THE TAXATION INSTITUTE OF HONG KONG

CTA QUALIFYING EXAMINATION PILOT PAPER

PAPER 5 – ADVANCED TAXATION PRACTICE

QUESTIONS

Section A – Case

Answer Question 1 in this Section (40 marks)

Lion Ltd is an investment holding company incorporated in the British Virgin Islands (the "BVI"). Its board of directors comprises members belonging to a Ku family residing in Hong Kong. Most of the top-level policies and the implementation of decisions are discussed between the board members and top management in Hong Kong.

Lion Ltd has a wholly owned Hong Kong subsidiary, namely Tiger Ltd, which was acquired by Lion Ltd in April 1986. It is managed and operating in Hong Kong and its principal business activity is trading of shoes and apparels. Tiger Ltd also holds 100% equity interest in another Hong Kong-incorporated company called Cat Ltd, and 20% equity interest in a company registered in Guangzhou called Mao Ltd.

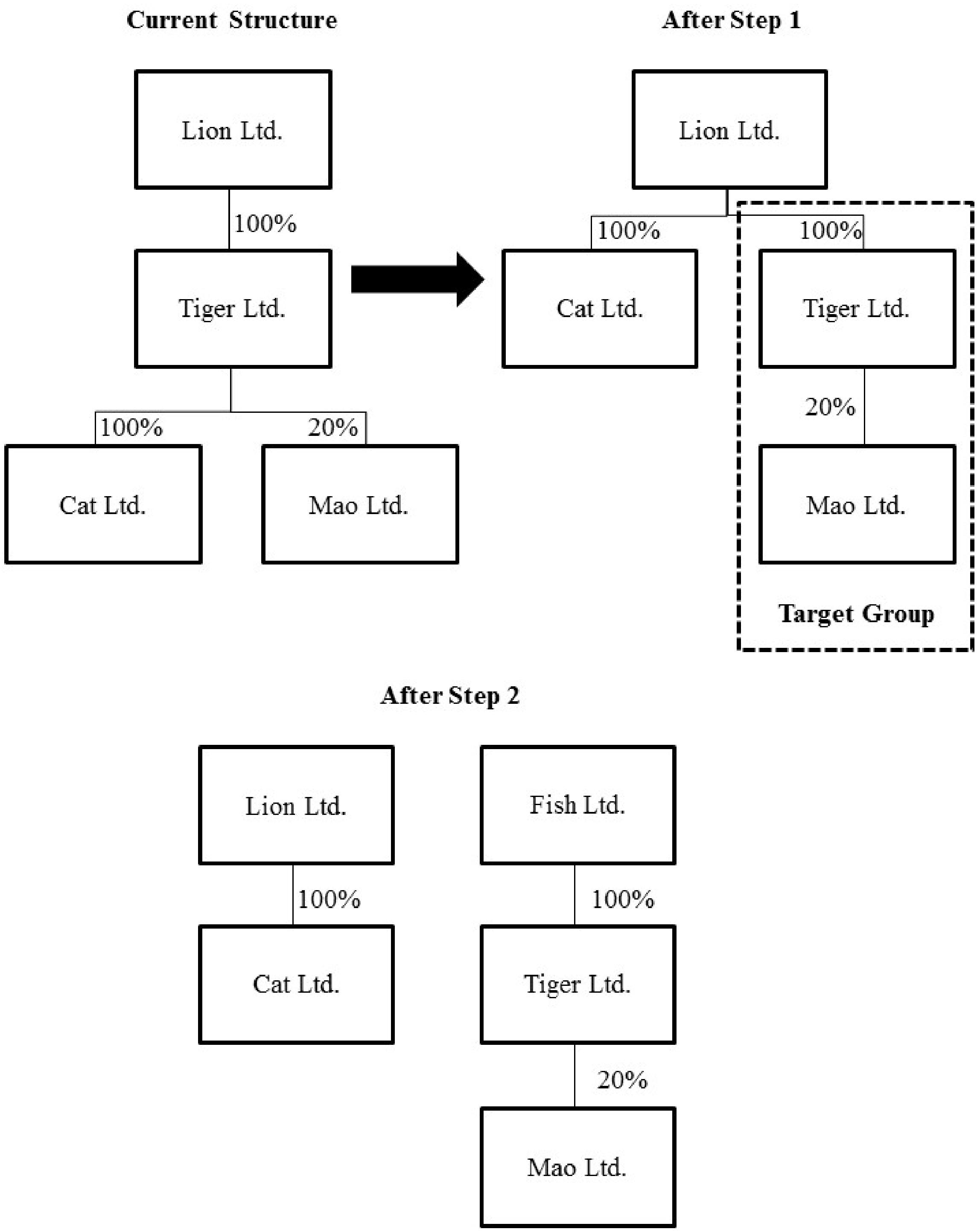
Cat Ltd which is centrally managed in Hong Kong, was set up by Tiger Ltd in early 1990s, at which time Cat Ltd directly acquired an office building in Shanghai (as permitted under the then legislation). Such building is still owned by Cat Ltd as of today and used by the group. Mao Ltd is a limited function manufacturing enterprise in Guangzhou, and owns a factory building located in Guangzhou which is its major asset. Mao Ltd purchased all raw materials from Tiger Ltd and sold all of its finished goods to Tiger Ltd.

The management of Lion Ltd was recently approached by an unrelated Cayman Island company, Fish Ltd. Fish Ltd proposed to acquire 100% equity interest in Tiger Ltd together with the 20% equity interest in Mao Ltd, but not any equity interest in Cat Ltd. The proposed acquisition was approved by the board in principle, except that an internal restructuring exercise would need to be conducted to spin off Cat Ltd prior to the acquisition. The following two steps illustrate the process of the acquisition:

- Step 1: Tiger Ltd would transfer its 100% equity interest in Cat Ltd to Lion Ltd. The consideration would be determined based on an independent valuation report and would be settled by Lion Ltd by cash.

- Step 2: Lion Ltd would then dispose of its 100% equity interest in Tiger Ltd to Fish Ltd. This deal is expected to be completed before the Lunar New Year in 2018.

The group structures after each of the two steps are illustrated as follows:



During the acquisition meeting with Fish Ltd, Lion Ltd was requested to provide additional information relating to Mao Ltd, including a projected statement of profit or loss of Mao Ltd for the year ending 31 December 2017 presented as follows:

Mao Ltd
Projected statement of profit or loss
for the year ending 31 December 2017

	2017
	CNY (million)
Revenue	5,919
Cost of sales	(5,378)
	541
Other non-operating income	4
Operating cost:	
- Distribution costs	(1)
- Administrative and other operating expenses	(96)
Non-operating cost:	
- Finance costs	(17)
- Other expenses	(7)
Profit before tax	424
Income tax expense	(106)
Profit for the year	318

Upon completion of the acquisition of Tiger Ltd in the first quarter of 2018, Cat Ltd would acquire 100% equity interest in a company incorporated in Indonesia called Ox Ltd for a long term investment purpose. It is planned that Ox Ltd will declare a special dividend to Cat Ltd and Cat Ltd will also declare a special dividend to Lion Ltd prior to the end of 2019.

Last month, Tiger Ltd received a letter from a Hong Kong bank with respect to the U.S. Foreign Account Tax Compliance Act ("FATCA") compliance. The staff of Tiger Ltd immediately consulted one of his friends, Mr Ng, who is a certified public accountant. Mr Ng advised that he has extensive experience in handling FATCA compliance and he would agree to provide assistance to Tiger Ltd at a competitive service charge. Upon further discussion, Mr Ng clarified that his knowledge on FATCA was acquired only through attending professional seminars organized by TIHK, and he would work with another business partner if the need arises.

Required:

(a) Pertaining to the current holding structure, discuss the relevant PRC Enterprise Income Tax and Hong Kong tax implications (including stamp duty, if any), arising from the transfer of Cat Ltd from Tiger Ltd to Lion Ltd.

(20 marks)

*Note: Reference should be made to the domestic rules and regulations in the PRC and Hong Kong. You are **not** required to discuss any tax withholding or reporting obligation.*

For the purpose of part (b) below, assume that you are engaged by Fish Ltd to perform a tax due diligence review with respect to the contemplated acquisition of Tiger Ltd.

(b) You are given to understand that Tiger Ltd and Mao Ltd would be regarded as related parties by the in-charge tax bureau in Guangzhou and the IRD, and a transfer pricing issue has been identified during the tax due diligence review.

In this connection, you are requested by Fish Ltd to perform a transfer pricing study for Mao Ltd and Tiger Ltd ("Covered Entities") based on the information for the year ending 31 December 2017 in respect of the sale and purchase of raw materials and finished goods of Mao Ltd from/to Tiger Ltd ("Covered Transactions"), and critically assess the transfer pricing risk(s) of the Covered Entities.

You may assume that both of the in-charge tax bureau in Guangzhou and the IRD would accept the Transactional Net Margin Method ("TNMM") as the most reliable method and the Net Cost Plus ratio as the best profit level indicator for analyzing single-function manufacturing companies. The following latest TNMM results for three year average of comparable companies of Mao Ltd are available for the purpose of the assessment:

2014 – 2016 3-Year Average Interquartile Range	**Lower Quartile**	**Median**	**Upper Quartile**
Net Cost Plus ratio	0.29%	2.26%	3.17%

Your assessment of the transfer pricing risk(s) of the Covered Entities should include:

- the PRC transfer pricing risk, if any;
- the Hong Kong transfer pricing risk, if any; and
- the tax reporting requirements, if any.

Note: You may assume that the commonly acceptable definition of Net Cost Plus ratio for use in a transfer pricing study is as follows:

$$\textit{Net Cost Plus ratio} = \frac{\textit{Operating Profit}}{\textit{Operating Expense + Cost of Goods Sold}}$$

(10 marks)

(c) With respect to the special dividend to be paid by Ox Ltd to Cat Ltd before the end of 2019, discuss whether, and if so to what extent, Indonesian Income Tax would be payable by Cat Ltd. For this part of the question, you should assume that Ox Ltd is an Indonesian tax resident enterprise, and the beneficial ownership test as required for the purpose of the application of the Double Taxation Agreement between Indonesia and Hong Kong is satisfied.

Note:

*(1) You may assume that the domestic anti-avoidance regulations imposed by the Indonesian government would not apply in the present case and you are **not** required to discuss such regulations.*

(2) The Double Taxation Agreement between Indonesia and Hong Kong is attached for reference.

(6 marks)

(d) Identify the ethical issues with respect to the provision of FATCA compliance services by Mr Ng, and provide your suggestions accordingly.

*Note: You should state and apply the relevant principles contained in the Code of Professional Conduct of TIHK. Explanation of the relevant principles is **not** required.*

(4 marks)

(Total 40 marks)

Section B – Answer THREE questions out of four (20 marks each question)

Question 2

Zebra Ltd is a Cayman Island company and does not exercise any management or control in Hong Kong. It owns 15% equity interest in Horse Ltd, which is incorporated in the Cayman Island but listed in Hong Kong.

Horse Ltd holds a wholly-owned subsidiary in Heilongjiang of the PRC, namely Ma Ltd. The senior management personnel of Horse Ltd spends substantial time in the branch of Ma Ltd located in the PRC to exercise the overall management and control of Horse Ltd and the group including the production business of Ma Ltd.

Zebra Ltd also has another trading company in Hong Kong called Rabbit Ltd. Rabbit Ltd and Ma Ltd has entered into a sales agreement, under which Ma Ltd would sell the self-manufactured finished goods to Rabbit Ltd. Rabbit Ltd will then sell such finished goods to unrelated customers in Hong Kong. To facilitate the manufacturing activities of Ma Ltd, Rabbit Ltd provides machinery to Ma Ltd for use without charge.

Required:

(a) You are given to understand that all the 15% equity interest in Horse Ltd would be disposed of by Zebra Ltd to an unrelated party. Evaluate whether, and if so to what extent, the disposal would give rise to potential PRC tax exposure.

Note:
(1) You may determine the residency status of Horse Ltd for tax purposes first.
*(2) You are **not** required to mention any tax withholding or reporting obligation.*

(13 marks)

(b) Assume that Rabbit Ltd is fully subject to Hong Kong Profits Tax on its sale profits. Discuss from the Hong Kong Profits Tax perspective whether any allowance or deduction would be available to Rabbit Ltd in respect of the machinery provided by Rabbit Ltd to Ma Ltd for use.

(7 marks)

(Total 20 marks)

Question 3

Mr Wong, a Hong Kong resident, is employed as an operational staff by Goat Ltd, a Hong Kong-incorporated company managed and controlled in Hong Kong. Recently, Goat Ltd set up a new wholly owned subsidiary in Shenzhen, namely Sheep Ltd.

Since Sheep Ltd is still at its startup stage, the management of Goat Ltd proposes to send Mr Wong to Sheep Ltd in Shenzhen and provide operational and training services. The posting will commence on 1 April 2018, on which Mr Wong will report duty, and will end on 31 March 2019. According to the tentative schedule, Mr Wong will be required to stay in the PRC for at least 315 days during the posting period. Mr Wong will continue to live in his own flat in Hong Kong with his family whenever he returns from Shenzhen.

Required:

(a) Identify the PRC tax risks arising from the contemplated posting arrangement in the following aspects:

- Enterprise Income Tax implications to Goat Ltd; and
- Individual Income Tax implications to Mr Wong.

*Note: Detailed discussions of the domestic rules and regulations in the PRC are **not** required.*

(9 marks)

(b) Discuss the Hong Kong Salaries Tax implications to Mr Wong in respect of the contemplated posting arrangement.

Note: Detailed discussions of the domestic rules and regulations in Hong Kong are required.

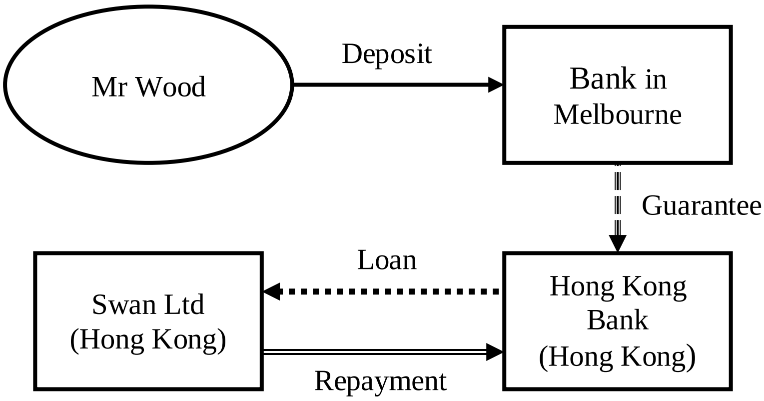
(11 marks)

(Total 20 marks)

Question 4

Mr Wood, an Australian citizen, owns Swan Ltd, a company carrying on business in Hong Kong as a property agency. Swan Ltd has recorded two bank loans. Loan-1 was obtained from Hong Kong Bank for setting up a company in Shenzhen, Eagle Ltd. Loan-1 was injected by Swan Ltd as equity fund into Eagle Ltd, which used the fund to acquire an office building in Dongguan for leasing in 2014.

Loan-2 was also obtained from Hong Kong Bank and all loan money was used as operating fund for the property agency business, including acquiring office and furniture, and hiring staff. All agency income is sourced and taxable in Hong Kong. Loan-2 is secured by an AUD deposit placed by Mr Wood with a bank in Melbourne, which is an associate of Hong Kong Bank. The arrangement of Loan-2 is illustrated as follows:



Required:

(a)(i) Evaluate the deductibility of the interest expense incurred by Swan Ltd on Loan-1 from the Hong Kong Profits Tax perspective.

Note: Your answer should include an explanation of the general principles for determining the deductibility of the interest expense.

(4 marks)

(ii) Discuss whether, and if so how, your answer to (i) above would be different if the fund was injected by Swan Ltd into Eagle Ltd in the form of an interest-bearing loan for financing the acquisition of the office building.

(2 marks)

(b)(i) Evaluate the deductibility of the interest expense incurred on Loan-2 from the Hong Kong Profits Tax perspective.

(4 marks)

(ii) Discuss whether, and if so how, your answer to (i) above would be different if Loan-2 was directly provided by Mr Wood to Swan Ltd as an interest-bearing shareholder loan.

(2 marks)

(c) You are given to understand that Eagle Ltd is a general Value Added Tax ("VAT") payer. Introduce in brief the VAT Reform, and advising on the VAT implications to Eagle Ltd after 1 May 2016 in relation to the operating lease of the office building. You should also mention in brief the Enterprise Income Tax and Real Estate Tax implications.

(8 marks)

(Total 20 marks)

Question 5

Cock Ltd is a Singapore-incorporated company which does not carry on a business in Hong Kong. Cock Ltd owns a trademark developed and registered in Singapore. It entered into a licence agreement which was signed in Hong Kong with Hen Ltd, under which the right to use the trademark in the Far East region was granted to Hen Ltd at a royalty. Hen Ltd is carrying on a business in Hong Kong as a manufacturer and is centrally managed in Hong Kong.

Chicken Ltd is a wholly-owned subsidiary of Hen Ltd and is incorporated in the PRC. Under a sub-licence agreement signed in Hong Kong, Hen Ltd granted Chicken Ltd the right to use the trademark in the PRC at a royalty. The trademark was used by Chicken Ltd in its manufacturing operation in the PRC.

Required:

(a) Discuss the PRC tax implications with respect to the royalties arising from the sub-licensing of the trademark from Hen Ltd to Chicken Ltd, in particular:

(i) the PRC Turnover Tax implications before and after the Value Added Tax ("VAT") Reform in the PRC; and

*Note: You are **not** required to include a brief introduction of the VAT Reform.*

(7 marks)

(ii) the PRC Enterprise Income Tax implications assuming that Hen Ltd satisfies the beneficial ownership test as required for the purpose of the application of the Double Taxation Arrangement between the PRC and Hong Kong.

(4 marks)

(b) Evaluate the Hong Kong Profits Tax position of the:

(i) royalties received by Hen Ltd from Chicken Ltd; and

(5 marks)

(ii) royalties received by Cock Ltd from Hen Ltd.

(4 marks)

(Total 20 marks)

– END OF QUESTION PAPER –

SUGGESTED ANSWERS

Answer 1(a)

PRC Enterprise Income Tax Implications

Under Guoshuihan [2009] Circular No. 698 ("Circular 698"), a non-PRC tax resident enterprise transferring shares in an offshore intermediary enterprise that directly or indirectly holds an equity interest in a PRC enterprise are subject to PRC tax on the gains from the transfer if the PRC tax authorities determine that the arrangement lacks a bona fide commercial purpose and re-characterize the indirect transfer as a direct transfer of the PRC enterprise.

Announcement of State Administration of Taxation ("SAT") [2011] No. 24 ("Announcement 24") was issued to clarify certain aspects of Circular 698.

Announcement of SAT [2015] No. 7 ("Announcement 7") issued on 6 February 2015 does not replace Circular 698 or Announcement 24 but abolishes certain provisions and clarifies certain issues. Announcement 7 introduces the term "Chinese Taxable Assets" which does not appear in Circular 698. Chinese Taxable Assets include assets attributed to an establishment in the PRC, immovable property in the PRC and shares in PRC resident enterprises. In other words, Announcement 7 expands the scope of indirect transfers to cover not only indirect transfer of shares.

In the present case, Cat Ltd owns an office building in Shanghai, which should be classified as a Chinese Taxable Asset. As such transfer of Cat Ltd by Tiger Ltd to Lion Ltd should be an indirect transfer of a Chinese Taxable Asset and is therefore subject to the relevant indirect transfer rules in the PRC.

Based on Announcement 7, if the in-charge tax bureau in Shanghai is of the opinion that the transfer does not have a bona fide commercial purpose and the arrangement is to avoid the payment of Enterprise Income Tax ("EIT"), the transaction should be re-characterized as a direct transfer of such Chinese Taxable Asset in accordance with Article 47 of the EIT Law. Announcement 7 clarifies that income attributable to immovable properties should be taxed according to Article 3(3) of the EIT Law, i.e. 10% on the gains arising from transferring PRC immovable properties.

Announcement 7 provides a safe harbour for indirect transfers resulting from qualifying group internal reorganizations if all of the (three) conditions specified therein are met. One of the conditions is that all consideration paid by the transferee (Lion Ltd in this case) must consist of its own shares or shares of a related enterprise with which the transferee has a controlling relationship (exclusive of shares of listed companies). In this case, since the consideration would be settled by cash, such safe harbour rule would not be applicable and the indirect transfer could not be deemed to have a bona fide commercial purpose.

Hong Kong Profits Tax Implications

Since Tiger Ltd is incorporated, managed and operating in Hong Kong, it will be considered as carrying on a business in Hong Kong. Therefore, if the gain received by Tiger Ltd is revenue and onshore in nature, it would be subject to Hong Kong Profits Tax at 16.5% to Tiger Ltd. If, however, the gain is capital in nature, it would not be subject to Hong Kong Profits Tax.

The Hong Kong Inland Revenue Department (the "IRD") will consider the following "six badges of trade" in determining whether the disposal of the equity interest in Cat Ltd is capital or revenue in nature:

a. Subject matter of the transaction;
b. Length of ownership;
c. Whether there have been successive or frequent similar transactions;
d. Whether supplementary activities have been performed to make the assets marketable;
e. Reasons for the disposal or realization of the subject matter; and
f. Taxpayer's motive.

No one factor is conclusive – one must look at all circumstances as a whole.

The gains to Tiger Ltd in question would probably be capital in nature and not taxable in Hong Kong based on the following understandings:

a. Cat Ltd was set up by Tiger Ltd in early 1990s;
b. Tiger Ltd has owned Cat Ltd for more than 20 years; and
c. The reason for disposal is to separate Cat Ltd from the target group which should consist of Tiger Ltd and Mao Ltd only.

Hong Kong Stamp Duty Implications

Generally, when Hong Kong stock is transferred, there will be Hong Kong Stamp Duty ("SD") at 0.2% (0.1% on each of the bought and sold notes) at the higher of the consideration or the market value of the shares being transferred, plus HKD 5 for the instrument of transfer.

Based on Section 45 of the Stamp Duty Ordinance (the "SDO"), SD is not chargeable when Hong Kong stock is transferred between associated bodies corporate.

One of the situations where incorporated bodies are associated bodies corporate is that, one is beneficial owner of not less than 90% of the issued share capital of the other, i.e. the transferor and the transferee are in the relationship of a holding company and a subsidiary with an ownership of 90% or over.

SD relief under Section 45 of the SDO should be available in this case since Tiger Ltd (being the transferor) and Lion Ltd (being the transferee) are associated bodies corporate as Lion Ltd holds 100% equity interest in Tiger Ltd. The fact that Lion Ltd was incorporated in the British Virgin Islands (the "BVI") is irrelevant.

However, under Section 45(4)(c) and Section 45(5A) of the SDO, if the transferor (Tiger Ltd in this case) and the transferee (Lion Ltd in this case) ceased to be associated within 2 years after the date of the transfer by reason of a change in the percentage of the issued share capital of the transferee in the beneficial ownership of the transferor or a third body corporate, the relief will be revoked.

Answer 1(b)

PRC Transfer Pricing ("TP") Analysis

Based on the projected statement of profit or loss for the year ending 31 December 2017, the Net Cost Plus ("NCP") ratio of Mao Ltd in respect of the manufacturing activities for the year should be 8.11% [Operating cost = 97 (96 + 1); Operating Profits = 444 (5,919 – 5,378 – 97); NCP ratio = 8.11% (444 ÷ (97 + 5,378))]

Generally speaking, if the NCP ratio of Mao Ltd in respect of the manufacturing activities for the year ending 31 December 2017 falls within the inter-quartile range and above the median, the PRC TP position of Mao Ltd would not be challenged. Now it is quite high and exceeds the inter-quartile range, therefore the PRC TP risk should be remote.

Based on Announcement of SAT [2016] No. 42 ("Announcement 42"), Mao Ltd is required to file annual disclosure forms which should be filed along with its annual EIT return on or before 31 May 2018.

Since the total related-party purchases and sales will be not less than CNY 200 million (only related-party sales is already expected to be CNY 5,919 million), based on Announcement 42, a Local File should be prepared by Mao Ltd by 30 June 2018 and such report should be submitted to the in-charge tax bureau within 30 days of a request.

Hong Kong TP Analysis

Under Section 20(2) of the IRO, if a transaction has been entered into between a Hong Kong resident and a closely connected non-resident and it produces to the Hong Kong resident either no profits which arise in or derive from Hong Kong or less than the ordinary profits which might be expected to arise in or derive from Hong Kong, the Commissioner of Inland Revenue is empowered to deem the non-resident as carrying on business in Hong Kong. Such non-resident shall then be chargeable to tax in Hong Kong in the name of the resident as if the resident was his agent, and all the provisions of the IRO shall apply accordingly.

In practice, the general anti-avoidance provision (Section 61A of the IRO) and the general deductibility provision (Section 16(1) of the IRO) are used more often to challenge non-arm's length transfer pricing.

The TP risk in Hong Kong is relatively higher and the Covered Transaction is likely to be questioned by the IRD since the NCP ratio of Mao Ltd in respect of the manufacturing activities for the year ending 31 December 2017 is too high which exceeds the inter-quartile range, implying that Tiger Ltd may earn less than the ordinary profits which might be expected.

Answer 1(c)

In general, withholding Indonesian Income Tax of 20% would be imposed on dividend received by a non-Indonesian tax resident enterprise from an Indonesian tax resident enterprise. The reduced or preferential withholding rate of 5% on dividends may apply under the Indonesia-Hong Kong Double Tax Agreement ("DTA") if all of the following requirements could be met:

a. Residency requirement, one party must be an Indonesian tax resident enterprise while another party must be a Hong Kong tax resident enterprise;
b. Beneficial ownership requirement; and
c. Shareholding requirement, in particular the dividend recipient should hold directly at least 25% of the capital of the payer company.

If only the residency requirement and beneficial ownership requirement are met, the reduced or preferential withholding rate of 10% may apply instead.

Ox Ltd is an Indonesian tax resident enterprise (given); Cat Ltd should be regarded as a Hong Kong tax resident enterprise since it is centrally managed in Hong Kong – residency requirement should be met.

In addition, the shareholding requirement should be met since it is likely that Cat Ltd would still maintain more than 25% equity interest in Ox Ltd at the time when the special dividend is distributed.

Since the beneficial ownership requirement is also met (given), dividend to be received by Cat Ltd from Ox Ltd should be subject to withholding Indonesian Income Tax of 5%.

Answer 1(d)

The following ethical issues are identified:

a. Honesty and integrity: Mr Ng should not represent to the staff of Tiger Ltd that he has extensive experience in providing FATCA compliance services.
b. Confidentiality: Mr Ng should not transfer the case and disclose the information of Tiger Ltd to a third party without the consent and approval of Tiger Ltd.
c. Competence: Mr Ng is not competent since his knowledge on FATCA was acquired only through attending professional seminars organized by TIHK and it is likely that he does not have any practical experience.

Based on Code of Professional Conduct for CTAs, the following proper actions should be taken:

a. Mr Ng should proactively tell the staff of Tiger Ltd that he has no relevant experience but he would work with another business partner if the need arises.
b. Mr Ng should obtain the consent and approval from Tiger Ltd before he discloses the information to a business partner.
c. Before Mr Ng chooses to work with a business partner, he should request such business partner to prove that he is competent and experienced in handling relevant cases.

Answer 2(a)

Based on the Enterprise Income Tax ("EIT") Law, a foreign incorporated company is regarded as a PRC tax resident if its effective management and control is exercised in the PRC.

Guoshuifa [2009] No. 82 ("Circular 82") sets forth the tests to determine whether a foreign incorporated company controlled by a PRC enterprise / enterprise group is a PRC tax resident enterprise. However, the tests may be used as a reference for a foreign incorporated company not controlled by a PRC enterprise / enterprise group.

Under Circular 82, a foreign incorporated company is a PRC tax resident when the following four conditions are all met:

a. The primary location of the day-to-day operational management is exercised in the PRC;
b. Decisions relating to the enterprise's financial and human resource matters are made or are subject to approval by organizations or personnel in the PRC;
c. The enterprise's primary assets, accounting books and records, company seals, board and shareholder meeting resolutions are located or maintained in the PRC; and
d. 50% or more of the voting board members or senior executives habitually reside in the PRC.

In the present case, if the place where the senior management of Horse Ltd exercised overall management and control over production and business was regarded by the PRC tax authority as located in the PRC, the place of effective management of Horse Ltd is in the PRC and Horse Ltd should be a PRC tax resident enterprise.

Assuming that Horse Ltd is a PRC tax resident enterprise, the offshore indirect equity transfer should be re-characterised as a direct transfer of a PRC tax resident enterprise. This is similar to a reported case in Jiamusi of Heilongjiang, where the Jiamusi tax bureau adopted the PRC tax resident enterprise concept to deem the offshore holding company as a PRC tax resident enterprise and impose tax on the direct transfer of such deemed PRC tax resident enterprise. The chance that the in-charge tax bureau will follow Jiamusi case appears to be higher since Ma Ltd is also located in Heilongjiang.

Since Zebra Ltd is not a Hong Kong tax resident enterprise, the PRC-Hong Kong Double Tax Arrangement should not be applicable and hence the PRC tax exemption on the gain on disposal of shares is not available even though the equity interest disposed of is less than a 25% equity interest in a PRC tax resident enterprise.

EIT of 10% would be imposed on the capital gain arising from the transfer of Horse Ltd.

Answer 2(b)

As the sales profits of Rabbit Ltd is fully subject to Hong Kong Profits Tax, Rabbit Ltd may potentially be able to claim a depreciation allowance in respect of the machinery, under Section 39B of the Inland Revenue Ordinance (the "IRO") or a 100% deduction for the cost of the machinery if it is a prescribed fixed asset pursuant to Section 16G of the IRO.

Section 39E(1)(b)(i) of the IRO stipulates that where there is a lease of machinery or plant in which the taxpayer is a lessor (including assets acquired under hire purchase) and the asset is used by a person other than the taxpayer wholly or principally outside Hong Kong, no depreciation allowance on capital expenditure on such an asset shall be granted.

"Lease" in relation to any machinery or plant is defined in Section 2 of the IRO as including "any arrangement under which a right to use the machinery or plant is granted by the owner of the machinery or plant to another person". The provision of machinery by Rabbit Ltd to Ma Ltd constitutes a "lease" arrangement under which a right to use the machinery is granted by Rabbit Ltd to Ma Ltd, despite that there is no charge.

Therefore, as reiterated by Departmental Interpretation and Practice Notes No. 15 (revised), if the machinery is "leased" by Rabbit Ltd to Ma Ltd for use, Section 39E of the IRO operates to deny Rabbit Ltd from claiming any depreciation allowance under Section 39B of the IRO.

Similarly, in *Braitrim (Far East) Limited v. CIR,* the Court of Appeal held that the term "lease" in Section 16G(6) of the IRO should follow the statutory definition under Section 2 of the IRO. Therefore, the machinery should be "excluded fixed assets" not qualifying for any tax deductions under Section 16G(6) of the IRO.

Answer 3(a)

The key Enterprise Income Tax ("EIT") risk arising from the contemplated posting arrangement is the Permanent Establishment ("PE") exposure.

In accordance with the PRC-Hong Kong Double Tax Arrangement ("DTA"), a Hong Kong company would have a PE if it sends its employee(s) to provide services in the PRC for more than 183 days in aggregate in any 12 months.

In our case, since Goat Ltd will send Mr Wong to Sheep Ltd in Shenzhen to provide operational and training services for 315 days during 1 April 2018 to 31 March 2019 (i.e. more than 183 days within 12 months), Goat Ltd should be regarded by the PRC tax bureau as having a PE in the PRC.

Under the EIT Law in the PRC, any profits attributable to such PE should be subject to EIT at 25%. Generally, the EIT payable would be determined based on a deemed profit method.

Since Mr Wong would spend more than 183 days in aggregate within 12 months, the treaty protection under the PRC-Hong Kong DTA would not be available and hence Mr Wong would be subject to Individual Income Tax ("IIT") on his PRC-sourced income from the first day he arrives in the PRC for the project. Mr Wong's work will be taxed pro rata, (i.e., based on the number of days he is in the PRC in a month).

Answer 3(b)

Section 8 of the Inland Revenue Ordinance (the "IRO") provides that Hong Kong Salaries Tax is charged on a person in respect of his income arising in or derived from Hong Kong from an employment; office or pension. As such, employment income received by Mr Wong would be chargeable to Salaries Tax if it arises in or is derived from Hong Kong, i.e., it has a Hong Kong source.

The source of employment income is determined by the locality of the employment. The principles are derived from *CIR v. George Andrew Goepfert* and explained in Departmental Interpretation and Practice Notes ("DIPN") No. 10 (revised). The Inland Revenue Department (the "IRD") looks at the following three factors:

a. Where the employment contract 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.

Where all of the three factors are located outside Hong Kong, the IRD may treat the employment as sourced outside Hong Kong, i.e., a non-Hong Kong employment. However, if the second factor (residence of employer) is located in Hong Kong, the IRD takes the position that the employment is sourced in Hong Kong, i.e., a Hong Kong employment. In the case of doubt, the IRD will consider all of the relevant facts and look beyond the three factors.

Under a Hong Kong employment, the employment income is potentially fully taxable unless all the services are rendered outside Hong Kong. No time-apportionment of income (in relation to services rendered outside Hong Kong) is allowed.

Under a non-Hong Kong employment, only income derived from services rendered in Hong Kong is chargeable under Hong Kong Salaries Tax under Section 8(1A) of the IRO. This is determined by the number of days the employee spends in Hong Kong during the basis period of each year of assessment, i.e., the time basis apportionment of income, subject to adjustment of the paid leave taken during the year.

Regardless of the source of employment, the employment income should not be chargeable to Salaries Tax if the employee renders all of his services outside Hong Kong under Section 8(1A)(b) of the IRO, or if the employee visits Hong Kong for not more than 60 days in a year of assessment under Section 8(1B) of the IRO.

Despite the fact that Mr Wong will spend less than 60 days in Hong Kong in a year of assessment, the 60-day rule does not apply to him because he is not a visitor. When he is in Hong Kong he will continue to live in his own flat in Hong Kong with his family and thus he maintains strong family ties in Hong Kong.

Since Goat Ltd (being the employer of Mr Wong) is managed and controlled in Hong Kong, it would be a resident in Hong Kong. Based on *Goepfert* principle, it is likely that the source of the employment income of Mr Wong is in Hong Kong. Therefore, Mr Wong's salaries income should be fully chargeable to Salaries Tax.

Since income attributable to services rendered by Mr Wong in the PRC is also chargeable to IIT in the PRC, double taxation arises. Mr Wong can apply for relief in the form of a tax credit under Section 50 of the IRO in respect of tax paid in the PRC (i.e. IIT) on the income which has been doubly taxed on both Sides. Alternatively, Section 8(1A)(c) of the IRO provides that income which has been charged to tax of substantially the same nature as Salaries Tax in the territory where the services are rendered is excluded from Salaries Tax. Therefore, instead of paying tax in both territories and seeking a tax credit, Mr Wong can pay IIT first and exclude from his HK chargeable income that portion of income taxed in the PRC. If tax return has been filed without making the adjustment under Section 8(1A)(c), he may apply for revision of the return in accordance with Section 70A of the IRO.

Answer 4(a)(i)

Based on the Inland Revenue Ordinance (the "IRO"), an interest expense could be tax deductible if all of the following conditions can be satisfied:

a. the interest expense is incurred in the production of assessable profits (Section 16(1) of the IRO);
b. the interest on money borrowed, together with other expenditures relating to the borrowings are incurred in the production of assessable profits (Section 16(1)(a) of the IRO);
c. the borrowing satisfies any one of the conditions in section 16(2) of the IRO;
d. the borrowing is not secured by any deposits or loans which derive non-taxable income in Hong Kong ("secured loan" test) (Section 16(2A) of the IRO); and
e. there is no arrangement in place such that the interest payment is ultimately paid back to the borrower or any connected person ("interest flow-back" test) (Section 16(2B) of the IRO).

If the loan money was used to set up Eagle Ltd in the form of equity, the return from such investment would be dividend which should not be chargeable to Hong Kong Profits Tax. Therefore, the bank interest expense incurred by Swan Ltd on Loan-1 would not be regarded as incurred in the production of assessable profits. Hence, Section 16(1) of the IRO is not satisfied and the bank interest expense should not be tax deductible. Other conditions in Sections 16(2), (2A) and (2B) of the IRO are irrelevant.

Answer 4(a)(ii)

If the loan money was on-lent by Swan Ltd to Eagle Ltd as a shareholder loan and interest was received from Eagle Ltd, the tax deductibility of the interest expense on Loan-1 would depend on whether the shareholder loan interest income is taxable in Hong Kong (Section 16(1) of the IRO). Assuming that Swan Ltd is not carrying on a money-lending business, the taxability of interest income would depend on whether or not the loan was first made available to the borrower (i.e. Eagle Ltd) in Hong Kong (the provision of credit test). If the shareholder loan was remitted to Eagle Ltd in the PRC where it was available for use by Eagle Ltd, the interest income was offshore Hong Kong and not taxable in Hong Kong. In the circumstances, the corresponding interest cost on Loan-1 would not satisfy Section 16(1) of the IRO and not deductible.

Answer 4(b)(i)

All loan money in respect of Loan-2 is used to finance the operation of the property agency business of Swan Ltd, including office, furniture and staff. Provided that all income generated from the business is taxable in Hong Kong, Section 16(1) and Section 16(1)(a) of the IRO are satisfied. This position remains the same even though part of the loan money was used to acquire capital asset as long as the capital asset is used in the course of the business. In addition, the loan has been borrowed from Hong Kong Bank (a financial institution) so Section 16(2)(d) of the IRO is also fulfilled.

However, Loan-2 is secured by a deposit made by Mr Wood with Hong Kong Bank's associate in Melbourne and this deposit generates interest income that is not subject to Hong Kong tax. Hence, Section 16(2A) of the IRO is not satisfied. As a consequence, the amount of deductible interest on Loan-2 would be restricted by the amount of non-taxable interest income on the deposit.

Answer 4(b)(ii)

The interest expense is not tax deductible even if Loan-2 was provided by Mr Wood to Swan Ltd directly as an interest-bearing shareholder loan.

Unless Mr Wood is carrying on a business in Hong Kong, the interest income received by him would not be taxable in Hong Kong. Hence, Section 16(2)(c) of the IRO is not satisfied. This position remains the same regardless of whether the loan is first made available in Hong Kong to Swan Ltd.

Answer 4(c)

The Valued Added Tax ("VAT") Reform started in Shanghai on 1 January 2012 and the nationwide rollout was on 1 August 2013 covering certain sectors. Based on Caishui [2016] No. 36 ("Circular 36") issued in March 2016, with effect from 1 May 2016 the VAT Reform would cover all sectors (e.g. the real estate sector including leasing of immovable properties), and Business Tax was completely replaced by VAT.

Based on Circular 36, since Eagle Ltd is a general VAT payer and the office building was acquired in 2008 (which was obtained no later than 30 April 2016), it can opt for the general method or the simplified method for the purpose of calculating the VAT payable on the rental income.

In the present case, under the general method, VAT rate applicable is 11%, and Eagle Ltd is able to claim input VAT credits, while under the simplified method, VAT rate of 5% is applicable and Eagle Ltd is not able to claim any input VAT credit.

Since Eagle Ltd is located in Shenzhen while the office building is located in Dongguan, provisional VAT should be paid to the Dongguan tax bureau, and the formal VAT filing should be performed with the in-charge tax bureau of Eagle Ltd in Shenzhen.

Based on the relevant Real Estate Tax ("RET") rules in the PRC, RET of 12% of the annual rental income should be imposed on Eagle Ltd.

Based on the Enterprise Income Tax ("EIT") Law, the rental income should be included in the taxable income of Eagle Ltd. The standard EIT rate of 25% should be applicable in the present case.

Answer 5(a)(i)

Under the Business Tax ("BT") Provisional Rules in the PRC, BT is levied on:

a. the provision of taxable labour services;
b. the transfer of intangible assets; and
c. the sale of immovable properties within the territory of the PRC.

BT is usually imposed on gross turnover.

According to Guoshuifa [1993] No. 149, "the transfer of intangible assets" should cover not only transfer of ownership but also transfer of the right of use of intangible assets (e.g. royalties). Therefore, before the commencement of the Value Added Tax ("VAT") Reform Pilot Program, royalties should be subject to BT at 5%.

After the VAT Reform has been completed, based on Caishui [2016] No. 36, royalties should be subject to VAT at 6%, with input credit available. It is no longer subject to BT. Since Hen Ltd has no establishment in the PRC, Chicken Ltd would be the VAT withholding agent.

Answer 5(a)(ii)

In general, withholding EIT of 10% would be imposed on royalty received by a non-PRC tax resident enterprise from a PRC tax resident enterprise.

The reduced or preferential withholding rate of 7% on royalties may apply under the PRC-Hong Kong Double Tax Arrangement ("DTA") if all of the following requirements could be met:

a. Residency requirement, one party must be a PRC tax resident enterprise while another party must be a Hong Kong tax resident enterprise; and
b. Beneficial ownership requirement (given).

Since Hen Ltd is centrally managed in Hong Kong and Chicken Ltd is incorporated in the PRC, Hen Ltd and Chicken Ltd should be Hong Kong tax resident enterprise and PRC tax resident enterprise, respectively – residency requirement should be met.

Since the beneficial ownership requirement is also met (given), the reduced withholding EIT of 7% should apply.

In general, based on the EIT Law the royalty expense paid by Chicken Ltd should be deductible for EIT purposes since it relates to its operating activities.

Since the royalty payment made to Hen Ltd is a cross-border intra-group royalty payment, its deductibility is also subject to Announcement of State Administration of Taxation [2017] No. 6 ("Announcement 6"). Under Announcement 6, if a royalty payment is made to an overseas related party who merely possesses the legal ownership but fails to contribute to the value creation of the intangible, and if such royalty payment is not at arm's length, tax authority is empowered to make adjustments up to the full amount of such royalty payment.

Answer 5(b)(i)

Section 14 of the Inland Revenue Ordinance (the "IRO") states that a person would be chargeable to profits tax in Hong Kong if he is carrying on a trade, business or profession in Hong Kong and profits attributable to that trade, business or profession are arising in or derived from Hong Kong.

The broad guiding principles of deciding the source of profits are derived from *CIR v Hang Seng Bank Limited* and *HK-TVB International Limited v CIR*, i.e., what the taxpayer has done to earn the profit in question; and where he has done it.

Whether royalties derived from licensing activities are chargeable to tax in Hong Kong depends on the facts of each case. No single legal test is decisive.

Departmental Interpretation and Practice Notes ("DIPN") No. 49 (but not DIPN No. 21) specifically states that, if a taxpayer (Hen Ltd in this case) only obtains a licence to use an intellectual property right ("IPR") from its owner (Cock Ltd in this case) (i.e. the taxpayer has not obtained the proprietary interest of the IPR) and then sub-licenses the IPR to another party (Chicken Ltd in this case) for use outside Hong Kong, the Hong Kong Inland Revenue Department (the "IRD") will, in ascertaining whether the royalties so derived are Hong Kong sourced income, take the place of acquiring and granting the licence as the source of income.

Since the use of the trademark was pursuant to an agreement signed in Hong Kong, Hen Ltd (being the taxpayer) acquires in Hong Kong the licence for use of the trademark (being the IPR), and grants a sub-licence to Chicken Ltd also in Hong Kong. Therefore, the royalties derived from sub-licensing the IPR will be regarded as derived from Hong Kong and subject to Hong Kong Profits Tax.

Answer 5(b)(ii)

Cock Ltd is an overseas company in Singapore. It does not carry on a trade or business in Hong Kong, therefore it is not caught by Section 14 of the IRO.

However, Section 15(1)(b) of the IRO imposes Hong Kong Profits Tax on a non-resident that received royalties for the use of any trademark, copyright, patent etc., in Hong Kong. Therefore, the royalties received by Cock Ltd should be subject to Hong Kong Profits Tax.

Under Section 21A of the IRO, the deemed profit percentage of 100% applies where the resident payer and the non-resident recipient are associated and the intellectual property was at any time partly or wholly, directly or indirectly owned by any person carrying on a trade, profession or business in Hong Kong. In all other cases, the deemed profit percentage would be 30%. In our case, the trademark was developed and registered by Cock Ltd in Singapore, i.e., it was not previously owned by a Hong Kong resident. Therefore, the deemed profit percentage should be 30% of the sum received.

Under Section 20B of the IRO, Hen Ltd has to withhold a sufficient sum for the payment of Profits Tax on the royalties, and is indemnified against any person in respect of the deduction of such sum.

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