- any amount paid by an employer in connection with the education of a child of an employee (僱員的子女) (s 9(2A)(b)); and
- any amount paid by an employer in connection with a holiday journey (度假旅程) of employees as from 1 April 2003 (s 9(2A)(c) and DIPN 41).

32. Section 9(1)(a)(iv) exempts any amount paid by the employer to any person other than the employee in discharge of a sole and primary liability of the employer to that other person. However, there must not be any surety to that liability by any other person. This exemption is subject to s 9(2A).

Housing Benefit

33. A rental value (RV) shall be included in the assessable income of an employee or a holder of an office if his employer or an associated corporation (相聯法團) has:

- provided him with a place of residence (PoR, 居住地方) rent-free (s 9(1)(b));
- provided him with a PoR at a rent less than the RV (s 9(1)(c)); or
- paid or refunded part or all of the rent for his PoR (s 9(1A)(b)).

34. This covers the situation where:

- the employer or associated corporation owns a PoR and allows the employee to occupy it rent-free or at a rent below the RV;
- the employer or associated corporation leases a PoR and allows the employee to occupy it rent-free or for a consideration payable to the employer or associated corporation which is below the RV; or
- the employee leases a PoR and the employer or associated corporation refunds part or all of the rent.

35. Where a PoR is provided to an employee at a rent less than the RV, the excess of the RV over such rent shall be added to his assessable income.

CALCULATION OF RENTAL VALUE (S 9(2))

36. The RV of a PoR is a fixed percentage on the employee's net assessable income (i.e., assessable income less outgoing and expenses, depreciation allowances, losses, gain on share option and any lump sum or gratuity paid upon the retirement or termination of the employee's employment).

The fixed percentages are:

- 4% — if the accommodation consists of not more than one room in a hotel, hostel or boarding house;
- 8% — if the accommodation consists of not more than two rooms in a hotel, hostel or boarding house (proviso (a) to s 9(2)); and
- 10% — all other cases (s 9(2)).

➤➤ *Example 6*

Mr Chan has been employed as an accountant by A Ltd. for a number of years. During the year ended 31 March 2016, A Ltd. provided Mr Chan a place of residence in a hotel suite consisting of two bedrooms and paid him a monthly salary of $30,000. Mr Chan had to pay a nominal rent of $1,000 to A Ltd. monthly. Mr Chan also paid an annual membership fee of $2,450 to the Hong Kong Institute of Certified Public Accountants (HKICPA).

The net assessable income of Mr Chan for the YA 2015/16 is as follows:

Mr Chan
Salaries tax computation
Year of assessment 2015/16
Basis period: year ended 31 March 2016

		$	$
Salary ($30,000 × 12)			360,000
Add:	Rental value ($360,000 − $2,450) × 8%	28,604	
Less:	Rent suffered ($1,000 × 12)	(12,000)	
Net rental value			16,632
			376,604
Less:	Allowable outgoings		(2,450)
Net assessable income			374,154

In cases where the RV is 10% of the net assessable income, the taxpayer may elect to use the rateable value instead of the 10% rental value.

➤➤ *Example 7*

Mr Wong has been employed by B Ltd. as a general manager for a number of years. As from 1 April 2015, B Ltd. provided Mr Wong with a rent-free flat for residence and paid Mr Wong a monthly salary of $150,000. The rateable value of the flat under the *Rating Ordinance* for the year ended 31 March 2016 was $144,000.

The assessable income of Mr Wong for the YA 2015/16 is as follows:

income. The sum was not incurred in the course of earning her income. Likewise, in D 102/03, professional indemnity insurance paid by an employed doctor was disallowed. The BoR commented that the sum could probably be deductible under profits tax if the doctor was practising on her own account.

21. In D 35/04, the taxpayer was required to repay part of the commission to his employer, being bad debt of his clients. The repayment of commission was required because he failed to observe the employer's credit policy. The BoR disallowed the sum as it was not incurred for the performance of duties but for deviation from his duties.

22. In *CIR v Franco Tong Sui Lun* (2006) HCIA 2/2006, the taxpayer was employed as a dealer's representative of a stockbroker company. He was required, under the contract of employment, to refund any commission to his employer if his clients failed to settle their accounts. The BoR allowed the deduction for the refund. The CFI reversed the Board's decision and ruled that the refund was not incurred in the production of income. In that case, the CFI compared the deduction regime under salaries tax with that under profits tax which also uses the words 'in the production of ...'. Profits tax allows expenses for the production of chargeable profits while salaries tax allows expenses in the production of chargeable income. The CFI pointed out that deduction under salaries tax is much more stringent and narrow. Incidentally, the CFI doubted whether the taxpayer should be chargeable to profits tax rather than salaries tax, but this was not the question to be determined by the CFI. The taxpayer's appeal to the CA was dismissed.

23. The *Franco Tong* and *Humphrey* cases recognized that for salaries tax purpose, to qualify as being 'incurred in the production of chargeable income' the expense must be incurred in the course of performing of the duties, i.e., the very task for which the taxpayer is employed to do. It is therefore not easy to obtain deduction for expenses under salaries tax.

24. In D 14/13, T made payment in lieu of notice (PILON) to his previous employer. The PILON was reimbursed by this new employer. T argued that the PILON was incurred in the performance of his duty in doing the work required by the new employer and should therefore be an allowable deduction. The BoR dismissed T's appeal. The PILON enabling T to take up his new job by a specified time is personal to T and was not incurred in the performance of T's duty in doing the work of the new employer. It was not 'necessarily' 'incurred in the production of assessable income' and was in fact capital expenditure. It did not satisfy the provision of s 12(1)(a) for a deduction.

INCURRED

25. There must be an established liability or a definite commitment arising in the YA concerned. A mere contingent liability or an anticipated future outgoing will not be deductible.

TREATMENT OF SPECIFIC TYPES OF EXPENSES

Travelling Expenses

26. Travelling expenses between home and the place of employment are not allowable (*CIR v Humphrey* HKTC 451), but expenses for travelling from one place of employment to another will be allowable (*Taylor v Provan* (1974) 49 TC 579 and *Pook v Owen* (1969) 45 TC 571).

Subscriptions to professional associations

27. In principle, subscriptions are not allowable in accordance with the strict interpretation of the deductibility of expenses because they are incurred in order to enable the taxpayer to produce income (see *CIR v Robert Burns*). However, by an extra-statutory concession, a subscription to a professional body will be allowable, provided that the retention of membership in the body is a prerequisite of the employment and the retention of membership, and keeping abreast of current development in that particular profession is of regular use and benefit in the employment. However, only a full member is entitled to the concession. A student member is not so entitled (DIPN 9, para 17).

Salary paid by the employee in lieu of proper notice of resignation required by the employment contract

28. This payment is not incurred in the production of AI and thus not allowable (*CIR v Sin Chun Wah* (1988) 2 HKTC 364).

Payments to assistants

29. These are generally not allowable as they are not necessarily incurred. It is not sufficient that employment of assistants can facilitate the performance of duties. However, in D 19/78, a person was employed as a runner attached to a firm of stockbrokers and earned commission based on the sales solicited by him. He was held to be able to claim deduction for fees paid to assistants for the purpose of bringing in business to the firm (DIPN 9, para 19).

Further education and examination fees

30. An employee, even if required by his employer to undertake further studies, is not allowed to deduct the expenses so incurred (*Blackwell v Mills* (1945) 26 TC 468). The expense is private and domestic in nature and also not incurred in the production of AI, thus not qualifying under s 12(1)(a), the general deduction sub-section.

31. Likewise, examination fees to sit for professional examinations are not allowable (*Lupton v Potts* (1969) 45 TC 643).

SUMMARY OF EMPLOYER'S OBLIGATIONS

40.

Employer's obligations	*Time limit*	*IRO ref*
Returns of remuneration of employees, including directors	Time specified in the returns	s 52(2)
Information of all new employees liable or likely to be liable to salaries tax	Within three months of commencement of employment	s 52(4)
Notification of employees who are about to cease to be employed	One month before cessation	s 52(5)
Notification of employees who are about to leave Hong Kong for more than one month (other than frequent business trips)	One month before employees' departure	s 52(6)
Retention of money payable to employee who will cease employment and is about to leave Hong Kong for more than one month	One month from the date of the s 52(6) notice	s 52(7)

Persons Responsible for Compliance

INCAPACITATED PERSON

41. The trustee (受託人) of an incapacitated person (無行為能力的人) is responsible for doing all acts required by or under the IRO, to be done by that incapacitated person (s 53).

42. 'Incapacitated person' means any minor, lunatic, idiot or person of unsound mind.

43. 'Trustee' includes any trustee, guardian, curator, manager or other person having the direction, contract or management of any property on behalf of any person. Trustee does not include an executor.

NON-RESIDENT

44. An agent (代理人) of the non-resident is responsible for doing all acts required by or under the IRO to be done by a non-resident (s 53).

45. The meaning of 'agent' and details of an agent's duties and responsibilities are explained in Chapter 23.

DECEASED PERSON

46. The executor (遺囑執行人) of a deceased person is:

- chargeable with tax for all periods prior to the date of death; and
- liable to do all acts, matters or things which the deceased person would be liable to do if he were alive (s 54).

47. An executor is defined by s 2(1) to mean:

- any executor;
- administrator; or
- other person administering the estate of a deceased person, including a trustee acting under a trust created by the last will of the deceased.

48. If the deceased person has committed tax evasion, no prosecution can be taken against the executor. However, the executor may be assessed to s 82A additional tax for such evasion (s 54 proviso (a)).

PARTNERSHIP

49. The precedent partner is answerable for doing all acts, matters or things required under the IRO by the partnership (s 56(1)).

50. A precedent partner (首合夥人) is defined by s 2(1) to mean a partner who is:

- resident in Hong Kong;
- first named in the partnership agreement;
- first named in the partnership name; or
- first named in any statutory statement of the names of the partnership.

JOINT OWNERS AND CO-OWNERS OF IMMOVABLE PROPERTIES

51. Any of the joint owners or co-owners of any land and/or buildings are answerable for doing all acts, matters and things as would be required to be done under the IRO by a sole owner (s 56(1)).

- considered that s 70A(1) was not intended to confer on the taxpayer a right to seek, a general correction of assessments and s 70A(1) must have been intended to have a narrow coverage;
- disagreed that the word 'omission' in the phrase 'arithmetical error or omission' (the second limb of s 70A(1)) to mean any omission, and not 'arithmetical omission' only; and
- disagreed with T's argument that the time periods prescribed by s 70A(1) were only 'prescriptive' and not 'mandatory'.

PREVAILING PRACTICE

72. An assessment cannot be reopened for an error or omission in a return or statement where that return or statement was made in accordance with the prevailing practice (s 70A proviso).

73. For example, prior to the *Hang Seng Bank* case, it was thought that no apportionment of profits was possible in an onshore/offshore profit case. *Hang Seng Bank* allows apportionment. The IRD in the revised DIPN 21 'Locality of profits' accepts a 50:50 apportionment in cases of certain manufacturing businesses. However, it states in the DIPN that it will refuse to entertain any error or omission claim to apportion profits on the ground of prevailing practices.

REFUSAL TO CORRECT

74. If an assessor refuses to correct the assessment under s 70A, he must give a written notice of refusal to the claimant and such notice will be treated as a NOA. Hence, objection and appeal can be made as if the notice of refusal is a NOA (s 70A(2)).

SECTION 70A CASES

75. D 142/01 involved a solicitor's firm which submitted returns without making any provision for bad debt. Subsequently the firm wished to claim a provision for bad debt. The BoR ruled that any 'change of the mind of the taxpayer in connection with how any part of the accounts should be made up' cannot be regarded as an error or omission in relation to the accounts previously submitted.

76. When a taxpayer wishes to challenge the accuracy of the audited accounts, strong evidence must be given (*Chinachem Investment Co Ltd v CIR* at 282).

77. A deliberate act in the sense of a conscientious choice of one out of two or more courses of action which subsequently turns out to be less than advantageous or which does not give the desired effect as previously hoped for cannot be regarded as an error within s 70A. A change of opinion of the auditor or accountant or a change of mind of the directors in connection with how any part of the accounts should be made up cannot constitute 'error' for the purpose of s 70A (*Extramoney Ltd* 4 HKTC 394, D 14/88).

78. As mentioned in paragraph 6, the majority of judges in the CFA in *Moulin Global Eyecare Trading Limited (in liquidation) (formerly known as Moulin Optical Manufactory Limited) v CIR* held that the liquidators could not rely on s 70A because T, knowing that the return was false, had not made an 'error' but had instead told a deliberate lie by filing the return. Tang PJ dissented on the issue of attribution and held that s 70A was applicable. According to Tang PJ, if the liquidators could prove that the profits had indeed been inflated, and that T paid more tax than was properly chargeable, justice and common sense should not allow knowledge of the fraudulent directors be attributed to T.

Payment of Tax

79. Tax, for the purposes of Part XII (payment and recovery of tax), includes any surcharges, fines, penalties, fees and interest payable upon settlement of objection or appeal. Section 82A additional tax, being a penalty for tax evasion, is thus included.

Tax must be paid on or before the due date fixed by the CIR (s 71(1)).

Tax not paid by the due date shall be deemed to be in default and a surcharge of 5% shall be added (s 71(5)). If any part of the tax and surcharge remain in default for a further six months or more, a further surcharge not exceeding 10% on the unpaid amount shall be added (s 71(5A)).

80. In *CIR v Tam Kin Chung* (2009) CACV 363/2008, the CA dismissed T's appeal and held that:

- the surcharge on tax imposed under ss 71(5) and (6) of the IRO was a penalty thus not provable in bankruptcy so T's discharge from bankruptcy did not release him from the liability to pay the surcharge; and
- any action by the Government to recover 'tax', which is given an extended meaning by s 72 of the IRO to include surcharge, is precluded from becoming statute-barred by virtue of s 37 of the *Limitation Ordinance*.

HOLD-OVER UPON OBJECTION OR APPEAL

81. Tax shall be paid on or before the due date notwithstanding any objection or appeal (s 71(2)).

The CIR may order the hold-over of tax in dispute pending the determination of objection or appeal.

There are two types of hold-over: conditional and unconditional.

82. No hold-over will be made if:

- the objection is considered to be of a frivolous nature or having little merit; or

an office in Bombay, and everything which he did to earn the profit he did in Bombay. The Commissioner argued that the fact that T had to employ brokers outside British India did not mean that what he earned by his own efforts in British India was earned where the brokers were located. The Privy Council disagreed and rejected the Commissioner's argument that because everything which T did, in particular the decision to engage in each transaction and the giving of instructions to the overseas brokers to carry it out, was done in British India, it followed that the profits arose in British India. Giving the opinion of the Council, Sir George Rankin said at page 345:

> It is difficult indeed to see that the place at which a man takes a decision to do something in New York, or to ask someone else to do something for him in New York, is the place at which arises the profit which results from the action taken in consequence of the decision ... It can hardly be maintained that whatever a man decides upon in Bombay, and whatever may be done abroad in pursuance thereof, the profit must necessarily arise in Bombay. One must look at the transaction to see what happened in British India and what happened elsewhere ....
>
> To determine the place at which such a profit arises not by reference to the transactions, or to any feature of the transactions, but by reference to a place in India at which the instructions therefor were determined on and cabled to New York is, in their Lordships' view, to proceed in a manner which cannot be supported if the transactions are to be looked at separately and the profits of each transaction considered by themselves.

29. The overseas brokers in *Mehta* who carried out T's instructions did so as principals and not as agents, but the opinion of the Privy Council contains no reference to agency and does not depend on any supposed identity of the agent and his principal. According to Lord Millett in *ING Baring*, it was sufficient that the profits arose from transactions entered into by brokers acting on the taxpayer's instructions and for his account and the same was true of *Hang Seng Bank*.

DIPN 21 'Locality of Profits'

BASIC PRINCIPLES FOR DETERMINING THE LOCALITY OF PROFITS

30. The IRD issued DIPN 21 'Locality of profits' (Revised) on 4 December 2009 in which it states that the basic principles for determining the locality of profits enunciated in the decisions of *Hang Seng Bank, HK-TVBI, Orion Caribbean, Kwong Mile, Kim Eng* and *ING Baring* can be summarized as follows (the 15 principles listed below are not meant to be exhaustive as the peculiar facts of a case may call for special consideration):

- The question of locality of profits is a hard, practical matter of fact. No universal judge-made test will cover every case. Whether profits arise in or are derived from Hong Kong depends on the nature of the profits and the transactions giving rise to them.
- The ascertainment of the source of profits though a practical, hard matter of fact requires an accurate legal analysis of the transaction.
- The transactions must be looked at separately and the profits of each transaction considered on their own.
- The broad guiding principle is that one looks to see what the taxpayer has done to earn the profits in question and where he has done it. In other words, the proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place.
- The operations in question must be the operations of the taxpayer.
- The relevant operations do not comprise the whole of the taxpayer's activities carried out in the course of his business but only those which produce the profit in question. It is necessary to appreciate the reality of each case, focusing on effective causes for earning the profits without being distracted by antecedent or incidental matters.
- The distinction between Hong Kong profits and offshore profits is made by reference to gross profits arising from individual transactions.
- In certain situations, where gross profits from an individual transaction arise in different places, they can be apportioned as arising partly in and partly outside Hong Kong.
- The place where day-to-day investment decisions are taken does not generally determine the locality of profits.
- It is necessary to examine the operations of the taxpayer irrespective of the fact that the taxpayer may be a company within a group. The source of profits must be attributed to the operations of the taxpayer which produce them and not to the operations of other members of the group. The operations of the group should not be looked at on the question of source. However, in appropriate cases, if a related company is in fact acting on behalf of the taxpayer, then the activities of the related company will be considered to see if appropriate weight should be accorded thereto.
- If an arrangement or scheme is implemented in Hong Kong to free transactions from overseas regulations or overcome trade barriers, this in itself does not mean that the profits will be sourced outside Hong Kong.
- Identifying an agent's acts with those of its principal, whilst imposing some unity on the law applicable to situations where one party represents or acts for another, should not be taken to an inappropriate degree or taken too literally since this is not conducive to arriving at the accurate legal analysis.
- In brokerage business, it is not necessary that the transaction which produced the profit was carried out by the taxpayer or his agent in the full legal sense (i.e., one who enters into a contract on his principal's behalf creating a contractual relationship between his principal and a third party). It is sufficient that the transaction was carried out on the taxpayer's behalf and for his account by a person acting on his instructions.

Exchange Profits

HOW EXCHANGE PROFITS ARISE

61. Profits tax is assessed on profits expressed in Hong Kong dollars (*CIR v Malaysian Airline Systems Berhad* (1993) HKTC 775). Accounts prepared in foreign currencies must be converted to Hong Kong dollars for the purpose of ascertaining the assessable profit.

GENERAL PRINCIPLE

62. Exchange receipts which are capital in nature are not taxable, while receipts which are revenue in nature are taxable.

63. An exchange profit has the same character as the asset or liability from which it arises. Therefore:

- Exchange profits arising from trading transaction are revenue (e.g., settlement of trade debts, acquisition of trading stock, etc.). Thus, the exchange profit in *Imperial Tobacco Co Ltd v Kelly* (1943) 25 TC 292 was held to be assessable. In that case, a tobacco company accumulated US dollars to finance its purchase of US tobacco leaves. The exchange profit arose from sale of US dollars.
- Exchange profits arising from acquisition or disposal of fixed assets are capital in nature.
- Exchange profits arising from raising capital or repayment of long-term loans are capital in nature.

➤➤ *Example 3*

On 1 October 2015, Gold Ltd. sold one million units of goods to a Utopian firm at Utopian $5 each. The exchange rate at that date was HK $1 for Utopian $2 (i.e., the trade debt at that date was HK$2.5 million). The merchant in Utopia settled the debt on 30 November 2015 when the Utopian dollar appreciated to HK $1 for Utopian $1.667. The sum received therefore became HK$3 million. There was a realized exchange gain of HK$500,000.

UNREALIZED EXCHANGE PROFIT/LOSS

64. Unrealized exchange profits arise from the conversion of the balance sheet items at the end of the accounting period. Unrealized exchange profits/losses can be assessable/deductible provided that the taxpayer consistently brings such profits/losses into account. However, the accounting treatment must be consistent. The case of *Secan* lays down the principle that the tax treatment must follow the accounting treatment. Following *Secan*, the IRD issued DIPN 42 (Part B) 'Taxation of foreign exchange differences', to set out its new policy. The IRD's new policy is that if profit or loss is recognized in the profits or losses account, it cannot be excluded in the tax computation on the ground that it is unrealized.

EXCHANGE PROFITS ON REPAYMENT OF LOANS

65. It is incorrect merely to look at the use of the loan. If the loan is long-term in nature, it is capital even though it may be used for acquisition of current assets (*Beauchamp v FW Woolworth Plc* (1989) 61 TC 542, *FCT v Hunter Douglas Ltd* (1983) 14 ATR 629).

66. Whether the exchange profit is capital or revenue in nature depends on whether the loan forms part of the fixed capital of the taxpayer. This depends on the purpose of the taxpayer: whether the loan is intended to augment the fixed capital or is merely a temporary accommodation. Relevant factors for determining the purpose of the loan are the terms of the loan and the use of the loan. It depends on the facts of each case.

67. If, however, the borrowing forms an integral part of the profit-making activities, the exchange profit/loss will be revenue (e.g., the borrowing is an integral part in the process of purchasing trading stock). This is illustrated in *Thiess Toyota Pty Ltd v FCT* (1978) 78 ATC 4463. In that case, letters of credit were obtained from a bank for the purpose of acquiring trading stock. The role of a trade creditor was therefore taken over by the bank.

TEMPORARY CREDIT FACILITIES

68. Temporary credit facilities may be regarded as increasing the capital base of a taxpayer if the facilities keep being extended. In D 77/88, a trading company borrowed a US dollar loan from a bank. The borrowing was by means of the taxpayer accepting short-term bills. The bills were rolled over on a monthly basis for three-and-a-half years. The fund derived from the borrowing was placed with its parent company, partly to discharge the cost of goods purchased from the parent company and partly for other purposes. The exchange loss arising on the borrowing was held to be capital in nature.

FINANCE COMPANY

69. Exchange profits/losses on borrowings by a finance company are more likely to be revenue in nature than in other businesses. Money to a money lender (of which a finance company is one) is analogous to stock-in-trade of a trader. In *CIR v Chinachem Finance Co Ltd* (1992) 1 HKRC 90-066, the taxpayer company borrowed loans repayable on demand, but in fact lent for various

84. The statutory meanings of some technical terms relating to relevant IPRs can be found from the following table:

Term	Meaning
copyright (版權)	(a) a copyright within the meaning of s 2(1) of the *Copyright Ordinance* (Cap 528), including an unregistered corresponding design as defined by s 87(5)(b) of that Ordinance; or (b) any right that: (i) subsists under the law of a place outside Hong Kong in any work in which a copyright referred to in paragraph (a) may subsist; and (ii) corresponds to a copyright referred to in paragraph (a) (s 16EA(11)).
know-how (工業知識)	any industrial information or techniques likely to assist in the manufacture or processing of goods or materials (s 16E(4)).
licence (特許), in relation to a relevant right	(a) a licence (however described and whether general or limited) authorizing the licensee to use the relevant right in the manner authorized by the licence; but (b) does not include an agreement under which the ownership of the relevant right will or may be sold to or pass to the licensee unless, in the CIR's opinion, the right under the agreement to purchase or obtain the ownership of the relevant right would reasonably be expected not to be exercised, and licensee (特許持有人) is to be construed accordingly (s 16EC(8)).
patent rights (專利權)	the right to do or authorize the doing of anything which would, but for that right, be an infringement of a patent (s 16E(4)).
registered design (註冊外觀設計)	a design registered under s 25 of the *Registered Designs Ordinance* (Cap 522) or under the law of any place outside Hong Kong (s 16EA(11)).
registered trademark (註冊商標)	a trademark registered under s 47 of the *Trade Marks Ordinance* (Cap 559) or under the law of any place outside Hong Kong (s 16EA(11)).

non-recourse debt (無追索權債項), in relation to the financing of the whole or a predominant part of the consideration for the purchase of any relevant right	a debt where the rights of the creditor in the event of default in the repayment of principal or payment of interest: (a) are limited wholly or predominantly to any or all of the following: (i) rights (including a right to moneys payable) in relation to the relevant right or the use of the relevant right; (ii) rights (including a right to moneys payable) in relation to goods or services that are produced, supplied or provided using the relevant right; (iii) rights (including a right to moneys payable) in relation to the loss or disposal of the whole or a part of: (A) the relevant right; or (B) the taxpayer's interest in the relevant right; (iv) any conjunction of those rights referred to in sub-paragraphs (i), (ii) and (iii); (v) rights in respect of a mortgage or other security over the relevant right; (vi) rights arising out of any arrangement relating to the financial obligations of the end-user of the relevant right towards the taxpayer, being financial obligations in relation to the relevant right; (b) are in the CIR's opinion capable of being limited as described in paragraph (a), having regard to either or both of the following: (i) the assets of the taxpayer; (ii) any arrangement to which the taxpayer is a party; or (c) if paragraphs (a) and (b) do not apply, are limited by reason that not all of the assets of the taxpayer (not being assets that are security for a debt of the taxpayer other than a debt arising in relation to the financing of the whole or part of the consideration for the purchase of the relevant right) would be available for the purpose of the discharge of the whole of the debt so arising (including the payment of interest) in the event of any action or actions by the creditor or creditors against the taxpayer arising out of the debt (s 16EC(8)).

23. If the POCM has been adopted and the contract eventually turned out to yield a loss, the IRD would refuse to accept a s 70A claim to correct assessments for previous years. The IRD considers that the errors were mere errors of judgment. The loss can only be carried forward or set-off against profits from other contracts. The only circumstances where s 70A would be entertained is where the contract constitutes the sole contract of the business which ceased after completion of the contract.

24. However, the IRD does not accept the recommendation of HKAS 11 that the expected excess of total contract costs over total contract revenue for the contract should be recognized as an expense immediately, i.e., a loss on a contract as a whole recognized in the accounts as soon as it is foreseen. The IRD would only accept that a proportion of the expected overall loss, calculated either by reference to time (normally up to the due completion date under the terms of the contract), or to expenditure incurred, may be taken into account year-by-year during the remainder of the contract period. This is so as long as all contracts, profitable or otherwise, are dealt with similarly.

Assessable profits in relation to incomplete long-term contracts

25. In D 19/07, T carried on the business of professional management, design and installation in the fields of architectural, structural, mechanical and electrical engineering and contracting. T recognized profits from incomplete contracts on the basis of the POCM in accordance with the Generally Accepted Accounting Practice (GAAP). T contended that for taxation purposes they were entitled to choose between the percentage of completion method (POCM) and the completion of contract method (COCM), and emphasised that they relied very heavily upon the 1976 DIPN 1 (*Note*: the DIPN was revised in July 2006). The BoR dismissed T's appeal and held that:

- A person's profits for taxation purposes must be ascertained in accordance with ordinary principles of commercial accountancy. No modification is required or permitted unless they conflict with the IRO. The IRD and T are bound by the latter's choice of accounting treatment. T's accounts were approved by its directors and certified by its auditors as having been prepared in accordance with the proper accounting principles generally accepted in Hong Kong. Therefore, in accordance with the GAAP, T recognized profit from incomplete long-term contracts on the basis of the POCM. T is bound by its accounting treatment and is not entitled to adjust or modify its assessable profits by way of a computational adjustment on the basis of the COCM.
- DIPNs are only for information and guidance of taxpayers and their authorized representatives. They have no binding force and do not affect a person's right of objection or appeal.

Property development

26. For a trade of developing property for sale, even though the contracts of sale may have been entered into and part payment received before completion of the development, it is common practice to take the profit on sale as arising when the contract is capable of completion by performance and the purchaser can be given possession. The sale is regarded as taking place when the Occupation Permit in respect of the relevant unit is issued by the Building Authority.

Property investment

27. For property developed for long-term holding as a capital asset, all overheads, including administration expenses, correctly attributable to the acquisition of the site and the construction of the property, are properly capitalized. These will include finance expenses up to the date when the property is capable of being used in the production of profits. This will usually be the date of the Occupation Permit or the date from which rent is first receivable. After that date, interest is correctly a revenue charge.

VALUATION OF STOCK ON CESSATION (S 15C)

28. Upon cessation of business, where the trading stock is sold to a person who will use the stock in a business carried on in Hong Kong and will claim the purchase cost as a deductible expense, the actual sale proceeds shall be used in the tax computation.

29. In any other situations, the open market value of the stock at the date of cessation would be taken as its value for tax purposes. In *Southtime Ltd v CIR* (2002) (HCIA 6/2001, 16 IRBRD 1034, 5 HKTC 571), the taxpayer acquired units in Kwai Chung Plaza, some of them for resale as trading stock and the rest as investment properties for rental income purposes. Subsequently, the taxpayer decided to transfer the unsold trading stock to fixed assets. It was held that the taxpayer carried on two businesses — trading in properties and holding properties for long-term investment, and that the 'trading in properties' had ceased. The unsold trading stock transferred to fixed assets was to be valued on an open market value basis at the date of cessation.

Sharkey v Wernher

PRINCIPLE

30. Where a trader has taken part of his stock for his own use, enjoyment or consumption instead of being sold, the market value of that stock at the time of such disposition is treated as a receipt in his trading account for tax purposes (*Sharkey v Wernher* (1955) 36 TC 275).

LUMP SUM FOR CANCELLATION / VARIATION OF CONTRACTUAL RIGHTS OF SELF-EMPLOYED INSURANCE AGENTS

22. Most lump sums received by SEIAs are revenue in nature and taxable. Where the cancelled contract or right relates to the whole structure of the insurance agency business, the IRD would consider whether it is capital in nature and non-taxable (DIPN 33, paras 11 and 12).

COMMISSION FROM OWN OR FAMILY MEMBER INSURANCE POLICIES OF SELF-EMPLOYED INSURANCE AGENTS

23. The commission income concerned has no difference from that earned by an SEIA from other ordinary customers and is therefore a trading receipt chargeable to profits tax (DIPN 33, para 14).

ALLOWABLE DEDUCTIONS OF SELF-EMPLOYED INSURANCE AGENTS

24. An SEIA may be allowed deductions for commission paid to sub-agents and runners, salaries and employment benefits to employees, gifts and entertainment expenses. Where an outgoing or expense is not wholly incurred in the production of assessable profit, it has to be apportioned on an appropriate basis. Proper business records have to be kept as required by s 51C. Where no proper business records are kept, doubtful and unsubstantiated claims will not be entertained. In addition, penal actions may be taken under ss 80, 82 and 82A (DIPN 33, paras 15–26 and 35).

25. In D 11/10, T was a SEIA and had an agency agreement with Company B. In order to achieve her targeted sales volume for promotion, she obtained a loan to pay for the premiums of the insurance policies taken out for herself and her relatives. The BoR held that:

- The commission paid by Company B to T was for her performance under the agency agreement. The commission is chargeable to profits tax in accordance with s 14(1).
- Even if the purpose of taking out the insurance policies was to achieve targeted sales volume, the policies did provide insurance cover for the assured. The motive of a consumer is not determinative. The premiums paid for her relatives and herself were not expenses incurred in producing profits for her insurance agency business and therefore not deductible under s 16(1) of the IRO.
- The premiums paid by T for her relatives are a private financial arrangement between the parties. They should be considered domestic or as private expenses and so were not deductible in accordance with s 17(1)(a).

Shipowners and Aircraft Owners

26. The relevant legislation for shipowners and aircraft owners is as follows:

- s 23B — Shipowners
- s 23C — Resident aircraft owners
- s 23D — Non-resident aircraft owners

SHIPOWNERS

27. Section 23B applies to a shipowner carrying on business in Hong Kong.

A shipowner carrying on business in Hong Kong means a person carrying on business as an 'owner' (擁有人) of a ship and:

- where the business is normally controlled/managed in Hong Kong (s 23B(1)(a));
- where the person is a company incorporated in Hong Kong (s 23B(1)(b)); or
- any ship owned by a person who carries on a business as an owner of ships calls at any location within the waters of Hong Kong (s 23B(2)). There is an exception: the CIR may disregard such calls if he considers in his absolute discretion that any call by a ship is a casual call and further calls by any ship of the same shipowner are unlikely (s 23B(6)). In such cases, s 23B is not applicable.

A 'shipowner' includes a person who charters a ship from another owner under a charter or agreement (e.g., a bareboat charter, time charter or voyage charter), but does not include one who is only involved with dealing in ships or shipping agency business (i.e., with demise of the vessel).

Calculation of assessable profits of shipowners

28. Section 23B provides that the assessable profit (AP) of a person carrying on the business of a shipowner in Hong Kong is computed as follows:

- Section 23B(3):

$$\text{AP} = \text{relevant sum} \times \frac{\text{total shipping profits}}{\text{total shipping income}}$$

- If there are practical difficulties in applying the above formula and the assessor is of the opinion that the formula cannot be satisfactorily applied, the AP is computed as follows:

$$\text{AP} = \text{fair percentage} \times \text{relevant sums (s 23B(4))}$$

Industrial Building Allowances (IBA)

INITIAL ALLOWANCE

13. From the YA 1965/66 onwards, IA is 20% of the qualifying expenditure and is granted to the YA in the basis period of which the expenditure was incurred (s 34(1)).

14. Expenditure incurred before a trade is commenced is treated as if it were incurred on the day on which trading commenced (s 40(2)).

15. When any IA has been made before the building is completed and when it first comes to be used, it does not qualify as an industrial building, and any IA given would be withdrawn by additional assessment (s 34(1) proviso (b)).

UNUSED BUILDING

16. IA is based on the qualifying expenditure (i.e., cost of construction, loan interest, etc.). It is not based on the purchase price, except when a person purchases the building or structure unused. For an unused building, the allowances are based on the lower of:

- the actual cost of construction; and
- the net price paid by the purchaser for the relevant interest in respect of the cost of construction (s 35B(b)(ii)).

17. Where the building is sold more than once before the building is used, only the last purchaser is entitled to IBA (s 35B(b) proviso (a) and (b)). Any IA given to the vendor shall be withdrawn by an additional assessment (s 35B(b) proviso (a)).

VENDOR-DEVELOPED PROPERTY FOR SALE

18. If the vendor of the building is the one who develops the building for the purpose of sale, the IBAs shall be computed on the net price paid by the purchaser for the relevant interest in the cost of construction (s 35B(b)(i)).

19. Where the building is sold more than once before the building is used, only the last purchaser shall be entitled to IBAs and the allowance shall be computed on:

- the net price on the first sale; or
- the net price paid by him;

whichever is less (s 35B(b) proviso (a)).

➤➤ *Example 2*

C Ltd. purchases an unused industrial building from B Ltd., who is a developer for resale, for $50,000,000 (including land) and uses the building for manufacturing purposes. The cost of development to B Ltd. is $40,000,000, comprising cost of land $25,000,000 and cost of construction $15,000,000. C Ltd. is entitled to claim IBA based on the net price paid by it in respect of the cost of construction, which is calculated as follows:

$$\text{Qualifying expenditure} = \$50{,}000{,}000 \times \frac{\$15{,}000{,}000}{\$40{,}000{,}000} = \$18{,}750{,}000$$

No IBA is due to B Ltd.

ANNUAL ALLOWANCE (AA)

20. To qualify for AA, the building or structure must be in use for a qualifying trade at the end of the basis period (s 34(2)(a)).

21. From the YA 1965/66 onwards, AA is 4% of the qualifying expenditure.

➤➤ *Example 3*

A Ltd. in its accounting year ended 31 October 2015, constructed a building for use in its trade of machinery manufacturing. The land was purchased at a price of $1,000,000 during the year ended 31 October 2014. The building was completed in May 2015. The costs of construction were:

	$
Land premium (before 31 December 2014)	1,000,000
Architect's fee (December 2014)	50,000
Foundation preparation (January 2015)	80,000
Building cost (before May 2015)	3,900,000
Loans interest (before May 2015)	120,000
Cost of lifts	800,000
Total cost	5,950,000

The interest of $120,000 was paid on the following loans:

		$
(a)	loan of $600,000 borrowed in 2014 to finance the land cost	50,000
(b)	loan of $840,000 borrowed in 2014 to finance the cost of construction of building	70,000
		120,000

Annual allowance is completed as follows:

Year of first use	—	2010/11
25th year after year of first use	—	2035/36
First year of AA to G Ltd.	—	2014/15
Number of years from 2014/15 to 2035/36	—	22

Annual allowances to E Ltd. $\frac{1}{22} \times \$768{,}000 = \$34{,}909$

Assuming G Ltd. continues to use the building in the future, it will get an AA of $34,909 for each YA from 2014/15 to 2035/36 until the RoE is reduced to nil.

Commercial Buildings

34. Any building or structure used by a person entitled to the relevant interest for the purpose of his trade, profession or business other than an industrial building or structure is a commercial building or structure (s 40).

PERSON ELIGIBLE TO CLAIM COMMERCIAL BUILDING ALLOWANCE

35. A person is entitled to an annual allowance (also called commercial building allowance (CBA) or rebuilding allowance (RBA)) if he:

- is, at the end of the basis period, entitled to the relevant interest in relation to the capital expenditure incurred on the construction of a commercial building/structure; and
- uses the building/structure for the purposes of his trade, profession or business (ss 33A and 40(1)).

QUALIFYING EXPENDITURE

36. Similar to IBA, the qualifying expenditure for CBA is the capital expenditure incurred on the construction of the building or structure. Therefore, land cost is excluded. According to DIPN 2 (Revised 1999), s 35B (see paras 16–17 above), which is concerned with industrial buildings bought unused, does not have any application in relation to a commercial building. See *Examples 5* and *8* in DIPN 2 (Revised 1999).

CBA BEFORE 1998/99

37. There were no IAs or balancing adjustments. The RBA was 2% of the qualifying expenditure from the YA 1990/91 up to the YA 1997/98 (0.75% p.a. before the YA 1990/91). There was no balancing adjustment upon sale.

CBA AS FROM 1998/99

38. There is no IA. The CBA is 4% of the qualifying expenditure for a new building or structure (s 33A(1)). On sale or disposal of the building while the building is a commercial building, balancing adjustments have to be made.

➤➤ *Example 12*

H Ltd. carries on business in Hong Kong and prepares its accounts to 31 March each year. During the year ended 31 March 2016, it purchased a new commercial building and used it as an office. The capital expenditure incurred on the construction of the commercial building was $100 million.

H Ltd. is entitled to claim an AA of $4,000,000 in respect of the commercial building for the YA 2015/16, being calculated as follows:

YA 2015/16	*Commercial building* $	*Allowance* $
Qualifying expenditure	100,000,000	
Annual allowance 100,000,000 × 4%	4,000,000	4,000,000
Residue of expenditure	96,000,000	

If H Ltd. continues to use the commercial building for the production of chargeable profits in the future, the capital expenditure will be completely written-off in the YA 2039/40.

COMMERCIAL BUILDING USED BEFORE THE YEAR OF ASSESSMENT 1998/99

39. The building or structure is deemed to be first used in the YA 1998/99. The qualifying expenditure as at the beginning of the YA 1998/99 is deemed to be the cost of construction less the total amount of CBA that would have been granted prior to the YA 1998/99. The AA for the YAs 1998/99 and thereafter are computed on the deemed qualifying expenditure.

Agreement for Sale of Residential Immovable Property — Head 1(1A)

25. An agreement for sale (AFS) in respect of a RPy is subject to SD. Such an AFS is called a 'chargeable agreement for sale'.

An AFS not intended to create legal relations (e.g., an AFS made 'subject to contract') does not attract SD. However, an AFS which is termed 'provisional' or 'informal' is still subject to SD if it amounts to a legally binding contract.

RATES OF STAMP DUTY

26. The rates of SD are specified in Head 1(1A). They are the same as for conveyance on sale under Head 1(1).

TIME FOR PAYMENT

27. Stamp duty is normally payable within 30 days after the relevant date (i.e., the date of making of the original AFS), whether written or unwritten. However, the person liable can apply to defer payment if certain conditions are fulfilled (see paras 34–36 below).

SERIES OF AGREEMENTS WITH A COMMON VENDOR

28. If one or more AFS is made in respect of the same property, after execution of the AFS and before the execution of the COS, each of such further AFS is chargeable to SD by reference to the consideration thereof (or the market value if the sale amounts to a voluntary disposition *inter vivos* (VDIV)).

CONVEYANCE ON SALE OF RESIDENTIAL PROPERTY

29. Where a COS of RPy is executed 'in conformity with' a chargeable AFS which is stamped, the COS is chargeable with SD of $100 only (s 29D(2)(a)).

The term 'in conformity with' means:

- the COS is in favour of the same purchaser(s) named in the AFS; and
- the conveyance is the whole or part of the immovable property which is the subject matter of the AFS (s 29D(6)(c)).

CONVEYANCE ON SALE TO CLOSE RELATIVES

30. For the purpose of deciding whether a COS is made 'in conformity with' a chargeable AFS, the:

- parent;
- spouse; and
- child

of a person are treated as the same person (s 29D(6)(c)).

31. If a COS is presented for stamping and the CSR has reason to believe that a chargeable AFS has been made in respect of that property and the said chargeable AFS has not been duly stamped, the CSR may refuse to stamp the COS.

32. Where a COS in conformity with an AFS is made:

- if the AFS is duly stamped, the COS is chargeable to SD of $100;
- if the AFS is not duly stamped, the COS is chargeable to SD under Head 1(1) of the First Schedule and the COS shall be deemed to be made on the date of making of the AFS. The AFS is chargeable with SD of $100.

Exemption for uncompleted agreement

33. No SD is payable if the AFS is cancelled, annulled or rescinded or is otherwise not performed other than by reason of a resale or disposal of the property by nomination or direction of the purchaser. If SD has been paid in such circumstances, the SD paid shall be refunded upon application made within two years after the cancellation, annulment or rescission of the agreement.

Deferral of payment of stamp duty on chargeable AFS

34. Upon application in the prescribed form to the CSR within 30 days after the date of execution of the AFS by the person liable to pay SD on the AFS, the time for stamping an AFS shall be deferred as follows:

- where the AFS is completed by a conveyance, 30 days after the execution of the conveyance or three years after the relevant date of the AFS whichever is the earlier;
- where before execution of a conveyance, the property is resold or disposed of by way of nomination or direction made by the purchaser under the AFS (including the making of a replacement agreement between the vendor and a sub-purchaser introduced or as instructed by the purchaser), seven days after the day of the subsale or disposition of the property or three years after the relevant date of the AFS whichever is the earlier; and
- in any other cases, three years after the relevant date of the AFS.

If the above conditions are not fulfilled, a contract note must be prepared and stamped as if a sale and purchase of that stock had been effected in Hong Kong. The borrower will then be solely liable to pay SD on the sale and purchase note.

DEEMED SALE AND PURCHASE OF HONG KONG STOCK

128. A stock borrowing shall be deemed to be a sale and purchase of the borrowed stock in Hong Kong if:

- the borrower ceased to be required to make a stock return (s 19(12)(a));
- the borrowed stock is not used for a permissible purpose (s 19(12)(b)); or
- the borrower fails to comply with the demand for the borrowed stock of the same quantity and of the same description (s 19(12)(c)).

129. For such cases, a contract note must be prepared and stamped as if a sale and purchase of that stock had been effected in Hong Kong. The borrower will then be solely liable to pay SD on both the sale and bought note which is computed as if there is a sale and purchase of the borrowed stock:

- on the specified day; and
- for a consideration based on the closing price of the borrowed stock quoted on the Hong Kong Stock Exchange on the day preceding the specified day.

SPECIFIED PURPOSES

130. Specified purposes include the settling of a sale of Hong Kong stock by the borrower or another person.

E.g., 10 July 2013 A entered into a stock lending and borrowing agreement (SLBA) with B.
A asked B to lend 20,000 W shares to him for the purpose of effecting a sale.

RE-PURCHASE AGREEMENT

131. Typically, a person who has equity or debt securities and needs cash (the seller) initiates a stock re-purchase transaction (or repo) by selling the securities to another person who has cash (the buyer) and agreeing to re-purchase a like amount of identical securities from the buyer at a specified price in the future, either at a set date or on demand. The re-purchase price includes a premium, usually a price differential over the original cash purchase price, as compensation for the use of the cash. Where the transaction is initiated by the buyer, it is known as a reverse repo.

132. Repos or reverse repos shall be exempt from SD, like stock borrowing and lending, provided that conditions similar to those of stock borrowing and lending are fulfilled.

133. Certain repos and reverse repo transactions under what are known as re-purchase agreements can be treated as stock borrowing and lending transactions.

STOCK COLLATERAL

134. Under stock borrowing and lending transactions (and sometimes under a repo), stocks or other securities may be provided by the borrower (or buyer) as collateral. Where Hong Kong stock is involved, the initial transfer of the collateral and the transfer upon its return are both exempt from *ad valorem* stamp duty by virtue of s 27(5) which applies to any 'transfer made for nominal consideration for the purpose of securing the repayment of a loan'.

Head 3: Hong Kong Bearer Instrument

DEFINITIONS

135. 'Bearer instrument' means any instrument to bearer by delivery of which any stock can be transferred other than an instrument relating to a foreign currency loan.
'Hong Kong bearer instrument' means a bearer instrument issued:

- in Hong Kong; or
- elsewhere by or on behalf of:
  - — a body corporate formed in Hong Kong; or
  - — an unincorporated body or person established in Hong Kong.

RATES OF STAMP DUTY

136. The rate is generally 3% of market value on issue (Head 3 of First Schedule).

TIME FOR STAMPING

137. The time for stamping is before the issue of the bearer instrument.

PERSONS LIABLE

138. The persons liable are the person, or his agent, who made the issue.

Deceased taxpayer

57. An assessment to s 82A additional tax can be made on the executor of a deceased person (s 82A(6)). The time limit of s 54 proviso (b) does not apply to s 82A additional tax.

Appeals against an assessment to additional tax (s 82B)

58. A taxpayer who wishes to contest the assessment to s 82A additional tax can appeal to the BoR.

59. Requirements for an appeal are:

- the taxpayer must lodge an appeal in writing to the BoR within one month of the notice of assessment being given to him. Before 25 June 2004, the BoR had no power to grant an extension of time for an appeal under s 82B (*Chan Min-ching trading as Chan Siu Wah Herbalist Clinic v CIR* (1999) HCIA 6/1998).
- as from 25 June 2004, the BoR may extend the time for lodging an appeal, if it is satisfied that an appellant was prevented by:
  — illness;
  — absence from Hong Kong; or
  — other reasonable cause

  from giving notice of appeal within the one-month period.
- the notice of appeal must be accompanied by:
  — a statement of the grounds of appeal;
  — a copy of the notice issued by the CIR or a dCIR under s 82A(4);
  — a copy of any written representations made by the taxpayer or his tax representative to the CIR or a dCIR's notice under s 82A(4); and
  — a copy of the notice of assessment.

60. Where the notice of appeal was given within the time limit but the required documents (the notice of intention to assess additional tax (s 82A(4) notice)) were not attached to the notice of appeal and only given seven days after the deadline for appeal, the notice of appeal was considered by one BoR to be invalid (D 48/05). However, another BoR has reservations about this view (D 33/06).

61. Appeals to the BoR can only be made on the following grounds:

- the taxpayer is not liable to additional tax (e.g., because he has a reasonable excuse);
- the amount of additional tax exceeds the amount to which the taxpayer is liable under s 82A (e.g., exceeds three times the tax undercharged or which would have been undercharged or if the amount of tax undercharged is incorrectly computed) (*CIR v Kwok Siu Tong* (1977) 1 HKTC 1012); or

- the amount of additional tax is excessive having regard to the circumstances (e.g., in D 63/87, the taxpayer was found to have no reasonable excuse, but the penalty was nevertheless reduced in view of the taxpayer's lack of wilful intention to evade tax and full co-operation).

62. It is a common fallacy of appellants in s 82A cases to argue that the basic tax (not the s 82A additional tax) is incorrectly computed (e.g., that the ABS contained errors as in D 42/88). Such arguments cannot be raised in a s 82B appeal which only deals with the three grounds stated above. In any case, if the assessment to basic tax has become final and conclusive under s 70 (e.g., the objection period has lapsed and there is no s 70A errors or omission claim), the assessment cannot be reopened.

Compromise settlement

63. In a number of cases, the taxpayers made a compromise settlement with the IRD to finalize the investigation/field audit. The compromise constitutes a valid contract. It is not open to the party to avoid the compromise (see *Ng Kuen Wai trading as Willie Textiles v Deloitte Touche Tohmatsu* 5 HKTC 211). In some cases when the CIR purported to impose a s 82A penalty, the taxpayers appealed to the BoR either on the basic tax or on the penalty. They attempted to reopen the settlement agreements. They were unsuccessful. The taxpayer was advised by professional accountants while entering into the compromise agreement and he did not seek to overturn the compromise settlement immediately afterwards (D 13/04). In D 55/88, the BoR held that s 70A did not apply where the assessment was issued as a result of an agreement or compromise and the taxpayer subsequently changed his mind. See also D 41/04.

Onus of proof

64. On a s 82B appeal, the burden of proof lies with the appellant, unlike in a prosecution under s 80(2) or s 82.

Bankrupt taxpayer

65. It was ruled in D 79/04 that an undischarged bankrupt has no right to appeal to the BoR under s 66 against the CIR's determination in respect of basic tax (see Chapter 8). However, he may have a right to appeal against a penalty imposed under s 82A because a debt owed to the Government in respect of a fine or monetary penalty imposed under an ordinance was not provable in bankruptcy (s 34(3A) *Bankruptcy Ordinance* (Cap 6)). As such, the penalty is personal to the bankrupt.

QUANTUM OF PENALTIES

66. The IRD has published its penalty guidelines on its website (to which reference should be made). The penalty guidelines include a table of penalty loadings.

14. Similar decisions were made in D 110/98 and D 32/94 which were concerned with medical practitioners. Service companies used by professionals, like doctors and lawyers, are dealt with by DIPN 24.

15. Section 61 was also applied to a similar situation in which a certified public accountant paid an annual management fee of $810,000 to the management company. There was no written agreement and no fixed date for payment of the management fee (*So Kai Tong v CIR* HCIA 4/2002, 6 HKTC 38).

16. Two doctors rented a property owned by a company controlled by them as the business premises of their medical practices. For the period from June 1998 to March 2002, the BoR ruled that the rent charged was far above market rent. There was no ground to agree to an increase in 20% of the rent in 1998 when there was a general downturn in the rental market. The BoR ruled that the entire transaction was not 'artificial' or 'fictitious' within s 61. Only the excess was not deductible (D 51/05).

17. A company carried out one transaction of buying and selling real property and was subject to tax on the profits arising therefrom. The company paid a commission to an associated company amounting to 73% of the gross profit of the taxpayer company. The BoR disallowed the commission as being artificial and fictitious. The commission totally lacked commercial reality (D 77/99).

18. In D 129/01, the taxpayer received commissions from two insurance companies and paid an equal amount of sum to a company under an agreement. The CIR only allowed one-third of the sum and rejected deduction of the balance relying on s 61. The BoR held that there was no connection between the payments made to the company by the taxpayer and the receipt of the commissions from the insurance companies. The BoR was not satisfied that the taxpayer had incurred the expense.

19. In D 25/02, the taxpayer reported to have derived income from three employers, one of which, Listco, was a company incorporated outside Hong Kong. The taxpayer claimed that the income from Listco should not be chargeable to Hong Kong tax as he rendered all services for Listco outside Hong Kong. The BoR found that he rendered part of his services for Listco in Hong Kong. Further, the BoR considered that it was artificial for the appellant to be employed and remunerated only for those part of his services rendered outside Hong Kong and that the only reason was to reduce his tax liability in Hong Kong.

MEANING OF ARTIFICAL OR FICTITIOUS

20. Lord Diplock's observation in *Seramco Trustees v IRC* (1977) AC 287 is often cited in defining the two terms. According to him, 'artificial' is not a term of legal art but is capable of bearing a variety of meanings according to the context in which it is used, while a fictitious transaction means one which those who are ostensibly parties to it never intended should be carried out.

21. The commercial realism of a transaction is a test for artificiality (D 44/92, per Woo VP in *Cheung Wah Keung* (2002) 3 HKLRD 733 at 789 D, 5 HKTC 698).

22. In *HIT Finance*, the CA accepted that a transaction of issuing loan notes which were purchased by group companies in the Luxembourg Stock Exchange and repayment of the loan notes by a circular route of payments involving a declaration of dividends was commercially realistic and outside the scope of s 61. The issue in the Luxembourg Stock Exchange was genuine and outsiders' interests were involved. It can therefore be seen that taking a more liberal view of the meaning of 'commercial realism', a transaction which is not normally entered into between unrelated parties and involving circular routing of funds may be commercially realistic.

23. In D 48/09, T was a limited company incorporated in Hong Kong. In the YAs 2003/04 and 2004/05, T reported deductions of HK$2,106,000 and HK$234,000, pursuant to a consultancy agreement entered with Company H. The consultancy agreement was dated prior to T's incorporation, in which T was required to pay US$18,000 per month to Company H in 2003/04, and US$15,000 per month in 2004/05. Company H was a shareholder of Company E, which in turn held 50% of shares in T. T's Vice-President (Mr J) was the brother of T's director. Mr J rendered services to T. Evidence showed that neither T's director nor Mr J was aware of the terms of the consultancy agreement. In addition, they could not explain how the fees were arrived at in the consultancy agreement, and the extent of the services Company H should provide. The IRD disallowed the consultancy fees. The BoR dismissed T's appeal and held, *inter alia*, the following:

- The consultancy agreement could not have been a contemporaneous document. Neither T nor Company H acted according to the terms of the consultancy agreement. Other supporting invoices and documents were also not contemporaneously prepared. The payment by T to Company H had no correlation with the agreed fees under the consultancy agreement. Also, the evidence from T did not support such a large amount of consultancy fee to be paid to Company H.
- Therefore, the consultancy agreement was an artificial and fictitious transaction for the purpose of s 61. T should be treated as not having entered into the consultancy agreement, and not having incurred any consultancy fees.

Housing allowance

24. Section 61 was also applied in a number of cases where some salaries taxpayers tried to take advantage of the exception of s 9(1A)(a) of reimbursement of rental

Service company
Profits tax computation

	$
Assessable profit per accounts	680,000

Advance Rulings (DIPN 31)

SCOPE

102. Advance rulings are provided by the IRD as a service under s 88A whereby the CIR may, on an application made by a person in accordance with Part I of Schedule 10 of the IRO, make a ruling on any of the matters specified in Part I. The IRD revised DIPN 31 'Advance Ruling' in November 2011 (to replace the original one issued in April 1998) to provide guidelines on the advance ruling process. The main objectives of this service are to:

- provide taxpayers with a degree of certainty about the taxation treatments basing on the current tax legislation for seriously contemplated arrangements;
- promote consistency in the application of the IRO; and
- minimise disputes between the IRD and taxpayers (DIPN 31, para 5).

103. The service covers:

- the application of the territorial source principle for profits tax purposes;
- those matters falling within the ambit of:
  — s 9A (service companies);
  — s 15E (stock borrowing and lending);
  — s 21A (royalty payments);
  — s 61A (the general anti-avoidance provision);
  — s 61B (sale of loss companies); and
  — s 87 (interest income exemption)
  of the IRO (see DIPNs 15, 20, 22, 25, 27 and 34); and
- cases where the IRD has, in appropriate circumstances, been prepared to offer an informal opinion on the taxation consequences of particular matters.

With some exceptions, the IRD will consider all of the above-mentioned requests for advance ruling.

104. The CIR may make a ruling on how any provision of the IRO applies:

- to the applicant; or
- to the arrangement described in the application

whether or not reference was made to that provision in the application (s 1, Part I of Schedule 10 to the IRO).

105. The term 'arrangement' includes:

- any agreement, arrangement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable or intended to be enforceable, by legal proceedings; and
- any scheme, plan, proposal, action, course of action or course of conduct (s 2).

106. However, a ruling will not be provided if the matter on which a ruling is sought involves:

- the imposition or remission of a penalty;
- the correctness of a return or other information supplied by any taxpayer;
- the prosecution of any taxpayer; or
- the recovery of any debt owing by any taxpayer (s 1, Part I of Schedule 10).

107. A ruling will:

- only be given for a seriously contemplated arrangement; and
- will not be provided:
  — for those arrangements that are hypothetical or speculative; or
  — for a matter where the profits tax is due and payable as at the date of the ruling request (DIPN 31, para 9).

108. A ruling will not normally be available once the due date for lodgement of the return in question has passed when the normal assessment and objection procedures will apply. An application for a ruling is not an acceptable ground for delaying the submission of a return (DIPN 31, para 9).

REFUSAL TO MAKE A RULING

CIR declining to make a ruling

109. The CIR may decline to make a ruling if:

- the application seeking the ruling would require him to determine or establish any question of fact. In this regard, a ruling will not be available on matters that are a pure question of fact, for example, whether or not the gain arising from the disposal of property is chargeable to tax;
- he considers that the correctness of the ruling would depend on the making of assumptions, whether in respect of:
  — a future event, or
  — any other matter;