Hong Kong Taxation and Tax Planning

21st Edition

Patrick Kin-wai Ho
Kelvin Po-lung Mak

Features of the Book

- Written in easily understood English
- Meets students' needs by explaining how to study taxation and achieve better examination results
- "Learning objectives" at the beginning of each chapter assists students in understanding what they are going to learn in each chapter
- "Questions to test your knowledge" at the end of each chapter reminds students of what they have learnt
- More than 180 tables to help students understand the knowledge more easily
- More than 240 numerical examples to demonstrate the requisite knowledge
- More than 140 concept maps to visually present the relationships between the key elements or components of a particular difficult tax issue or concept
- A total of 47 "examination questions" at the end of Sections B to K and 28 "mock examination questions" to test students' tax knowledge; suggested answers and time allowed are provided for students' reference
- Major rewrites in Chapters 1, 2, 3, 4, 5, 8, 9, 10, 11, 13, 15, 16, 17, 22, 23, 24, 26, 27, 29, 30, 33, 35, 36, 39, 40, 41, 46 and 47 to include materials on tax law updates and cases between April 2021 and June 2023
- The law discussed in this book was updated to mid-June 2023

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Chapter

1 Introduction to the Hong Kong Taxation System

★ Learning Objectives

After having studied this chapter, you would generally:

a. understand the different sources of law and practice affecting the levying of tax in Hong Kong;

b. understand the characteristics of the Hong Kong taxation system;

c. understand the tax administration under the Inland Revenue Ordinance including the issue of returns, the issue of assessments, the lodging of an objection to and appeal against the CIR's determination or court decisions;

d. understand the charge of salaries tax;

e. understand the charge of profits tax;

f. understand the charge of property tax;

g. understand the election for personal assessment; and

h. understand the charge of stamp duty.

I Law and Practice

1. Law

Taxation is a legal subject matter. Studying taxation requires not just the basic knowledge of what the relevant sources of tax law are, but more importantly, the ability to explain the relative authority (i.e., the legal binding power) of each of the sources of tax law.

a. Statute

The tax law of Hong Kong is governed by the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China (the Basic Law), and the statutes and subsidiary legislation passed by the Legislative Council and decisions in precedent cases (known as case law).

Major tax legislation passed by the Legislative Council includes the Inland Revenue Ordinance (IRO), Stamp Duty Ordinance (SDO), and Estate Duty Ordinance (EDO) (Estate Duty had been abolished since 11 February 2006); and the Inland Revenue Ordinance subsidiary legislation which covers Inland Revenue Rules, Exemption from Salaries Tax Order, Double Taxation Relief, Exemption from Profits Tax (Interest Income) Order, the Order of various Comprehensive Double Taxation Agreements that the HKSAR has concluded, etc.

b. Case law

Tax legislation possesses the highest legal authority. In the judicial system, court judges are empowered to deal with the questions of law in dispute cases and interpret the legal intendment of the wording of the tax and other relevant legislation. Judges' decisions become precedent and are legally binding to future cases where the facts are sufficiently similar. This process is known as judicial precedent.

Sometimes, case law decisions may be overruled by a subsequent amendment in the tax legislation. For instance, the enactment of Section 15(1)(ba) overruled the decision in the *Emerson Radio Corporation* case (2000).

c. Board of Review

The Board of Review (Inland Revenue Ordinance) is an independent statutory body constituted in 1947 under Section 65 of the IRO to hear and determine tax appeals. The law provides that the Board shall consist of a chairman and ten deputy chairmen who shall be persons with legal training and experience, and not more than 150 members, all of whom shall be appointed by the Chief Executive.

The functions of the Board include hearing appeals to the CIR's determination and appeals to additional tax imposed under Section 82A of the IRO.

2. Inland Revenue Practice

a. In order to assist the public to understand the tax law easier, and know the IRD's practice in the course of administration of the law, the IRD issues Inland Revenue Departmental Interpretation and Practice Notes (DIPNs) and advance rulings to explain the IRD's interpretation in particular situations based on cases forwarded by taxpayers. Neither the contents of the DIPNs nor those of the advance rulings are binding, and taxpayers may object to the tax treatments described in the DIPNs and advance rulings.

b. Inland Revenue Departmental Interpretation and Practice Notes (DIPNs)

The Commissioner of Inland Revenue (CIR), who is also the Collector of Stamp Revenue (CSR) and the Commissioner of Estate Duty (CED), issues DIPNs to explain how the IRD would interpret the legislation and how the IRD would enforce the law in practice. Up to the time of publishing this edition, the IRD has issued 63, 8 and 1 DIPNs under the IRO, SDO and EDO respectively which are currently effective.

c. Advance rulings

In 2000, the CIR started publishing advance ruling cases regarding business arrangements of taxpayers under contemplation. The objectives of this practice are to draw the attention of the public and to clarify how the IRD would treat certain scenarios under the IRO. The types of ruling deliberated by the CIR include *specific rulings* and *general rulings*. *Specific rulings* apply to a specific person who is entitled to rely upon such rulings. *Specific rulings* cover advance tax rulings, clearances and advance pricing arrangements. *General rulings* address groups or types of persons provided with a given and defined set of parameters, circumstances or activities, instead of applying to a specific person.

3. Summary of authority of different sources of law

The level of authority of the different sources of law may be summarised as follows:

a. the Basic law, Inland Revenue Ordinance and Stamp Duty Ordinance,

b. subsidiary legislation to the Inland Revenue Ordinance, e.g., Inland Revenue Rules, Exemption from Salaries Tax Order, Exemption from Profits Tax (Interest Income) Order and various specifications of arrangements concerning double taxation relief agreements concluded with foreign contracting states, jurisdictions, etc.

c. case law derived from precedent court cases both in Hong Kong and common law countries,

d. decisions of the Board of Review,

e. departmental interpretation and practice notes, and

f. advance rulings.

(With the statute as the supreme one at the top of the list and advance rulings as the least persuasive at the end of the list) [See also IX Concept Map 51.]

4. Current Inland Revenue DIPNs

a. The IRD issues new DIPNs after the enactment of new provisions under the Inland Revenue Ordinance. Also, it revises the relevant DIPNs when there is a change in assessing practice. There are 63 newly issued or revised DIPNs in place.

b. In June 2023, the IRD revised DIPN 54 Taxation of Aircraft Leasing Activities to clarify that a beneficial owner of an aircraft under a bare trust arrangement would be entitled to the tax concessions under the aircraft leasing regime provided that the specified conditions are satisfied.

c. Please visit URL: https://www.ird.gov.hk/eng/ppr/dip.htm for a full list of current DIPNs.

d. DIPNs may be categorised by tax technical areas as follows:

- Tax administration;
- Property tax;
- Salaries tax and personal assessment;
- Profits tax;
- Depreciation allowances;
- General and specific anti-avoidance provisions;
- Double taxation relief; and
- Transfer pricing

Tax administration		
No.	**Inland Revenue DIPNs**	**Issued Date (or Revised Date)**
6	Inland Revenue Ordinance — Provisions as to (A) Objections to the Commissioner (B) Appeals to the Board of Review (C) Appeals to the Courts	(November 2016)
11	Field audit and investigation	(October 2007)
31	Advance rulings	(April 2020)

Property tax		
No.	**Inland Revenue DIPNs**	**Issued Date (or Revised Date)**
4	Lease premiums / Non-returnable deposits / Key or tea money / Construction fees etc. *(interaction with Profits Tax)*	(February 2006)
14	Property tax	(March 2011)

Salaries tax & personal assessment		
No.	**Inland Revenue DIPNs**	**Issued Date (or Revised Date)**
9	Major deductible items under salaries tax	(September 2006)
10	The charge to salaries tax	(June 2007)
16	Salaries tax — Taxation of fringe benefits	(October 2003)
18	Assessment of individuals under salaries tax and personal assessment	(February 2020)
23	Recognised retirement schemes *(Salaries tax issues for employees)*	(May 2019)
33	Insurance agents *(Tax treatment under salaries tax)*	(October 2009)
35	Concessionary deductions: Sections 26E and 26F — Home loan interest	(February 2020)
36	Concessionary deductions: Section 26D — Elderly residential care expenses	(February 2020)
37	Concessionary deductions: Section 26C — Approved charitable donations	(February 2020)
38	Salaries tax — Employee share-based benefits	(March 2008)
41	Salaries tax — Taxation of holiday journey benefits	August 2003
56	Concessionary deductions: Sections 26H to 26M — Health Insurance Premiums	(February 2020)
57	Concessionary deductions: Sections 26N to 26U — Annuity Premiums and MPF Voluntary Contributions	(February 2020)

Profits tax		
No.	**Inland Revenue DIPNs**	**Issued Date (or Revised Date)**
1	Profits tax — Part A: Computing assessable profits Part B: Revenue recognition Part C: Measurement of inventories or stock	(September 2020)
3	Profits tax — Apportionment of expenses	(July 2008)
4	Lease premiums / Non-returnable deposits / Key or tea money / Construction fees etc. *(interaction with Property Tax)*	(February 2006)
5	Profits tax deductions for expenditure on — Technical education Building refurbishment Prescribed fixed assets Environmental protection facilities	(April 2019)
8	Profits tax — Losses	(September 2009)
12	Commission, rebates and discounts	(September 2001)

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 an office is taxed; and

g. understand how income from a 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;

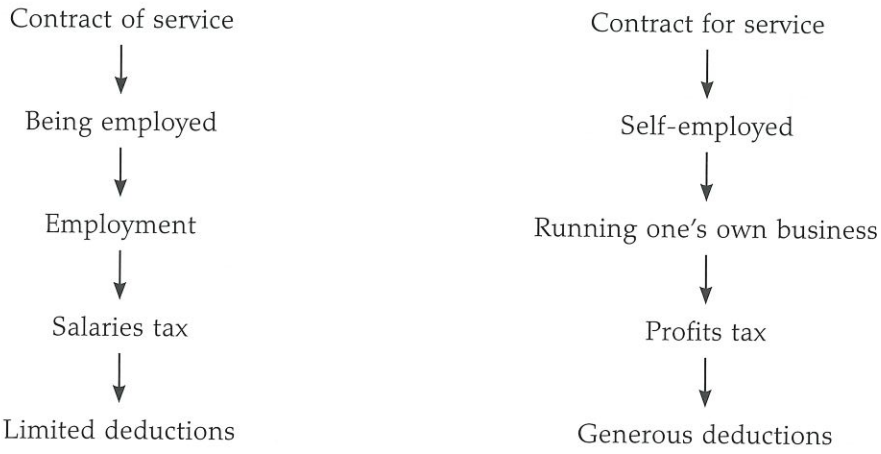
b. employment and office; and

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.



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

II Hong Kong and Non-Hong Kong Source Employment (See also XIV Concept Map 64.)

8. Significance of a non-Hong Kong source employment

The tax effects of a Hong Kong source employment and a non-Hong Kong source employment are different. Generally, a non-Hong Kong source employment is liable to a less amount of salaries tax liability. Therefore, it is very important to distinguish whether an employment is of a Hong Kong source or a non-Hong Kong source (i.e. a foreign employment).

9. Assumption of a Hong Kong source employment

According to the practice of the IRD, an employment is treated as sourced in Hong Kong unless it is proved to the contrary that an employment is sourced outside Hong Kong.

10. Two-tier approach

The CIR revised DIPN 10 in June 2007, and adopts a two-tier approach to determine the source of employment. He or she will first apply the three tests in DIPN 10. If it is found that the source of employment is outside Hong Kong after the application of the three tests, he or she will apply the totality of facts approach to see whether it is a genuine non-Hong Kong source employment.

11. Three conditions in DIPN 10 on the determination of source of employment

The CIR explained in DIPN 10 that source of employment is a practical hard matter of fact. The IRD takes all the relevant factors and circumstances into consideration on the determination of source of employment. In particular, the IRD places emphasis on the following three factors:

a. where the contract of employment was negotiated and entered into, and is enforceable, whether in Hong Kong or outside Hong Kong;

b. where the employer is resident, whether in Hong Kong or outside Hong Kong; and

c. where the employee's remuneration is paid to him, whether in Hong Kong or outside Hong Kong.

If any one of the three factors is in Hong Kong, the IRD will treat the employment as sourced in Hong Kong. If all the three factors are outside Hong Kong, the IRD may treat the employment as sourced outside Hong Kong subject to the analysis of totality of facts approach.

In DIPN 10, the CIR provided detailed analysis on how to apply the three factors in the determination of source of employment. If readers wish to have a more detailed understanding on this, they may download DIPN 10 from the IRD's website: www.info.gov.hk/ird.

12. Totality of facts approach

In some situations, the IRD may look beyond the three conditions stated in DIPN 10. If the IRD finds that all the three conditions mentioned in DIPN 10 are outside Hong Kong, but based on other relevant factors, the IRD may consider that the employment is sourced in Hong Kong.

Generally, the IRD looks into whether the employee's remuneration is reimbursed by a Hong Kong company. If so, the employment is considered sourced in Hong Kong.

15. Exclusion of income already taxed outside Hong Kong

If a person pays tax outside Hong Kong on income from employment which is chargeable to Hong Kong salaries tax, he or she may exclude such income from his or her salaries tax assessment provided that the following two conditions of Section 8(1A)(c) are satisfied:

a. the nature of the tax which he or she paid in the territory where he or she performed services is of substantially the same nature of salaries tax chargeable in Hong Kong;

b. there is evidence that the foreign tax has been paid or deducted; and

c. the countries/jurisdictions where he or she derived overseas income from are not having a bilateral double taxation arrangement with Hong Kong, Section 8(1C).

All the above conditions must be fulfilled before the income can be excluded from assessment.

16. Tax of substantially the same nature

Tax of substantially the same nature of Hong Kong salaries tax means that the foreign tax is charged and paid as a result of a person carrying out services at that overseas place, and the tax is imposed on income derived from the services rendered.

If the tax is not imposed on services rendered but based on the residence or citizenship of the taxpayer, the overseas tax is not of the same nature of Hong Kong salaries tax. In such circumstances, the income already taxed by an overseas country cannot be excluded from Hong Kong salaries tax.

17. Tax credit available under Double Taxation Arrangement with the Mainland of China

Hong Kong residents working in the Mainland of China are able to deduct the income tax paid in the Mainland of China from his or her salaries tax payable in Hong Kong. However, the maximum amount of credit available is restricted to the tax charged at the same rates as those charged on his or her Hong Kong income. As the individual income tax rates in the Mainland of China are higher than those of Hong Kong, only a proportion of the tax paid in the Mainland of China can be set off against the Hong Kong salaries tax liability.

18. Comparison of exclusion of income and tax credit methods

a. Generally, the method of exclusion of income is more beneficial to a taxpayer who earns his or her income in a foreign place with a lower tax rate.

b. When using the income exclusion method, only the income not taxed outside Hong Kong is taken into account in calculating a taxpayer's salaries tax liability. When using the tax credit method, a taxpayer's full income is taken into account in the computation of his or her gross Hong Kong salaries tax liability before deducting the tax credit available.

c. The income exclusion method is applicable to non-tax-treaty foreign places only, e.g. Australia, the USA.

V Income from Non-Hong Kong Source Employment

19. Time-basis apportionment

If an employment is sourced outside Hong Kong, only income derived from services rendered in Hong Kong is chargeable to Hong Kong salaries tax under Section 8(1A). This is usually determined by the number of days the employee stayed in Hong Kong during the basis period of each year of assessment. This is referred to as "Time Basis".

REQUIRED:

How is Mr. Chan's income derived from A Limited chargeable to Hong Kong salaries tax?

Answer

The first issue is whether Mr. Chan's employment is sourced in Hong Kong or sourced outside Hong Kong. A Limited is a company incorporated and carrying on business in Hong Kong, and the IRD will treat A Limited as resident in Hong Kong. Thus, Mr. Chan's employment is sourced in Hong Kong. As a result, Mr. Chan's employment income is either fully taxable or fully exempt from salaries tax.

Since Mr. Chan carries out some services in Hong Kong, he cannot get the exemption from the condition of all services being carried out outside Hong Kong under Section 8(1A)(b).

Mr. Chan stays in Hong Kong for 60 days or less. It is required to consider whether he is entitled to exemption under the 60-day rule of visit under Section 8(1B). Mr. Chan's family is in Hong Kong, and he is not able to satisfy as a visitor. The 60-day rule of visit does not apply to him.

Since he cannot get any exemption under the 60-day rule, all his employment income is chargeable to salaries tax.

33. **Example 8.5: visitor with a Hong Kong employment stayed in Hong Kong for 60 days or less**

Mr. Large is employed by B Limited which is a company incorporated and carrying on business in Hong Kong. Mr. Large is an expatriate who signed his employment contract with B Limited outside Hong Kong. Mr. Large's wife and children live in Australia. According to the job description, he has to travel extensively outside Hong Kong. Thus, he carries out his duties both in and outside Hong Kong. He stays in Hong Kong for 60 days in the current year of assessment.

REQUIRED:

How is Mr. Large's income derived from B Limited chargeable to Hong Kong salaries tax?

Answer

The first issue is whether Mr. Large's employment is sourced in Hong Kong or sourced outside Hong Kong. B Limited is a company incorporated and carrying on business in Hong Kong, and the IRD will treat B Limited as resident in Hong Kong. Thus, Mr. Large's employment is sourced in Hong Kong although the employment contract was signed outside Hong Kong. As a result, Mr. Large's employment income is either fully taxable or fully exempt from salaries tax.

Since Mr. Large carries out some services in Hong Kong, he cannot get the exemption from the condition of all services being carried out outside Hong Kong under Section 8(1A)(b).

Mr. Large stays in Hong Kong for not more than 60 days. It is required to consider whether he is entitled to exemption under the 60-day rule of visit under Section 8(1B). Mr. Large's family lives in Australia, and he is able to satisfy as a visitor. The 60-day rule of visit applies to him. Thus, all his employment income is exempt from salaries tax.

34. **Example 8.6: visitor with a Hong Kong employment stayed in Hong Kong for more than 60 days**

Mr. Small is employed by C Limited which is a company incorporated and carrying on business in Hong Kong. Mr. Small is an expatriate who signed his employment contract with C Limited outside Hong Kong. Mr. Small's wife and children live in Canada. According to the job description, he has to travel extensively outside Hong Kong. Thus, he carries out his duties both in and outside Hong Kong. He stays in Hong Kong for 61 days in the current year of assessment.

REQUIRED:

How is Mr. Godo's income derived from E Limited chargeable to Hong Kong salaries tax?

Answer

The first issue is whether Mr. Godo's employment is sourced in Hong Kong or sourced outside Hong Kong. E Limited is a company carrying on business in Japan, and the IRD will treat E Limited as resident outside Hong Kong. As the employment contract is also signed outside Hong Kong, Mr. Godo's employment is sourced outside Hong Kong. As a result, Mr. Godo's employment income is either taxable on time basis or fully exempt from salaries tax.

Since Mr. Godo carries out some services in Hong Kong, he cannot get the exemption from the condition of all services being carried out outside Hong Kong under Section 8(1A)(b).

Mr. Godo's family lives in Japan, and he is able to satisfy as a visitor. However, he stays in Hong Kong for more than 60 days. As a result, he is not entitled to exemption under the 60-day rule of visit under Section 8(1B). Thus, his income is chargeable on a time apportionment basis of 70/365.

37. **Example 8.9: Hong Kong resident with a non-Hong Kong employment stayed in Hong Kong for more than 60 days**

Mr. Cheung is employed by F Limited which is a company carrying on business in Macao. Mr. Cheung is a Hong Kong resident who signed his employment contract with F Limited in Macao. Mr. Cheung's wife and children live in Hong Kong.

According to the job description, he stations in Macao's head office, but he has to travel to Hong Kong once a month. He is required to oversee the operations of F Limited's branch in Hong Kong. He stays in Hong Kong for ten days each month and lives with his family in Hong Kong. Thus, he carries out his duties both in and outside Hong Kong. He stays in Hong Kong for 120 days in the current year of assessment. His employer pays his monthly salary into his bank account maintained with a bank in Macao.

REQUIRED:

How is Mr. Cheung's income derived from F Limited chargeable to Hong Kong salaries tax?

Answer

The first issue is whether Mr. Cheung's employment is sourced in Hong Kong or sourced outside Hong Kong. F Limited is a company carrying on business in Macao, and the IRD will treat F Limited as resident outside Hong Kong. As the employment contract was signed outside Hong Kong, the IRD would accept that Mr. Cheung's employment is sourced outside Hong Kong. As a result, Mr. Cheung's employment income is either taxable on time basis or fully exempt from salaries tax.

Since Mr. Cheung carries out some services in Hong Kong, he cannot get the exemption from the condition of all services being carried out outside Hong Kong under Section 8(1A)(b).

Mr. Cheung's family lives in Hong Kong, and he is not able to qualify as a visitor. As a result, he is not entitled to exemption under the 60-day rule of visit under Section 8(1B). Since he stays in Hong Kong for more than 60 days and his employment is outside Hong Kong, his income is taxable on time basis of 120/365.

b. Corporation as a partner in a partnership

Schedule 8B provides that for a corporation as a partner in a partnership,

i. profits tax is charged at 8.25% for the net share of profits up to the threshold; and

ii. profits tax is charged at 16.5% for the net share of profits over the threshold.

("Threshold" is defined to mean $2,000,000 multiplied by the ratio at which the corporation shares the profits or losses of the partnership during the basis period for the year of assessment concerned – Section 2 of Schedule 8B.)

c. Connected entity

Section 14AAC provides that if a person or a corporation has any "connected entity" which is broadly defined as one has control over the other or both of them are under the control to the same another entity, the two-tiered profits tax rates are not applicable to such person or corporation when any of the connected entity of such person or corporation has obtained the reduced rate at 7.5% or 8.25% for the year of assessment.

III Charge of Profits Tax

4. Section 14 of IRO – main charging section of profits tax

The charge of profits tax is governed by Section 14(1) which reads as follows:

"Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.".

5. Conditions required for income to be chargeable to profits tax

Under Section 14, if ***all*** the following three conditions are satisfied, a profit is chargeable to profits tax –

a. a trade, profession or business is carried on in Hong Kong;

b. the profit is derived from such trade, profession or business (except profit arising from the sale of capital assets – commonly known as "capital gain"); and

c. the profit must be arising in or derived from Hong Kong – commonly expressed as "profit sourced in Hong Kong".

If any one of the above conditions is not satisfied, that profit is not chargeable to profits tax under Section 14.

6. Tax implication of Section 14

a. The place of incorporation of a company is not relevant in the charge of profits tax (e.g. an overseas incorporated company may be liable to Hong Kong profits tax).

b. A company carries on a business in Hong Kong may not be chargeable to profits tax if the profit is a capital gain or the profit is sourced outside Hong Kong.

c. A non-resident company does not carry on a business in Hong Kong, but earns profit sourced in Hong Kong, that profit may not be chargeable to profits tax.

ii. **Facts**

(1) From about 1992 Mr. Lee spent much time buying and selling shares and futures. Most of these transactions were in his own name but a significant number were done through a wholly owned company called Y.S. Tide Ltd. ("YST").

(2) Up to 1997, his losses were greater than his gains but in early 1997 very large profits were made, exceeding his previous losses by $15 million. Then came the Asian financial crisis and by 1998, he was sustaining substantial overall losses.

(3) The taxpayer had an office and the necessary equipments and facilities for share dealings, and a secretary to keep those records and accounts, these amenities enjoyed by him were not those of his own. He was able to use them because of his special relationship with Y.S. Tide and Kin Tak Fung.

(4) The taxpayer operated 18 margin accounts at any one time, invested a quarter of his wealth in his share dealings and sub-underwrote share offerings.

iii. **Court of Final Appeal Decision**

(1) Whether a person is carrying on a trade or business is a matter of fact and degree, to be decided on all the circumstances of each case. For trading in securities or futures, there has to be a habitual and systematic course of dealing.

(2) As the taxpayer could not show on the evidence that there had been a trade, the only conclusion the Board could reasonably have come to was that the taxpayer was not carrying on a trade, the appeal must fail.

iv. **Observation by the authors**

Although the taxpayer appeared to be trading in the layman's view, all the conditions have to be considered. Therefore, no one factor is conclusive, and all the facts have to be taken into account before coming to a decision of a capital asset or a trading asset. This is also true for speculation in shares. Whether a share dealing business exists is a matter of degree. What the judges consider is whether there is a habitual and systematic course of dealing.

VI Whether There Is a Business Carried On

15. Statutory definition of "business"

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

16. Explanation and interpretation

a. The definition of a "business" is very wide. Any activities not falling within the definition of trade and profession may be treated as a "business" under the IRO.

b. Section 2 specifically includes the following activities as carrying on a business:

i. agricultural undertaking,

ii. poultry and pig rearing,

21. The relation between permanent establishment and carrying a business in Hong Kong

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 charging profits tax.

22. Two types of permanent establishment provided in Schedule 17G

Schedule 17G divides permanent establishment into two categories:

a. permanent establishment of a DTA territory resident person; and

b. permanent establishment of a non-DTA territory resident person.

Before determining whether a non-resident has a PE in Hong Kong, it is important to find out whether the non-resident comes from a DTA territory or a non-DTA territory.

23. Permanent establishment of a DTA territory resident person in Hong Kong

In Part 2 of Schedule 17G, Section 3 provides that whether a non-resident coming from a DTA territory resident person has a PE in Hong Kong is determined in accordance with the relevant provisions under the double taxation arrangement concerned.

Hong Kong DTAs are based on and modified from OECD's model tax treaty. Generally, Article 5 of Hong Kong's DTA provides similar features of a PE as follows:

a. space

b. function

c. time – 6-month rule and 183-day rule

d. agent

For details of the classification of the aforesaid features in respect of a non-resident or a non-DTA resident, readers may refer to Chapter 47 of this book. For ease of reference and comparison, concept maps for the features of a PE for a non-resident from a Non-DTA country and a DTA country are shown at the end of this chapter.

24. Permanent establishment of a non-DTA territory resident person in Hong Kong

a. A fixed place of business

In Part 3 of Schedule 17G, Section 4(1) provides that an enterprise that is a non-DTA territory resident person is treated as having a permanent establishment in Hong Kong if it has a *fixed place of business* in Hong Kong through which the business of the enterprise is wholly or partly carried on.

Section 4(2) defines a fixed place of business includes a place of management, a branch, an office, a factory, a workshop; and a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

b. A building site or construction or installation project

Section 4(3) provides that a building site or construction or installation project is a permanent establishment of an enterprise (subject enterprise) only if –

(a) the subject enterprise has carried on activities at the site or project for a period of more than 12 months; or

e. Independent agent not constituted as permanent establishment

Section 7(3) of Schedule 17G provides that an independent agent from a non-DTA territory is not taken as a permanent establishment in Hong Kong if it acts for the enterprise in the ordinary course of that business.

A person is not an independent agent if the person acts exclusively, or almost exclusively, on behalf of one or more enterprises that are closely related to the person.

25. Persons not treated as an agent of a non-resident

Section 20AA is an exception to the general rule of an agent under the IRO. Section 20AA provides that generally brokers and approved investment advisors are not deemed as an agent for a non-resident if:

a. at the time of the transaction, the broker or the approved investment advisor was carrying on the business of a broker or an approved investment advisor; and

b. the broker or the approved investment advisor was not an associate of the non-resident during the year of assessment.

26. The mere setting up of a buying office in Hong Kong

If an overseas company (i.e. a non-resident) sets up an office as a buying office in Hong Kong, it is not treated as carrying on a business in Hong Kong. The reason is that what the overseas company does in Hong Kong does not involve the sale of goods but solicits source of purchases.

Thus, the existence of a permanent establishment in Hong Kong does not necessarily means that the company carries on a business in Hong Kong within the meaning of Section 14. It is required to look into the activities carried out by such entity in Hong Kong before a conclusion is arrived at.

VIII Non-residents Chargeable to Hong Kong Profits Tax

27. Non-residents receiving income from a Hong Kong company

The following non-residents receiving income from a Hong Kong company is chargeable to Hong Kong profits tax:

a. consignment sale (i.e. local agent holding a stock of merchandise for non-resident);

b. royalty income chargeable under Section 15(1)(a), (b), (ba) (bb), or (bc) [Please refer to paragraphs in Chapters 15 and 16 for details on this topic];

c. hire income received on lease of machines (i.e. movable property) in Hong Kong under Section 15(1)(d) [Please refer to paragraphs 19 and 79 in Chapter 16 for details on this topic]; and

d. non-resident entertainer performing in Hong Kong under Section 20B.

28. Local agent holding a stock of merchandise

a. Consignment sale

If a local agent keeps a stock of merchandise from which he regularly fills orders on behalf of an overseas principal, the overseas principal is regarded as having a permanent establishment under Section 7(1) of Schedule 17G and it is treated as carrying on business in Hong Kong.

b. How to charge profits tax on consignment sale

Under Section 20A(3), the overseas principal is charged with profits tax at the rate of not more than 1% on the goods sold. As a matter of practice, the IRD usually charges 1/2% of the sales proceeds as the profits tax payable for the profits so made. The profits tax from such business is commonly known as "consignment tax".

II Not Setting up a Permanent Trading Establishment in Hong Kong

Basic principle

4. 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.

New rules define permanent establishment

5. The Inland Revenue (Amendment) (No. 6) Ordinance 2018 was enacted on 13 July 2018 and took 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.

Planning techniques

6. ***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).

Since the new sections contained in Schedule 17G have come into effect in 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;

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 the Mainland of 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.)

VII Services Rendered

17. Basic principle

The source of income for services rendered is determined by operations test. The locality of the profit is where the services are carried out. The location where the contract is signed or effected is generally not relevant. This is usually applied to marketing services performed by a Hong Kong company in overseas countries.

24. Planning techniques

In order to avoid the royalty income from being taxable in Hong Kong, the intellectual property has to be developed outside Hong Kong. If the intellectual property is developed outside Hong Kong, it should be registered outside Hong Kong. If it is registered in Hong Kong, the income derived from the use of the intellectual property outside Hong Kong is also chargeable to Hong Kong profits tax.

Concerning value creation contributions for intellectual property ("IP"), the principle is to let the non-Hong Kong entities own the IP and receive royalty income and licence fees where those activities and/or assets relating to IP creation are in fact carried out by the associated Hong Kong resident.

X Transfer Pricing with Overseas Companies and Domestic Transactions

25. Basic principle

The principle is to increase the incoming cost of goods purchased and to reduce the selling price of goods sold. When the supplier is an overseas associated company and the immediate customer is also an overseas associated company, the profit is able to be locked up in the overseas companies. In this way, the profits earned by the Hong Kong company are reduced and the profits of those overseas companies are not chargeable to Hong Kong profits tax.

26. Planning techniques

In order to be successful, the pricing between associated companies must be at arm's length. In particular, specific references must be made to the current statutory transfer pricing regime under the Inland Revenue (Amendment) (No. 6) Ordinance 2018 mentioned above. In general, the prices set and used must be *comparable* to those at the market rates. Profits allocated among entities within a group, including those companies in Hong Kong, have to be justifiable if the prices involved are deviated from the arm's length principle. That is to justify, but not limited to the following examples:

a. a higher incoming price of goods purchased and/or a lower selling price for goods sold; and

b. the amount of royalties or licence fees received against the activities performed and/or assets deployed by entities regarding the development, enhancement, maintenance, protection or exploitation (DEMPE functions/assets) in relation to intellectual properties.

27. Caution

a. Challenged by Section 20 up to 2017/18 and 50AAF from 2018/19 onwards

The previous provision Section 20 that used to catch transfer pricing arrangement has been repealed. The new Section 50AAF is used to adjust a taxpayer's profits upwards or losses downwards if the taxpayer has entered into transaction(s) with an associated person, and the pricing is not at arm's length and has created a Hong Kong tax advantage. The scope of the whole Part 8AA covers both cross-border and domestic transactions, and includes transactions involving tangible and intangible assets, services financial and other business arrangements. (Please refer to Part X of Chapter 36, Part III of Chapter 37 and Chapter 48 for the detailed arrangement.)

XIII Year-end Tax Planning

32. Basic principle

The principle is to increase the amount of deduction and to reduce the amount of taxable income before the close of the accounting year.

33. Planning techniques for purchase of machinery

If a company wishes to purchase equipment or machinery at the beginning of the following year, it may purchase the equipment or machinery before the close of the current account year. In this way, company will get depreciation allowance on those assets in the year of purchase, and this can reduce the assessable profits of the current year.

34. Planning techniques for delaying issuing invoices

If a company wishes to reduce its revenue for the current year, it may withhold from sending invoices to its customers before the year end or wait until the work has been completed. In this way, the income is reflected in the following year, and the profits tax liability may be delayed for one year.

35. Planning techniques for doubtful debts

A company may adopt a more stringent debt control policy by shortening the period of collection and recognising doubtful debts at an earlier stage. As long as the policy is consistently carried out in a reasonable manner, the practice is accepted by the IRD. A more stringent policy on the provision of doubtful debts will reduce the net profit of a company.

36. Planning techniques for obsolete stock

Similar to the provision of doubtful debts, a more stringent stock policy will recognise slow-moving stock at an earlier stage, and provides a larger provision deductible from assessable profits. If the policy is consistently carried out in a reasonable manner, the IRD will not challenge the practice. A more stringent policy on the provision of obsolete stock will reduce the net profit of a company.

XIV Court-free Company Amalgamation

37. Background

Division 3 of Part 13 of the Companies Ordinance (Cap. 622) ("CO") provides a "Court-free Company Amalgamation".

Section 680(1) of the CO provides a vertical amalgamation in that an amalgamating holding company and one or more of its wholly owned subsidiaries may amalgamate, and continue, as one company if the members of the amalgamating companies approve the amalgamation on the terms specified in Section 680(2).

Section 681(1) of the CO provides a horizontal amalgamation in that two or more of the wholly owned subsidiaries of a company may amalgamate, and continue, as one company if the members of each amalgamating company approve the amalgamation on the terms specified in Section 681(2).

REQUIRED:

Calculate Mr. Brown's personal assessment income before deduction of personal allowances.

Solution

Net assessable value ($200,000 × 80%)	$160,000
Assessable income (before deduction of charitable donations)	270,000
Assessable profits (after deduction of charitable donations)	130,000
	560,000
Less: Charitable donation	
[limited to 35% × ($560,000 + $70,000) – $70,000]	150,500
Personal assessment income before personal allowances	$409,500

Readers may be aware of the following two issues:

a. The total amount of donations now deductible is $220,500 [i.e. 35% × $(160,000 + 270,000 + 130,000 + 70,000)]. $220,500 is more than the total deductions of $164,500 (i.e. $94,500 + $70,000) already claimed under salaries tax and profits tax.

b. The amounts of net assessable income and assessable profits brought to personal assessment are treated differently from the angle of charitable donations. For income chargeable to salaries tax, the amount brought to personal assessment is the income before deduction of any concessionary deduction. However, for income chargeable to profits tax, amount brought to personal assessment is the assessable profits after the deduction of charitable donation.

III Who May Elect (See also X Concept Map 27.)

8. Persons eligible for personal assessment

Section 41(1) provides that an individual –

a. who is of or above the age of 18 years or is under that age if both parents are dead, and

b. who is either ordinarily resident in Hong Kong or a temporary resident

may elect for personal assessment on the individual's total income.

9. Meaning of "ordinarily resident in Hong Kong"

a. Section 41 does not define the meaning of "ordinarily resident in Hong Kong". Generally, this means that an individual maintains a place of abode in Hong Kong.

b. DIPN 18 (revised in February 2020) provides the following guidelines:

   i. An individual is ordinarily resident in Hong Kong if he or she resides in Hong Kong voluntarily and for a settled purpose (e.g. education, business, employment or family) with a sufficient degree of continuity.

   ii. It refers to a person, to a certain degree, habitually and normally resides at a place, apart from temporary or occasional absences of long or short duration.

   iii. Whether a person ordinarily resides at a place is a question of fact, and the issue depends on the particular circumstances of each case. There must be sufficient connection with the purpose of residing at a place in order for that purpose to be regarded as a settled purpose.

c. In D11/15, the Board of Review decided that the taxpayer's departure from Hong Kong was more for a settlement purpose. The evidence provided was insufficient to establish that he was "ordinarily resided" in Hong Kong although he could demonstrate his link with Hong Kong by owning a property and using it as his home whenever he was in Hong Kong, and keeping

c. The last date for election for personal assessment for the year of assessment 2022/23 is 31/03/2025 (which is the later date between 30/12/2023 and 31/03/2025).

12. Married couples (See also X Concept Map 28.)

a. Up to the year of assessment 2017/18 – joint personal assessment only

Before the year of assessment 2018/19, there was no separate taxation for personal assessment for married couples. At that time, both spouses must jointly elect for personal assessment, and all their income must be aggregated together for deductions of personal allowances.

b. From the year of assessment 2018/19 – separate or joint personal assessment

i. Separate personal assessment – Section 41(1)

A married couple, not living apart, may elect for personal assessment on his or her own income if he or she is ordinarily resident or is a temporary resident in Hong Kong.

ii. Joint personal assessment – Section 41(1A)

A married couple, not living apart and having income chargeable under the IRO, may jointly make an election for personal assessment, if either one is or both are ordinarily resident or temporary resident(s) in Hong Kong.

iii. No separate personal assessment if joint assessment under salaries tax – Section 41(1B)

If both spouses, not living apart, have elected for joint assessment in salaries tax under Section 10(3), the individual and the spouse are not eligible for separate personal assessment. (Nevertheless, they may still elect for joint personal assessment together.)

V Computation of Income and Tax under Personal Assessment

13. Aggregation of assessable income under personal assessment

An individual's income is aggregated together to form assessable personal assessment income as follows:

a. net assessable value,

b. net assessable income (before deductions of concessionary deductions), and

c. assessable profit (after the deduction of charitable donations).

14. Deductible items under personal assessment payable

The following items are deducted from an individual income computed above:

a. interest financing the purchase of rental income generating property,

b. business loss, and

c. concessionary deductions, namely, charitable donations, elderly residential care expenses, home loan interest, contributions to mandatory provident fund, health insurance premiums, qualifying annuity premiums and MPF voluntary contributions. (Please refer to Chapter 10 for detailed explanation of those items.)

15. Computation and payment of personal assessment tax payable

Same as salaries tax, there are two ways to compute the personal assessment tax payable. One is to apply the progressive rates to the income after deductions of personal allowances – Section 43(1). The other is to apply the standard rate to the income before deductions of personal allowances. The personal assessment tax payable is the lower amount as calculated with progressive rates and standard rate – Section 43(1A).

VI Payment of Personal Assessment Tax

19. No provisional tax for personal assessment

Although there is a provisional payment for the current year of assessment for profits tax, property tax and salaries tax, there is no provisional tax payable for personal assessment.

20. Split payment of personal assessment tax between spouses

For married couples, the personal assessment tax is calculated on a joint basis. However, the liability for payment of tax is apportioned between the husband and the wife based on their respective proportion of income after deductions of concessionary deductions – Section 43(2B).

Example 34.7

Mr. Black owns a property and received rental income of $250,000 for the year of assessment 2022/23, and the tenant is responsible for the payment of rates. For the year of assessment 2022/23, Mr. Black received salaries of $444,000 from his employer, and contributed $22,200 to his mandatory provident fund. Mrs. Black's sole-proprietorship business's assessable profits was $164,000. Mrs. Black paid $130,000 to a Hong Kong registered nursing home for her 65-year-old mother's residence fee. They do not have any children below the age of 18.

REQUIRED:

Calculate Mr. and Mrs. Black's personal assessment tax liability for the year of assessment 2022/23.

Solution

		Mr. Black	Mrs. Black
		$	$
Net assessable value ($250,000 × 80%)		200,000	0
Net assessable income		440,000	0
Assessable profits		0	164,000
		644,000	164,000
Less: Elderly residential care expenses (max. $100,000)		0	100,000
Contribution to mandatory provident fund (max. $18,000)		18,000	0
		626,000	64,000
Total joint income			690,000
Less: Married person's allowance			264,000
Net chargeable income			426,000
Tax at progressive rates	$50,000 @ 2%		1,000
	$50,000 @ 6%		3,000
	$50,000 @ 10%		5,000
	$50,000 @ 14%		7,000
			38,420
			54,420
Less: Tax rebate (max. $6,000)			6,000
Joint personal assessment tax payable			48,420

(Tax at standard rate $690,000 x 15% – $6,000 = $97,500, and this amount is higher than $48,420.)

If the tax payable is for a charge on the profits, it is not deductible as it is not incurred in the production of profits. However, if the tax can be described as a charge on earnings (rather than on profits) that is payable regardless of whether or not a profit is made, the tax is not an appropriation of the profits, and a deduction is allowable under Section 16(1). Therefore, foreign taxes in the form of withholding tax on income derived by way of interest or royalties are allowable as an expense deductible from the assessable profits unless the foreign tax is withheld by a state which signed a DTA with Hong Kong. In this situation, a part of the tax withheld may be used to set off against Hong Kong profits tax payable.

V Foreign Borrowing and Deduction of Interest Expenses

11. This part involves the assessment or exemption of interest income received by foreigners under Section 15(1) and the deduction of interest expenses so paid by a Hong Kong taxpayer under Section 16(2).

12. Assessment of interest income received by an overseas person from a Hong Kong taxpayer

If an overseas person or company lends money to a person (including a partnership or corporation) in Hong Kong, generally the interest income he so received is exempt from Hong Kong tax even though he receives the interest in Hong Kong. The reason is that the overseas person does not carry on a business in Hong Kong and the conditions of Section 14 are not satisfied. If the overseas person carries on a trade, profession or business in Hong Kong, he will be liable to Hong Kong profits tax if the money borrowed was made available to the borrower in Hong Kong. There is no withholding tax on interest income in Hong Kong, and the interest is paid to the lender at the gross amount.

13. Foreign borrowing arrangement not done through an overseas financial institution – Section 16(2)(c)

If the interest income received by an overseas person is not taxable in Hong Kong, the interest paid to that overseas person by the Hong Kong borrower does not satisfy Section 16(2)(c). The interest so paid is not a deductible expense under Hong Kong profits tax.

14. Foreign borrowing arrangement – through an overseas financial institution – under Section 16(2)(d)

If a Hong Kong borrower wishes to borrow money from overseas, it may request its overseas group companies to arrange a loan from an overseas financial institution. If the loan from the overseas financial institution is not wholly or partly secured by a deposit or another loan of which the interest income is not chargeable to Hong Kong profits tax, the interest paid to the overseas financial institution is deductible under Sections 16(2)(d) and (2A). In case the loan is secured by a deposit or another loan, the interest income from such deposit or another loan has to be taxable in Hong Kong, so that the interest expense paid on the foreign loan is allowable. If the foreign loan is not secured by any deposit or another loan, but mortgage on property, or personal or corporate guarantee, the interest expense is deductible under Hong Kong profits tax.

VII Hong Kong Companies Setting up an Overseas Subsidiary to Earn Foreign Income

20. If a Hong Kong company sets up an overseas subsidiary or an overseas office to earn overseas income, such income is not derived from or arising in Hong Kong, and it is not subject to Hong Kong profits tax. However, the Hong Kong company has to make sure that as an international tax planning, the foreign income should not be liable to a high local income tax rate and there should not be any problem, such as remittance of money or foreign exchange control, on the repatriation of profits back to Hong Kong.

VIII Licensing and Franchising

21. Intellectual property owned by a Hong Kong company

When a Hong Kong company has intellectual property registered in Hong Kong and licensing such right to non-residents outside Hong Kong, and in return, receives royalty income, such income is taxable under Section 14, not Section 15(1). The royalty income is 100% chargeable to Hong Kong profits tax.

22. Intellectual property owned by a non-resident

If an overseas company grants licences in Hong Kong for the use of its intellectual property in Hong Kong, the overseas company is chargeable with Hong Kong profits tax under Section 15(1)(a), (b) or (ba), and the assessable profit is deemed to be 30% on the royalty so received if the recipient is not associated with the Hong Kong payer under Section 21A. In other cases, the royalty income is taxable in full. (For further details on this anti-avoidance provision, please refer to paragraph 29 of Chapter 37.)

23. Withholding tax

Section 20B(2) provides that the tax chargeable on a non-resident person under Section 15(1)(a), (b) or (ba) is demanded from the person in Hong Kong who paid or credited such sum (i.e. the royalty) to the non-resident person, and the tax so charged shall be recoverable from that person (i.e. the payer) in Hong Kong. Thus, the payer usually deducts the tax at source before making payment to the non-resident person.

IX Non-resident persons derived income from Intellectual Property in Hong Kong

24. Section 15F of the IRO

This provision imposes Hong Kong profits tax on the income generated from intellectual property even though the legal owner of the intellectual property is a non-resident, so long as part of the value creation activities are performed in Hong Kong. Readers should refer to paragraph 40 of Chapter 16 of this book.

II Interest Deduction under Sections 16(2), (2A), (2B) and (2C)

2. Section 16(2) is to prohibit taxpayers from raising funds in Hong Kong to finance non-taxable overseas income. In the absence of Section 16(2) in the past, it would be possible for a taxpayer to raise a loan in Hong Kong, and lend the money to an overseas group company to acquire assets producing non-taxable income. In this way, the receipt would come from an offshore source and be exempted from profits tax while the interest expenses would be deductible under profits tax.

3. Section 16(2) restricts the deduction of interest expenses by requiring the taxpayer to satisfy one of the six conditions imposed on that section before the interest expense can be deducted. The main concerns are Sections 16(2)(c), (d) and (e). Candidates are required to have a thorough knowledge of these three subsections.

4. Section 16(2)(c) requires the recipient to have the interest income to be taxable in Hong Kong. Section 16(2)(d) applies to bank loans. Section 16(2)(e) provides an alternative to those cases where the interest income is not taxable in Hong Kong in the hand of the recipient. Under that subsection, interest expenses are still deductible if the loan is raised for the purchase of trading stock or plant and machinery for the purpose of producing chargeable profits in Hong Kong, and the lender is not associated with the borrower.

5. With effect from 25 June 2004, if the interest expenses are paid under one of the conditions of Section 16(2)(c), (d) or (e), additional restrictions are imposed under Sections 16(2A) and (2B) to disallow the interest expenses. Under Section 16(2A), if the loan is secured by a deposit or another loan, and the interest income receivable on the deposit or another loan is not taxable in Hong Kong, then the interest expenses payable or paid on the loan may be wholly or partly disallowed under profits tax. Under Section 16(2B), if the interest expenses are, under an arrangement, directly or indirectly, payable back to the borrower or an associate of the borrower, and they are not liable to pay profits tax on such interest income so received, then the interest expenses on the loan may be wholly or partly disallowed under profits tax.

6. With effect from 25 June 2004, if the interest expenses are paid under the condition of Section 16(2)(f) (i.e. payable on listed debentures or marketable instruments), additional restrictions are imposed under Section 16(2C) to disallow the interest expenses. Under Section 16(2C), if the interest expenses are, under an arrangement, directly or indirectly, payable back to the borrower or an associate of the borrower, and they are not liable to pay profits tax on such interest income so received, then the interest expenses on the loan may be wholly or partly disallowed under profits tax.

III Transfer Pricing

7. Up to 2017/18 – Section 20

Section 20 was abolished in 2018. Section 20 applies up to the year of assessment 2017/18. This section taxes non-residents who are closely connected with their trade associates in Hong Kong. If a non-resident carries on business with a resident with whom he is closely connected and the operations of such business are so arranged that it produces to the resident either no profits which arise in or derived from Hong Kong or less than the ordinary profits which might be expected to arise in or derive from Hong Kong, the business done by the non-resident is deemed carrying on in Hong Kong.

The non-resident is assessable and chargeable to tax in respect of his profits derived from such business in the name of the resident as if the residents were his agent and all the provisions of the IRO shall apply accordingly.

14. "Tax benefit" is defined in Section 61A(3) as the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof.

15. If a taxpayer can prove that there is commercial justification for carrying out the transaction in question, and the tax benefit is merely obtained by incidence, Section 61A may not apply.

VII Utilisation of Losses to Avoid Tax under Section 61B

16. A corporation would exist forever until it is wound up or struck off from the Companies Registry. In the past, many profitable businesses acquired corporations having substantial assessed loss for the purpose of utilising the losses brought forward from previous years to set off against the company's future profit.

17. The objective of Section 61B is to prohibit the set-off of losses brought forward against future profit if there is a change of shareholding in a corporation, and the sole or dominant purpose of such change is to utilise the loss to avoid tax liability.

VIII Transfer of Rights to Receive Income under Section 15A

18. If a person transfers a right to receive income to another person, and receives consideration for that purpose, that income is of a capital nature and is not assessable under the general principle of taxation.

19. Section 15A is to disallow taxpayers from using any methods to reduce or transfer the tax liability to another person having a tax loss by selling a right of receiving income to such person. Section 15(1)(m) deems sums received or receivable by a person as consideration in respect of the transfer of a right to receive income, as provided for in Section 15A, as trading receipts.

IX Limited Partner Loss Relief under Section 22B

20. According to Section 19C(5), when a corporation is carrying on a partnership business with other persons, and sustains losses in that partnership, the corporation is entitled to use its share of loss in that partnership to set off against the assessable profit of its own business. Sometimes, the share of the taxpayer's share of loss in that partnership far exceeds the amount of contributions made by the taxpayer to that partnership, and this usually occurs in leveraged leasing. (For details of leveraged leasing, please refer to Chapter 31.)

21. The objective of Section 22B is to restrict the amount of loss that a taxpayer may claim from a limited partnership. The maximum of loss that may be set off against the assessable profits of the limited partner is limited to the less of:

    a. the amount of the limited partner's share of loss in the partnership, or

    b. an amount referred to as the "relevant sum".

22. The "relevant sum" is defined in Section 22B(1) as the amount of a person's contribution to the partnership at the end of the relevant year of assessment in which the loss is sustained, except that where the person ceased to be a partner in the partnership during that year of assessment it is the time when he so ceased.