III Obligations of an Employer

6. Section 52 imposes the following obligations on an employer:

   a. to furnish employer's returns on the details of his or her employees and remuneration paid to each – Section 52(2);

   b. to notify the Commissioner of the commencement of employment of employees not later than 3 months after the date of commencement of such employment – Section 52(4);

   c. to notify the Commissioner of the cessation of employment of employees not later than 1 month before such cessation – Section 52(5);

   d. to notify the Commissioner of the departure of employees leaving Hong Kong for a period of more than 1 month; the notice is to be given not later than 1 month before the expected date of departure – Section 52(6);

   e. to withhold payment of money to the employee who is to leave Hong Kong for more than 1 month and notice under Section 52(6) has been served to the Commissioner – Section 52(7).

7. **Summary of major obligations and related penalties for Section 52 (See also XV Concept Map 44.)**

With respect to the level of penalty below, it is cross-referenced to Criminal Procedure Ordinance Cap. 221 Schedule 8 Level of Fines for Offences.

- Level 3: $10,000

Section	Obligation	Penalty for Non-compliance
S.52(1)	*Furnish* information requested in a notice given by the Commissioner within the time specified in the notice.	A fine at level 3 and court order for compliance within the time specified in the order – S.80(1)(a).
S.52(2)	*File employer's return* within the time specified in the return.	A fine at level 3 and court order for compliance within the time specified in the order – S.80(1)(a).
S.52(4)	*Notify* Commissioner in writing of the *commencement of employment* of staff not later than 3 months after the date of commencement of such employment.	A fine at level 3 and court order for compliance within the time specified in the order – S.80(1)(c).
S.52(5)	*Notify* Commissioner in writing of the *cessation of employment* of staff not later than 1 month before such individual ceases to be employed in HK.	A fine at level 3 and court order for compliance within the time specified in the order – S.80(1)(c).
S.52(6)	*Notify* Commissioner in writing of the *departure* of staff from HK for more than 1 month not later than 1 month before the expected date of departure.	A fine at level 3 and court order for compliance within the time specified in the order – S.80(1)(c).
S.52(7)	*Not to make any payment* of money to staff who is leaving HK for a period of 1 month from the date the employer serves the notice to Commissioner under S.52(6).	A fine at level 3 and court order for compliance within the time specified in the order – S.80(1)(c).

8. **Different forms of employer's returns**

Form Number	Relevant Section	Situation Required
BIR56A	Section 52(2)	Covering sheet for employer's return
IR56B	Section 52(2)	Annual employer's return
IR56E	Section 52(4)	Commencement of employment
IR56F	Section 52(5)	Cessation of employment
IR56G	Section 52(6)	Employee departure from Hong Kong
IR56M	Section 52(2)	Employer's return for commission recipients and subcontractors etc. who are not employees

IV Obligations of a Reporting Entity under CbCR Requirement

9. Sections 58E, 58H and 58L impose the following obligations on a reporting entity:

a. a Hong Kong ultimate parent entity of a reportable entity must file a CbCR in respect of an accounting period (begins on or after 1 January 2018) by the filing deadline specified in the notice served by the assessor — Section 58E(1).

b. each Hong Kong entity of a reportable group must file a written notice with the Commissioner informing the Commissioner the name, address and business registration number of each of the group's Hong Kong entities; identifying among them the Hong Kong ultimate parent entity or the surrogate parent entity that is resident for tax purposes in Hong Kong — Section 58H(1)(a).

c. to inform the Commissioner within 1 month after the change of the address should a reporting entity has changed it — Section 58L(1).

d. a reporting entity must keep sufficient records to enable the accuracy and completeness of the CbCR filed — Section 58L(2)(a).

e. a reporting entity must retain the records for a period of 6 years beginning on the date which the CbCR is filed — Section 58L(2)(b).

10. **Summary of obligations and penalties for Sections 58E, 58H and 58L (See also XV Concept Map 45.)**

With respect to the level of penalty below, it is cross-referenced to Criminal Procedure Ordinance Cap. 221 Schedule 8 Level of Fines for Offences.

- Level 5: $50,000
- Level 6: $100,000

Section	Obligation	Penalty for Non-compliance
S.58E(1)	*File a CbCR* before filing deadline specified.	A fine at level 5 and court may order for compliance within the time specified in the order – Section 80G(3); a further fine of $500 for every day or part of a day during which the offence continues after conviction – Section 80G(4).

CHAPTER

3 Objections, Holdover Claims and Revision of Errors

Learning Objectives

After having studied this chapter, you would:

a. understand the objection procedure against a tax assessment;
b. understand the appeal procedure to the Board of Review and Courts;
c. understand the holdover procedure for payment of provisional tax;
d. understand the procedure for revision of assessment under Section 70A; and
e. understand the difference between objection, correction of error and refund of tax overpaid.

I Introduction

1. Taxpayer's rights

If a taxpayer finds that he is entitled to pay tax less than demanded in a notice of assessment, the IRO provides four channels that he may rely on to lodge a claim to the CIR within the period stipulated in the IRO.

The channels are:

a. lodging an objection within one month after the date of the notice of assessment – Section 64;
b. application for a correction of error in the assessment – Section 70A;
c. application for a refund of tax paid in excess of the amount with which he or she was properly chargeable – Section 79; and
d. application for holdover of provisional tax – Sections 63E, 63J and 63O.

II Objection

2. Objection procedure

The requirements for lodging a valid objection against an assessment (final assessment) under Section 64(1) are as follows:

a. a written notice addressed to the Commissioner of Inland Revenue;
b. the notice must be received by the Commissioner within one month after the date of the notice of assessment;
c. the notice must state precisely the grounds of objection; and
d. if the assessment was issued in the absence of a return under Section 59(3), the notice of objection must be supported by a duly completed tax return; if the taxpayer is a corporation, the tax return must be accompanied by the corporation's balance sheet, profit and loss account and auditors' report (except in the case of small business or small corporation having a gross income not more than $2,000,000).

3. Late objection

If a notice of objection is received by the Commissioner after the stipulated objection period, the Commissioner may extend the objection period if the reason for the lateness is owing to the taxpayer's absence from Hong Kong, sickness or other reasonable causes. These two reasons of lateness are usually applicable to an individual or a sole proprietor. The Commissioner does not accept these two as a reasonable excuse for a partnership or a corporation.

4. Application of holdover of tax in dispute

When a taxpayer lodges an objection to an assessment, he may apply for holdover of tax in dispute (i.e. not to pay the tax on a temporary basis). The Commissioner may accept his application, and holdover the tax upon the outcome of the objection. This is a discretionary power of the Commissioner. He may reject the taxpayer's holdover application, and demand the tax to be paid when it is due for payment.

5. Consequences of tax heldover and not heldover

When a taxpayer applies for holdover of tax in dispute, the Commissioner may accept or reject his or her holdover application in one of the following four ways:

a. No holdover of tax in dispute

i. The taxpayer has to pay the tax on or before the due date.

ii. If the taxpayer finally wins the case, the tax paid is refunded to the taxpayer without interest.

iii. If the taxpayer finally loses the case, no further action is needed as the tax has been paid already.

b. Unconditional holdover of the tax in dispute

i. The taxpayer is not required to pay the tax until the decision of the case has been finalised.

ii. If the taxpayer finally wins the case, no further action is needed as no tax was paid.

iii. If the taxpayer finally loses the case, he or she has to pay the tax withheld. In addition to the tax payable, he or she has to pay interest at a rate fixed by the Chief Justice by notice in the Gazette under Section 50 of the District Court Ordinance on the tax withheld from the date of holdover to the date of settlement of the tax.

c. Conditional holdover of the tax in dispute with the purchase of tax reserve certificate

i. The taxpayer is not required to pay the tax, but he or she has to purchase tax reserve certificates with the same amount of tax heldover.

ii. If the taxpayer finally wins the case, the tax reserve certificate purchased is refunded to the taxpayer with interest.

iii. If the taxpayer finally loses the case, the tax reserve certificate purchased is used to set off the tax payable without interest. Unused portion of the tax reserve certificate is refunded to the taxpayer with interest.

d. Conditional holdover of the tax in dispute with the provision of a banker's undertaking

i. The taxpayer is not required to pay the tax, but has to obtain an undertaking from a bank that the bank will undertake to pay the tax on behalf of the taxpayer on an irrevocable basis.

CHAPTER 6

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（管有承按人）,
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 March 2011) provides, in paragraph 12, 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.

CHAPTER 8

Scope of Charge and Sources of Income

Learning Objectives

After having studied this chapter, you would:

a. understand how to determine the source of Hong Kong employment;

b. understand how the charge of Hong Kong salaries tax on employment is affected by the payment of overseas income tax;

c. understand how non-Hong Kong source employment income is taxed;

d. understand the 60-day rule of visit;

e. understand how the income of ship and aircraft crew is assessable;

f. understand how income from office is taxed; and

g. understand how income from pension is taxed.

I Introduction: Scope of Charge of Salaries Tax

1. The charge of salaries tax is governed by Section 8 of the Inland Revenue Ordinance (IRO). Section 8(1) reads as follows:

   "Salaries tax shall, subject to the provisions of this Ordinance, be charged for each year of assessment on every person in respect of his income arising in or derived from Hong Kong from the following sources –

   a. any office or employment of profit; and

   b. any pension."

2. There are three sources of income chargeable to salaries tax as follows:

   a. employment,

   b. office, and

   c. pension.

3. It is important to make a distinction between the following pairs of items:

   a. employment and independent contractor;

   b. employment and office; and

   c. pension and lump sum retirement payment.

4. **Employment and independent contractor**

   Income from an employment is chargeable to salaries tax while income from an independent contractor is chargeable to profits tax. An employment is called "a contract of service" and may be referred to as "being employed". An independent contractor runs a business on his own account and is called "a contract for service". It is also referred to as "self-employed". Many people prefer a contract for service to a contract of service as the income from a contract for service is chargeable to profits tax and the taxpayer is entitled to more generous deductions under Section 16(1) than those under Section 12(1) in salaries tax.

Their differences may be summarised with the following diagram.

Contract of service	Contract for service
↓	↓
Being employed	Self-employed
↓	↓
Employment	Running one's own business
↓	↓
Salaries tax	Profits tax
↓	↓
Limited deductions	Generous deductions

In order to determine whether there is a contract of service or a contract for service, the CIR generally applies the following tests:

a. **Control test**

To determine whether the relevant person (i.e. the so-called employer) controls the performance of the relevant individual (i.e. the so-called employee or taxpayer); [evidence includes whether the person to whom the services are rendered can instruct the taxpayer as to what to do, how to do it, and when to do it; whether the taxpayer may work for other persons without the approval of the service recipient, etc.]

b. **Integration test**

To determine whether the relevant individual holds a position within the organisation of the relevant person; [evidence includes whether the taxpayer is "part and parcel" of the organisation, whether he or she represents to third parties that he or she is a staff member of the organisation, etc.]

c. **Economic reality test**

To determine whether the relevant individual is at risk with his or her own capital at the performance of duty for the relevant person; [evidence includes whether the taxpayer provides his or her own equipment or assistants; whether he or she contributes capital; his or her degree of responsibility and any opportunity of profiting, etc.]

d. **Mutuality of obligation test**

To determine whether the relevant individual is obliged to provide his or her work or skill to the payer; is the service recipient (i.e. the relevant person) obliged to provide work and pay a wage or remuneration to the relevant individual; [evidence includes whether either party can terminate the relationship without incurring any liabilities, intention of the parties, terms of the agreement, etc.]

5. ***CIR v Pang Fai* (2017)**

a. **Issue**

Whether honorarium received by workshop facilitator and examination marker from a professional body should be assessed under salaries tax or profits tax.

CHAPTER 15

Source of Profit

Learning Objectives

After having studied this chapter, you would:

a. understand when profits are regarded as arising in or derived from Hong Kong;
b. understand how trading profits are taxable in Hong Kong;
c. understand how manufacturing profits are taxable in Hong Kong;
d. understand how income from services rendered is taxable in Hong Kong;
e. understand how interest income is taxable in Hong Kong;
f. understand how royalty income is taxable in Hong Kong;
g. understand how income received from qualifying debt instruments is taxed in Hong Kong;
h. understand how profits received from qualifying reinsurance and captive insurance businesses are taxed in Hong Kong; and
i. understand how profits received by qualifying corporate treasury centre 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:

a. It is the gross profit of a transaction, not the net profit of a company, to be considered.

b. 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.

c. 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.

d. 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:

a. antecedent activities and incidental activities, and

b. 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

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.

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.

CHAPTER

24 Profits Tax Planning

Learning Objectives

After having studied this chapter, you would:

a. understand how an overseas company may avoid profits tax liability by not carrying on business in Hong Kong;
b. understand how income derived from trading transactions may avoid being taxed in Hong Kong;
c. understand how income derived from manufacturing activities may avoid being taxed in Hong Kong;
d. understand how income derived from services performed may avoid being taxed in Hong Kong;
e. understand how interest income may avoid being taxed in Hong Kong;
f. understand how transfer pricing activities may avoid being taxed in Hong Kong;
g. understand how to make use of loss company within a group to reduce profits tax liability;
h. understand how to select the first accounting date to reduce profits tax liability;
i. understand how to prepare year-end tax planning;
j. understand the cautions needed to be aware of for developing a profits tax plan; and
k. understand how to answer profits tax planning questions in an examination.

I Introduction

1. There is no magic in profits tax planning. The objective of profits tax planning is to make use of the characteristics of the Hong Kong tax system, and arrange tax affairs in such a way that a less amount of profit is taxed under the Inland Revenue Ordinance.

2. The common tax planning methods include:

   a. not to set up a permanent establishment constituted by a fixed place of business in Hong Kong,

   b. use of capital gain techniques to make the profit from a sale of an asset exempt from profits tax,

   c. arrangement of source of profits outside Hong Kong,

   d. infringement commission,

   e. transfer pricing with overseas companies,

   f. use of loss companies within a group,

   g. selection of accounting date at the commencement of business, and

   h. year-end tax planning.

3. This chapter cannot be read in isolation on its own. It should be read with Chapter 14 on the scope of charge of profits tax, and understand the relationship between permanent establishment and carrying on a business in Hong Kong, Chapter 15 on source of profits, Chapter 23 on basis periods, Chapter 34 on non-residents and overseas activities, and Chapter 35 on anti-avoidance. Readers should be aware of the newly enacted provisions concerning arm's length principle and transfer pricing rules.

II Not Setting up a Permanent Trading Establishment in Hong Kong

4. Basic principle

Section 14 provides that an income is chargeable to Hong Kong profits tax only when all the three conditions provided in that section are satisfied. One of the required conditions is that a person carries on a trade, a profession or a business in Hong Kong. If an overseas company does not carry on a business in Hong Kong, it is not chargeable to profits tax.

5. New rules define permanent establishment

The Inland Revenue (Amendment) (No. 6) Ordinance 2018 was enacted on 13 July 2018 that takes legislative effect on 1 April 2018 or 1 April 2019, with the relevant provisions specified in Part 8AA of the amendment ordinance. The provisions concerning arm's length principles and permanent establishment definitions would take retrospective effect to the year of assessment 2018/19, while the new provisions concerning permanent establishment profit attribution take effect from the year of assessment 2019/20.

The new rules replace the then existing Inland Revenue Rule 5(1). Section 50AAK(1) provides that a non-Hong Kong resident person who has a permanent establishment in Hong Kong is regarded as carrying on a trade, profession or business in Hong Kong for the purposes of profits tax. Please refer to Chapter 14 Scope of Charge for technical details.

6. Planning techniques

Before the enactment of Section 50AAC and Schedule 17G

If an overseas company merely sets up a buying office or a representative office, it does not have any exposure to profits tax in Hong Kong. However, the overseas company has to ensure that the receipts that it receives do not fall within one of the deeming provisions of trading receipts chargeable under Section 15(1).

After the new sections contained in Schedule 17G have come into effect from 2018/19

Apart from keeping special cautions to Section 15(1), there are new regulations to observe. Schedule 17G divides permanent establishment ("PE") into PE of a DTA territory resident person and PE of a non-DTA territory resident person. PE issues in Hong Kong for a DTA territory resident would follow the relevant provisions under the DTA concerned; while those for a non-DTA territory resident are governed by Part 3 of Schedule 17G. Readers are advised to refer to Chapter 14 Scope of Charge concerning the differences between them.

Briefly, under the new provisions, a PE is constituted by a place of business and it includes *but is not limited to* the 6 establishments stipulated under Section 4(2) of Schedule 17G. Section 5 of Schedule 17G provides the exclusion, and a PE is deemed not to exist *only* when certain activities performed are preparatory or auxiliary in relation to the business as a whole.

Under the new PE regime, the attention is shifted from looking at the activities engaged by the place of business *per se* to whether or not the "preparatory or auxiliary" exclusion could be applied. The potential pitfalls under the new regulations include:

a. warehousing activities are likely to constitute a PE of retail multinational companies ("MNC") and particularly those that are involved in online sales;

b. likewise, if retail MNCs interpose and use central buying entities in local Hong Kong market, the activities performed by the local entities also constitute a PE as the purchasing function performed is essential and significant to the MNCs as retailers; and

c. even though there may be activities being considered as "preparatory or auxiliary" by themselves, Section 6 of Schedule 17G provides the "anti-fragmentation" principle that deems the existence of a PE.

III Capital Gain Exempt from Profits Tax

7. Basic principle

Section 14 provides that the profit derived from the sale of a capital asset is not chargeable to Hong Kong profits tax. Whether an asset is a capital asset is a question of facts and the six badges of trade are often employed for the determination of a capital asset or a trading stock. Sometimes, it is possible to make use of this exemption by classifying assets as capital assets instead of trading stock.

8. Planning techniques

A company may prove that a property is a capital asset by classifying the property as a fixed asset, and not leaving the property as vacant or unused. Sometimes, it is possible to argue that the sale of the property is involuntary, and it is not intended to make a quick sale for a profit at the time of purchase of the property.

IV Arrangement of Source of Profits outside Hong Kong

9. Basic principle

Section 14 provides that only profit derived from or arising in Hong Kong is chargeable to Hong Kong profits tax. If a person can arrange his business operations outside Hong Kong, it is possible that the profit is sourced outside Hong Kong, and it is exempt from Hong Kong profits tax.

10. Planning techniques

Whether a profit is sourced in Hong Kong or outside Hong Kong is a question of facts, each case is determined on its own merits. Different rules are applicable to different types of business. Examples are:

a. Trading transactions – contract effected test and totality of facts approach as in *Magna Industrial Co. Ltd. v CIR*

b. Manufacturing – operations test

c. Services rendered – operations test

d. Interest income – provision of credit test and operations test as in *CIR v Orion Caribbean Ltd.*

e. Royalty income – development test or registration test

V Trading Transactions

11. Basic principle

According to DIPN 21, the Commissioner of Inland Revenue (CIR) is of the view that trading profits are exempt from profits tax if both the contract for purchase and contract for sale are effected outside Hong Kong. There is no apportionment of trading profit even when either the purchase contract or the sale contract is effected in Hong Kong.

12. Planning techniques for contract effected test

In order to satisfy the exemption criterion, a person has to send travelling executives to overseas countries where the suppliers and the clients situate, and negotiate and finalise the details of the contracts outside Hong Kong. If the travelling executives have the general authority to finalise the contracts outside Hong Kong, and are not required to refer back to Hong Kong for instruction by fax or telephone or email, the contracts would be treated as effected outside Hong Kong. Thus, the trading profits would be regarded as sourced outside Hong Kong, and not subject to Hong Kong profits tax.

13. Planning techniques for totality of facts approach

Although the contract effected test shows that the source of trading profit is in Hong Kong, a person may rely on the totality of facts approach as in Magna case to argue that the trading profit is sourced outside Hong Kong. The most important element is that a person has to demonstrate that the overseas selling efforts are substantially more than those of local purchasing efforts in Hong Kong.

VI Manufacturing Profit

14. Basic principle

According to DIPN 21, the CIR allows apportionment of profit made from the sale of goods manufactured by a person outside Hong Kong. Generally, the apportionment is 50:50. That means that half of the profit is exempt from Hong Kong profits tax. The important element is that a Hong Kong company is heavily involved in the manufacturing process in Mainland China.

15. Planning techniques

In order to satisfy the exemption criterion, a Hong Kong company is to sign a processing or assembling agreement with a Mainland entity. Under that agreement, the Hong Kong company provides raw materials, machinery and supervisory staff to the Mainland entity which provides factory and unskilled labour. In this way, half of the profits made from the sale of such finished goods are exempt from Hong Kong profits tax no matter whether the goods are sold to Hong Kong customers or overseas customers. The same exemption effect is achieved if a Hong Kong company is able to set up its own factory in the Mainland for manufacturing goods there.

16. Caution

If the relationship between the Hong Kong company and the Mainland entity is that of a sub-contractor, the 50% exemption rule will not apply. The transactions of the Hong Kong company become trading activities. The source rule is the contract effected test. The profits derived from the sale of such goods are either fully taxable or fully exempt. (See also the Datatronic case and the CG Lighting case in Chapter 15 Source of Profit.)

CHAPTER

29 Plant and Machinery

Learning Objectives

After having studied this chapter, you would:

a. understand the format of a depreciation allowance schedule;
b. understand how to compute depreciation allowance for assets acquired under hire-purchase terms;
c. understand how to compute depreciation allowance for private assets introduced to business use;
d. understand in what circumstances that the expenditure incurred for the acquisition of fixed assets can be fully deducted;
e. understand how to treat assets disposed in the computation of depreciation allowance;
f. understand how to compute depreciation allowance for assets acquired under the sale and leaseback scheme; and
g. understand how to compute depreciation allowance for assets acquired under leveraged leasing terms.

I Introduction

1. Depreciation allowances under Inland Revenue Ordinance (IRO)

Each enterprise has different accounting policy for the provision of depreciation on capital assets, and this leads to different amount of accounting depreciation on the same set of capital assets. The IRO disallows the deduction of accounting depreciation, and replaced it with another set of rule for the calculation of the depreciation allowances provided in the IRO.

2. Distinction between plant and machinery with building and structure

Plant and machinery is something which is movable while building and structure are not movable. Building is further divided into industrial building and non-industrial building. Industrial building allowance (IBA) is granted for the use of an industrial building while commercial building allowance (CBA) is granted for the use of a building or structure not belonging to the category of industrial building.

3. Basis of calculation of depreciation allowance for plant and machinery with building

Depreciation allowance on plant and machinery is based on the amount of consideration (including incidental cost and installation cost etc.) incurred by the taxpayer (i.e. the buyer). It makes no difference whether the plant and machinery is a new one (first-hand user) or an old one (second-hand user).

For the first-hand user, industrial building allowance (IBA) and commercial building allowance (CBA) are based on the cost of construction (not based on the purchase price incurred by the buyer) incurred for the building or structure by the first-hand user of the building or structure. For the second-hand user, the annual allowance is based on a fraction of the residue of expenditure (ROE) of the building or structure.