served (whichever is later). If the claim is proved to the satisfaction of the Commissioner, the taxpayer is entitled to have the amount of tax overpaid to be refunded (see ¶9-8700).

Payment and recovery of tax are dealt with in Chapter 9 (¶9-0200ff).

¶1-3900 Offences and penalties

Failure to comply "without reasonable excuse" (see ¶11-4400) with the various requirements of the Ordinance is an offence, for example:

- failure to furnish a return or furnishing an incorrect return; or
- failure to comply with the Commissioner's request for information.

More serious offence includes wilful intention to evade tax through false statements or supplying inaccurate information.

It is also an offence for breaches of official secrecy under the Ordinance.

Evasion

A person who wilfully intends to evade or assists another person in evading tax through, for example, non-disclosure, making false statements, providing false information or maintaining false records, is guilty of an offence (see ¶11-5100). Penalties for wilful evasion range from a set fine, together with a further fine of up to treble the amount of tax undercharged, to imprisonment for three years. Severe penalties have been handed down by the courts in circumstances involving blatant tax evasion.

Offences and penalties are dealt with in Chapter 11 (¶11-0200ff).

¶1-4000 Transfer pricing regime

The *Inland Revenue (Amendment) (No. 6) Bill 2017* was gazetted in December 2017. The Bill seeks to introduce a transfer pricing regime in Hong Kong that deals with various issues in relation to transfer pricing, such as requiring all related-party transactions to be priced on an arm's length basis, attribution of profits to a permanent establishment in Hong Kong, granting of corresponding transfer pricing adjustments, the advance pricing arrangement regime and penalties for non-compliance with the transfer pricing rules, etc. The Bill also introduces a three-tiered Transfer Pricing Documentation

("TPD") requirement under which Hong Kong companies with related-party transactions may be required to prepare Master File, Local File and Country-by-Country (CbC) report if they do not meet one of the exemption thresholds.

Once the Bill is enacted into law, the new transfer pricing legislation will be effective from year of assessment 2018/19 although there is a grandfathering provision for transactions entered into or effected before the commencement date of the Bill. On the other hand, the TPD requirement will apply to accounting periods beginning on or after 1 April 2018 (for Master File and Local File) and accounting periods beginning on or after 1 January 2018 (for CbC report). (see ¶14-4000ff)

For more on International Tax, see ¶14-0500ff.

STAMP DUTY ORDINANCE

¶1-4500 Overview of stamp duty scheme

Stamp duty is levied under the *Stamp Duty Ordinance*. The scheme of the Ordinance is relatively straightforward. Stamp duty applies only to instruments evidencing transactions which involve immovable property, stocks or shares. Some instruments attract a fixed amount of duty per instrument while others are subject to *ad valorem* duty.

Instruments which are chargeable with stamp duty are:

- instruments for the conveyance or lease of immovable property in Hong Kong (see ¶13-0400);
- agreements for the sale of immovable residential property in Hong Kong (see ¶13-1080);
- instruments for the sale, purchase or other transfer of Hong Kong stock (see ¶13-1550);
- Hong Kong bearer instruments (see ¶13-2700); and
- duplicates and counterparts (see ¶13-2900).

The Government has adopted several measures for the property market over the past years, for example, the introduction of Special Stamp Duty ("SSD") in November 2010, which is imposed on transactions of residential properties for all values if the residential property was acquired by the vendor or transferor on or after

20 November 2010 and resold or transferred within 24 months after acquisition.

Effective from 27 October 2012, the Stamp Duty Ordinance was amended to impose higher rates of SSD on certain transactions of residential property acquired on or after that date if a property is resold within 36 months after the acquisition. Furthermore, Buyer's Stamp Duty ("BSD") was also introduced to impose a duty of 15% on agreements for sale and conveyances on sale of residential property executed on or after 27 October 2012 if the purchaser or transferor is not a Hong Kong permanent resident.

Pursuant to the *Stamp Duty (Amendment) (No. 2) Ordinance 2014*, a new scale of ad valorem stamp duty ("AVD") rates (called Scale 1 AVD rates) has been introduced and the charging of AVD on non-residential property transactions has been advanced from the conveyance on sale to the agreement for sale effective from 23 February 2013. Any residential property (except that acquired by a Hong Kong permanent resident who does not own any other residential property in Hong Kong at the time of acquisition) and non-residential property acquired on or after 23 February 2013, either by an individual or a company, are now subject to the Scale 1 AVD rates.

On 4 November 2016, the Government further introduced a new round of measures to convert the Scale 1 AVD rates to a new flat rate of 15% for residential property acquired by individuals or companies. The new measure was effective on 5 November 2016. The relevant *Stamp Duty (Amendment) Ordinance 2018* was gazetted on 19 January 2018.

On 20 April 2018, the *Stamp Duty (Amendment) (No. 2) Ordinance 2018* was gazetted, which further tightened the exemption arrangement for Hong Kong permanent residents acquiring more than one residential property under a single instrument on or after 12 April 2017, where the transaction will no longer be exempted and will be subject to AVD at the 15% rate.

To help promote the development and trading of exchange traded funds ("ETFs") in Hong Kong, a proposal was made in the 2014/15 Budget Speech that the stamp duty for the trading of all ETFs would be waived. The *Stamp Duty (Amendment) Ordinance 2015* was published in the Gazette on 13 February 2015. Any contract notes and instruments of transfer for the transactions of shares or units of ETFs effected on or after 13 February 2015 are no longer required to be stamped or endorsed under the *Stamp Duty Ordinance*.

The amount of duty payable, the time limits within which the stamp duty must be paid (penalty rates apply if the instrument is not stamped in time), and the persons whose primary responsibility is to pay the duty are all set out in the First Schedule to the Stamp Duty Ordinance. The Collector of Stamp Revenue has the power to extend, in appropriate circumstances, the time for payment of duty beyond the period referred to in the Schedule and to accept payment of any duty or penalty by instalments.

In addition to the person nominated in the Schedule as being responsible for payment of any stamp duty, any person who "uses" a document will incur joint and several civil liability to the Collector for payment of the duty and penalties which may apply under the Ordinance. However, the Collector is not able to recover any stamp duty payable in respect of a document after the lapse of six years from the expiration of time for stamping of the document.

¶1-4700 Stamping procedure

As a general rule, documents which are subject to duty must be submitted to the Stamp Office, with the appropriate amount of duty, for stamping (see ¶13-5030). The date of stamping and the amount of duty paid are impressed with a franking machine, thereby denoting that the document has been duly stamped in accordance with the Ordinance. The payment of duty may also be evidenced by the Stamp Office affixing an appropriate stamp bearing the words "Stamp Office Hong Kong." If this alternative method is adopted, the date of stamping, the amount of the duty paid and the Collector's signature must also appear. If the document is an instrument to which Pt IIA of the *Stamp Duty Ordinance* applies, the Collector may issue a stamp certificate in respect of the document instead.

There is no special form of construction required for instruments liable to stamp duty, except that stamp duty must be capable of appearing on the "face of the instrument" and when so affixed shall not be used for, or applied to, any other document (see ¶13-4950). If an instrument contains or relates to several distinct matters, it is charged with duty in respect of each separate subject matter.

All the facts and circumstances affecting the amount and liability to stamp duty of a document are required to be fully set out in the instrument. In determining the liability of a document to stamp duty, the Collector has the power to call for additional material in order to satisfy himself that all the facts and circumstances affecting liability of the document to duty or the amount of duty chargeable on the instrument are fully disclosed therein (see ¶13-6000). Any person who,

with intent to defraud the Government, (a) executes any document which does not contain all the relevant details, or (b) is involved in the preparation of any instrument and neglects to include all the facts and circumstances, commits a criminal offence (see ¶13-7700).

Adhesive stamps

Contract notes for the sale or purchase of "Hong Kong stock" may be stamped by means of adhesive stamps in lieu of submitting the document to the Collector for stamping (see ¶13-5030). Adhesive stamps are available for purchase from the Stamp Office.

Where stamp duty is permitted to be denoted by an adhesive stamp, the stamp must be cancelled in such a manner as to render it incapable of being used again. The normal manner in which this is done is by writing the word "cancelled" across the face of the stamp, together with the date and the signature or initials of the person cancelling it. A contract note is not regarded as having been stamped for the purposes of the Stamp Duty Ordinance if the adhesive stamp has not been properly cancelled.

Electronic stamping (e-stamping)

Electronic stamping was introduced in 2004 and is mainly applicable to property documents, such as sales and purchases agreement and tenancy agreement. However, e-stamping does not apply to cases which requires adjudication or SSD or tenancy agreement which contains consideration other than rent.

The electronic stamp certificates will be generated replacing conventional stamps. These certificates have the same legal status as conventional stamps on instruments. Authenticity check of certificates is available at the website of the Stamp Duty Office.

¶1-4900 Time limit for stamping

The period within which an instrument is required to be stamped is set out in the First Schedule (see ¶13-5190). Where a document is required to be stamped before "execution", then it must be stamped prior to signature by any party to the instrument.

Late stamping

A document which is not stamped within the appropriate time period may be stamped by the Collector out of time upon payment of penalties, in addition to normal stamp duty, as follows:

- when the document is stamped within one month of the time limit imposed by the Stamp Duty Ordinance, the penalty is double the duty listed in the Schedule;
- when stamped later than one month but within two months of the time limit, the penalty is four times the normal amount of stamp duty; and
- after the expiration of two months from the proper date, the penalty is ten times the amount of the prescribed duty (see ¶13-5270).

The Collector has overriding discretion to waive payment of part or all of these penalty rates of duty.

The penalty scheme outlined above does not apply where a request is made to the Collector for an opinion as to (i) whether an instrument is liable for duty and/or (ii) the amount of duty chargeable (see ¶13-6090). The duty only becomes payable after the expiration of one month from the date of the Collector's adjudication, even though the time period in the Schedule may have expired.

¶1-5100 Duty on instruments

The Stamp Duty Ordinance imposes duty on instruments rather than transactions. The amount or rate of duty and the types of instruments which are subject to stamp duty are listed in the First Schedule. The Schedule must be read in conjunction with the substantive provisions of the Stamp Duty Ordinance, as the latter contains general as well as more specific requirements which modify and vary liability to duty.

See further ¶13-3100ff.

¶1-5200 Exemptions from stamp duty

The following exemptions are available:

- a general exemption for the Government;
- leases or conveyances of exempted premises between exempted persons;
- gifts to exempt institutions;
- conveyances between associated companies; and
- specific exemptions set out in various other Ordinances (see ¶13-7000).

¶2-0050 Overview

Salaries tax is charged, under Pt III of the *Inland Revenue Ordinance*, on any income arising in or derived from Hong Kong from an office, employment or pension (s 8).

"Income" is defined in the Ordinance, but not exhaustively (see ¶2-0300). Consequently, common law principles need to be referred to for the purpose of determining whether a payment constitutes taxable "income" (see ¶2-1100). Certain income is specifically exempt from salaries tax: for example, the income of an employee who only visits Hong Kong for a short period of time (see ¶2-3700).

To be assessable to salaries tax, a taxpayer's income must have been derived from an office, employment or pension. Certain factors indicate when an "office" or "employment" exists (see ¶2-2800 and ¶2-2850). The geographical source of a taxpayer's income is crucial in determining whether he or she is liable to salaries tax since income which has not been derived from Hong Kong is not subject to Hong Kong tax.

See further ¶2-3000.

A taxpayer's salaries tax liability is charged at the lower of progressive rates on net chargeable income or standard tax rate on net assessable income after concessionary deductions. The net chargeable income is arrived at by making various deductions from the taxpayer's income as determined under the general charging and income definition provisions (ss 8 and 9) (see ¶2-4250). Deductions are made for allowable deductions, including outgoings and expenses (see ¶2-4950), self-education expenses (see ¶2-5300), depreciation and other capital allowances (see ¶2-6100), and losses (see ¶2-6150); concessionary deductions, including approved charitable donations (see ¶2-6450), elderly residential care expenses (see ¶2-6550), home loan interest (see ¶2-6700), and contributions to recognised retirement schemes (see ¶2-6900); and personal allowances (see ¶2-7050).

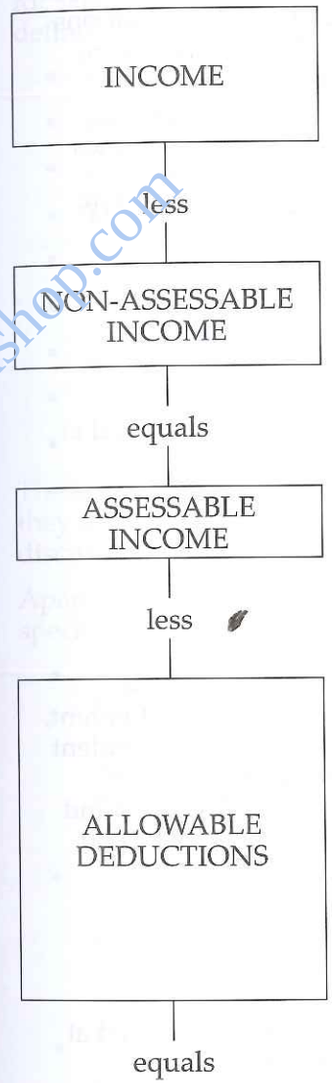
The *Inland Revenue (Amendment) (No. 4) Bill 2018* gazetted on 18 May 2018 proposed to introduce a tax deduction for health insurance premiums under the Voluntary Health Insurance Scheme (VHIS) to taxpayers who are subject to salaries tax or elect personal assessment (see ¶2-7000) commencing from the year of assessment 2018/19.

For more on the flowchart, refer to ¶2-0100.

Every person who is liable to salaries tax is also liable to pay provisional salaries tax under Pt XA of the Ordinance (refer to Chapter 8 at ¶8-8000ff).

¶2-0100 Flowchart

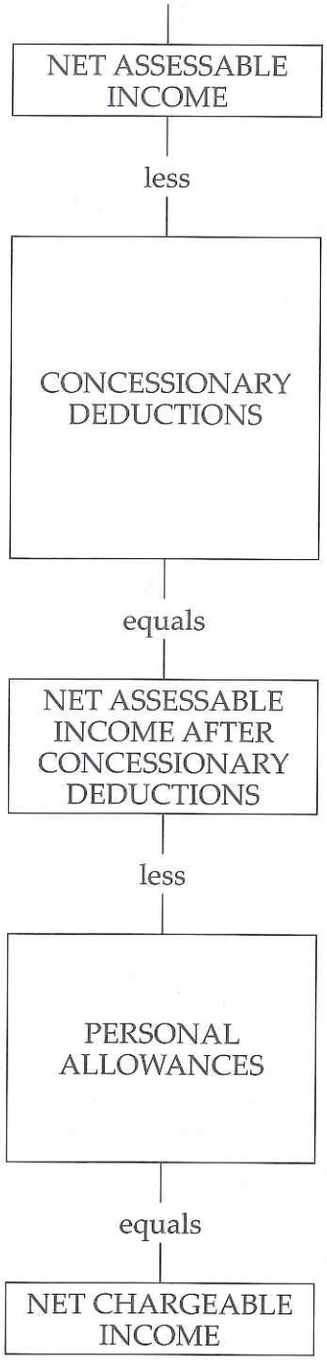
The following flowchart demonstrates the process by which a taxpayer's salaries tax liability is determined.



Comprised of all of the taxpayer's Hong Kong-sourced income (¶2-0300ff) from any employment (¶2-2850), office (¶2-2800) or pension.

Any income which has not accrued (¶2-4650) *or* been received (¶2-4700) by the taxpayer.

All outgoings and expenses (other than domestic, private or capital expenditure) wholly, exclusively and necessarily incurred in the production of assessable income (¶2-4950ff), self-education expenses (¶2-5300), depreciation and other capital allowances (¶2-6100), and losses (¶2-6150). Balancing charges are added (¶2-6200).



Concessionary deductions available are: approved charitable donations (¶2-6450), elderly residential care expenses (¶2-6550), home loan interest (¶2-6700), contributions to recognised retirement schemes (¶2-6900), and proposed health insurance premiums under VHIS (commencing from 2018/19) (¶2-7000).

On which salaries tax is charged at standard tax rate.

Allowances available are basic, married person's, dependent parent, dependent grandparent, dependent brother or sister, child, disabled dependant, personal disability and single parent allowances (¶2-7050 and ¶3-0100ff).

On which salaries tax is charged at progressive rates (¶2-7700).

DEFINITION OF "INCOME"

¶2-0300 Statutory definition of "income"

The basic charging section for salaries tax (s 8) requires that salaries tax be charged on every taxpayer in respect of his or her Hong Kong-sourced office, employment and pension income. The Ordinance gives some aid in identifying payments which qualify as "income" for salaries tax purposes. It does not, however, provide an exhaustive definition of the term. "Income" is defined as including:

- wages;
- salaries;
- leave pay;
- fees;
- commissions;
- bonuses;
- gratuities;
- perquisites; and
- allowances (s 9(1)(a)).

These forms of payment qualify as "income" regardless of whether they are derived from an employer or some other person. They are discussed further at ¶2-1750.

Apart from the general definition, the following payments are specifically categorised as "income" under s 9 of the Ordinance:

- Any amount (other than a pension) received by an employee from a **pension or provident fund**, scheme or society (other than a recognised occupational retirement scheme or mandatory provident fund scheme) to the extent that it represents his or her employer's contributions to the relevant fund, scheme or society (s 9(1)(aa); see ¶2-1950).
- Any amount (other than a pension) received by an employee from a **recognised occupational retirement scheme** other than on termination of service, death, incapacity, terminal illness or retirement, to the extent that it represents his or her employer's contributions to the scheme (s 9(1)(ab)(i); see ¶2-1950).
- Any amount (other than a pension) received by an employee from a **recognised occupational retirement scheme** upon

termination of service to the extent that it represents his or her employer's contributions to the scheme in excess of the "proportionate benefit" permitted to be exempt under s 8(5) (s 9(1)(ab)(ii); see ¶2-1950).

- Any amount received by an employee, in accordance with a court order made under s 57(3)(b) of the *Occupational Retirement Schemes Ordinance* for **any shortfall** in the funding of a beneficiary's benefits, to the extent that the amount is attributable to the employer's contributions to the relevant occupational retirement scheme (s 9(1)(ac); see ¶2-1950).
- Any accrued benefit received or taken to have received by an employee from a **mandatory provident fund scheme** other than on retirement, death, incapacity, terminal illness or termination of service, to the extent that it represents contributions paid to the scheme by the employer (s 9(1)(ad); see ¶2-1950).
- Any accrued benefit received or taken to have received by an employee from a **mandatory provident fund scheme upon termination of services** to the extent that it represents voluntary contributions paid to the scheme by the employer in excess of the "proportionate benefit" calculated under s 8(5) (s 9(1)(ae); see ¶2-1950).
- The **rental value** of any residence provided rent free by an employer or an associated corporation (s 9(1)(b); see ¶2-2100).
- When a place of residence is provided by an employer (or an associated corporation) at a rent less than the rental value, the **excess of the rental value** over the rent paid (s 9(1)(c); see ¶2-2400).
- Any gain realised by the **exercise of, or by the assignment or release of a right to acquire shares** or stock in a corporation if the right was obtained by virtue of the taxpayer's employment or office in that or any other corporation (s 9(1)(d); see ¶2-2600).
- Any **benefits provided by an employer not in connection with a holiday package and capable of being converted into money** by the recipient (s 9(2A)(a); see ¶2-1550).
- Any **education benefits** paid by an employer for the education of an employee's child (s 9(2A)(b); see ¶2-1600).
- Any amount paid by an employer to an employee in connection with a **holiday journey** (s 9(2A)(c); see ¶2-1630).

DEEMED EMPLOYMENT INCOME

¶2-0500 Remuneration paid to service company or trust

Remuneration paid to a service company for the services of an individual who controls the company, or whose associate or associates control the company, is deemed to be income derived by that individual from employment and is therefore brought within the charge to salaries tax under s 8. This is provided under s 9A. Remuneration paid to a trust of which the individual or an associate of the individual is a beneficiary is also deemed to be employment income under s 9A.

Section 9A applies to remuneration paid on or after 18 August 1995. The section was introduced to prevent the avoidance of salaries tax through service company arrangements which disguise employer/employee relationships.

The Inland Revenue Department has issued Departmental Interpretation and Practice Notes ("DIPN") No 25: Service Company "Type I" Arrangements, Salaries Tax, which sets out the practice it intends to adopt in relation to s 9A.

Deemed employment

Under "Type I" arrangements, the person paying the remuneration and the individual (the "relevant individual") providing the relevant services under a service company agreement are treated as having an employer/employee relationship commencing either from 18 August 1995 (the date of commencement of s 9A) or from the day on which the individual commenced performing services, whichever is later (s 9A(1)(c)(i)(A)). The employment is treated as ceasing when the agreement terminates, *unless* the individual continues carrying on services as an employee, in which case the employment is regarded as continuing (s 9A(1)(c)(i)(B)).

The remuneration is treated as having been received by and accrued to the individual as employment income at the time that it is paid or credited to the service company or trust concerned (s 9A(1)(iii)).

The taxpayer in *Case* M17 (2003) HKRC ¶80-882 (*D118/01* IRBRD Vol 16) alleged that he was the sole proprietor of an architectural services firm which had been appointed to provide services to Company A. The income received from Company A had been assessed to estimated salaries tax following the taxpayer's failure to

furnish a salaries tax return. The taxpayer alleged that the income received belonged to the firm and as the sole proprietor, he should be assessed on the net business income which was much lower than the estimated salaries income assessed.

The Service Agreement evidencing the nature of the relationship between Company A and the taxpayer referred to the appointment of the taxpayer to the position of Director of Property Development. He had specified duties, annual leave and other employee benefits and was subjected to restrictions against him engaging in business outside the Company or in competition with the Company. The taxpayer's testimony was not accepted that the income he received from Company A belonged to the firm. At the time the draft Service Agreement was prepared by Mr C, the chairman of Company A, the existence of the firm was known to Mr C. The contract would have been clear that it was contracting with the firm rather than with the taxpayer. The terms of the Service Agreement provided further support for the existence of an employer/employee relationship. See also *Case* M80 (2003) HKRC ¶80-945 (*D43/02* IRBRD Vol 17).

If the agreement under which the remuneration is paid is silent as to the amount of the remuneration to be paid, then any sum which is paid or credited to the service company or trust is deemed to be remuneration paid under the agreement, unless it is established that it is not remuneration for the services carried out (s 9A(2)). When a service company agreement provides for services to be carried out by two or more relevant individuals and/or for payments to be made for purposes other than remuneration for services, it is advisable for the parties to make clear, whether in the agreement or otherwise, the amount of remuneration paid for the services of each relevant individual. Otherwise, each individual may be liable to salaries tax in respect of the full amount paid to the service company (DIPN No 25 (Revised), para 20).

Notification requirements

When an employment relationship is deemed to exist under s 9A, the relevant person and the relevant individual who are deemed employer and employee, respectively, are required to fulfil all applicable notification and compliance requirements imposed under the *Inland Revenue Ordinance*. In particular, the relevant person must comply with the requirements imposed upon employers under s 52 to give notice of the commencement (and cessation) of the individual's employment and other details (see ¶8-3100ff). Failure to do so is an offence under s 80 (see ¶11-0900).

Agreements to which s 9A applies

Section 9A applies in relation to any agreement under which remuneration for an individual's services is paid or credited, by a person carrying on a trade, profession, business, or prescribed activity, to:

(a) a corporation controlled either by the individual himself or herself, by an associate or associates of the individual, or by the individual together with one or more associates;

(b) a trustee of a trust estate under which the individual, or one or more of his or her associates, is a beneficiary; or

(c) a corporation controlled by a trustee as described in (b) (s 9A(1)(a)–(c)).

The agreement need not be in writing.

Section 9A also applies in relation to agreements which were entered into before 18 August 1995, but only in relation to services carried out and remuneration paid or credited on or after that date.

The scope of s 9A is extremely wide as the term "associate" is broadly defined to mean:

- a relative (ie a spouse, parent, child, brother or sister) of the individual;
- a partner of the individual, or a relative of that partner;
- a partnership in which the individual is a partner;
- any corporation controlled either by the individual, a partner of the individual, or a partnership in which the individual is a partner;
- any director or principal officer of such a corporation; or
- any other individual who is also a party to the service company or trust agreement (s 9A(8)).

If an agreement applies to two or more individuals, then s 9A(1) applies to them individually, not collectively (s 9A(7)(a)).

Prescribed activity

As yet, no activities have been prescribed for the purposes of s 9A. Therefore, the section currently applies only where the person who pays remuneration to a service company is carrying on or deemed to be carrying on a trade, profession or business. According to DIPN No 25 (Revised), this is expected to cover the vast majority of disguised

employment arrangements. However, if it is discovered that other persons are entering into such arrangements, the Commissioner has the power to prescribe specific activities, under s 9A(6), to bring them within the net of s 9A (DIPN No 25 (Revised), para 9).

¶2-0550 Section 9A "escape" provisions

To prevent legitimate non-employment arrangements from being deemed employee/employer relationships, s 9A sets out circumstances in which remuneration paid under such arrangements will not be deemed to be income from an employment. The conditions for exclusion from the operation of s 9A(1) are quite strict. It will be difficult for taxpayers to establish that service company or trust arrangements entered into by them are not simply disguised employer/employee relationships.

There are basically three circumstances in which an arrangement will "escape" the operation of s 9A(1):

(i) where all of the key characteristics of an employment relationship are absent (s 9A(3));

(ii) where the Commissioner is satisfied that no office or employment of profit exists (s 9A(4)); and

(iii) where the person paying the remuneration and the individual performing the services are one and the same (s 9A(7)(b)).

Where specified characteristics of employment are absent

An individual performing services will not be deemed to be an employee of a person paying the remuneration for those services to a service company or trust if *all* of the following conditions are met:

(a) Neither the agreement under which the remuneration is paid, nor any related undertaking, provides for the remuneration to include or provide for annual leave, passage allowances, sick leave, pension entitlements, medical payments or accommodation or similar benefits (s 9A(3)(a)). The question is not whether the relevant individual has received employment-type benefits but whether the agreement or related undertaking provides for such benefits (DIPN No 25 (Revised), para 22).

(b) The individual personally carries out the same or similar services for persons other than any person for whom services are required to be carried out under the agreement (s 9A(3)(b)). This caters for genuine contractors who normally have more than one client (DIPN No 25 (Revised), para 23).

(c) The performance of services by the individual is not subject to control or supervision, which would commonly be exercised by an employer, by any person other than the corporation or trustee concerned referred to in s 9A(1)(a), (b) or (c) (s 9A(3)(c)). Any control or supervision exercised by the service company may be disregarded. As a matter of practice, the Department also will not take into account supervision or control which can be attributed to statutory requirements and is not dependent on the existence of an employer/employee relationship (DIPN No 25 (Revised), para 25).

(d) The remuneration is not paid or credited periodically or calculated on a basis commonly used under a contract of employment (s 9A(3)(d)). Regard must be had to the basis for calculating the payments. For contractor situations, payments are generally based on an agreed sum for specified work under a contract. Employment payments are usually in respect of time worked, or position occupied, and made on a regular basis (DIPN No 25 (Revised), para 27).

(e) The person paying the remuneration does not have the right to cause the individual to cease performing services in the way that an employer has the right to dismiss an employee under a contract of employment (s 9A(3)(e)). An employee's services can generally be terminated by providing notice or meeting other requirements under an award or statute. An independent contractor's contract is usually discharged by performance or it may specify default situations under which it can be terminated (DIPN No 25 (Revised), para 28).

(f) The relevant person is not held out to the public as an officer or employee of the person paying the remuneration (s 9A(3)(f)). "Held out to the public" is not defined in the Ordinance and, therefore, must be given its ordinary meaning. Members of the public may be led to believe that an individual is an officer or employee of the relevant person, for example, through material included in trade or professional directories, journals or other publications, the issue of name cards, statements at public functions, information contained in press releases, etc (DIPN No 25 (Revised), para 29).

Since all of the above conditions must be fulfilled in order for a service company or trust arrangement to escape the effect of s 9A(1), it is expected that s 9A(3) exemption will rarely apply. It is unlikely

that even a taxpayer who genuinely is not an employee would be able to fulfil the stringent requirements of this provision.

The taxpayer in *Case* M12 (2003) HKRC ¶80-877 (*D108/01* IRBRD Vol 16) was an actor who incorporated a service company for the purpose of contracting out the actor's services to a TV broadcasting company (the TV company) in Hong Kong. However, on application to the Commissioner in 1995 and in 1997, the Commissioner rejected the arrangement and took the view that the taxpayer was liable to salaries tax under s 9A(1) on the payments from the TV company. The taxpayer objected and appealed to the Board of Review. The taxpayer argued that s 9A(3) was satisfied as some paragraphs had been satisfied.

The Board of Review held that s 9A(1) shall not apply only where all the paragraphs in s 9A(3) are satisfied. In this case, that some paragraphs of s 9A(3) were satisfied did not assist the taxpayer. All the paragraphs must be satisfied in order for s 9A(1) not to apply. The taxpayer worked exclusively for the TV company and was bound to follow the directions of the TV company's production executives. His performance was controlled or subject to controls commonly exercised by an employer over an employee. It was clear from the 1995 and 1997 service deeds that the TV company had contracted for the exclusive personal services of the taxpayer and that the interposition of the service company between the taxpayer and the service company was artificial. The onus of proving the assessment to be incorrect was on the taxpayer, and this onus had not been discharged.

See also *Case* R6 (2008) HKRC ¶81-224 (*D5/07*), *Case* Q28 (2007) HKRC ¶81-214 (*D78/06* IRBRD Vol 22), *Case* P19 (2006) HKRC ¶81-171 (*D13/06* IRBRD Vol 21), and *Case* N53 (2004) HKRC ¶81-029 (*D62/03* IRBRD Vol 18).

In *Case* H45 (1998) HKRC ¶80-553 (*D103/97* IRBRD Vol 12), the consultancy agreement between the employer and the taxpayer's own company was found to be artificial and fictitious. The consultancy fees were held to be remuneration paid to the taxpayer. The arrangements were disregarded, and the taxpayer was assessed to salaries tax on the payments received by his own company.

Where the Commissioner is satisfied that no employment exists

An individual performing services will not be deemed to be an employee of a person paying the remuneration for those services to a service company or trust if the individual can establish, to the

satisfaction of the Commissioner, that his or her performance of services was not, in substance, the holding of an office or employment of profit (s 9A(4)).

In exercising his discretion under this provision, the Commissioner will have regard to whether or not the individual's performance of services displays the accepted characteristics of an office or employment of profit as opposed to a contract for services, as set down in case law.

See ¶2-2850 for a discussion of the "control test", the "economic reality test" and the "integration test."

On the surface, this provision appears to provide a less stringent avenue for escaping the application of s 9A(1). However, careful consideration of all of the circumstances of the relevant arrangement will be required to determine whether or not an employment relationship exists. In practice, since the Inland Revenue has repeatedly expressed its intention to curtail the avoidance of tax through service company arrangements, the Commissioner is unlikely to exercise his discretion lightly. In order to escape the effect of s 9A(1) under this provision, an individual may be required to establish many, if not all, of the factors required under s 9A(3) (listed above) in order to satisfy the Commissioner that he or she does not hold an office or employment of profit. Note, in this regard, the information required to be provided and the list of questions required to be answered by an individual who requests an advance ruling under s 9A(4) (see below).

In *Case* P19 (2006) HKRC ¶81-171 (*D13/06* IRBRD Vol 21), the taxpayer sought to rely on s 9A(4) after failing to satisfy all the six criteria set down in s 9A(3). The Board noted the following facts of the case:

(i) The taxpayer had only one full-time job at all material times, being a deputy director or consultant at the hospital. He had committed himself to work exclusively for the hospital for five years.

(ii) The taxpayer received a steady monthly income from the hospital.

(iii) The taxpayer was under the hospital's control and held himself out as its officer.

(iv) The Board was unable to see any real entrepreneurship on the part of the taxpayer due to the absence of any business

decision or managerial function to be made by the taxpayer and risk taken by the taxpayer.

By looking at the whole picture, the Board concluded that the relationship in question was one of employment in substance and s 9A(4) was not satisfied.

Where the individual performing the services and the person paying the remuneration are the same

An employer/employee relationship cannot exist when there is only one party involved: a person cannot employ himself. Therefore, for the avoidance of doubt, it is specifically declared that s 9A(1) does not apply where either:

(i) the person paying the remuneration is also the person performing the services; or

(ii) the person paying the remuneration is a partnership and the person performing the services is a partner of the partnership (s 9A(7)(b)).

This excludes sole proprietors and professional firms with service companies from the operation of s 9A. The Inland Revenue's treatment of these service company arrangements is set out in DIPN No 24 (Revised): Profits Tax — Service Company "Type II" Arrangements (see ¶6-5740 and ¶12-4900).

Advance rulings

An indication of whether or not the Commissioner will exercise his discretion under s 9A(4) in favour of a taxpayer can be obtained through an advance ruling. Rulings will not be provided, however, in respect of hypothetical, contemplated or proposed situations (DIPN No 25 (Revised), paras 47–49).

A request for an advance ruling must be in writing and signed by the relevant individual or his or her authorised representative. The following documentation should be provided in support:

- copies of the relevant agreement and any related undertaking (details must be provided if the agreement is not in writing);
- full details of remuneration payable under the agreement;
- copies of the organisation charts of the relevant person and the service company;
- a statement setting out the individual's:

  - duties and obligations in relation to the relevant person and the service company; and
  - previous employment history with the relevant person or any associated party;
- a statement listing the specified characteristics in s 9A(3) which have been satisfied; and
- an explanation why it is considered that the individual does not hold an office or employment of profit.

DIPN No 25 (Revised), Appendix B sets out the following series of questions relevant to the control, integration and economic reality tests, answers to which should be provided in an application for an advance ruling.

Questions to be Answered when Applying for an Advance Ruling

A. *Control Test* (to determine whether the relevant individual is controlled by the relevant person).

1. Who decides the work to be done by the relevant individual? Who prescribes the time schedule?
2. Is there a fixed place of work? Who provides the place of work?
3. Does the agreement (or related undertaking) between the service company and the relevant person requires the relevant individual to perform the work personally?
4. Is the relevant individual required to follow the rules and regulations of the relevant person?
5. Can the service company or the relevant individual work for others without the approval of the relevant person? Can the service company or the relevant individual refuse the performance of a particular task or job requested by the relevant person?

B. *Integration Test* (to determine whether the relevant individual is holding a position within the organisation of the relevant person).

1. Does the relevant individual represent to third parties that he is a staff member of the relevant person?
2. Does the relevant individual get promotions within the organisation framework of the relevant person?
3. Does the relevant individual have subordinates who are staff of the relevant person?

4. Is the relevant individual part and parcel of the organisation of the relevant person?

5. Is the relationship a continuing one or does it exist only to procure a result?

C. *Economic Reality Test* (to determine whether the income of the relevant individual is in effect derived from the relevant person and whether the relevant individual is at risk with his capital).

1. Does the relevant person provide the equipment or assistants while the relevant individual is performing his duties?

2. Does the relevant individual contribute capital and in what amount? Can the capital be at risk and in what way?

3. How is the remuneration received by the service company from the relevant person computed? How is the remuneration received by the relevant individual from the service company computed?

4. What is the duration of the agreement between the service company and the relevant person? Will the agreement be renewed and on what basis?

The Commissioner, in some cases, may seek further information from the relevant individual or a third party in order to make an advance ruling.

For details on the advance rulings system provided for under the *Inland Revenue Ordinance*, refer to ¶12-0100ff in Chapter 12.

¶2-0600 Prevention of double taxation

To prevent the double taxation of income, where an individual becomes chargeable to salaries tax on remuneration deemed to be employment income under s 9A(1):

(i) the corporation or trustee to whom the remuneration was paid or credited is not chargeable to tax on that remuneration; and

(ii) the individual is not chargeable to tax on any remuneration paid or credited to him or her by the corporation or trustee in respect of any office or employment held by the individual with the corporation or trust (to the extent that the remuneration is attributable to services performed under the service company or trust arrangement) (s 9A(5)).

¶2-0650 Application of general anti-avoidance provisions

The Inland Revenue's view is that, depending upon the facts of the case, an arrangement which falls outside the scope of s 9A may nevertheless be charged to salaries tax by the operation of the general anti-avoidance provisions of the *Inland Revenue Ordinance* (ss 61 and 61A) (DIPN No 25 (Revised), para 58). The Privy Council decision in *CIR v Challenge Corporation Limited* (1987) 2 WLR 24 is cited as authority for the proposition that a general anti-avoidance provision can apply notwithstanding the existence of specific anti-avoidance provisions.

Note, however, DIPN No 25 (Revised), like all DIPNs, is not legally binding and does not affect a taxpayer's appeal rights.

The taxpayer in *Case* M107 (2003) HKRC ¶80-972 (*D86/02* IRBRD Vol 17) acquired a shelf company to accommodate the business income he earned from acting as a principal in an insolvency department of a Hong Kong company. The shelf company was incorporated in Hong Kong, and the taxpayer and his wife were its only shareholders and directors. No written contracts were entered into between the Hong Kong company, the shelf company and the taxpayer for the arrangement. The Hong Kong company paid the taxpayer a fixed monthly sum and a variable profit share via the shelf company's bank account.

The Board found that the taxpayer had entered into a transaction involving the interposition of the shelf company between the taxpayer and the Hong Kong company that was artificial within the terms of s 61. The Board noticed that while the shelf company received substantial remuneration from the Hong Kong company, the shelf company only paid little or even no income to the taxpayer in the years under review. The Board found that the shelf company had no role whatsoever other than as being the vehicle for deriving very significant taxation advantages. The Board, therefore, held that even if its conclusion on s 61 was wrong, the arrangement fell under s 61A as being one entered into for the sole or dominant purpose of obtaining a tax benefit. See also *Case* M39 (2003) HKRC ¶80-904 (*D155/01* IRBRD Vol 17) and *Case* M38 (2003) HKRC ¶80-903 (*D154/01* IRBRD Vol 17).

¶6-0030 Overview

Profits tax is charged under Pt IV of the *Inland Revenue Ordinance* ("IRO"). Every "person" who carries on a trade (see ¶6-0350), business (see ¶6-1100) or profession (see ¶6-1250) in Hong Kong is chargeable to profits tax on the assessable profits from that trade, business or profession which have a Hong Kong source (see ¶6-1700). Only profits arising in or derived from Hong Kong are assessable.

> For more on the basic liability to profits tax, see ¶6-0200.

Person includes a corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons (s 2(1)) (see ¶6-0240). Hence both unincorporated bodies and corporations can be liable to profits tax. However, corporations are taxed at a higher rate.

> For profits tax rates, see ¶6-9100.

Profits tax is charged for each year of assessment on the "assessable profits" which arose in or were derived from Hong Kong by the taxpayer during the basis period (see ¶6-8700) of that year. A taxpayer's "assessable profits" are calculated by determining its total Hong Kong business receipts and making various adjustments as required or allowed under the Ordinance.

A taxpayer's total Hong Kong business receipts are comprised of:

- all those receipts which fall under the basic charge to profits tax because they were arising in or derived from a trade, business, or profession carried on in Hong Kong and were sourced in Hong Kong; and
- any receipts deemed to be assessable trading receipts under the Ordinance (see further ¶6-2200).

Additionally, the value of the taxpayer's trading stock or work in progress must be taken into account.

> For the treatment of trading stock and work in progress, see ¶6-2850.

Certain business receipts are specified as being non-assessable and must be deducted from a taxpayer's total receipts for profits tax purposes. Profits arising from the sale of capital assets are excluded from the profits tax computation pursuant to the general charging

section (s 14) (see further ¶6-3440). Other non-assessable profits include interest from tax reserve certificate, profits from government bonds (see further ¶6-3400), etc. Also, only profits which have "accrued or been derived" by a taxpayer are subject to profits tax. The question of whether (and when) a particular taxpayer's profits were arising in or were derived from Hong Kong during the basis period is an important consideration (see ¶6-4100).

Deductions are allowed under the Ordinance for various expenses which have been incurred by a taxpayer in the production of assessable profits or in the normal course of his or her business. For more details on allowable deductions, see ¶6-4600. A taxpayer's assessable profits are increased/decreased by balancing charges/allowances (see ¶7-5000) and decreased by depreciation and other capital allowances (refer to Chapter 7 at ¶7-0100), as well as any losses brought forward (see ¶6-6500).

> Refer to the flowchart provided at ¶6-0070.

Profits tax is generally assessed on a basis period of twelve months in a year of assessment. However, there are circumstances where the basis period will comprise a period other than twelve months. In particular, provisions are made for different basis periods to apply in the commencement and cessation years of a business or when a taxpayer changes its accounting date (see ¶6-8860).

There are circumstances where certain classes of taxpayers demand alternative assessment methods. The Ordinance contains special provisions for the computation of the profits of:

- partnerships (see ¶6-7140);
- insurance corporations (see ¶6-7380 and ¶6-7500);
- ship owners (see ¶6-7620) and aircraft owners (¶6-7860); and
- clubs and trade associations (see ¶6-8020 and ¶6-8140).

Special provisions are also made for the assessment to profits tax of non-residents (see ¶6-8260).

In addition, the Ordinance includes a number of special concessions aimed at encouraging the development of Hong Kong's financial services sector. These include: the exemption from tax of certain investment profits (see ¶6-3400); an exemption for stock borrowing and lending transactions ("SBLTs") (see ¶6-3760); an exemption for offshore funds (see ¶6-3850); a 50% or 100% tax reduction for

qualifying debt instrument profits (see ¶6-3880); and the exemption from the withholding obligations of brokers and investment advisers to settle the profits tax liabilities, if any, in respect of the profits derived by non-resident investors for whom they act as agents (see ¶6-8340).

In recent years the Hong Kong Profits Tax concessionary regimes are introduced for

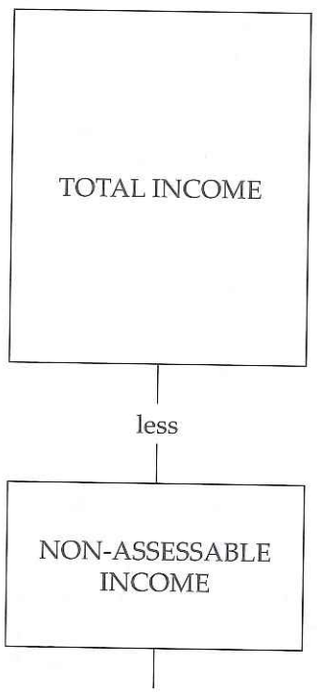
- qualifying corporate treasury centres (see ¶6-3900); and
- qualifying aircraft financing and leasing businesses (see ¶6-3910)

The applicable profits tax rate is 8.25% (half rate of the prevailing Hong Kong Profits Tax rate) for qualifying profits under these regimes.

Every taxpayer who is liable to profits tax is also liable to pay provisional profits tax under Pt XB of the Ordinance (refer to Chapter 9 at ¶9-8000).

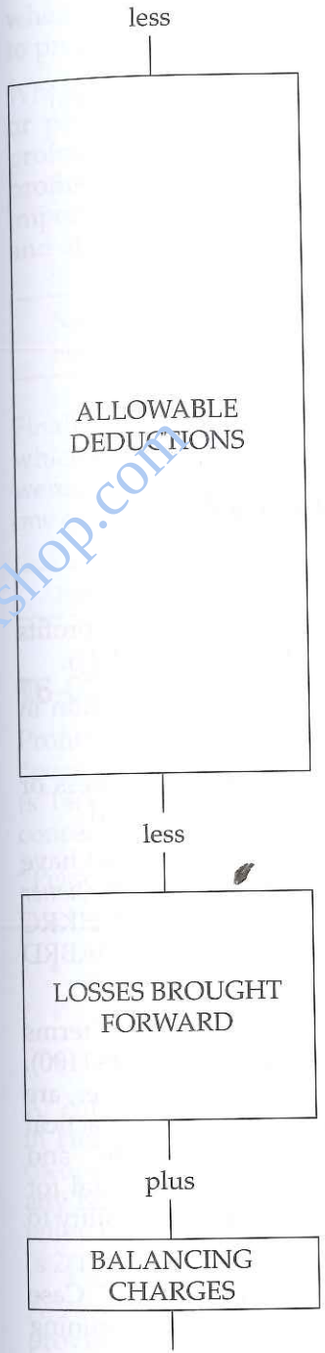
¶6-0070 Flowchart

The following flowchart demonstrates the process by which a taxpayer's profits tax liability is determined.



Consisted of the taxpayer's total receipts derived from any trade (¶6-0350), business (¶6-1100) and/or profession (¶6-1250) for the relevant basis period (see ¶6-8700). This includes all Hong Kong-sourced receipts falling under the general charge to profits tax (see ¶6-0200) and any receipts specifically deemed to be assessable (see ¶6-2200). The value of trading stock or work in progress also must be taken into account (see ¶6-2850).

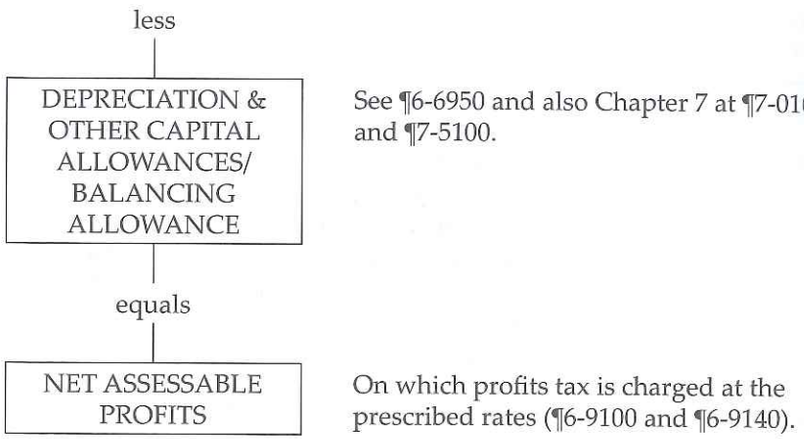
Income not arising in or derived from Hong Kong (¶6-1700); capital receipts (¶6-3440); and certain dividends, profits already assessed and other specified exempt receipts (see ¶6-3400).



Outgoings and expenses incurred by the taxpayer in the production of chargeable profits (¶6-4640); expenses connected with borrowing money (¶6-4940); rent (¶6-5060); foreign taxes (¶6-5100); bad debts (¶6-5140); repair costs of premises, plant, etc. (¶6-5180); replacement costs (¶6-5220); expense of registering trademarks, patents, etc. (¶6-5260); special contributions made to recognised occupational retirement schemes (¶6-5300); expenditure on research and development (¶6-5420); payments for technical education (¶6-5500); approved charitable donations (¶6-5540); expenditure for purchasing certain intellectual property rights (¶6-5580); non-domestic building refurbishment expenditure (¶6-5620); capital expenditure on prescribed fixed assets (¶6-5660); and capital expenditure on deduction of environmental protection facilities. See ¶6-6000 for non-deductible expenses and losses.

Losses brought forward from previous years are used to offset against the assessable profits for subsequent year(s) (¶6-6500). Note that an adjustment factor applies when losses in respect of concessionary trading receipts are set off against normal trading receipts and vice versa (¶6-6700).

See ¶6-6950 and also Chapter 7 at ¶7-5000.



LIABILITY TO PROFITS TAX

¶6-0200 Prerequisites for liability

Three criteria must be fulfilled before a person will be liable to profits tax under the general charging section of the Ordinance (s 14(1)):

(i) the person is carrying on a trade, business or profession in Hong Kong;

(ii) the person has derived profits from that trade, business or profession in Hong Kong (except for capital gains); and

(iii) the profits from that trade, business or profession must have arisen in or been derived from Hong Kong (*Commissioner of Inland Revenue v Hang Seng Bank Limited* (1990) 1 HKRC ¶90-044; *Case* A145 (1991) 1 HKRC ¶80-145 (*D32/91* IRBRD Vol 6, 74)).

The Ordinance provides guidance as to the meanings of the terms "person", "trade", and "business" (see ¶6-0240, ¶6-0350 and ¶6-1100). The Ordinance's definitions of "trade" and "business", however, are neither comprehensive nor exhaustive and so are of limited practical assistance. Consequently, the identifying features of "trade" and "business" which have been established by the courts are vital for ascertaining whether a person satisfies the first criteria for liability to profits tax (see ¶6-0500 and ¶6-1100).

No statutory definition is provided for the term "profession." Case law is solely relied upon to provide guidance when determining

whether a taxpayer has performed professional services and is liable to profits tax (see ¶6-1250).

When it is found that a person has been engaged in a trade, business, or profession, it must be established that the trade, business or profession was carried on in Hong Kong in order for a charge to profits tax to arise. In considering the second criterion, it becomes important to determine when a business commences and/or ceases and also to distinguish between business and preparatory activities.

See ¶6-1400 for more on "commencement and cessation of trade, business or profession."

Finally, profits tax liability only arises if the taxpayer has profits which were sourced in Hong Kong — that is, if the profits arose in or were derived from Hong Kong. The question of the source of profit is one of the most problematic issues in Hong Kong revenue law.

For the current judicial approach to the issue, see ¶6-1700.

¶6-0240 Persons liable to profits tax

Profits tax is charged on the Hong Kong-sourced gains of every "person" carrying on a trade, profession or business in Hong Kong (s 14(1)). In practice, the term "person" covers all possible trading concerns.

"Person" is defined in the Ordinance as including:

- a corporation;
- a partnership;
- a trustee; and
- a body of persons (s 2(1)).

A "corporation" is any company which is incorporated or registered in Hong Kong or elsewhere. However, the term does not include a co-operative society or trade union (s 2(1)). A "body of persons" is any body politic, corporate or collegiate or any company, fraternity, fellowship or society of persons whether corporate or not corporate (s 2(1)).

A trustee is subject to profits tax on its own profits arising from the provision of trustee services and will not be personally liable to tax in

respect of the chargeable profits of the entity for which it acts. When a trustee is involved in a profitable transaction, the profit must be looked at to determine whether it belongs to the trustee or some other person (*Case* D20 (1994) 1 HKRC ¶80-270 (*D37/93* IRBRD Vol 8)).

In *Case* D20 (*D37/93*), a trustee which had purchased and sold a property as trustee for an unrelated company (Company X) was not chargeable to profits tax on the sale proceeds. The purchase price for the property had been paid directly to the vendor by Company X, and Company X had directly received the sales proceeds. The Board of Review said that there was no way that the profit belonged to the trustee for tax purposes. Company X had been carrying on business for its own account and only used the trustee as its nominee. The trustee had done nothing. It made no decisions, did not provide capital and did not receive sale proceeds. The profit was profit of Company X.

DEFINITION OF TRADE

¶6-0350 Definition of trade

"Trade" is defined in the Ordinance as including:

(i) every trade and manufacture; and

(ii) every adventure and concern in the nature of trade (s 2(1)).

This definition, however, is of limited practical assistance for determining whether a taxpayer has been engaged in trade. Consequently, courts tend to look at the established characteristics or identifying features of trade which are reflected in earlier cases and assess whether the transaction in question displays any of those characteristics (*Griffiths (Inspector of Taxes) v JP Harrison (Watford) Ltd* (1963) AC 1). The various characteristics or "badges of trade" are discussed at ¶6-0500.

Whether a person is, or has been, engaged in trade is a question of fact, not law (*IRC v Scottish Automobile and General Insurance Co* (1932) 16 TC 381). The question therefore turns to the circumstances of the relevant case, which must be examined in their entirety. In *Erichsen v Last* (1881) 4 TC 422, the Master of Rolls said:

> "There is not, I think, any principle of law which lays down what carrying on trade is. There are a multitude of things which together make up the carrying on of trade, but I know no one distinguishing incident, for it is a compound fact made up of a variety of incidents."

Furthermore, the fact that one or all of the usual "badges of trade" is or are absent does not negate the existence of an adventure in the nature of trade (see ¶6-0500).

CHARACTERISTICS OF TRADE

¶6-0500 Badges of trade

The basic characteristics of trade have been established through case law. In particular, six identifying features have emerged which are normally taken into consideration when determining whether a taxpayer is, or has been, engaged in trade. These "badges of trade", as they have become known, are:

(i) the subject matter of the transaction/s (see ¶6-0540);

(ii) the length of ownership (see ¶6-0580);

(iii) whether there have been successive or frequent similar transaction/s (see ¶6-0620);

(iv) whether supplementary activities have been performed to make the asset/s marketable or to attract purchasers (see ¶6-0660);

(v) the reasons for the disposal or realisation of the subject matter (see ¶6-0700); and

(vi) the taxpayer's motive (see ¶6-0740).

The badges of trade substantially originated from the case of *Leeming v Jones* (1930) 15 TC 333. They were specifically identified and enunciated by the United Kingdom Royal Commission on the Taxation of Profits and Income (Comd. 9474) in 1955.

In addition to the general badges of trade, there are two other significant features to which courts attach considerable weight. They are:

(i) the taxpayer's intention to trade (see ¶6-0780); and

(ii) the existence of a commercial purpose in the taxpayer's transaction/s (see ¶6-0820).

If a taxpayer lacks an intention to trade or the transaction/s in question lack commercial purpose, a claim that the taxpayer was engaged in trade is likely to be defeated.

It is not necessary for all the badges of trade to be present for a taxpayer to be found to have been trading. The fact that only some

features of trade can be identified is enough in certain circumstances to convince a court that a trading adventure has been embarked upon. Indeed, one activity undertaken by the taxpayer may outweigh all other considerations and point to a trading venture.

Similarly, the fact that a tribunal or a court does not expressly refer to all the possible badges or features of trade when deciding whether a taxpayer was trading does not necessarily mean that it has been misdirected. A Board of Review which, focusing particular attention on a joint venture entered into by a taxpayer, found that the taxpayer had been involved in a trading venture was found not to have been misdirected in reaching its decision simply because express reference had not been made to all of the relevant facts. Rather, the High Court found that what the Board had been saying was that, while having in mind all of the various considerations, the taxpayer's activity in entering the joint venture had heavily outweighed those considerations and pointed to a trading venture (*Crawford Realty Limited v Commissioner of Inland Revenue* (1992) 1 HKRC ¶90-060).

¶6-0540 Subject matter of transaction/s

Certain forms of property, such as commodities or manufactured items, are normally the subject of trading ventures: only exceptionally are they the subject matter of an investment. Accordingly, evidence that a taxpayer's activities involve the acquisition and resale of such property points to the taxpayer having been engaged in a trading venture.

Property acquired by a taxpayer who does not yield either income or personal enjoyment through its ownership is normally regarded as having been acquired for trading purposes. A taxpayer who bought one million rolls of toilet paper and sold them at a profit, for example, was found to have been engaging in an adventure in the nature of trade (*Rutledge v IRC* (1929) 14 TC 490). The nature and quantity of the property dealt with by the taxpayer excluded the suggestion that the purchase had been a capital investment.

A bank account held by a non-financial institution is essentially a capital item. An account in which foreign currency is deposited in the ordinary course of business and accumulated over time is capital in nature. However, in *Case* H31 (1998) HKRC ¶80-539 (*D73/97*), the Board of Review held that a foreign currency time deposit purchased for a speculative purpose cannot simply be equated with a typical bank account. Accordingly, the exchange loss incurred was found deductible.

¶6-0580 Length of ownership

When a taxpayer purchases and immediately sells an asset, there is a *prima facie* inference that the asset was acquired with a view to its sale at a profit and that the taxpayer is trading (*Case* E60 (1995) 1 HKRC ¶80-357 (*D3/95* IRBRD Vol 10, 74)).

In the case of *Johnston (Inspector of Taxes) v Heath* (1970) 3 All ER 915, a taxpayer who was in a position to purchase some land at a favourable price, but could not raise a loan, contracted to sell the land to a purchaser, at a profit, even *before* he had contracted to buy it. This persuaded the Court that the transaction was an adventure in the nature of trade. Similarly, when two taxpayers bought and sold a large quantity of machinery, which they had no intention of holding, the Court categorised the venture as trade (*Edwards (Inspector of Taxes) v Bairstow & Harrison* (1955) 36 TC 207). The taxpayers had not purchased the machinery to consume or enjoy but had been planning to sell it even before they had purchased it.

The inference of trading may be rebutted if the circumstances of a fast resale explain its suddenness: for example, if the sale was forced by financial necessity (see further ¶6-0700). However, the inference of trading is very strong where the length of ownership of an asset is short and clear evidence must be provided to support a claim that the taxpayer was not engaged in trade. For example, in *Case* E51 (1995) 1 HKRC ¶80-348 (*D79/94* IRBRD Vol 9, 409), lack of supporting evidence defeated the taxpayer's claim that she was not trading when she sold a residential property less than five weeks after it was acquired. This was notwithstanding the fact that the taxpayer in many respects did not fit the classic mould of a property speculator or trader. See also *Case* I2 (1999) HKRC ¶80-571 (*D13/98* IRBRD Vol 13).

¶6-0620 Frequency and regularity of transactions

The involvement in successive transactions of a similar nature over a period of time, or the undertaking of numerous transactions at the same time, points to a taxpayer having been engaged in trade. The systematic repetition or undertaking of multiple transactions strongly suggests that a taxpayer has been trading. Indeed, a series of transactions may constitute the carrying on of a trade even though each transaction, taken individually, is not a trade.

A taxpayer who bought a mill, resold it at a profit, and then repeatedly conducted similar transactions was found to have been trading in *Pickford v Quirke (Inspector of Taxes)* (1927) 13 TC 251. Individually, the

example, a taxpayer who bought two metal stills and extensively cleaned them before reselling them was held not to be trading in *Jenkinson (Inspector of Taxes) v Freedland* (1974) 39 TC 636. The Court accepted the taxpayer's explanation that his intention for doing the repairs himself before selling the stills was to enable the purchasing companies to obtain higher capital allowances. In *Taylor v Good (Inspector of Taxes)* (1974) 49 TC 277, a taxpayer bought a house on impulse and then decided not to live in it. Planning permission was obtained for the land which was consequently sold at a profit. It was conceded that the original purchase of the house as a residence was not in the way of trade. The Court did not consider that taking steps to enhance its value had made the taxpayer a trader in this instance. It was stated in the *Taylor* case that the authorities seem to point strongly against the theory of law that a man who owns or buys without a present intention to sell land is engaged in trade when, not being a developer himself, he merely takes steps to enhance the value of the property in the eyes of a developer.

¶6-0700 Circumstances of sale

The resale of property immediately after its acquisition strongly suggests that a taxpayer has engaged in trade. However, if there is a valid explanation for the quick sale: a sudden emergency or an unforeseen contingency, for example, the inference of trading may be rebutted.

In *West v Phillips (Inspector of Taxes)* (1958) 38 TC 203, it was found that a taxpayer who built a large number of houses, some for letting and some for resale, was not "trading" when it sold its unprofitable letting premises. The Court found that 2,208 houses built to let were investments, that the sale had been forced, and that, therefore, the taxpayer was not engaged in trade.

Taxpayers' explanations for the quick resale of property have been accepted in the following situations:

- where the subject property was acquired to cater for the schooling schedule of the taxpayers' daughter and was subsequently disposed of owing to unexpected delays in the completion of the property (*Case* I1 (1999) HKRC ¶80-570 (*D12/98* IRBRD Vol 13));
- where mortgage loans were overdue and too heavy a burden on the owner, forcing the sale of property (*Wing On Cheong Investment Co Ltd v Commissioner of Inland Revenue* (1990) 1 HKRC ¶90-035);

- where the resale was made in connection with the winding-up of a company (*Tai Shun Investment Co Ltd v Commissioner of Inland Revenue* (1968) 1 HKTC 370; *BR 6/76* IRBRD Vol 1, 213);
- where the sale was prompted by a recession, an inability to cope with computerisation, and nearby construction works (*D65/87* IRBRD Vol 3, 66);
- where the appearance of a fortuitous offer at a very good price caused the taxpayer to decide to sell part of its capital structure (*Beautiland Co Ltd v Commissioner of Inland Revenue* (1991) 1 HKRC ¶90-053 (PC));
- where the taxpayer accepted an unsolicited purchase offer which allowed him to realise his investment for an 87% return (*Case* E50 (1995) 1 HKRC ¶80-347 (*D76/94* IRBRD Vol 9, 394));
- where the taxpayer took advantage of a rising market to make a profit on his investment (*Case* E70 (1995) 1 HKRC ¶80-367 (*D17/95* IRBRD Vol 10, 151));
- where residential premises acquired by taxpayers, upon reassessment, were found to be unsuitable and were replaced with more desirable premises (*Case* H26 (1998) HKRC ¶80-534 (*D61/97*); *Case* F1 (1996) HKRC ¶80-379 (*D18/95*); and *Case* E62 (1995) 1 HKRC ¶80-359 (*D8/95* IRBRD Vol 10));
- where a serviced apartment acquired was sold shortly due to problems encountered relating to air conditioning, pests and water leakage which could not be fixed within a short period of time (*Case* V24 (2012) HKRC ¶81-350 (*D35/11* IRBRD Vol 26));
- where an investment property was sold so that the taxpayer could change to a better investment (*Case* F11 (1996) HKRC ¶80-389 (*D42/95*); *Case* E76 (1995) 1 HKRC ¶80-373 (*D30/95* IRBRD Vol 10)); and
- where the sales of properties were due to the death of the founder of the taxpayer and economic recession (*Case* H24 (1998) HKRC ¶80-532 (*D59/97* IRBRD Vol 12)).

The taxpayers' explanation was not accepted in the following case:

- where an industrial property was sold before its completion, the taxpayers claimed that the property had originally been acquired to be used as a factory and that the sale was prompted by losses incurred by their business. The Board found that the taxpayers had failed to discharge their onus of proof (*Case* I5 (1999) HKRC ¶80-574 (*D17/98* IRBRD Vol 13)).

Change of intention

A taxpayer may change his or her intention from investment to trading (or vice versa). Careful consideration is necessary, however, when a change of intention is alleged. There must be clear and unequivocal evidence that such a change has occurred (*D16/88* IRBRD Vol 3, 225). Precision is required, particularly as to the date of change (*Wing On Cheong Investment Co Ltd v Commissioner of Inland Revenue* (1990) 1 HKRC ¶90-035).

A change in accounting classification of a property from trading stock to fixed asset may constitute a change in intention and be regarded as a deemed disposal. As a consequence, the revaluation surplus on the property which was reclassified from trading stock to fixed asset was held as assessable (*Case* I74 (2000) HKRC ¶80-643 (*D180/98* IRBRD Vol 14)). However, it should be noted that in a subsequent court decision, *Commissioner of Inland Revenue v Nice Cheer Investment Limited* (2013) HKRC ¶90-252, it was held that unrealised, anticipated profits should not be taxable.

A change of intention cannot be inferred simply because an investor sells off investment assets or takes steps to realise his or her investment advantageously (*Wing On Cheong*). If there is clear evidence that an asset was bought for investment, for instance, a quick resale will not of itself make the transaction an adventure in the way of trade. The reason for sale may be looked upon as an unforeseen contingency or some other valid reason (see ¶6-0700). Similarly, the mere holding of trading stock for a substantial time or the renting out of trading stock does not of itself evidence a change of intention from trade to investment (*D16/88* IRBRD Vol 3).

Change of intention is discussed in further detail at ¶6-3520.

¶6-0820 Commercial purpose of transaction/s

It is established by the English authority that, in addition to the outward "badges of trade", a transaction should have a commercial purpose in order to qualify as trade (*Overseas Containers (Finance) Ltd v Stoker (Inspector of Taxes)* (1989) STC 364). The Board of Review in Hong Kong has also stated that the expression "trade or business" in s 14 of the IRO connotes transactions with a commercial flavour (*D64/87* IRBRD Vol 3, 60).

Accordingly, when a taxpayer's transactions have no apparent commercial justification, a court is unlikely to find that the taxpayer was engaged in a trading venture. In *D64/87*, for example, a taxpayer who quickly resold property was found not to have been trading

as his activities had no commercial basis. He had bought a flat in anticipation of a Government Home Purchase Scheme which did not come into effect and, faced with the prospect of losing his tenancy allowance, had immediately resold the property. The Board decided that the taxpayer's profits were not assessable because the taxpayer's activities were not of a sufficiently commercial nature to be treated as an adventure in the way of trade. The Board emphasised the dominant factor in the taxpayer's mind in the determination of whether there had been an activity of a commercial nature. The dominant factor in the taxpayer's mind at the time of the purchase was the prospect of the Home Purchase Scheme. According to the Board, the fact that the taxpayer was aware that he could sell the property for more than the purchase price if he needed to did not mean that the taxpayer had embarked upon an adventure in the nature of trade.

In similar circumstances, a taxpayer was found not to have been trading when he quickly sold property after becoming aware that a home purchasing scheme which he was relying on could be delayed (*Case* A14 (1991) 1 HKRC ¶80-014 (*D49/89* IRBRD Vol 4)). The Board of Review, in reaching its decision, indicated its concurrence with the earlier decision in *D64/87*.

TYPES OF TRADE

¶6-0970 Mutual trading

Profits derived from mutual trading are not chargeable to profits tax (*Municipal Mutual Insurance Ltd v Hills (Inspector of Taxes)* (1932) 16 TC 430; *D1/79* IRBRD Vol 1, 328). Mutual trading takes place when a group of people all contributes to a common fund and is entitled to participate in the surplus, and all participants in the surplus are contributors to the common fund. In other words, there must be complete identity between the contributors and the participants (per Lord Macmillan at p 448 of the *Municipal Mutual Insurance* case).

Although a mutual association is not normally liable to tax as far as its members are concerned, it will be liable to tax as a trader for any portion of its profit which is derived from outsiders. A golf club which made a profit from providing facilities to non-members was assessable to tax on that profit in *Carlisle and Silloth Golf Club v Smith (Surveyor of Taxes)* (1913) 3 KB 75.

Mutual trading generally takes place in three types of organisations: insurance organisations; trade associations; and clubs. These bodies

are each assessed to profits tax under special provisions of the Ordinance.

> See ¶6-8020 for clubs; ¶6-8140 for trade associations; and ¶6-7380ff for insurance organisations.

¶6-1010 Illegal trading: are the profits taxable?

It is generally accepted that the profits of an illegal trade are taxable. The chargeability of a taxpayer's profits from the illegal trade, profession or business of smuggling was not challenged in *Lee Ma Loi v Commissioner of Inland Revenue & Anor* (1992) 1 HKRC ¶90-057. The profits obtained from shipping whisky to the USA during prohibition were held to be taxable in *Lindsay, Woodward and Hiscox v IRC* (1932) 18 TC 43, as were the profits from illegal wagering contracts in *Partridge v Mallandaine (Surveyor of Taxes)* (1886) 2 TC 179. In *Mann v Nash* 16 TC 523, it was held that the profits from providing licensed victuallers with automatic amusement machines for use for unlawful gaming were taxable even though the profits were derived from illegal trade.

Profits from theft are unlikely to be considered taxable since theft does not have the characteristics of trade. Similarly, gambling profits are generally not taxable as there is usually no trading or other business-like activity involved.

Winnings from betting on horse races were held not to be assessable in *Graham v Green (Inspector of Taxes)* (1925) 9 TC 309 and also in *D55/87* IRBRD Vol 3, 1. In the *Graham* case, the taxpayer's profits from betting were not taxable even though his sole means of livelihood was betting on horses from his home. In *D55/87*, the Board found that there is no legal principle which says that gambling activities cannot constitute the carrying on of business but that it is not sufficient for there simply to be a reasonable prospect for making money. The individual must have some organisation or associated activity to convert a pastime, hobby or pursuit into a business activity. As the taxpayer in *D55/87* had no form of business-like organisation and did no more than regularly attend race meetings and closely studied the form, he was not carrying on a business and his betting gains were not taxable.

DEFINITION AND CHARACTERISTICS OF BUSINESS

¶6-1100 Statutory definition of business

As with "trade", the IRO provides only an inclusive definition for "business" which is of little practical assistance. Section 2(1) defines "business" as including:

- an agricultural undertaking;
- poultry and pig rearing;
- the letting or sub-letting of premises by any corporation; and
- the sub-letting by any other person of premises held under a lease or tenancy other than from the Government.

The latter two categories are significant because they bring individuals and companies who are not property owners and are therefore not assessable to property tax, within the charge to profits tax.

The definition provided in s 2(1) is one of extension rather than limitation (*Kwan-Nang Kwong & Anor v Commissioner of Inland Revenue* (1989) 1 HKRC ¶90-017; *D3/81* IRBRD Vol 1). Consequently, unless a taxpayer's activities fall within one of the categories specifically included in the definition, it is necessary to look beyond the Ordinance to the broader meaning of "business", as established through case law, to determine whether the taxpayer has been carrying on business activities.

¶6-1140 Meaning of business according to Case Law

It is accepted that the term "business" has a very wide meaning and is a significantly wider concept than "trade" or "profession" (*Kwan-Nang Kwong & Anor v Commissioner of Inland Revenue* (1989) 1 HKRC ¶90-017; *Lam Woo Shang v Commissioner of Inland Revenue* (1961) 1 HKTC 123). It is considered, for instance, that "trade" must involve an active occupation. "Business", on the other hand, can be more passive. The receipt of share profits was held to be a business in *IRC v Korean Syndicate Ltd* (1921) 3 KB 258. The receipt of a fixed annuity was categorised as a business in *South Behar Railway Co Ltd v IRC* (1925) AC 476. Similarly, it has been held that the receipts of income by a holding company, or the mere activity of depositing, are businesses (*D15/87* IRBRD Vol 2, 373).

Although it is considered that the word "business" is of large and indefinite import, with extensive meaning wider than "trade" (*Lam Woo Shang v Commissioner of Inland Revenue* (1961) 1 HKTC 123), many of the *indicia* of trade are applied when determining whether a business has been carried on.

In *Ferguson v FC of T* 79 ATC 4261, the factors taken into account included:

- whether there was a profit-making motive;
- the organisation of activities in a business-like manner, the keeping of books and records and the use of any system in a business-like manner;
- whether there was repetition and regularity of activity; and
- the size and capital value of the activities.

The absence of a commercial motive was an important factor in *Case* D10 (1994) 1 HKRC ¶80-260 (*D27/93* IRBRD Vol 8). In that case, the taxpayer was a shelf company that had been acquired simply to allow another company to borrow money outside Hong Kong against the security of Hong Kong deposits. The taxpayer had held and rolled over deposits with banks in Hong Kong without any commercial motive as far as it was concerned and therefore, according to the Board of Review, was not carrying on a business. In *D55/87* IRBRD Vol 3, 1, the Board of Review said that a taxpayer's gambling activities did not constitute a business because they lacked the necessary degree of organisation or associated activity. The factors considered in each of these cases closely resemble several "badges of trade" (see ¶6-0500). See also *Case* N34 (2004) HKRC ¶81-010 (*D16/03* IRBRD Vol 18).

Companies — presumption of business activity

When a company, which is incorporated for the purpose of making profits for its shareholder, puts *any* of its assets to *any* gainful use, there is a *prima facie* inference that the company is carrying on a business (*American Leaf Blending Co Sdn Bhd v Director General of Inland Revenue (Malaysia)* (1978) STC 561). However, the Inland Revenue Department accepts that not every gainful use of a company's assets would necessarily lead to the conclusion that a trade or business is being carried on. Each case has to be decided on its own facts (Departmental and Interpretation Note No 39, para 7).

When a taxpayer is an individual, a presumption of business activity arises less readily (*D57/88* IRBRD Vol 4, 35).

The principle established by the Privy Council in the *American Leaf Blending Co* case was applied in the Hong Kong case of *Commissioner of Inland Revenue v Bartica Investment Ltd* (1996) HKRC ¶90-080. In the *Bartica* case, the taxpayer company was involved in placing offshore deposits and pledging them as security for bank loans made to an associated company. The taxpayer had been acquired by the family who owned the associated company specifically for this purpose. The activities were authorised under the taxpayer's Memorandum of Association.

The taxpayer did not receive consideration from the associated company for providing the security for the bank loans. It did, however, earn interest income which was assessed to profits tax. On appeal, the Board of Review found that the taxpayer was not carrying on an active business of borrowing money and placing it on deposit. The Board said that there was no commercial motive as far as the taxpayer was concerned. On further appeal, however, the High Court found that there was a gainful use of the assets of the taxpayer which constituted *prima facie* the carrying on of a business. The other circumstances of the case did not dispel that inference but only served to reinforce it.

It must be noted that it is not the case that an act done by a company that is authorised by its Memorandum incontrovertibly constitutes the carrying on of a business. Ultimately, whether a company is carrying on business is a question of fact to be determined having regard to the circumstances as a whole. While a strong *prima facie* presumption that the company is carrying on business may arise, that presumption may be rebutted if clear evidence to the contrary is produced.

One-off transactions

The term "business" was defined in *CIR v Marine Steam Turbine Co Ltd* (1920) 1 KB 193 as "an active occupation or profession continuously carried on." However, "business" also has been held to encompass not only passive conduct but also one-off transactions (*Re Abenheim* (1913) 109 LT 219; *George Hall & Son v Platt (Inspector of Taxes)* (1954) 35 TC 440).

CHARACTERISTICS OF A PROFESSION

¶6-1250 Characteristics of a profession

The term "profession" is not defined in the Ordinance. It has been held, however, to connote work requiring purely intellectual skill or manual labour dependent upon purely intellectual skill (*IRC v Maxse* (1919) 1 KB 647). In the *Maxse* case, the Court of Appeal said that:

> "... a profession in the present use of language involves the idea of an occupation requiring either purely intellectual skill, or of any manual skill, as in painting and sculpture, or surgery, skill controlled by the intellectual skill of the operator, as distinguished from an occupation which is substantially the production, or sale, or arrangement for the production or sale of commodities. The line of demarcation may vary from time to time."

Membership of a professional body may point to a taxpayer carrying on a profession (*Currie v IRC* (1921) 12 TC 245) but is not a conclusive factor on its own.

If a person practises a profession but is an employee (for example: an in-house lawyer), he or she is not considered to be carrying on a profession for the purposes of profits tax but will be assessed to salaries tax. To determine whether a professional person is an employee assessable to salaries tax, it must be determined whether that person is in a master/servant relationship (see further ¶2-2850).

The term "business" is interpreted so widely that it encompasses most professions. If what the taxpayer does, however, is to fulfil a series of engagements by moving from one to another and there is no such thing as occupying a position and staying in it, the taxpayer will be treated as carrying on a profession. In *Davies v Braithwaite* (1931) 18 TC 198, the taxpayer was an actress who accepted and fulfilled different and various engagements as long as her professional qualifications equipped her to do so. In a year, she acted in various stage plays in the UK and the USA under different contracts, performed on the BBC and performed for record companies. It was held that she was carrying on a profession and not earning income as an employee.

Profit from professional activity

When a taxpayer carries on a profession in Hong Kong, only those profits which arise out of or are derived from the taxpayer's professional activities are assessable (s 14(1)). In each case, the circumstances must be considered in full to determine whether a professional's receipts are in consideration of professional services rendered and accordingly assessable to profits tax.

Interest earned by a firm of solicitors from clients' accounts has been found to be assessable professional income (*Commissioner of Inland Revenue v Lau & Ors* (1990) 1 HKRC ¶90-028). The solicitors argued that the interest was not profit arising from their profession as it did not represent a charge levied by them against their clients. The High Court found, however, that in view of agreements made between the solicitors and clients, entitling the former to the interest, there was no doubt that the solicitors had received the interest in consideration of professional services rendered.

COMMENCEMENT AND CESSATION OF TRADE, BUSINESS, OR PROFESSION

¶6-1400 Commencement

Since profits tax is only charged for the period for which a trade, business or profession is carried on, it is important to determine with precision when a trade, business or profession commences (and when it ceases; see ¶6-1440).

The time at which a business commences is a question of fact and degree (*O'Kane & Co v IRC* (1922) 12 TC 303). A business ordinarily commences with the beginning of commercial production or current operations. The activities signifying the commencement of business do vary, however, according to the nature of the business involved.

It cannot be assumed that a business only commences when the first sale is made or the first receipt is received. It has been held, for example, that the business of a property developer commences when it first buys the land to develop, even though resale may not occur for several years (*D3/86* IRBRD Vol 2, 231). The Board found that the date of commencement is the date upon which the taxpayer's intentions begin to translate into an activity which can be characterised as trading.

Preparatory activities

The commencement of a trade, business or profession must be distinguished from activities which are merely preparatory or preliminary. When a taxpayer has carried on activities which go no further than allowing business to commence, the activities are not regarded as constituting "business activities." In *Southern Estates Pty*

industrial building or structure (s 40(1)). Specifically excluded from the definition of "capital expenditure" are grants, subsidies or any other financial assistance paid to the taxpayer who incurred the expenditure, and any amount already deductible under the profits tax provisions of the Ordinance (s 40(1)).

What is being included in the interpretation of capital expenditure provided in s 40(1) is not exhaustive. Attention must also be paid to general principles (see ¶6-6120 for more on identifying capital expenditure).

Expenditure incurred on construction

To qualify for an initial allowance, a taxpayer must have incurred capital expenditure on the *construction* of an industrial building or structure. Expenditure incurred on acquisition of land, or rights in or over land, is not capital expenditure incurred on construction (s 40(3)). Just as the cost of acquiring a site to build on cannot be included in computing an initial allowance, neither can the costs of demolishing a building already located on the site (*D5/79* IRBRD Vol 1, 340).

Expenditure incurred on ordinary work done in preparation for the laying of foundations, or in the laying of drains, sewers and water mains for a building may be included in the taxpayer's capital expenditure for the purpose of calculating the initial allowance to which the taxpayer is entitled (DIPN No 2 (Revised), para 16).

¶7-0700 Annual depreciation allowance

A person who is entitled to an interest in an industrial building or structure (see ¶7-0300) at the end of the basis period of a year of assessment is entitled to an annual allowance for depreciation of the building or structure to reflect the wear and tear (s 34(2)). The amount of the annual allowance granted to a qualifying taxpayer is equal to 4% of the capital expenditure incurred on the construction of the building.

See ¶7-0600 for more on capital expenditure.

Each year, the amount of the annual allowance is subtracted from the amount of the original capital expenditure until the residue of expenditure is nil (any initial allowance, balancing allowances and/or balancing charges are also taken into account) (s 40(1)).

Example

P Limited constructed an industrial building which was completed and brought into use in September 2018 at a cost of $100,000. P Limited's accounts are made up to 31 March. The depreciation schedule for the building would be as follows:

		$
2018/19		
Cost at September 2018		100,000
LESS		
Initial allowance (capital expenditure × 20%) (see ¶7-0500)	–	20,000
		80,000
LESS		
Annual allowance (capital expenditure × 4%)	–	4,000
	=	76,000
2019/20		
Residue of expenditure		76,000
LESS		
Annual allowance (capital expenditure × 4%)	–	4,000
	=	72,000
2020/21		
Residue of expenditure		72,000
LESS		
Annual allowance (capital expenditure × 4%)	–	4,000
	=	68,000

This process continues until the residue of expenditure is nil. In this case, if P Limited continues using the building, the final year in which annual allowance would be granted is 2037/38.

The annual allowance granted to a taxpayer in a year of assessment must never exceed the residue of expenditure at the end of the basis period for that year. In the final year in which annual allowance would be granted, if the annual allowance to be made exceeds the residue, only an amount equal to the residue will be allowed.

Qualifying taxpayers — the meaning of "relevant interest"

A taxpayer may qualify for an annual allowance even though the taxpayer did not personally incur any capital expenditure on its construction. To qualify for the allowance, however, the taxpayer

must have a "relevant interest" in the building or structure at the end of the basis period for the relevant year of assessment. This means that the taxpayer must have the same legal interest in the building or structure as the person who incurred the original capital expenditure in constructing the building (s 40(1)).

A person who purchases the relevant interest in a building or structure is entitled to annual depreciation allowances for the property. The amount of the allowances granted to the purchaser is determined by the application of special formulae.

See further ¶7-0800.

¶7-0800 Purchaser's entitlement to annual allowance

When the "relevant interest" (see ¶7-0700) in a building or structure which has been used at any time before the sale as an industrial building or structure or otherwise is sold, the purchaser is entitled to an annual allowance for wear and tear based on the residue of expenditure immediately after the sale (s 34(2)(b)). The "residue of expenditure" consists of the amount of the capital expenditure incurred in the construction of the building or structure reduced by any initial, annual or balancing allowances that have already been granted, or any notional amounts written off (see below), and increased by any balancing charges made when the building or structure was used previously as an industrial or commercial building or structure (see ¶7-5100).

For the purpose of determining the residue of expenditure which a purchaser inherits when buying the relevant interest in a building, a notional amount is written off for any year in which no initial or annual allowance was made (s 40(1)). The notional amount equals:

- for a year before 1 April 1965 — 2% of the capital expenditure; and
- for the years of assessment commencing 1 April 1965 and following — 4% of the capital expenditure.

The rate of the annual allowance available to a purchaser is determined by formulae which take into account the date when the building was first used (s 34(2)(b)(i) and (ii)).

- For a building or structure which was first used before the basis period for 1965/66, the annual allowance is equal to:

$$\text{Residue of expenditure} \times \frac{2}{\text{Number of years of assessment from the basis period in which the sale takes place, to the 50th year after first use.}}$$

- For a building or structure which was first used during or after the 1965/66 basis period, the annual allowance is equal to:

$$\text{Residue of expenditure} \times \frac{1}{\text{Number of years of assessment from the basis period in which the sale takes place, to the 25th year of assessment after first use.}}$$

The rationale for the different denominator is that before 1965/66, annual allowances were calculated at the rate of 2% (ie 1/50). From 1965/66, the rate was amended to 4% (i.e. 1/25).

Example

W Ltd closes its accounts on 31 December. It was the owner of an industrial building which was constructed in 2000 at a cost of $500,000. The building had been used by W Ltd in its qualifying trade from 2000 until the relevant interest in it was sold to V Ltd in January 2010 at $250,000.

V Ltd carries on a qualifying trade. It closes its accounts on 31 December.

W Ltd

2000/01	$
Cost of construction	500,000
Initial allowance (20%)	(100,000)
Annual allowance (4%)	(20,000)
Tax written-down value	380,000
2001/02 to 2009/10	$
Annual allowance:	
$500,000 × 9 × 4%	(180,000)
2010/11	
Residue of expenditure before sale	200,000
Sale proceeds	(250,000)
Balancing charge	50,000

V Ltd

V Ltd was entitled to annual allowance from 2010/11 onwards, which is calculated as follows:

V Ltd

Residue of expenditure = $200,000 + $50,000 = $250,000
Year of assessment in which the sale takes place: 2010/11
Year of assessment that the building was first used: 2000/01
The 25th year of assessment after first use is 2025/26
The number of years of assessment from 2010/11 to 2025/26 is 16
Annual allowance = $250,000 × 1/16
= $15,625

If V Ltd acquired another industrial building (which was first used in 1963/64) in 2010/11 with a residue of expenditure of $250,000, the annual allowance will be calculated as follows:

Year of assessment in which the sale takes place: 2010/11
Year of first use: 1963/64
The 50th year of assessment after first use is 2013/14
The number of years of assessment from 2010/11 to 2013/14 is 4
Annual allowance = $250,000 × 2/4
= $125,000

ALLOWANCES FOR COMMERCIAL BUILDINGS OR STRUCTURES

¶7-1200 Annual allowance

A person who is entitled to an interest in a commercial building or structure at the end of the basis period of a year of assessment is eligible for an annual allowance for depreciation of the building or structure by wear and tear (s 33A). This annual allowance for commercial buildings and structures was introduced with effect from the 1998/99 year of assessment, replacing the rebuilding allowance.

A "commercial building or structure" is any building or structure used by a person for the purposes of his or her trade, profession or business which is not an "industrial building or structure" (see ¶7-0300 for the definition of "industrial building or structure") (s 40(1)).

The amount of the annual allowance for a commercial building or structure is equal to 4% of the capital expenditure incurred on the construction of the building (s 33A(1)). Each year, the amount of the annual allowance is subtracted from the amount of the original capital expenditure until the residue of expenditure is nil.

The annual allowance granted to a taxpayer in a year of assessment must never exceed the residue of expenditure at the end of the basis period for that year. In the final year in which annual allowance would be granted, if the annual allowance to be made exceeds the residue, only an amount equal to the residue will be allowed (s 33A(3)).

Qualifying taxpayers — the meaning of "relevant interest"

A taxpayer may qualify for an annual allowance for a commercial building or structure even though he or she did not personally incur any capital expenditure on its construction. To qualify for the allowance, however, the taxpayer must have a "relevant interest" in the building or structure at the end of the basis period for the relevant year of assessment. This means that the taxpayer must have the same legal interest in the building or structure as the person who incurred the original capital expenditure in constructing the building (s 40(1)).

A person who purchases the relevant interest in a building or structure is entitled to annual depreciation allowances for the property. The amount of the allowances granted to the purchaser is determined by the application of special formulae.

See further ¶7-1400.

Where rebuilding allowance was claimed before 1 April 1998

The annual allowance for commercial buildings and structures was introduced with effect from the year of assessment 1998/99, replacing the former rebuilding allowance provided under s 36. In cases where rebuilding allowances have been claimed for years prior to 1998/99 for capital expenditure incurred on the construction of a commercial building or structure, the following applies in order to calculate the annual allowance which will be permitted under s 33A for the year of assessment 1998/99 and the subsequent years:

(i) the capital expenditure incurred by the buyer on the construction of the building or structure is deemed to have been reduced by the aggregate of the rebuilding allowances already claimed; and

(ii) the building or structure is deemed to have been first used in the year of assessment 1998/99 (s 33A(4)).

¶7-1300 Qualifying capital expenditure

"Capital expenditure" for which an allowance may be granted under s 33A includes any interest paid and any commitment fees incurred in connection with a loan made for the purpose of financing a commercial building or structure (s 40(1)). Specifically excluded from the definition of "capital expenditure" are grants, subsidies or any other financial assistance paid to the taxpayer who incurred the expenditure, and any amount already deductible under the profits tax provisions of the Ordinance (s 40(1)).

What is being included in the interpretation of capital expenditure provided in s 40(1) is not exhaustive. Attention must also be paid to general principles.

See ¶6-6120 for more on identifying capital expenditure.

Expenditure incurred on construction

To qualify for an annual allowance under s 33A, a taxpayer must have incurred capital expenditure on the *construction* of a commercial building or structure. Expenditure incurred on the acquisition of land, or rights in or over land, is not capital expenditure incurred on construction (s 40(3)). Just as the cost of acquiring a site to build on cannot be included in computing an initial allowance, neither can the costs of demolishing a building already located on the site (*D5/79*).

Expenditure incurred on ordinary work done in preparation for the laying of foundations, or in the laying of drains, sewers and water mains for a building may be included in the taxpayer's capital expenditure (DIPN No 2 (Revised), paras 16 and 37).

Case R13 (2008) HKRC ¶81-231 (*D21/07*) was a case which involved the determination of the cost of construction. In that case, the taxpayer deducted commercial building allowances on four properties based on one-half of the costs incurred on the acquisition of the properties. The Assessor viewed that the commercial building allowance should be based on the capital expenditures incurred on construction of the properties and estimated that the costs of construction should not be more than one-half of the first assignment prices of the properties. In the absence of any evidence adduced by the taxpayer on the actual cost of construction, the Board agreed with the Commissioner's

submission that taking half of the first assignment price as the deemed cost of construction was fair, reasonable and appropriate. The Commissioner added that it had been the practice of the Inland Revenue Department for many years to determine the cost of construction based on the first assignment price. The logic was explained as follows:

(i) The acquisition cost incurred on a property comprised three elements: (1) construction cost; (2) land cost; and (3) appreciation or depreciation in value over time. The first two elements were static historical costs, whereas the third element would vary depending on the market conditions.

(ii) The first assignment price of a newly completed property comprised the first two elements and a profit margin for the developer. It would be unlikely to be on the low side to estimate the first element by taking it as half of the first selling price.

(iii) With inflation and a buoyant property market, the acquisition cost would be substantially higher than the original construction cost over the years. The appreciation, in turn, comprises the upsurge in the land value and the profits of the subsequent sellers. Over time, the third element would far exceed the other two elements, but only the first element would qualify for rebuilding allowance or commercial building allowance. Taking half of the acquisition cost incurred by the taxpayer in the 1990s as the cost of construction of the properties would be a gross over-estimate of the cost of construction by merging the big appreciation in value of the properties over time with it.

¶7-1400 Purchaser's entitlement to annual allowance

When the "relevant interest" (see ¶7-1200) in a building or structure which has been used at any time before the sale as a commercial building structure or otherwise is sold, the purchaser is entitled to an annual allowance for wear and tear based on the residue of expenditure immediately after the sale (s 33A(2)). The "residue of expenditure" consists of the amount of the capital expenditure incurred in the construction of the building or structure reduced by any initial, annual or balancing allowances that have already been granted, or any notional amounts written off (see below), and increased by any balancing charges made when the building or structure was used

previously as an industrial or commercial building or structure (see ¶7-5100) (s 40(1)).

For the purpose of determining the residue of expenditure which a purchaser inherits when buying the relevant interest in a building, a notional amount is written off for any year in which no annual allowance was made (s 40(1)). The notional amount is equal to 4% of the capital expenditure.

The rate of the annual allowance available to a purchaser is determined using the following formula:

$$\text{Residue of expenditure} \times \frac{1}{\text{Number of years of assessment from the basis period in which the sale takes place, to the 25th year after first use.}}$$

In cases where rebuilding allowances had been claimed for the relevant commercial building or structure prior to the introduction of the annual allowance in the 1998/99 year of assessment, the rate of annual allowance allowed would be determined by the following formula:

$$\text{Residue of expenditure} \times \frac{1}{\text{Number of years of assessment from the basis period in which the sale takes place, to the 25th year after the 1998/99 year of assessment (in which the annual allowance scheme commenced).}}$$

¶7-1500 Rebuilding allowance (pre-1998/99)

In the years of assessment preceding the year of assessment 1998/99, commercial buildings or structures were not eligible for the same annual allowance as industrial buildings for capital expenditure incurred on their construction.

Instead, up to the basis period for the year of assessment 1997/98, where a taxpayer was entitled to a "relevant interest" (see ¶7-1200) in a commercial building or structure at the end of the basis period of a year of assessment, he or she was entitled to a rebuilding allowance for that year. The amount of the rebuilding allowance granted to a taxpayer was equal to 2% of the capital expenditure incurred on the construction of the building or structure (s 36).

For more on qualifying capital expenditure, see ¶7-0600.

BUILDINGS AND STRUCTURES BOUGHT UNUSED

¶7-2000 Entitlement to allowances

The initial allowance for capital expenditure on industrial buildings or structures is normally granted to the person who incurred the expenditure (s 34(1)). When, however, the building or structure is sold before it has been used, the purchaser of the property is entitled to the allowance (s 35B). No allowance may be claimed by the seller, and any initial allowance which has already been granted is withdrawn (DIPN No 2 (Revised), para 23).

Sale in course of property development trade

When a person who has incurred expenditure in constructing a building or structure sells the relevant interest in the building, before it is used, in the course of a trade consisting of the development of buildings or structures for sale, the buyer is deemed to have incurred capital expenditure on the construction of the building equal to the net price paid for the interest (s 35B(b)(i)). The initial allowance available to the buyer is calculated on the deemed capital expenditure which is regarded as having been incurred on the date on which the purchase price becomes payable.

If the relevant interest is sold more than once before the building or structure is used, only the last buyer before use is deemed to have incurred the capital expenditure. In such a case, the expenditure is deemed to be equal to the lesser of the price paid by the last buyer or the net price paid on the first sale.

Other sale

When the relevant interest in a building or structure is sold before it is used, other than in the course of a property development trade, the buyer is deemed to have incurred capital expenditure on the construction of the building or structure equal to the lesser of the net price paid or the actual expenditure incurred on the construction (s 35B(b)(ii)). If the relevant interest is sold more than once before the building or structure is used, then this has an effect only in relation to the last of the sales.

Example — Calculation of initial allowance

Z Ltd is a company engaged in the business of property development. During 2004, Z Ltd incurred $650,000 on the construction of a factory building. In late 2015, the relevant interest in the building was sold to A Ltd for a net price of $800,000. Z Ltd had not used the building which had been constructed for the sole purpose of subsequent sale. The $800,000 was payable on 1 April 2018. A Ltd's accounts are made up to 31 March.

For the 2018/19 year of assessment:

(i) *If A Ltd retains building:*

Initial allowance available to A Ltd
= capital expenditure deemed to have been incurred on construction × 20%
= net price paid for relevant interest in building × 20%
= $800,000 × 20%
= $160,000

(ii) *If the building had been sold to A Ltd other than in the course of Z Ltd's property development trade:*

Initial allowance available to A Ltd
= capital expenditure deemed to have been incurred on construction × 20%
= lesser of actual construction expenditure or net price paid by A Ltd × 20%
= $650,000 × 20%
= $130,000

(iii) *If A Ltd, before using the building, sold the relevant interest in it to X Ltd for a net price of $850,000:*

Initial allowance available to X Ltd
= capital expenditure deemed to have been incurred on construction × 20%
= lesser of net price paid by A Ltd on first sale or net price paid by X Ltd × 20%
= $800,000 × 20%
= $160,000

BUILDING REFURBISHMENT DEDUCTION

¶7-2300 Building refurbishment — profits tax deduction in lieu of allowance

Section 16F of the *Inland Revenue Ordinance* provides for the deduction of capital expenditure incurred on the renovation or refurbishment of any building or structure which is not used for domestic purposes. A deduction is allowed for 20% of the qualifying capital expenditure in the basis period in which it was actually incurred. The remainder is deductible by four equal deductions over the next succeeding four years.

The deduction is available only for expenditure incurred on refurbishment. It is not available for expenditure incurred on the initial construction, decoration and fitting-out of a building or structure.

A taxpayer who applies for the deduction under s 16F is not eligible for a capital allowance under Pt VI of the Ordinance in respect of the same capital expenditure.

For more on the building refurbishment deduction for profits tax purposes, refer to ¶6-5620.

ALLOWANCES FOR MACHINERY OR PLANT

¶7-2600 "Machinery or plant"

The Ordinance does not define "machinery or plant." Therefore, the words are given their ordinary meaning. It is normally obvious when an item constitutes "machinery." Whether or not an item constitutes "plant" is more difficult to determine.

"Plant" has been described as the apparatus used by a business person for carrying on his business (*Yarmouth v France* (1887) 19 QBD 647). Plant should not be confused with trading stock which is bought for sale. Rather, a taxpayer's "plant" is the goods and chattels which he or she keeps for the purpose of permanent employment in his or her business (*Yarmouth*). The phrase "permanent employment" does not mean that only very long lasting goods are plant. Only some degree of durability is necessary. A life of more than two years is probably

sufficient (see *Hinton (Inspector of Taxes) v Maden and Ireland Ltd* (1959) 38 TC 391).

An important distinction exists between "plant" and the building or structure in which it is housed. It is the frontier between the two that has given rise to the most difficulties. The English courts have distinguished between "plant" and the "setting" into which plant is placed. An asset will normally be regarded as "plant" if it has a functional use in furthering the trade as opposed to simply functioning as premises or a part of the "setting" (*Wimpy International Ltd v Warland (Inspector of Taxes)* (1989) BTC 58). The two, however, are not mutually exclusive. There is only a very fine line of difference. For example, light fittings in restaurants and hotels designed to create atmosphere or ambience are treated as "plant" (*IRC v Scottish and Newcastle Breweries Ltd* (1982) BTC 187). Ordinary lighting, however, is regarded as part of the setting (*J Lyons & Co Ltd v A-G* (1944) Ch 281).

In special cases, premises may be classified as "plant." A dry dock and a swimming pool have both been regarded as "plant." The dry dock, because it performed an active role of removing and returning ships to the water (*IRC v Barclay Curle & Co Ltd* (1969) 45 TC 221). The swimming pool, because it performed a function and was not a mere container (*Cooke (Inspector of Taxes) v Beach Station Caravans Ltd* (1974) 49 TC 514).

The patients' medical records kept in a medical practice may be "plant", but not for the goodwill of the medical practice (*Case* I87 (2000) HKRC ¶80-656 (*D23/99*)).

Buildings which do more than provide convenient housing, premises or setting for an operation may be classified as "plant." Mining buildings which played a part in the manufacturing process have been regarded as "plant" (*FC of T v Broken Hill Pty Co Ltd* 69 ATC 4028), and a dyehouse was classified as "plant" because the Court considered that it was an essential part of the efficient and economic operation of the taxpayer's business (*Wangaratta Woollen Mills Ltd v C of T* (1969) 43 ALJR 324).

This does not mean, however, that a purpose-built building will automatically be regarded as "plant." If it functions as part of the premises, it is not "plant" but remains the place where the business is carried on and is not something with which the business is carried on (*Wimpy International Ltd* per Fox LJ at p 97).

In *Carr (Inspector of Taxes) v Sayer* (1992) BTC 286, the taxpayer carried on the business of providing quarantine kennels for dogs and cats and had constructed a number of permanent kennels specifically for

that purpose. Nicholls V-C, finding that the kennels were not "plant", commented (at p 292) that:

> "A purpose-built building, as much as one that is not purpose-built, *prima facie* is no more than premises in which the business is conducted."

Referring to the *Wimpy International Ltd* and *Carr* cases, the Court of Appeal in *Gray (Inspector of Taxes) v Seymours Garden Centre (Horticulture)* (1995) BTC 320 ruled that a glasshouse which was specially constructed to preserve plants for sale was not "plant." Neither the fact that the glasshouse provided the function of nurturing and preserving the plants nor the fact that it was a purpose-built structure was enough to say that it was "plant." It was simply the premises in which the business was carried on.

The fact that a structure performs the function of premises particularly well does not change the structure from being premises in which business or trade is carried on to being "plant" with which the business is carried on. Thus, in *Attwood (Inspector of Taxes) v Anduff Car Wash Ltd* (1996) BTC 44, a car wash site and building which incorporated sophisticated car washing machinery and controls did not qualify as "plant."

The roof of a building does not qualify as "plant" since it is an integral part of the building. A sign attached to a roof, however, does qualify as "plant" and, provided that a separate cost can be attributed to the structure comprising the sign, it will qualify for capital allowances (*Case* D19 (1994) 1 HKRC ¶80-269 (*D36/93* IRBRD Vol 8, 301)).

In *Case* O25 (2005) HKRC ¶81-081 (*D52/04*), the taxpayer was a barrister in Hong Kong and argued that he should be entitled to depreciation allowance under s 39B of the *Inland Revenue Ordinance* in respect of four paintings (the "Paintings") hung on the walls of his chambers. The issue for the Board was whether the Paintings were plant for the purposes of producing profit for the taxpayer's practice, and as such, justifying the allowance of the cost of provision of the Paintings when computing the amount of the taxpayer's deductible chamber management fees under s 39B of the *Inland Revenue Ordinance*.

Although the Board accepted that the Paintings were decorative items that embellished the interior of the taxpayer's chambers, the taxpayer had failed to prove that, in his practice as a barrister, the Paintings were purchased to provide an atmosphere or ambience for the purposes of producing profit or promotion of the taxpayer's practice. In addition, the Board was not convinced of the existence of a convention for senior barristers to spend on paintings and

decorations in order to promote their practice and to generate greater profits. As such, the Board dismissed the taxpayer's appeal and held that the taxpayer had not discharged the burden of showing that the Paintings were plant for the purposes of promoting his practice as a barrister and/or for the purposes of generating profits.

¶7-2700 Items which qualify as "machinery or plant"

The expression "machinery or plant" is deemed to include the following items:

- air-conditioning plant;
- bank safe deposit boxes, doors and grills;
- broadcasting transmitters;
- cables (electric);
- lamp standards (street) — gas or electric;
- lifts and escalators (electric);
- mains (gas and water);
- oil tanks;
- shipping — ships, junks, sampans, lighters, tugs, launches, ferry vessels, hydrofoils and outboard motors;
- sprinklers;
- domestic appliances;
- furniture (excluding soft furnishings);
- room air-conditioning units;
- taxi meters;
- type and blocks (if not dealt with on renewals basis);
- aircraft (including engines);
- bar syphon apparatus;
- bicycles;
- bleaching and finishing machinery and plant;
- concrete pipe moulds;
- electric cookers and kettles;

- electronic data processing equipment;
- electronics manufacturing machinery and plant;
- motor vehicles;
- plastic manufacturing machinery and plant including moulds;
- silk manufacturing machinery and plant;
- sulphuric and nitric acid plant;
- tank lorries;
- textile and clothing manufacturing machinery and plant;
- tractors, bulldozers and graders;
- weaving, spinning, knitting and sewing machinery; and
- machinery used for purposes of a transport, tunnel, dock, water, gas or electric undertaking or a public telephone or public telephone service (*Inland Revenue Rules*, r 2(1)).

The Inland Revenue Department has indicated that the following items also qualify as plant or machinery (DIPN No 7 (Revised), Appendix B):

- design and process plans (for the construction of a machine to be used in the production of the saleable product of the taxpayer);
- display platforms;
- First Registration Tax (paid on acquisition of a new motor vehicle);
- iron gates (where not an integral part of a building or structure);
- office partitioning (where not an integral part of a building or structure); see also *Jarrold (Inspector of Taxes) v John Good & Sons Ltd* (1963) 40 TC 681;
- poster-boards (advertisement hoardings);
- sign-boards;
- dry docks; see also *IRC v Barclay Curle & Co Ltd* (1969) 45 TC 221;
- lighting and decor items installed to provide atmosphere or ambience in, but not forming an integral part of, licensed premises such as hotels and restaurants whose trade includes the provision of "atmosphere" or "ambience"; see also *Leeds*

Permanent Building Society v Procter (Inspector of Taxes) (1982) BTC 347; and

- barrister's books; see also *Munby v Furlong (Inspector of Taxes)* (1977) 50 TC 491.

The following items have been characterised as machinery or plant:

- **Knives and lasts** — with an average life span of three years, used on a shoe manufacturer's machines (*Hinton (Inspector of Taxes) v Maden and Ireland* (1959) 38 TC 391).
- **Concrete silos** — for holding grain in a particular position to facilitate delivery (*Schofield (Inspector of Taxes) v R & H Hall Ltd* (1975) 49 TC 538).
- **Permanent swimming pool** — because it performed a function and was, therefore, more than a container (*Cooke (Inspector of Taxes) v Beach Station Caravans Ltd* (1974) 49 TC 514).
- **Trunking** — for telephone system; **equipment and wiring** for heating and ventilation, **clocks, cash registers, burglar alarms, smoke detectors** and other apparatus; transformers and associated switchgear; main **electrical switchboard; window panels, external signs, kitchen equipment** and ancillary wiring (*Cole Bros Ltd v Phillips (Inspector of Taxes)* (1982) BTC 208).
- A **sign** — attached to a roof of a building (*Case* D19 (1994) 1 HKRC ¶80-269 (*D36/93*)).

¶7-2800 Items excluded from "machinery or plant"

The following items, according to the Inland Revenue Department, do not qualify as machinery or plant (DIPN No 7 (Revised), Appendix C):

- acoustic tile ceilings (installed as an integral part of a building);
- ceiling lighting points;
- cocklofts;
- fish ponds and fish storage barge;
- shop fronts, fixed wall and floor coverings, suspended ceilings, raised floors, balustrades and stair;
- telephone cable and wiring (installed as an integral part of a building);

- wiring and electrical fixtures and fittings (installed as an integral part of a building);
- car parks and piers;
- canopies over petrol-filling stations; and
- car-wash halls (i.e. buildings housing washing and control equipment).

The following articles are prescribed by the Board of Inland Revenue (*Inland Revenue Rules*, r 2), to be "implements, utensils and articles" and are excluded from the expression "machinery or plant":

- belting;
- crockery and cutlery;
- kitchen utensils;
- linen;
- loose tools; soft furnishings (including curtains and carpets);
- surgical and dental instruments; and
- tubes for X-ray and infra-red machines (*Inland Revenue Rules*, r 2(1)).

Although no depreciation allowance is available for these items and any initial expenditure is disallowed as capital expenditure (*D12/86* IRBRD Vol 2, 245), the cost of replacing the items is fully deductible from a taxpayer's profits under s 16(1)(f) (see ¶6-5220).

Wharves are also specifically excluded from machinery or plant (*Inland Revenue Rules*, r 2(3)) and, therefore, can only qualify for allowances as industrial structures (see ¶7-0300ff).

Assets which have not qualified as machinery or plant include the followings:

- A **new concrete stand at a football club**, because it was not part of the apparatus with which the club carried on its trade (*Brown (Inspector of Taxes) v Burnley Football and Athletic Co Ltd* (1980) 53 TC 357).
- A **ship** bought and adapted as a restaurant, because it constituted premises (*Benson (Inspector of Taxes) v Yard Arm Club Ltd* (1979) 53 TC 67).
- The **roof or shelter** over the service area of a garage, because it merely gave protection from the weather and was not functional in supplying petrol (*Dixon (Inspector of Taxes) v Fitch's Garage*

Ltd (1975) 50 TC 509). (Note, however, that this decision was criticised in subsequent cases: see *IRC v Scottish and Newcastle Breweries Ltd* (1982) BTC 187; *Coles Bros Ltd v Phillips (Inspector of Taxes)* (1982) BTC 208.)

- A **false ceiling** installed by caterers to conceal pipes and wiring, because it was characterised as part of the premises (*Hampton (Inspector of Taxes) v Fortes Autogrill Ltd* (1980) 53 TC 691).
- **Electric lamps** installed for general illumination, and therefore forming part of the setting (*J Lyons & Co Ltd v A-G* (1944) Ch 281).
- **Acoustic ceilings** and **electrical installations** which were found to have no special function (*Imperial Chemical Industries of Australia and New Zealand Ltd v FC of T* (1970) 120 CLR 396).
- The **roof of a building** because it was an integral part of the building (*Case* D19 (1994) 1 HKRC ¶80-269 (*D36/93* IRBRD Vol 8, 301)).
- A specially constructed **glasshouse**, because it was simply the premises in which the taxpayer's business was carried on. The fact that it was purpose-built to nurture and preserve plants prior to their sale was not enough to say it was "plant" (*Gray (HM Inspector of Taxes) v Seymours Garden Centre (Horticulture)* (1995) BTC 320).
- A **car wash site and building** incorporating car washing machinery and control equipment, because, notwithstanding their sophisticated design, the site and building constituted premises (*Attwood (HM Inspector of Taxes) v Anduff Car Wash Ltd* (1996) BTC 44).
- A **share of the facilities** in a building, because there was no evidence as to what capital expenditure had been incurred for the provision of what share of machinery or plant (*Case* H21 (1998) HKRC ¶80-529 (*D49/97* IRBRD Vol 12, 324)).

¶7-2900 Calculation of allowances — the pooling system

A pooling system is applied to calculate initial and annual allowances (and balancing allowances and charges; see ¶7-5200) for machinery and plant. Under the pooling system, items are fitted into a class, and then, the allowance (or charge) is calculated on that class as a whole.

This system has been applied since the year of assessment 1980/81 and is designed to make the calculation of allowances (and balancing allowances or charges) as simple as possible by minimising the number of calculations involved. Previously, the allowances for plant and machinery were calculated individually for each of the taxpayer's separate assets. The former system is still employed in certain circumstances (see ¶7-3400).

> For an example of the calculation of allowances for plant and machinery under the pooling system, see ¶7-3300.

As an alternative to claiming allowances, capital expenditure on research and development relating to the taxpayer's trade, profession or business (as described in s 16B(1)(b)) or capital expenditure on prescribed fixed assets (as described in s 16G); see ¶6-5420 and ¶6-5660 respectively (s 39B(1)) are deductible from the taxpayer's assessable profits under Pt IV of the Ordinance at the time these expenditures are incurred.

¶7-3000 Initial allowance for capital expenditure

An initial allowance is available to any taxpayer carrying on a trade, profession or business who incurs capital expenditure (see ¶7-3100) on the provision of machinery or plant (see ¶7-2600) for the purposes of producing assessable profits (s 39B(1)).

Amount of allowance

The amount of the initial allowance to which a taxpayer is entitled is equal to the following percentages of the total capital expenditure incurred by the taxpayer on plant or machinery in the relevant year (s 39B(1A)):

Year of Assessment	*Percentage Allowance*
1980/81	35%
1981/82 to 1988/89	55%
1989/90 and following	60%

Entitlement to allowance

The taxpayer's machinery or plant need not have been used in the relevant basis period in order for an initial allowance to be made. It is enough that capital expenditure was incurred while the taxpayer was carrying on a trade, profession or business. Additionally, a taxpayer who claims an initial allowance for plant or machinery need not be

the owner of the asset. An allowance can be claimed for a contribution to the cost of an asset, provided that the taxpayer has the use of it.

However, the taxpayer is not entitled to initial allowance for those assets that were brought into the business after non-business use (DIPN No 7 (Revised), para 26).

Timing of allowance

As initial allowance is allowed for capital expenditure "incurred", it is not limited to sums actually paid. Where a contractual obligation exists, the due date for payment of deposits, instalments, etc, will be regarded as the date when the expenditure is incurred, even if actual payment occurs at a later date. However, unless the deposit or advance payment is non-refundable in respect of a binding purchase contract, it may still be regarded as merely a contingent liability, and no allowance can be made.

If no written contract is available, the date of delivery of the plant or machinery is normally taken to be the date on which the expenditure is incurred (DIPN No 7 (Revised), para 17).

¶7-3100 Qualifying capital expenditure

"Capital expenditure" for which an initial allowance may be granted includes any interest paid and any commitment fees incurred in connection with a loan made for the purpose of financing the provision of machinery or plant (s 40(1)). Specifically excluded from the definition of "capital expenditure" are grants, subsidies or any other financial assistance paid to the taxpayer who incurred the expenditure, and any amount deductible under the profits tax provisions of the Ordinance (s 40(1)).

What is being included in the interpretation of capital expenditure provided in s 40(1) is not exhaustive. Attention must also be paid to general principles (see ¶6-6120 for more on identifying capital expenditure).

The expression "capital expenditure on the provision of machinery or plant" includes any capital expenditure incurred on alterations made to an existing building incidental to the installation of machinery or plant for the purposes of the taxpayer's trade, profession or business (s 40(1)).

In this regard, the qualifying capital expenditure is the net cost of acquisition of the asset, which is represented by the supplier's price, plus any charges relating to freight, insurance, delivery, import

duties, etc, and less any discounts, rebates, subsidies, etc, accorded to the purchaser (DIPN No 7 (Revised), para 6).

Capital expenditure incurred prior to commencement of business

Where a person carries on a trade and incurs capital expenditure on the provision of assets for a new trade about to be commenced, the expenditure is regarded as if it were incurred on the day that the new trade commences (s 40(2)). Accordingly, capital allowances are deductible against the profits of the new trade once it has commenced, but not against those of the taxpayer's existing trade (DIPN No 7 (Revised), para 11).

Where a person ceases to carry on a particular trade and transfers machinery or plant previously used in it to another trade which he or she carries on, it is not considered that the person is entitled to claim more than one annual allowance in respect of that machinery or plant for any one year of assessment. This is because the allowance is granted to the "person", and not to the "trade" (DIPN No 7 (Revised), para 12).

Basis period

The basis period for the purpose of calculating capital allowances is generally the same as that of computing assessable profits, other than these two specified exceptions (s 40(1)):

- where two basis periods overlap, the period common to both is deemed to fall into the first period only; and
- where there is an interval between the end of the basis period for one year of assessment and the beginning of the basis period for the next succeeding year of assessment, the interval is deemed to fall into the second basis period.

¶7-3200 Annual depreciation allowance

An annual depreciation allowance is available for wear and tear on machinery or plant owned and used for purposes of producing assessable profits in an assessment year (s 39B(2)). Unlike the old system, there is no requirement for an annual allowance under the pooling system that the asset must be owned and in use at the end of the basis period.

Under the pooling system (see ¶7-2900), the taxpayer's various items of machinery or plant are fitted into various classes according to the

rates of depreciation prescribed by the Board of Inland Revenue (see ¶7-3300). Machinery or plant to which the same rate applies makes up a class. Annual allowances are granted for each class (s 39B(2)). An allowance is computed on the "reducing value" of the relevant class of machinery or plant (s 39B(3)).

> For an example of the calculation of annual allowances under the pooling system, see ¶7-3300.

Reducing value

The reducing value of a class of machinery or plant is the total capital expenditure incurred on its provision, reduced by:

- the aggregate of any initial or annual allowances already made for plant or machinery belonging to the class (under either the pooling system or the former individual item system; see ¶7-3400);
- any sale, insurance, salvage or compensation moneys received for machinery or plant belonging to the class; and
- the estimated open market value of any machinery or plant which is not used wholly and exclusively in the production of assessable profits and so falls outside the pooling system in accordance with s 39C(3) (s 39B(4)).

Any machinery or plant which was the subject of a balancing allowance or charge (see ¶7-5000) before 7 November 1980 is excluded from the relevant class of machinery and plant for the purposes of determining the reducing value (s 39B(5)).

When a taxpayer succeeds to any trade, profession or business which was carried on by another person, and the machinery or plant used in the production of assessable profits is not sold to the successor, the reducing value of the machinery or plant is taken as the reducing value of the assets which is still unallowed to the seller at the time of succession (s 39B(7)). In a case where reductions from the aggregate capital expenditure incurred on the class of machinery or plant exceed the expenditure, no allowance is made (s 39B(9)).

Reducing value when asset not initially used to produce assessable profits

When machinery or plant is owned and used by a taxpayer for a period before it is used in the production of assessable profits, the

capital expenditure incurred on its provision is computed, for the purpose of calculating the asset's reducing value, by deducting a notional amount from the actual cost (s 39B(6)). The notional amount deducted is equivalent to the amount of annual allowances which would have been allowed if the owner had used the machinery or plant for the purpose of producing assessable profits from the time of its acquisition.

Example

X Ltd acquired a machine in 2015 for a cost of $500,000. Its accounts are made up to 31 December. The machine was used but not used in the production of assessable profits until mid-2018. The depreciation rate applicable to the machine is 20%. The capital expenditure incurred on its provision would be determined as follows:

		$
Original cost		500,000
LESS		
		$
2015/16 notional annual allowance ($500,000 × 20%)	–	100,000
		400,000
LESS		
2016/17 notional annual allowance ($400,000 × 20%)	–	80,000
		320,000
LESS		
2017/18 notional annual allowance ($320,000 × 20%)	–	64,000
		256,000
EQUALS		
Adjusted capital expenditure for 2018/19	=	256,000

¶7-3300 Rates of depreciation

Rates of depreciation for various types of plant and machinery are specified in the *Inland Revenue Rules* (r 2) as follows:

Plant or machinery	*Rate of depreciation*
10% Class (or Pool)	
Air-conditioning plant (excluding room air-conditioning units)	10%
Bank safe deposit boxes, doors and grills	10%

Plant or machinery	*Rate of depreciation*
Broadcasting transmitters	10%
Cables (electric)	10%
Lamp standards (street) — gas or electric	10%
Lifts and escalators (electric)	10%
Mains (gas and water)	10%
Oil tanks	10%
Shipping — ships, junks, sampans, lighters, tugs	10%
Sprinklers	10%
Machinery used for purposes of a transport, tunnel, dock, water, gas or electric undertaking or a public telephone or public telephone service	10%
20% Class (or Pool)	
Domestic appliances	20%
Furniture (excluding soft furnishings)	20%
Room air-conditioning units	20%
Shipping — launches, ferry vessels, hydrofoils	20%
Taxi meters	20%
Type and blocks (if not dealt with on renewals basis)	20%
30% Class (or Pool)	
Aircraft (including engines)	30%
Bar syphon apparatus	30%
Bicycles	30%
Bleaching and finishing machinery and plant	30%
Concrete pipe moulds	30%
Electric cookers and kettles	30%
Electronic data processing equipment	30%
Electronics manufacturing machinery and plant	30%
Motor vehicles	30%
Plastic manufacturing machinery and plant including moulds	30%
Shipping — outboard motors	30%
Silk manufacturing machinery and plant	30%
Sulphuric and nitric acid plant	30%
Tank lorries	30%
Textile and clothing manufacturing machinery and plant	30%
Tractors — bulldozers and graders	30%
Weaving, spinning, knitting and sewing machinery	30%

Any machinery or plant not specifically mentioned in the above list should be depreciated at the rate of 20%.

In exceptional circumstances, for example if the plant or machinery has a very short life, the Commissioner may exercise his discretion and set a depreciation rate higher than that prescribed by the Board of Inland Revenue (s 39B(11)). That machinery or plant would then fall into a class of its own for the purposes of the pooling system.

Note that a profits tax deduction for capital expenditure incurred on prescribed fixed assets is available under s 16G. Under this section, taxpayers can write off 100% of their capital expenditure on prescribed fixed assets.

See ¶6-5600 for the definition of prescribed fixed assets and more details on this deduction.

Example

X Ltd is a textile manufacturing company. The written-down values of its various classes (or pools) of plant and machinery brought forward to 2018/19 from 2017/18 are as follows:

	Written-down values $
Motor vehicles (30% Class)	800,500
Air-conditioning units and office furniture (20% Class)	250,000
Lifts and air-conditioning plant (10% Class)	120,000

X Ltd makes up its accounts to 31 December. Assume that in the period up to 31 December 2018, X Ltd:

- sells a motor vehicle for $70,000;
- sells office furniture for $5,000 (which originally cost $4,750); and
- buys another motor vehicle for $50,000.

The capital allowances to which X Ltd is entitled for 2018/19, and the reducing value to be carried forward to 2019/20, would be determined as follows:

Limitation

A taxpayer cannot claim an allowance for capital expenditure on plant or machinery under s 37 if a deduction has been allowed for the same capital expenditure for profits tax purposes on the basis that it is capital expenditure on research and development under s 16B(1)(b) or capital expenditure on prescribed fixed assets under s 16G (s 37(1), 37(3)).

Where taxpayer has ceased to use plant or machinery wholly and exclusively to produce profits

Where any machinery or plant which qualifies for allowances under the pooling system has ceased to be used wholly and exclusively in the production of assessable profits, the non-pooling system is applied to calculate the allowances available for the relevant asset in the year of assessment in which the cessation of use occurred (s 39C(3)).

The annual depreciation allowance is calculated at the rates set out in the *Inland Revenue Rules* (r 2; see ¶7-3300) on the reducing value of the particular machinery or plant. The "reducing value" in this situation is the amount which the Commissioner considers the machinery or plant would have realised if it had been sold in the open market at the time it ceased to be used for the production of profits.

¶7-3500 Allowance for plant or machinery acquired under hire-purchase

Initial and annual allowances are granted for machinery or plant acquired under a hire-purchase agreement. The allowances, however, are calculated separately from the pool of the taxpayer's plant. A "hire-purchase agreement" is defined as an agreement for the bailment of goods under which the property in the goods will, or may, pass to the bailee (s 2(1)).

Initial allowance for capital expenditure

The initial allowance for an item of plant or machinery bought by hire-purchase is spread over the period in which the taxpayer pays instalments. An initial allowance is made to the taxpayer for each year of assessment in which an instalment is paid (s 37A(1)). The amount of the initial allowance is calculated as a percentage of the capital portion of the instalment payment. The percentage allowances for different years of assessment are as follows (s 37A(1A)):

Year of Assessment	*Percentage Allowance*
Up to and including 1973/74	20%
1974/75 to 1979/80	25%
1980/81	35%
1981/82 to 1988/89	55%
1989/90 and following	60%

Example — Initial allowances for asset bought by hire-purchase

R Ltd entered into a hire-purchase agreement on 1 September 2018 to purchase machinery to be used in the course of the company's plastic product manufacturing business for the purpose of producing profits. R Ltd agreed to pay $624,000 for the machinery (the cash price of which was $480,000) in 24 equal monthly instalments of $26,000. Each instalment was comprised of a capital element of $20,000 and a revenue element of $6,000. R Ltd's accounts are made up to 31 March

Initial allowances would be available and calculated as follows:

	$
2018/19	
Capital element of instalments for 2018/19 (7 months × $20,000)	140,000
Initial allowance (60% × capital element)	84,000
(Interest element (7 × $6,000) deductible from R Ltd's profits as a revenue expense under s 16; see further ¶6-4600)	
2019/20	
Capital element of instalments for 2019/20 (12 months × $20,000)	240,000
Initial allowance (60% × capital element)	144,000
(Interest element (12 × $6,000) deductible)	
2020/21	
Capital element of instalments for 2020/21 (5 months × $20,000)	100,000
Initial allowance (60% × capital element)	60,000
(Interest element (5 × $6,000) deductible)	

Annual depreciation allowance

An annual allowance for wear and tear is granted for plant or machinery acquired under a hire-purchase agreement. The allowance is calculated on the reducing value of the machinery or plant at the rates prescribed by the Board of Inland Revenue (see ¶7-3300)

For more details on the deductions for specific capital expenditure incurred in relation to environmental protection facilities, refer to ¶6-5720.

LEASING ARRANGEMENTS

¶7-4000 Availability of allowances restricted

Section 39E restricts the availability of initial and annual allowances for machinery or plant in the case of taxpayers who have entered into certain lease arrangements. Section 39E, introduced into the *Inland Revenue Ordinance* to prevent revenue loss, denies initial and annual allowances to lessors of plant or machinery:

- when the plant or machinery has been purchased from and leased back to the same person (see ¶7-4200ff);
- when a lease arrangement has been entered into in relation to plant or machinery (except ships or aircraft) and the asset is used principally or wholly outside Hong Kong;
- when a lease arrangement has been entered into in relation to a ship or aircraft and the lessee is not an operator of a Hong Kong ship or aircraft; or
- when the asset was acquired through a leverage lease transaction, financed by a "non-recourse debt" (see ¶7-4400ff).

¶7-4100 Meaning of "lease"

For the purposes of s 39E, a "lease" includes any arrangement by which a right to use machinery or plant is granted to a person by the owner (s 2(1)). The term also covers arrangements under which the right to use machinery or plant may be successively granted by the lessee to another person.

Hire-purchase agreements and conditional sale agreements are deemed not to fall within the definition of "lease" unless the Commissioner believes that the right to purchase or obtain the property under the relevant agreement would not reasonably be expected to be exercised (s 2(1)). Lessors, therefore, are normally not precluded from claiming capital allowances when such agreements have been entered into.

For the purposes of s 39E, a "hire-purchase agreement" is defined as an agreement for the bailment of goods under which the bailee may buy the goods, or under which the property in the goods may pass to the bailee (s 2(1)). A "conditional sale agreement" is defined as an

agreement for the sale of goods under which the purchase price, or part of it, is payable by instalments and the property in the goods must remain with the seller, even if the buyer has possession of the goods, until conditions specified in the agreement have been fulfilled (s 2(1)).

Lease or purchase agreement?

It is important to draw a distinction between a lease and a purchase agreement. Assessors will carefully consider whether payments made by a "lessee" are lease rentals or whether they are, in substance, consideration for the sale of goods purported to be leased (DIPN No 15 (Revised), para 63).

The following factors are considered when determining whether an agreement is a lease:

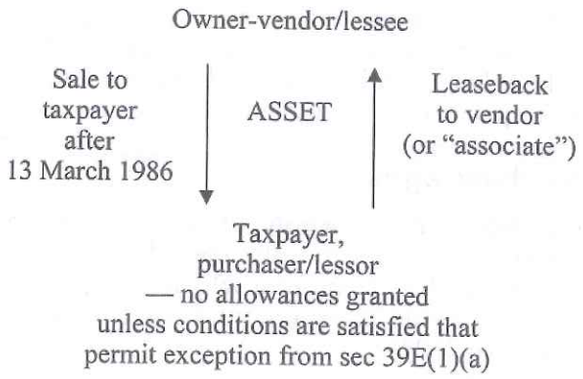
- Do any express or implied agreements exist (whether in the lease agreement or in a subsidiary document or correspondence) under which property in the goods would pass from the lessor to the lessee?
- Does the "residual value" of the goods represent their reasonable commercial value at the expiry date of the lease? (The "residual" value is the lessor's anticipated sale price at the end of the lease, from which the amount of monthly lease rentals is usually determined.)

An agreement will generally be regarded as a purchase agreement if the lessee has a right or option to purchase the goods. However, if the Commissioner accepts that such right or option would reasonably be expected not to be exercised, then such an agreement is a lease as defined, notwithstanding its form. An agreement is accepted as a lease only if the lessee does not have an obligation, right or option to purchase the goods during the term of the lease or at its end (DIPN No 15 (Revised), para 65).

SALE AND LEASEBACK

¶7-4200 Denial of allowances after sale and leaseback

No initial or annual allowances are granted to a taxpayer who incurs capital expenditure on the acquisition of machinery or plant for the purpose of producing profits if the machinery or plant is subsequently leased back to the person, or an associate of the person, who owned and used the asset before it was acquired by the taxpayer (s 39E(1)(a)).



"Acquisition" means acquisition as an owner and includes hiring or holding under a hire-purchase agreement or holding as a purchaser if the hire-purchase agreement is a conditional sale agreement. In the absence of a written contract of acquisition, the relevant date is fixed by referring to the established rules of offer and acceptance.

Meaning of "owned and used"

The term "owned" is not defined for the purposes of s 39E but, in practice, is given its ordinary meaning. The word "used" is defined to include "held for use" which means installed ready for use or held in reserve (s 39E(5)). Consequently, even if machinery or plant which was formerly owned by the lessee had not been used, but had been installed and ready for use by him or her, s 39E would apply to deny the granting of allowances to the purchaser/lessor.

Meaning of "associate"

The term "associate" is very broadly defined in order to prevent the circumvention of s 39E by the interposition of third parties. An "associate" of a lessee, or of a person deemed to be holding rights as a lessee, is:

- If the lessee is a natural person:
  - a relative of the lessee;
  - a partner of the lessee, or a relative of the partner;
  - a partnership in which the lessee is a partner;
  - a corporation controlled by a lessee or any of the persons listed above; or
  - a director or principal officer of such a corporation.

- If the lessee is a corporation:
  - an associated corporation (see below);
  - a person who controls the corporation, or a partner of such person, or a relative of the controller or partner;
  - a director or principal officer of the corporation (or any associated corporation), or a relative of that director or officer; or
  - a partner of the corporation, or a relative of a partner.
- If the lessee is a partnership:
  - any partner, and if a partner is a partnership, any partner of that partnership;
  - any partner with the partnership in any other partnership, and if that partner is a partnership, any partner of that partnership;
  - any relative of any partner;
  - a corporation controlled by the partnership, or by a partner or any relative of a partner;
  - a director or principal officer of such a corporation; or
  - a corporation of which any partner is a director or principal officer.

The scope of the term "associate" was expanded to include associates of persons deemed to be holding rights as lessees with effect from 13 March 1992.

An "associated corporation" is either a corporation over which the lessee has control, a corporation which has control over the lessee, or a corporation under the same control as the lessee (s 39E(5)). From 13 March 1992, the definition of "associated corporation" was also expanded to include corporations controlled by, controlling, or under the same control as a person deemed to be holding rights as a lessee. "Control" in relation to a corporation means the power of a person to ensure that the affairs of the corporation are conducted in accordance with their wishes. This may be achieved by holding shares, or possessing voting power in the corporation or any other corporation, or by virtue of powers conferred by the articles of association or other documents regulating the corporation or any other corporation (s 39E(5)).