:			*Less:*	
Allowances			Allowances	
Basic	(132,000)	132,000	Married person's	(264,000)
Dependent parent	(50,000)		Dependent parent	(50,000)
Child (2 children)	(240,000)		Child (2 children)	(240,000)
Net chargeable income	378,000	NIL	Net chargeable income	306,000
Total tax payable	46,260	NIL	Total tax payable	34,020
Unabsorbed allowances	NIL	72,000	Unabsorbed allowances	NIL

Clearly, it would be beneficial in this instance for the taxpayers to elect joint assessment in order to obtain the benefit of the $72,000 of Mrs A's basic allowance which would otherwise be unabsorbed.

When joint assessment is elected to allow a married couple to take full advantage of the allowances available to them in a year of assessment, the spouse who would have been chargeable to salaries tax in the absence of the election is chargeable to salaries tax on the aggregated net chargeable income (s 10(3)(a)). This would be Mr A in the above example.

Aggregated assessment reducing overall tax liability

Joint assessment may also be elected when both spouses have a net chargeable income and the total tax payable by them, if separately assessed, would be greater than the tax that would be payable if their incomes were combined (s 10(2)(b)).

If joint assessment is elected to reduce overall tax liability, the spouses may nominate which of them will be chargeable to the salaries tax payable on their aggregated income (s 10(3)(b)).

[¶2-7200] Marriage or death of taxpayer

A husband and wife who were married during the year of assessment for which they have elected to be jointly assessed are deemed to have married at the commencement of that year (s 10(5)). In the event of the death of a spouse, an executor has the same right to make

PERSONAL DISABILITY ALLOWANCE

[¶3-6000] Eligibility and calculation

A newly introduced personal disability allowance is deductible from a taxpayer's net assessable income (see ¶2-4900) if the taxpayer is eligible to claim an allowance under the Government's Disability Allowance Scheme.

Further to the Inland Revenue (Amendment) (No. 4) Ordinance 2018 gazetted on 25 May 2018, the amount of the allowance is $75,000 starting from the year of assessment 2018/19 (Sch 4, Item 2).

SINGLE PARENT ALLOWANCE

[¶3-6500] Eligibility and calculation

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

The amount of the single parent allowance for the years of assessment 2018/19 and 2019/20 is $132,000 (Sch 4, Item 9). The allowance is only granted for a taxpayer's first child. A taxpayer is not entitled to claim the single parent allowance for his or her second child or for any subsequent children (s 32(2)(c)).

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

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

In *Case* M27 (2003) HKRC ¶80-892 (*D140/01* IRBRD Vol 17), the Board of Review held that whether a parent can be considered to have predominant care of his child is a question of fact. The fact that the taxpayer did not have sole custody was not conclusive if, on the fact, he could show that he had predominant care of the child for part of the time. A sole custody order is common in divorce and related proceedings; however, to provide stability for the child, parental care and control over the child can be shared. The taxpayer in this case had predominant care of the child for at least 30% of the time during the relevant year of assessment, although the taxpayer's wife had sole custody of the child. The Board of Review held that the single parent allowance should have been apportioned and 30% of the allowance was granted to the taxpayer.

dependent sister allowance and a child allowance will not be given for the same dependent child.

Agreement between taxpayers

When two or more taxpayers are eligible to claim an allowance for the same parent, grandparent, brother, sister or child in any year of assessment the taxpayers should agree between them who will claim the allowance. The Commissioner will not consider an allowance claim until such an agreement is made (s 33(2)). Similarly, when there are taxpayers who are eligible to claim, respectively, a dependent parent allowance and a dependent grandparent allowance for the same dependent person, or a dependent brother or dependent sister allowance and a child allowance for the same child, the taxpayers must agree which of the allowances is to be claimed (s 33(3A)).

Apportionment of allowances

Apportionment of allowances is permitted in limited circumstances. In the case of child allowances, s 31(2) allows apportionment of the allowance when two or more taxpayers, other than a husband and wife living together, have contributed to a child's maintenance and education (see ¶3-4100). A disabled dependant or single parent allowance may also be apportioned when more than one taxpayer is entitled to the allowance for the same child (s 31A(2), 32(3)) (see ¶3-5400 and ¶3-6200).

Additional assessments

If, contrary to the Ordinance:

- a dependent parent allowance, dependent grandparent allowance, dependent brother or dependent sister allowance, disabled dependant allowance or child allowance is granted to two or more taxpayers for the same dependant;
- a dependent parent allowance and a dependent grandparent allowance have both been granted in respect of the same person; or
- a dependent brother or dependent sister allowance and a child allowance have both been granted in respect of the same dependent child,

the Commissioner will ask the relevant taxpayers to agree on who should receive the allowance, or which allowance should be given. The Commissioner is entitled to raise additional assessments under s 60 (see ¶9-6400) in accordance with the taxpayers' agreements. The Commissioner may also raise additional assessments if the taxpayers fail to reach an agreement within a reasonable time (s 33(3); 33(3B)).

Similarly, when a dependent parent, dependent grandparent, dependent brother or dependent sister, disabled dependant or child allowance has been granted to a taxpayer and, within six months, either:

(i) another person appears to be eligible for the same allowance in respect of the same parent, grandparent, brother, sister or child; or

(ii) in the case of a dependent parent or dependent grandparent allowance, or a dependent brother or sister or child allowance, another person appears to be eligible for the other allowance in respect of the same dependent person,

the Commissioner will again ask the relevant taxpayers to agree who should receive the allowance, or which allowance should be given (s 33(3)(c); s 33(3C)). Additional assessments may be raised accordingly (s 33(3D)).

REVISION QUESTIONS

[¶3-9000] Test your knowledge

Question 1

Mr Brown is a US citizen employed by Pine Inc. He was seconded to work in Hong Kong for 6 months during the year of assessment 2019/20. Mrs Brown worked as a teacher in the US. They have a son, aged 19, studying part-time in a vocational college. The total amount of personal allowances Mr Brown is entitled to under Hong Kong salaries tax for the year of assessment 2019/20 is:

(a) $132,000

(b) $192,000

(c) $252,000

(d) $264,000.

Question 2

Richard Chung is a civil servant with annual salary income of $520,000. He married Crystal in August 2019. Crystal has a son, aged 10, with her ex-spouse who has passed away two years ago. Crystal worked as a part-time secretary and her salary for the year ended 31 March 2020 is $96,000. Richard's parent aged 62 and 58 during the year, are residing in the mainland China. Richard has remitted $60,000 to his parents to support their living expenses. Crystal's grandfather, aged 87, is residing in a registered caring home in Hong Kong. She has paid his residential care expenses of $96,000 for the year.

The total amount of deductions for Richard and Crystal under Hong Kong salaries tax for the year of assessment 2019/20 pertaining to the information given above is:

(a) $348,000

(b) $435,000

(c) $480,000

(d) $484,000.

Question 3

For salaries tax purposes, which of the following statements are **INCORRECT**?

(I) If the husband has no chargeable income, the wife can claim married person's allowance.

(II) If the couple was separated during the year of assessment, both of them are not eligible for single parent allowance for that year.

(III) The person who has sole contribution towards the maintenance of the child is eligible for single parent allowance.

(IV) Child allowance must be granted to one person only and cannot be apportioned even if there are two eligible claimants.

(a) I & II only

(b) II & IV only

(c) III & IV only

(d) I, III & IV only.

- When the taxpayer has income which is only assessable to either profits tax or property tax. If the standard tax rate which would be applied to the income (see ¶6-9100 and ¶5-8500) is higher than the graduated tax rate which would be applied under personal assessment (see ¶4-8000), it would clearly be to the taxpayer's advantage to make the election.
- One off tax reduction is not generally available under property tax (except year of assessment 2007/08). A property owner who derives rental income may benefit from the election of personal assessment by enjoying one-off tax reduction (see ¶4-8000).

A taxpayer has an option to elect for personal assessment. He or she is obliged to observe the terms of the scheme once the election is made.

In *Wong Tai Wai, David & Lee Chi Man* v *Commissioner of Inland Revenue* (2004) HKRC ¶90-128 (*Case* M92 (2003) HKRC ¶80-957 (*D64/02* IRBRD Vol 17)), the taxpayers were husband and wife who elected for personal assessment to deduct interest expenses against their respective share of net assessable value of a property. The election resulted in a reduction of their total tax liability. The taxpayers despite the reduction appealed to the Board of Review based on their observation that if they were not married in the relevant years, their income would not have been aggregated under s 42A and would thus have attracted a lower tax rate. The taxpayers relied on Art 8, 11 and 25 of the *Basic Law* and argued that the provisions in the *Inland Revenue Ordinance* were unfair or against the *Basic Law*.

The Court of First Instance observed that it was a question of tax policy for the legislature as to whether a married couple should have been treated as a single tax unit under certain circumstances. As the consequences applied across the board to all married taxpayers, the Court of First Instance held that the *Inland Revenue Ordinance* was not in contravention of Art 25 of the *Basic Law* and that the taxpayers had not been discriminated by reason of their family status. The Court of First Instance also held that the Commissioner had no discretion to permit separate assessments for the taxpayers once they had elected for personal assessment.

The decision of the Court of First Instance was upheld in the Court of Appeal in *Wong Tai Wai, David* v *Commissioner of Inland Revenue* (2004) HKRC ¶90-134.

Pursuant to the *Inland Revenue (Amendment) (No. 9) Ordinance 2018* gazetted on 23 November 2018, a married person may elect personal assessment either separately from, or jointly with, his or her spouse effective from the year of assessment 2018/19.

ELIGIBLE TAXPAYERS

[¶4-1200] Eligible taxpayers

For the year of assessment up to 2017/18

A taxpayer is eligible to elect personal assessment if he or she is:

- 18 years of age or over; and
- a permanent or temporary resident in Hong Kong, or his or her spouse is a permanent or temporary resident (s 41(1)).

A taxpayer who is under 18 years of age is eligible to elect personal assessment if both of his or her parents are deceased. A permanent resident means an individual who ordinarily resides in Hong Kong.

The following factors may be taken into consideration to determine where an individual resides:

- **Physical presence.** If an individual is physically present in Hong Kong for a considerable amount of time during an assessment year, the inference may be that he or she resides in the territory;
- **Taxpayer's history.** The history of the taxpayer's residences and movements may be taken into account when determining where he or she resides;
- **Visit details.** When an individual is a visitor to a country, the frequency, regularity, purpose and duration of the visits may be an influential factor in determining whether he or she has resided in that country in the relevant year (*Lysaght* v *IRC* (1927) 13 TC 511);
- **Reason for absences.** When an individual has been outside a country for part of a year the purposes for the absence may be of assistance. If the only reason for the absence was business, this would support the claim that the individual is a resident (*Miesegaes* v *IRC* (1957) 37 TC 493);
- **Location of home.** The maintenance of a home in a country, although dependent on the facts, often infers a residence in that country (*Peel* v *IRC* (1928) 13 TC 443); and
- **Nationality.** Normally, nationality is not a relevant consideration. It may be taken into account, however, in borderline cases: see *Levene* v *IRC* (1928) 13 TC 486.

The fact that a person has a Hong Kong identity card does not necessarily mean that they reside in Hong Kong (*D20/83* IRBRD Vol 2, 33). Being entitled to reside in Hong Kong does not on its own constitute "permanent residence" in Hong Kong.

Example

Mr Chan lived and worked in Hong Kong for many years and holds a permanent Hong Kong identity card. In January 2019, he sold his residential property in Hong Kong and migrated to Canada. As Mr Chan did not have a place of abode in Hong Kong and did not visit Hong Kong during the year ended 31 March 2020, he is not regarded as a permanent resident in Hong Kong for the year of assessment 2019/20 despite the fact that he has a permanent Hong Kong identity card. However, depending on the number of days he stayed in Hong Kong prior to his migration, thers is still a possibility that he may be treated as a temporary resident for the year.

A "temporary resident" is an individual who stays in Hong Kong:

- for more than 180 days during the year of assessment for which personal assessment is elected; or
- for more than 300 days in two consecutive years, one of which is the year of assessment for which an election has been made (s 41(4)).

The *Inland Revenue Ordinance* (Cap 112) does not define the word "day". In the *Shorter Oxford English Dictionary*, "day" is defined as the space of 24 hours. Note, however, that part of a day may count as a "day" for the purpose of calculating the time spent by an individual in Hong Kong (Case *E5* (1995) 1 HKRC ¶80-302 (*D12/94* IRBRD Vol 9, 131); see ¶2-3750).

(*D14/03*); *Case* N1 (2004) HKRC ¶80-977 (*D104/02*); *Case* M110 (2003) HKRC ¶80-975 (*D93/02*); *Case* M84 (2003) HKRC ¶80-949 (*D49/02*); *Case* M82 (2003) HKRC ¶80-947 (*D45/02*); *Case* M72 (2003) HKRC ¶80-937 (*D33/02*); *Case* M60 (2003) HKRC ¶80-925 (*D13/02*); *Case* C40 (1993) 1 HKRC ¶80-249 (*D8/93*));

- car licences listed as "current" assets in the taxpayer's accounts (*Case* C33 (1993) 1 HKRC ¶80-242 (*D63/92*));
- computer equipment which had been leased and later sold to certain companies (*Case* C8 (1993) 1 HKRC ¶80-217 (*D31/92* IRBRD Vol 7)). The eventual sale of the equipment had been contemplated from the beginning by the taxpayer;
- two sets of flats which the taxpayer alleged had been purchased with the intention of being used as residences if his wife agreed to move (*Case* B33 (1992) 1 HKRC ¶80-194 (*D4/92* IRBRD Vol 7));
- two units which were sold only a few months after acquisition as the taxpayer discovered that their intended use as a plastics factory was prohibited (*Case* I78 (2000) HKRC ¶80-647 (*D10/99* IRBRD Vol 14));
- a property sold six months after acquisition due to the view of a cemetery from the property (*Case* I82 (2000) HKRC ¶80-651 (*D15/99* IRBRD Vol 14));
- property sold prior to the issuance of the occupation permit due to concerns and uncertainties in Hong Kong (*Case* J63 (2000) HKRC ¶80-731 (*D15/00* IRBRD Vol 15));
- in *Case* J57 (2000) HKRC ¶80-725 (*D148/99* IRBRD Vol 15), a taxpayer was selling properties immediately for re-development. The taxpayer entered into a sub-sale agreement with option to purchase the redeveloped units. The taxpayer exercised the option but was rejected. The taxpayer received liquidated damages under the sub-sale agreement. The Board held that the taxpayer was engaged in the trading activities at all relevant time. The taxpayer claimed that the properties were used for long-term rental purposes but the Board found it was too remote given that the properties had been declared dangerous. The Board held that the "liquidated damages" of HK$8 million should be assessable to profits tax. It was found that the sub-sale agreement was an arrangement such that the taxpayer could defer the reaping of part of the profit coupled with a remote chance for more profit;
- an industrial building sold due to change in investment strategy (*Case* J61 (2000) HKRC ¶80-729 (*D9/00*)):
- shares of an investment and company secretarial services company, where the directors argued that the premium payable on the transfer of the shares did not represent profits on disposal of property but was to compensate them for their loss of their directorship.

The Board agreed with the Commissioner that the sale of shares was something done in the course of an operation of business, undertaken in pursuance of a profit-making scheme and the profit realised was accordingly income. The Board found no reason for the payment of compensation for loss of office to the taxpayers (*Case* K37 (2001) HKRC ¶80-768 (*D68/00* IRBRD Vol 15));

- shares of a company which secured a first priority in selecting a property unit. The taxpayers had disposed of their shares within a period of ten days. The Board found that the taxpayers had no genuine intention to acquire any unit in the housing estate. They had simply embarked upon a scheme to secure an early priority and to reap the profit arising from such priority (*Case* L25 (2002) HKRC ¶80-826 (*D26/01* IRBRD Vol 16));

(c) rights, options or interests in, or in relation to any stocks referred to above, except when they are rights, options or interests under an employee's share purchase or share option scheme,

but does not include loan capital; bills of exchange, promissory notes or certificates of deposit; Exchange Fund debt instruments or Hong Kong dollar denominated multilateral agency debt instruments; or any bond issued under the *Loans Ordinance*; or debentures, loan stocks, funds, bonds or notes which are not denominated in Hong Kong currency, except to the extent that they are redeemable in that currency (s 2(1), *Stamp Duty Ordinance* (Cap 117)).

Exemption extended to transactions involving other "specified securities"

As an incentive to encourage the development of the financial services sector, the profits tax exemption provided under s 15E for stock borrowing and lending transactions has been extended to transactions which involve securities which are not Hong Kong stock but are specified by the Commissioner. This extension took effect from the 1996/97 year of assessment.

"Specified securities" are securities of the types described in paragraphs (a)–(c) above, which are not Hong Kong stock subject to the rules and practices of a recognised stock market, and which the Commissioner has specified in writing, either generally or in any particular case, as qualifying for the purposes of s 15E (s 15E(8)–(10)).

The Commissioner has specified in writing in Inland Revenue DIPN No 26 (Revised) that, where associated parties are not involved, securities falling into the following categories are "specified securities" for the purposes of s 15E:

(i) any debt or equity security listed on a stock exchange in Hong Kong or any other stock exchange or over-the-counter market recognised by the Commissioner;

(ii) any unlisted debt issued to third parties or guaranteed to third parties by listed companies (including affiliates owned 50% or more by listed companies);

(iii) any unlisted sovereign debt (including, for this purpose, government agency debt, multilateral agency debt and debt guaranteed by multilateral agencies or sovereign governments); and

(iv) any unlisted debt or equity securities issued pursuant to a private placement authorised by the Hong Kong Securities and Futures Commission or a similar supervisory body in another jurisdiction.

For agreements which involve associated parties, application may be made on a case-by-case basis to the Commissioner to have the subject securities declared to be "specified securities" for the purposes of s 15E. In such cases it is necessary to establish that the agreement is a *bona fide* stock borrowing and lending agreement entered into on an arm's length basis which does not have the main purpose of obtaining a tax benefit (DIPN No 26 (Revised), Sch, para 5).

Tax exemption provisions

Determination of lender's chargeable profits

Where a stock lender has received payments (or incurred losses) in relation to stock which is the subject of a stock borrowing or lending agreement, the amount received (or loss incurred) is treated, to the extent that a stock return has been made, as if the stock borrowing and lending had not taken place (s 15E(2)). The lender is treated as if it had held the relevant borrowed stock at all times during the borrowing period, and as if the stock which has been returned was the borrowed stock:

This is provided that the SPV is a corporation, partnership, trustee of a trust estate or any other entity that is:

a) wholly or partially owned by a non-resident person;

b) is established solely for the purpose of holding, directly or indirectly, and administering one or more excepted private companies;

c) is incorporated, registered or appointed in or outside Hong Kong;

d) does not carry on any trade or activities except for the purpose of holding, directly or indirectly, and administering one or more excepted private companies; and

e) is not itself an excepted private company. (s 20ACA(2))

Assessable profits of a non-resident person (i.e. the offshore fund) from a transaction in an SPV that qualifies as one under s 20ACA(2) would be considered as a "specified transaction" (Sch 16, Pt 2) and exempted from Profits Tax pursuant to s 20AC(1).

An offshore private equity fund deriving profits from transactions in securities of an excepted company can enjoy exemption. The term "excepted private company" refers to a "private company", incorporated outside Hong Kong, which at all times within the three years before a transaction (to be claimed for exemption) in securities of the SPV or private company:

(a) did not carry on any business through or from a permanent establishement in Hong Kong;

(b) falls within either of the following descriptions:

  (i) it did no hold share capital in one or more private companies carrying on any business through or from a permanent in Hong Kong; or

  (ii) it held such share capital, but the aggregate value of the holding of the capital is equivalent to not more than 10% of the value of its own assets; and

(c) falls within either of the following descriptions:

  (i) it neither held immovable property in Hong Kong, nor held share capital in one or more private companies with direct or indirect holding of immovable property in Hong Kong; or

  (ii) it held such immovable property or share capital, but the aggregate value of the holding of the property and capital is equivalent to not more than 10% of the value of its own assets.

In ascertaining whether the 10% safe-harbour rules is satisfied, the market value of the relevant share capital, immovable property in Hong Kong and assets of the excepted private company should be considered.

Example

In January 2005, ABC (HK) Co. was incorporated in Hong Kong. It was a private company, which had been engaged in trading and property investment business in Hong Kong since incorporation. ABC (HK) Co. was wholly owned by Fund-One, which is a resident in Jurisdiction One. In December 2010, ABC (HK) Co. disposed all of its assets and became dormant thereafter. In January 2011, Fund-One made use of ABC (HK) Co. to acquire Fund-Two Co., an excepted private company incorporated and resident in Jurisdiction Two. In October 2015, Fund-One sold its shares in ABC (HK) Co. and made a profit.

The exempt profits of the SPV which amount is regarded as assessable profits of the resident person for a particular day in a year of assessment are calculated using the following formula:

$$A = \frac{B1 \times B2 \times C}{D}$$

where:
- A means the exempt profits of the SPV for a particular day in a year of assessment
- B1 means the extent of the resident person's beneficial interest in the non-resident person on the particular day
- B2 means the extent of the non-resident person's beneficial interest in the SPV on the particular day
- C means the exempt profits of the SPV for the accounting period of the SPV in which the particular day falls
- D means the total number of days in the accounting period of the SPV in which the particular day falls

Example

Company A is a resident in Hong Kong for profits tax purposes. On 30 March 2010, Company A acquired 50% of the share capital of Company B, a non-resident. For the year of assessment 2009/10, Company B has derived $500,000 from transactions in securities which qualifies for a tax exemption under s 20AC of the *Inland Revenue Ordinance* (Cap 112).

Under s 20AE, Company A will be liable to profits tax on the tax exempt profits of Company B unless the Commissioner is satisfied that the beneficial interest is bona fide widely held. The exempt profits of Company B on 30 March 2010 and 31 March 2010 will be calculated as follows:

Exempt profits of Company B $= \frac{50\% \times \$500,000}{365}$

$= \$684.93$

Company A has direct beneficial interest in Company B for 2 days in the 2009/10 year of assessment. The assessable profits of Company A is determined as follows:

Assessable profits of Company A $= \$684.93 \times 2$

$= \$1,369.86$

Example

A Limited, a resident company, purchased 25% of the issued shares of D-Fund Limited, a tax-exempt offshore fund on 15 October 2009. On 1 February 2010, A Limited purchased a further 30% of the issued shares of D-Fund Limited. A Limited has an accounting year end of 31 March. For the year ended 31 March 2010, D-Fund Limited derived assessable profits of $6,500,000 from transactions in futures contracts.

The deemed assessable profits of A Limited for the year of assessment 2009/10 is $6,500,000 × 55% × (59 days/365 days) = $577,877, where 59 days refer to the period from 1 February 2010 to 31 March 2010 and 365 days refer to the year ended 31 March 2010. The period from 15 October 2009 to 31 January 2010 need not be taken into account as A Limited held less than 30% in D-Fund Limited during that period.

No deemed loss for resident persons

The deeming provisions only impose deemed profits but not losses on a resident person. A resident person will not be entitled to claim any proportionate amount of the losses sustained by a tax-exempt offshore fund in which beneficial interest is held (DIPN No 43

"Incurred"

An expense or outgoing is "incurred" when it is paid out or when the liability to pay arises (*Lo & Lo v Commissioner of Inland Revenue* (1984) 2 HKTC 34). The term "incurred" cannot be exhaustively defined. It has been established, however, that "incurred" expenses are not only those expenses which have been defrayed, discharged or borne, but also those expenses which have been encountered, run into or fallen upon (*New Zealand Flax Investments Ltd v FC of T* (1938) 61 CLR 179). For example, interest payments which a taxpayer had an obligation to pay, but had not yet paid, were deductible as "incurred" expenses in *Case* D13 (1994) 1 HKRC ¶80-263 (*D30/93* IRBRD Vol 8, 241).

The term "incurred" is not so wide in scope as to include expenses which are no more than impending, threatened, or expected (*New Zealand Flax Investments*). A taxpayer which set aside sums to meet the holiday entitlements of its employees, for instance, was not permitted to deduct the amounts from its taxable income. In setting aside the sums, the taxpayer had not incurred a loss or an outgoing; it had simply faced the possibility that a loss or outgoing might be incurred (*FC of T v James Flood Pty Ltd* (1953) 88 CLR 492).

Similarly, a taxpayer company which made a special bonus to a director in its accounts, but did not in fact pay the bonus due to lack of funds, could not deduct the amount of the bonus from its taxable profits even though it had been credited to an account entitled "provision for special bonuses". The Board of Review found that the taxpayer had not incurred any expense because it had not been subject to a definite liability to pay the bonus, which had been conditional upon funds being available (*D50/88* IRBRD Vol 3, 448).

It is important to note that in *Lo & Lo v Commissioner of Inland Revenue*, Hunter J at first instance said of the meaning of "incurred":

"I am unable to regard the word 'incurred' as having some fixed and settled meaning in all contexts, or to accept that in section 16(1) necessarily has the meaning ascribed to it by the High Court of Australia in section 51(1) of the Australian Act."

In the *Lo & Lo* case it was held that the UK approach was preferable to the Australian approach. UK authorities allow the deduction of an apportioned part of a future liability if it can be shown to have matured in the course of an accounting period and is precisely calculated (*IRC* v *Titaghur Jute Factory Ltd* (1978) STC 166, *Southern Rly of Peru Ltd* v *Owen (Inspector of Taxes)* (1957) AC 334). The Court said in *Lo & Lo* that, if anything, the meaning of "incurred" within the Hong Kong legislation is wider than even the British interpretation.

In any cash-settled share-based payment transactions, the "incurred" test under sec 16(1) is satisfied and hence a deduction would be given only when the vesting conditions are fully satisfied and the payee (eg employee, supplier) has become "unconditionally" entitled to the payment. Any liability recognised before then is only a contingent liability, and hence not allowable for deduction.

Under a group share-based compensation scheme in the form of stock option or share award granted by the parent company, if the parent company re-charges all or part of its costs to the subsidiary concerned, which would record a liability payable to parent, the Inland Revenue Department considers such cost recharge arrangement would generally meet the "incurred" test under sec 16(1) if the subsidiary concerned has become unconditionally liable to pay the recharge. Any provision for the recharge claim of the subsidiary in the basis period in which the stock option or share award has not been exercised or vested should be disallowed. Further, the Inland Revenue Department considers that whether the parent company issues its own shares or acquires them from the market, the related recharge borne by the subsidiary would be tax deductible to the extent that the "incurred"

(i) The costs were incurred by the taxpayer primarily for business purposes as he had to defend himself to avoid being suspended from practice.

(ii) The taxpayer's defence against the main complaint was on the basis that his practice as a barrister did not amount to a breach of undertaking, if any. The Board viewed that the disciplinary proceedings against the taxpayer did have a substantial connection with his practice as a barrister.

(iii) The disciplinary proceedings in this case should be regarded as posing a risk to a peripheral or short-term damage to the taxpayer's right to practise rather than a risk of total loss of such right. As such, the taxpayer should be regarded as undergoing maintenance or damage control to a structural asset and the expenses arising therefrom was held to be of revenue rather than capital nature.

However, the Court of First Instance held that the costs must be really incidental to the trade itself, and that they must be made for the purpose of earning the profits. The Court considered that the disciplinary proceedings concerned the taxpayer's dealings with a university when he applied for postgraduate studentship and that application had nothing to do with his practice as a barrister. The only way in which the disciplinary proceedings could relate to the taxpayer's practice as a barrister was that, if the charges were found proven, they could result in the cessation of the taxpayer's practice.

The Court also agreed with the Commissioner that the costs paid by the taxpayer were in the nature of fines or penalties, which would not be deductible.

Investigation fees and exceptional loss provision

The taxpayer in *Case* M20 (2003) HKRC ¶80-885 (*D128/01*) was a securities dealer trading as Company B. It committed a number of breaches of internal control and its branch manager committed fraud and disappeared. Its District D branch office was closed down. The company appointed a consultancy firm to undertake an investigation into the breaches and extent of loss incurred. The investigation fee paid was $2,400,000 which the taxpayer claimed as a deductible expense for the year of assessment 1997/1998. The Commissioner denied the deduction on the basis that it was not incurred in the production of profit but in the course of a special management audit. The company also made a provision for exceptional loss of $45,113,875 and claimed a deduction for the amount provided. The Commissioner denied the claim on the basis that the amount had not been incurred in the normal course of business.

The Board of Review allowed the investigation fee deduction under s 16 of the *Inland Revenue Ordinance* (Cap 112) and noted that the expense was not prohibited under s 17. The Board of Review found in favour of the Commissioner on the exceptional loss provision. The Board noted that while a deduction is not restricted to only sums of expenditure actually paid by the taxpayer and may include a sum where there is an obligation to pay, the taxpayer did not have a legal or practical liability to pay the exceptional loss. The amount of the loss was not an accrued legal or practical liability for payment. In any event the deduction claimed for the exceptional loss provision was prohibited under s 17(1)(e) of the *Inland Revenue Ordinance* (Cap 112), that is, for any sum recoverable under an insurance or contract of indemnity.

Lost bank deposit

The amount of a bank deposit which was lost by the taxpayer when the bank went bankrupt was not allowed as a deduction for profits tax purposes in *Case* F22 (1996) HKRC ¶80-400 (*D55/95* IRBRD Vol 11, 10). Foremost, the Board of Review said that the debt written off in this case was a loss and not an outgoing or expense deductible under s 16(1). Secondly, the Board found that, even if the loss had been an outgoing or expense, it had not been incurred in the production of taxable profits or for the purpose of producing such profits.

borrowing of money are only deductible if at least one of the six qualifying conditions prescribed in s 16(2) is satisfied. All claims for deductions under s 16(1)(a) must be supported by sufficient details or evidence to satisfy the Commissioner that this is the case (see *Commissioner of Inland Revenue v County Shipping Co Ltd* (1990) 1 HKRC ¶90-034). The interest deduction scheme had been revamped substantially by the *Inland Revenue (Amendment) Ordinance 2004*. The Department's views and practices on the interest deduction scheme that applied before and after the commencement of the Amendment Ordinance are set out in DIPN No 13A: Profits Tax — Deductibility of Interest Expense issued in December 2004.

Condition 1: The money was borrowed by a financial institution (s 16(2)(a))

A "financial institution" is an authorised institution within the meaning of s 2 of the *Banking Ordinance* (Cap 155). The term includes any associated corporation of such authorised institution which would have been liable to be authorised as a deposit-taking company or restricted licence bank had it not been exempted under s 3(2) of that Ordinance (s 2(1)).

This condition referred to borrower taxpayers who were financial institutions. All borrowings by a financial institution satisfy Condition 1 (DIPN No 13A, para 3). One should pay attention and should not mix this condition up with Condition 4 concerning money borrowed from financial institutions, which "puzzled" the Board in *Case* R22 (2008) HKRC ¶81-240 (*D35/07*).

Condition 2: The money was borrowed by a public utility company specified in the Third Schedule of the *Inland Revenue Ordinance* (s 16(2)(b))

The Third Schedule currently specifies three public utility companies: The Hong Kong Electric Company, Limited; China Light and Power Company, Limited; and The Hong Kong and China Gas Company, Limited. Interest paid by these companies is deductible, provided that the interest rate imposed is not above that specified by the Financial Secretary by notice in the *Gazette*.

With effect from 1 December 2002, by virtue of *Rate of Deductible Interest Notice* (LN 110 of 2002), the rate of interest specified for the purpose of s 16(2)(b) shall be the highest interest rate on Hong Kong dollar savings accounts as quoted from time to time by the banks set out in the Schedule to the *Legal Tender Notes Issue Ordinance* (Cap 65).

Condition 3: The money was borrowed from a person other than a financial institution and the payable interest is chargeable to tax under the *Inland Revenue Ordinance* (s 16(2)(c))

DIPN No 13A indicates that where the money borrowed has been made available to the borrower in Hong Kong it usually will be clear that any interest paid on the loan will be chargeable to tax in the hands of the lender. In such cases, to demonstrate that Condition 3 is satisfied, it is sufficient to establish the identity and business address of the lender and the place where the money was made available to the borrower.

On the other hand, where the money borrowed has been made available to the borrower outside Hong Kong there will be a prima facie presumption that the interest payable on the offshore loan is not chargeable to tax in Hong Kong. This presumption can be rebutted, and Condition 3 satisfied, only if the borrower can demonstrate that the lender carried on business in Hong Kong and was chargeable to tax on the interest received notwithstanding that the loan was offshore (DIPN No 13A, para 4). Also see *Case* L44 (2002) HKRC ¶80-845 (*D58/01*).

This condition is also subject to restrictions under s 16(2A) and 16(2B) of the *Inland Revenue Ordinance* (Cap 112) (see below).

management) or Pt I of Sch 5 (Regulated Activities) of the *Securities and Futures Ordinance* (Cap 571). The meaning of asset management in that Schedule includes securities or futures contracts management.

(iii) The remuneration received by the broker or approved investment adviser for providing services to the non-resident person must have been calculated at a rate no less than the customary rate of remuneration for the class of business;

The Department will consider whether the remuneration arrangements are in line with those generally acceptable within the industry at the relevant time, given the nature of the transaction involved, to determine if this requirement has been met. Provided that the terms are not abnormal, incentive or performance fees are acceptable (DIPN No 30 (Revised), para 10(c), 12(c)).

(iv) The non-resident person must not have been treated as having the broker or approved investment adviser as his or her agent in relation to other chargeable profits.

This requirement would not be satisfied during the year of assessment under consideration if, apart from acting as a broker or an approved investment adviser, the person concerned also acted as an agent of the non-resident in some other capacity through which the non-resident derived chargeable profits.

However, the non-resident may derive chargeable profits through other agents in Hong Kong without it affecting the application of s 20AA in respect of the broker or approved investment adviser (DIPN No 30 (Revised), para 10(d), 12(d)).

Where the relevant activities constitute only part of a business, s 20AA is only applicable to that part as a separate business. It follows that s 20AA would not be applicable to activities performed by an agent for the non-resident in some capacity other than as a broker or an approved investment adviser (DIPN No 30 (Revised), para 14).

(v) The broker or approved investment adviser must not have been an "associate" of the non-resident person (see below) and, in the case of an approved investment adviser, must have been acting in an "independent capacity" (see below) (s 20AA(2) and (3)).

Where a transaction is carried out through a Hong Kong broker or an approved investment adviser at the request of a non-resident who is an associate of the broker or investment adviser, it does not necessarily follow that s 20AA cannot apply to the broker or investment adviser in respect of the transaction. Section 20AA will still apply if the non-resident associate is, in turn, acting as an agent in respect of the transaction for another non-resident who is not an associate of the Hong Kong broker or investment adviser. In other words, the Department will apply the associate test in respect of the relationship of the Hong Kong broker or investment adviser to the non-resident person (principal) who derived the profits in question.

In cases where an overseas associate of a broker or an investment adviser amalgamates orders from individual clients and passes them on as a single order (eg, through an omnibus account) to the Hong Kong broker or investment adviser, transactions for principals who are associated parties of the broker or investment adviser should be identified and excluded (DIPN No 30 (Revised), para 10(e), 12(e)).

Qualifying as broker or approved investment advisor

To qualify, a broker must be licensed to carry on a business in dealing in securities under Pt V of the *Securities and Futures Ordinance* (Cap 571). An investment adviser must be licensed to carry on a business in advising on securities on asset management under Pt V of that Ordinance.

"Associated corporation"

An "associated corporation", in relation to a person, is either a corporation over which the person has control; a corporation which has control over the person; or a corporation under the same control as the person (s 20AA(6)). "Control", in relation to a corporation, means the power of a person to ensure that the affairs of the corporation are conducted in accordance with his or her wishes. This may be achieved by holding shares, or possessing voting power in the corporation or any other corporation; or by virtue of powers conferred by the articles of association or other documents regulating the corporation or any other corporation (s 20AA(6)).

[¶6-8380] Assessment of non-resident in name of person making payments

A non-resident who receives royalties or licence fees from Hong Kong, or who is an entertainer or sportsperson who performs in Hong Kong, is assessed to profits tax in the name of any person who pays or credits him or her with payments in Hong Kong (s 20B(2)). This provision was inserted into the Ordinance so that any person who makes payments to a non-resident on a principal to principal basis, and is therefore not an agent of the non-resident, can nevertheless be charged to profits tax on the non-resident's behalf (DIPN No 17 (Revised), para 4–6).

Application of section

Section 20B applies when a non-resident is liable to tax on:

- sums received or accrued from the exhibition or use in Hong Kong of cinematographic or television film or tape, any sound recording, or any connected advertising material (such sums are deemed assessable under s 15(1)(a); see ¶6-2260);
- sums received or accrued for the use of (or right to use) a patent, design, trademark, copyright material, secret process, formula or other property of a similar nature in Hong Kong, or for imparting or undertaking to impart knowledge directly or indirectly connected with the use in Hong Kong of any such property (such sums are deemed assessable under s 15(1)(b); see ¶6-2260);
- sums received or accrued for the use of (or right to use) a patent, design, trademark, copyright material, secret process, formula or other property of a similar nature outside Hong Kong, or for imparting or undertaking to impart knowledge directly or indirectly connected with the use outside Hong Kong of any such property, which are deductible in ascertaining the assessable profits of any person (such sums are deemed assessable under s 15(1)(ba); see ¶6-2260); or
- sums which are derived from a performance given in Hong Kong by a non-resident entertainer or sportsperson in his or her character as an entertainer or sportsperson, or in connection with a commercial occasion or event including:
  - (i) any appearance made in connection with the promotion of a commercial occasion or event; and
  - (ii) any participation by the entertainer or sportsperson in sound recording, films, videos, radio, television or similar transmissions (whether live or recorded) (s 20B(1)).

The phrase "entertainer or sportsman" means a person, other than a corporation, who gives performances in the character of an entertainer or sportsperson in any kind of entertainment or sport, including any activity of a physical kind which the public may be permitted to see or hear (s 20B(4)).

Option one is to lodge an offshore claim for previous years. Mr. Chan is of the view that only profits derived from Hong Kong is taxable. Moreover, it is a practice of the Inland Revenue Department that only 50% of a company's profit is taxable if such company derives its profit from sale of goods partly produced in Hong Kong and partly outside Hong Kong. Mr. Chan opines that as all manufacturing activities were carried out in the Mainland China, TPL's profit should be offshore in nature. Alternatively, at least the 50/50 practice should be applicable to TPL's case.

Another option is to set-up a company in overseas, like Mauritius or BVI. This new company will become a conduit between TPL and TME. Under the new structure, TME will sell products to the new company, which will re-sell the same to TPL. The new company is simply a "letter box", that is TME will issue invoice to it and it then will re-issue invoice to TPL. The new company may employ one staff to handle the re-invoicing activities, to prepare the accounts and to deal with other related administration functions. The overseas company will sell products to TPL at a price consisting of a fixed amount plus 50% of TPL's gross profit that can be derived from selling the products.

Required:

(a) Comment on the draft tax computation prepared by TPL's accounting manager, as well as on any other relevant items in the draft profit and loss account from Hong Kong profits tax perspectives. If necessary, make assumptions and identify any additional information required.

(b) Evaluate the two tax mitigation options from Hong Kong profits tax perspectives.

Question 18 (Tax Planning and Corporate Treasury Centre)

ABC Inc. is a US company, which wholly owned a Hong Kong trading company, namely Dee Ltd. (DL). DL imported goods from the mainland China and exported them to various countries in the Asia Pacific Region. Leveraging on the free and mature financial system and sound legal system in Hong Kong, DL also helped other groups companies located in other less developed Asian countries to raise funds for business operation. Noting that there are new laws passed in Hong Kong in the year 2018 for corporate treasury centre, the management is evaluating if DL can enjoy the new tax benefits.

Required:

(1) State the tax benefits provided by the new laws in relation to corporate treasury centre, the conditions for being entitled to the benefits, and its effective date.

(2) Evaluate if DL is likely to enjoy the benefits.

(3) Assume DL is not likely to enjoy the benefits, what strategies the management of ABC Inc. can take to strengthen the potential for enjoying the benefits.

Question 19 (E-commerce)

Burger Summer Ltd (BSL) was a famous internet business company incorporated in the US and has run the following business in connection with Hong Kong customers:

(a) Books trading

The Hong Kong customers can order e-books from a server of a BSL and downloads the same to a device for their own reading. BSL rents the server from an Internet Service Provider in Hong Kong.

(b) Software hosting

The Hong Kong customers who hold licenses to use software products pay BSL a fee for uploading the software to a server (located outside Hong Kong) which is owned and operated by BSL. Technical support and maintenance of the server is

- for the purposes of a farming business; or
- for the purposes of research and development in relation to any trade, profession or business (s 40(1)).

The phrase "industrial building or structure" also includes any building or structure, used in any trade, undertaking or business mentioned in this list, which is provided for the welfare of workers. A lunchroom, first aid room or rest room, for example, would qualify as an industrial building or structure.

When only part of a building falls within the definition, provided that the capital expenditure incurred on the part which does not fall within the definition does not exceed 10% of the whole expenditure, then the whole building is regarded as falling within the definition (DIPN No 2 (Revised), para 13).

"Buildings and structures"

The words "buildings and structures" must be given their ordinary meaning as they are not defined in the Ordinance. In practice, the term "structure" is regarded as including artificial works that are not commonly considered to be buildings, including:

- walls;
- bridges;
- dams;
- roads;
- bore holes;
- wells;
- sewers;
- water mains;
- tunnel linings; and
- wharves.

Boundary walls, railway sidings and other works forming part of a premise also qualify for capital allowances (DIPN No 2 (Revised), para 11).

The phrase "industrial building or structure" includes part of a building or structure. Consequently, when additions are made to an existing building, the capital expenditure incurred attracts separate allowances (DIPN No 2 (Revised), para 14).

Building or structure used for manufacturing or processing

"Manufacturing" is given its normal meaning according to the ordinary usages of the language of commerce. The exact meaning of the term is not defined. One description of "manufacture" is that it is the creation of a new thing, having a new industrial use (*MP Metals Pty Ltd* v *FC of T* (1967) 14 ATD 407 per Windeyer J). Ultimately, whether manufacturing has taken place in a building or structure is a question to be decided on the particular facts of each case.

"Processing" has a much wider meaning than "manufacturing". Goods may be subject to a process even if they are not adapted or changed. Placing goods or materials in a room and fumigating them has been regarded as processing. Pest extermination is likewise regarded as processing (*D3/87* and *D4/87*). The freezing of goods has been held to be a process (*Ellerker (Inspector of Taxes)* v *Union Cold Storage Co Ltd* (1939) 22 TC 195). The trade of a restaurant, however, was held to have nothing to do with manufacturing or

For the purposes of the double tax arrangements, "international traffic" generally means transport or carriage by an aircraft operated by an airline of a contracting party where the aircraft is not operated solely between places in the area of the other contracting party.

The double tax arrangements are contained in:

- *Specification of Arrangements (Government of Canada Concerning Air Services) (Double Taxation) Order*;
- *Specification of Arrangements (Government of the Republic of Korea Concerning Air Services) (Double Taxation) Order*;
- *Specification of Arrangements (Government of New Zealand Concerning Air Services) (Double Taxation) Order*;
- *Specification of Arrangements (Government of the Kingdom of the Netherlands Concerning Air Services) (Double Taxation) Order*;
- *Specification of Arrangements (Government of the Federal Republic of Germany Concerning Air Services) (Double Taxation) Order*;
- *Specification of Arrangements (Government of the United Kingdom of Great Britain and Northern Ireland Concerning Air Services) (Double Taxation) Order*;
- *Specification of Arrangements (Government of the State of Israel Concerning Air Services) (Double Taxation) Order*;
- *Specification of Arrangements (Government of the Republic of Mauritius Concerning Air Services) (Double Taxation) Order*;
- *Specification of Arrangements (Government of the Russian Federation Concerning Air Services) (Double Taxation) Order*;
- *Specification of Arrangements (Government of the Kingdom of Norway Concerning Air Services) (Double Taxation) Order*;
- *Specification of Arrangements (Government of the Kingdom of Denmark Concerning Air Services) (Double Taxation) Order*;
- *Specification of Arrangements (Government of the Kingdom of Sweden Concerning Air Services) (Double Taxation) Order*;
- *Specification of Arrangements (Government of the People's Republic of Bangladesh Concerning Air Services) (Double Taxation) Order*;
- *Specification of Arrangements (Government of the Republic of Estonia Concerning Air Services) (Double Taxation) Order*;
- *Specification of Arrangements (Government of the Republic of Croatia Concerning Air Services) (Avoidance of Double Taxation) Order*;
- *Specification of Arrangements (Government of the Macao Special Administrative Region) (Avoidance of Double Taxation on Income from Aircraft Operation) Order*;
- *Specification of Arrangements (Government of the Republic of Singapore) (Avoidance of Double Taxation on Income from Shipping or Aircraft Operations) Order*;
- *Specification of Arrangements (Government of the Democratic Socialist Republic of Sri Lanka) (Avoidance of Double Taxation on Income from Shipping and Air Transport) Order*;
- *Specification of Arrangements (Government of Hashemite Kingdom of Jordan) (Avoidance of Double Taxation on Income from Aircraft Operation) Order*;

- Non-PRC resident with establishment in PRC, EIT is charged at 25% on PRC source income and non-PRC source income connected to PRC establishment taxable, establishment includes:

  1) a place of management, operation or administration;

  2) a farm, factory or place of extraction of natural resources;

  3) a place where services are rendered;

  4) a place of construction, installation, assembly, repair, and

  5) exploitation, etc.;

  6) other establishments engaged in manufacturing and business operating activities; and

  7) a business agent which signs contracts, or stores and delivers commodities on behalf of the non-resident enterprise on a regular basis

- For an enterprise which is a resident of a jurisdiction having entered into double tax agreement/arrangement with China (e.g. Hong Kong, Singapore, etc.), such enterprise will not be subject to EIT for business carried on in China unless its business activities constitute a "permanent establishment" (see above 8-6500 for details).

- Non-TREs which do not have establishment in China, but derives income from China, may be subject to EIT on that income. The applicable tax rate is 10% on the gross income, ie without deduction on any expenses. The Chinese payers are required to withhold and report the tax to the relevant tax authority.

- For Non PRC resident without establishment in PRC, only PRC source income taxable, at 10% on withholding basis

- PRC source income, include

  – Dividend from a Chinese resident company

  – Interest income from a Chinese resident company

  – Royalty income from a Chinese resident company

  – Rental income from immovable property located in China

  – Gain on disposal of shares of a Chinese resident company

- The Chinese resident taxpayers have to withhold, report and pay tax for the non resident for the cases where the non resident has no establishment in China.

- Non-resident enterprises may be recognized as resident enterprises under Guoshuifa [2009] No. 82 (22 April 2009) (Circular 82) and hence subject to EIT on a worldwide basis rather than only be subject to EIT on China sourced income.

  – Circular 82, following the principle of "substance-over-form" , indicates that an overseas incorporated domestically-controlled enterprise that satisfies all of the following conditions shall be determined to have its place of effective management in the PRC, and accordingly be recognized as a PRC tax resident (namely a TRE), and will be subject to EIT on income derived from both inside and outside China:

    (1) Senior management are in charge of day-to-day activities and the place for senior management to execute their duties is mainly located in China;

- whether the foreign enterprise assets mainly consist of direct or indirect investments made within the territory of China, or whether the main income obtained is directly or indirectly from China;
- whether the functions actually performed by and the risks undertaken by a foreign enterprise and its subsidiary directly or indirectly holding Chinese taxable property can confirm that the enterprise structure is of economic substance;
- duration of shareholders, business modes and related organizational structure of the foreign enterprise;
- information about the payment of due income tax outside China on indirect transfer of Chinese taxable property;
- the substitutability of indirect investment by equity transferor, indirect transfer of Chinese taxable property and direct investment, and direct transfer of Chinese taxable property;
- Chinese tax conventions or arrangement applicable to the proceeds from indirect transfer of Chinese taxable property; and
- other relevant factors.

III Individual income tax (IIT)

IIT is imposed on the taxable income derived by individuals (including 9 taxable items, such as income from wages and salaries and income from production, operation derived by individual industrial and commercial households). All foreigners are required to register with the Chinese tax authorities as soon as they become liable to IIT. IIT is assessed on a monthly basis. The tax year is from 1 January to 31 December every year. The employer or the person who pays taxable income to an individual is required to withhold the tax, file the tax returns and remit the tax so withheld to the tax authorities.

General charging scope

- China-domiciled individuals and non-China-domiciled individuals who reside in China for 183 days or more in a tax year are considered residents for IIT purpose. Residents in general are subject to IIT on their worldwide income (see special rule for non-China-domiciled individuals below)
- Non-China-domiciled individuals who reside in China for less than 183 days in a tax year are considered non-residents for IIT purpose. Non-residents in general are subject to IIT on their China-source income only.
- China domiciled individuals are:
  - Individuals maintaining residence in China because of legal residency status, family, or economic ties and habitually residing in China, or
  - Chinese nationals

Special rule for non-domiciled individuals:

- If a non-domiciled individual resides in mainland China ("China") for 183 days or more in a tax year, he will be subject to IIT on both China and non-China sourced income, ONLY if the following conditions are satisfied.

REVISION QUESTIONS

[¶8-9000] Test your knowledge

Question 1

A Hong Kong company carries on business in Hong Kong and China –

(I) may be subject to income tax in China in respect of its business profit sourced from China

(II) may be subject to income tax in China in respect of its business profits attributable to a permanent establishment in China

(III) may be subject to income tax in China in respect of its business profits derived from an import processing arrangement with a PRC entity.

(a) I

(b) II

(c) III

(d) I, II, III.

Question 2

In respect of a Hong Kong resident, income from dependent personal service will be subject to income tax in China if –

(I) the relevant person works in China more than 90 days

(II) the relevant person works in China more than 183 days

(III) the income will be borne by a permanent establishment in China, disregard how long the relevant person works in China.

(a) I, III

(b) II, III

(c) II

(d) III

Question 3

A PRC entertainer –

(I) will be subject to profits tax in Hong Kong, if his performance is made in Hong Kong

(II) will be subject to profits tax in Hong Kong, only if his/her performance made in Hong Kong constitute as a permanent establishment

(III) will be subject to salaries tax in Hong Kong, if his/her stay in Hong Kong is more than 183 days within any 12-month period.

(a) I

(b) I, II

(c) I, II, III

(d) II, III

(b) Analyze if BHK's software fee would be subject to EIT, your analysis should include, but not limited to, whether it is most tax efficient to just manage the time of the staff working in mainland China from EIT perspective;

(c) Analyze the EIT liability, if any, in respect of the dividend paid by GAC to BHK;

(d) Analyze the EIT impact of BA's investment exit strategy.

(e) Analyze the possible tax treatment the Hong Kong Inland Revenue Department (IRD) will apply on the software fee received by BHK from GAC and suggest any counter argument BHK can take against the IRD's treatment.

Question 8

Bobby (HK) Ltd. ("BHK") is a company incorporated in Hong Kong and principally engaged in the business of running preparation courses for candidates of professional examinations in Hong Kong. It also sold training materials and books for the examination. BHK was holding a subsidiary company in China namely Gold Advancement Company (GAC) in China. GAC's business was similar to BHK and it just started its business in China one year ago. Hence, it needed the help of BHK to establish its business. BHK had carried out the following businesses in mainland China.

Secondment

BHK and GAC had entered into a secondment agreement whereby BHK had seconded four staff members to work for GAC for a period of one and half year from 1 July 2017 to 31 December 2018. GAC reimbursed BHK the actual salaries of the staffs for the relevant China working period plus 10% mark-up thereon. The staffs were all under the supervision of BHK's Hong Kong management. They did not sign any employment contract with GAC. The actual working periods in China of BHK's staff members were respectively as follows:

Staff 1	1/7/17 to 30/9/17
Staff 2	1/10/17 to 30/11/17
Staff 3	1/5/18 to 30/6/18
Staff 4	1/12/18 to 31/12/18

Guangzhou library and e-trading of learning materials

BHK also sold books and learning packs for professional accountancy examinations to mainland students. BHK registered a representative office in China, which was running a library in Guangzhou. At the library, candidates who had enrolled courses of GAC could borrow books and learning packs for 4 hours, free of charge, for reading at the library only. Candidates could not make any copies of the materials. Any person who would like to buy the books and learning packs could place orders to BHK via its website. Books and learning packs would be delivered to the candidates directly by BHK.

Professional Training Services

Moreover, BHK provided professional training to various corporate clients in mainland during the year ended 31 December 2015 for 104 days (being every Saturday and Sunday). BHK did not rent or purchase any training centre on the mainland. BHK signed an agreement with an executive training company in mainland whereby the company would provide a training centre to BHK free of charge for delivery of the training services. The Chinese company would promote BHK's services and solicit clients for BHK. The company would share 50% tuition fee for administrative and marketing support provided to BHK.

[¶9-2500] Powers of seizure and retention

Under a search warrant granted by a magistrate, the Commissioner may take possession of books, records, accounts or documents which are found during a search and which afford evidence of a defaulting person's tax liability (s 51B(1)(iii)).

Material which the Commissioner is entitled to take possession of may be retained for as long as it is reasonably required for any tax assessment to be made, or for any proceedings to be completed (s 51B(1)(iv)). The person whose affairs the seized material relates to is entitled to examine and make extracts from the material at times and under conditions determined by the Commissioner (s 51B(3)).

Application for return of material

When books, records, accounts or documents have been retained for more than 14 days, the person from whom they were taken may apply for an order directing their return. An application for an order directing the return of seized material must be made in writing to the Board of Review. The Board hears submissions from both the applicant and the Commissioner, or their representatives, before deciding whether to make an order for the return of the material. An order may be made either unconditionally, or subject to a condition which the Board considers proper to impose (proviso to s 51B(1)).

[¶9-2600] Execution of warrant

When exercising powers under a search warrant, the Commissioner (or an authorised officer) must, upon demand, produce the warrant for inspection (s 51B(2)). A person who obstructs or hinders the Commissioner in the exercise of the powers granted by a search warrant, commits an offence. The penalties for this offence on conviction are a level 3 fine (see ¶600) and imprisonment for six months (s 51B(4)).

Any officer of the Inland Revenue Department, under the direction of the Commissioner or an authorised officer, may assist in the execution of a warrant. An assisting officer may exercise the powers of entry, search and possession (s 51B(1A)).

Duties of employers and public officers

[¶9-3000] Duty of employer to furnish return

Employers who receive a notice in writing from an assessor requiring them to do so, must, within a reasonable time, furnish tax returns to the Department. An employer's return must contain the names, places of residence and the full amounts of remuneration of:

- all persons whom he or she employs who receive remuneration in excess of a minimum amount fixed by the assessor; and
- any persons named by the assessor whom he or she employs (s 52(2)).

Directors of companies, and persons engaged in the management of companies, are regarded as persons employed by those companies for tax return purposes (s 52(3)).

[¶9-3100] Duty of employer upon employing taxpayer

When an employer employs, in Hong Kong, either an individual who is (or is likely to be) chargeable to salaries tax, or any married person, a notice must be given to the Commissioner (s 52(4)). The notice should contain the full name and address of the new employee, the date of commencement and the terms of his or her employment. A notice must be made in writing no later than three months after the employment commences.