Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Annual Meeting

The Inland Revenue Department

and

The Hong Kong Institute of Certified Public Accountants

2019
ANNUAL MEETING BETWEEN
THE INLAND REVENUE DEPARTMENT AND
THE HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Preamble

As part of the Institute's regular dialogue with the government to facilitate tax compliance, improve procedural arrangements and to clarify areas of interpretation, representatives of the Institute met the Commissioner of Inland Revenue (CIR) and members of his staff in May 2019.

As in the past, the agenda took on board items received from a circulation to members of the Institute prior to the meeting. The minutes of the meeting, prepared by the Inland Revenue Department (IRD) are reproduced in full in this Tax Bulletin and should be of assistance in members' future dealings with the IRD. Part A contains items raised by the Institute and Part B, items raised by IRD.

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2019
ANNUAL MEETING BETWEEN
THE INLAND REVENUE DEPARTMENT AND
THE HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Full Minutes

The 2018/19 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department was held on 10 May 2019 at the Inland Revenue Department.

In Attendance

Hong Kong Institute of Certified Public Accountants (the Institute)

Mr KK So	Chair, Taxation Faculty Executive Committee
Mr Curtis Ng	Deputy Chair, Taxation Faculty Executive Committee
Ms Sarah Chan	Member, Taxation Faculty Executive Committee
Ms Agnes Cheung	Member, Taxation Faculty Executive Committee
Ms Jo An Yee	Member, Taxation Faculty Executive Committee
Ms Cecilia Lee	Member, China Tax Sub-committee
Mr Peter Tisman	Director, Advocacy and Practice Development
Mr Eric Chiang	Deputy Director, Advocacy and Practice Development
Mr Nicolas Cheng	Associate Director, Advocacy and Practice Development

Inland Revenue Department

Mr Wong Kuen-fai	Commissioner of Inland Revenue
Mr Chiu Kwok-kit	Deputy Commissioner of Inland Revenue (Technical)
Mr Tam Tai-pang	Deputy Commissioner of Inland Revenue (Operations)
Mr Yim Kwok-cheong	Assistant Commissioner of Inland Revenue
Ms Fong Wai-hang	Assistant Commissioner of Inland Revenue
Mr Leung Kin-wa	Acting Assistant Commissioner of Inland Revenue
Mrs Wong Yu Sui-ying	Chief Assessor (Tax Treaty)1
Mr Chan Sze-wai	Chief Assessor (Tax Treaty)2
Ms Hui Chiu-po	Senior Assessor (Research)

Mr Wong Kuen-fai (CIR) welcomed the representatives of the Institute to the meeting and thanked the Institute's support for the past year. CIR introduced the IRD officers in attendance, in particular two officers, Mr Leung and Mr Chan, who attended the meeting for the first time. Mr So on behalf of the Institute's Tax Faculty thanked CIR for arranging the annual meeting. He expressed that the Institute always treasured the annual meeting which served as a valuable platform of communication on issues of common interest. He remarked that the questions put forward by the Institute this year had been sharpened and trimmed down with a view to convening the meeting in more efficient manner. CIR appreciated the efforts made by the committee members of the Tax Faculty in preparing the agenda for this year's meeting. The meeting then proceeded to discussion of the agenda items raised by both sides.

PART A - MATTERS RAISED BY THE INSTITUTE

Agenda Item A1 - Profits Tax Issues

(a) Taxability of revenue recognized for customized goods manufactured under Hong Kong Financial Reporting Standard (HKFRS) 15

According to HKFRS 15, a manufacturing entity recognizes revenue on an over time recognition basis if:

- the entity is manufacturing customized goods for its customer and those goods have no alternative use to the entity; and
- the entity has an enforceable right to payments for the work completed to date (the right to payments for work completed to date should at least include a reasonable mark-up on the cost incurred if the contract is terminated by the customer or another party for reasons other than the entity's failure to complete its obligation).

The accounting principle here is the manufacturer recognizes revenue to depict the transfer of control of the promised goods or services to customers. If the manufacturer has no alternative use for the customized goods and the customer is required by law to compensate the manufacturer for all work completed up to the point of cancelling the contract, HKFRS 15 would deem that the manufacturer transfers control of the customized goods to the customer over the period of manufacturing.

In a case that a manufacturing entity is manufacturing goods for the buyers, there is no alternative use of the goods. In addition, there is a compensation provision in the contract between the manufacturing entity and the buyer that when the buyer terminates the contract premature unilaterally, the manufacturing entity would have an enforceable right to recover from the buyer the cost incurred plus a reasonable mark-up.

If there is no premature termination of contract, the manufacturing entity would only issue invoice to the buyer when the goods are delivered to the buyer. This is the point of time (the triggering point) when the manufacturing entity could collect payments from the buyer in relation to the finished goods.

In this scenario, the manufacturing entity recognizes revenue based on an over time recognition basis. Accordingly, where there is no premature termination of contract, revenue would likely be ahead of the triggering point.

The Institute would like to seek the IRD's views on the following question-

Making reference to the decision of the *Nice Cheer* case, should the revenue be only subject to tax in the hands of the manufacturing entity when it could collect payments from the customers as a result of goods delivery (i.e. the triggering point) but **not** when it recognizes revenue based on the over time recognition basis?

CIR referred to the established tax law principle that the profits computed in accordance with the generally accepted accounting standards formed the basis for computing the assessable profits chargeable to profits tax under the Inland Revenue Ordinance (IRO), unless otherwise provided in the IRO.

CIR also referred to the *Nice Cheer* case which was related to the gains arising from revaluation of trading stock of securities (before entering into any sale transaction). It was ruled that, for profits tax purposes, chargeable profits should be “actual or realized and not potential or anticipated profit”. CIR emphasized that the *Nice Cheer* case did not modify the aforesaid established legal principle.

CIR said that, in the example given, the manufacturing entity entered into business contracts with its customers to manufacture customized goods and followed HKFRS 15 to select the appropriate accounting method to recognize revenue by measuring the progress towards the complete satisfaction of the performance obligation under the business contracts. Most importantly, HKFRS 15 accepted that an entity might take into account the contract terms and customary business practices in determining the amount of consideration to which the entity expected to be entitled in exchange for transferring the promised goods or services to a customer.

CIR pointed out that the entity had based on the contract terms to quantify the revenue to be recognized in its accounts in accordance with HKFRS 15. The recognized revenue over which the entity had an enforceable right to payments for the work completed to date was not anticipated and, instead, was determined with reasonable certainty.

CIR expressed that it was the IRD’s view that the revenue recognized pursuant to HKFRS 15 (including a reasonable mark-up on the cost incurred if the contract with a customer was cancelled before the title of the tailored made goods was transferred to the customer) should be assessed in the year of recognition.

Mr Chiang pointed out that some contracts traditionally accounted for under the percentage-of-completion method would require for over-time recognition of revenue with certain new criteria under HKFRS 15 (e.g. a right to payments for the work completed to date); and in the case of non-payment by customers, the revenue would not be recognized. Mr Chiang would like to ask the IRD's view on the deductibility of bad debts in such a situation. CIR replied that bad debts would be deductible if they satisfied the deduction conditions under section 16(1)(d) of the IRO.

(b) Withholding obligations of Hong Kong payers under section 20B when an amount is accrued but not yet payable

Consider the case where the terms of a trademark licensing agreement between a non-resident person (NR Licensor) and the Hong Kong payer (HK Payer) require the HK Payer to pay royalties accrued to the NR Licensor 18 months after the relevant calendar year end. For example, the HK Payer is obliged to pay the royalties accrued for the year ended 31 December 2018 to the NR Licensor in June 2020.

According to section 15(1)(b) of the IRO, the royalties will be deemed taxable sums when the royalties accrue to or are received by the NR Licensor. According to the "accrue to" condition, the Hong Kong Payer is required to report the royalties accrued to the non-resident in the calendar year 2018 in the 2018/19 Profits Tax return – in respect of Non-Resident Persons (i.e. BIR54). Consequently, an assessment would likely be raised in the name of the HK Payer shortly after the BIR54 is filed.

The Institute would like to know:

(i) How should the term "credit" in section 20B(3) be interpreted? In particular, would an accounting credit entry for the accrual of the royalties payable in the HK Payer's books of record be considered as a "credit" for the purposes of section 20B(3)? If so, how can the HK Payer withhold any payment when no amount is contractually payable by the HK Payer to the NR Licensor at the time the accounting credit entry was made and when the tax of the NR Licensor is normally due in December 2019?

Mr Yim responded that section 20B(2) provided that a non-resident person was chargeable to profits tax in respect of the sums described in section 20B(1) (including royalties) in the name of the person in Hong Kong who paid or credited the sums to the non-resident person and the tax so charged should be recoverable from the person in Hong Kong.

Mr Yim pointed out that the HK Payer, by making a credit entry in its accounts, recognized the accrued liability to pay royalties to the NR Licensor. Section 20B(2) would apply and the NR Licensor was chargeable to tax in respect of the sums credited to him by the HK Payer.

Mr Yim said that section 20B(3) provided that the HK Payer should, at the time it made the payment or credit, deduct from the sum so much thereof as was sufficient to produce the amount of tax chargeable on the NR Licensor. The HK Payer, hence, bore the legal obligation to produce the tax chargeable on the NR Licensor when it paid or credited the sum to the NR Licensor.

(ii) Would the IRD issue a notice of assessment to the NR Licensor directly before June 2020 so that the HK Payer will not be required to withhold tax from payments to the NR Licensor?

Mr Yim replied that section 20B provided that, without prejudice to section 20A, the NR Licensor was chargeable to tax in respect of the royalties in the name of the HK Payer and the HK Payer should, at the time he made the payment or credit, deduct from the royalties so much as was sufficient to produce the amount of tax chargeable.

Mr Yim indicated that the IRD might raise an assessment under section 20A directly on the NR Licensor where circumstances warranted. Regarding the HK Payer’s legal obligation under section 20B to withhold tax, the obligation arose once it made the payment or credit to the NR Licensor. Mr Yim said that, in the generality of cases, the IRD would raise an assessment on the NR Licensor some time later. Therefore, the HK Payer could not be relieved from the legal obligation to withhold tax by any subsequent assessment raised on the NR Licensor.

(c) Timing and the amount of rental payments qualifying for tax deductions where a rent-free period is part of a lease term under HKFRS 16

The IRD confirmed in the 2017 Annual Meeting that implementation of HKFRS 16 *Leases* would have no effect on the operation of sections 16 and 17 of the IRO but the legal form and substance of the relevant contractual arrangements for a lease matter. To this end, the Institute would like to confirm the tax treatments in the following example where there is a rent-free period in the lease.

<u>Example</u>

Company A has a 3-year typical operating lease commencing from 1 January 2018 with a monthly rental of HK$20,000 and a rent-free period of 6 months. In case of early termination, Company A will be required to pay the landlord an amount equal to the rent payable for the remaining lease period.

According to HKFRS 16, the net rent payable for the lease period average out evenly over the rental period, i.e. the yearly rental payment is HK$20,000 × 30 months ÷ 3 years = HK$200,000.

If there is no early termination of the lease, the Institute would like to know what would be the deductible amount, i.e. amount charged to the profit and loss account of HK$200,000/year or based on the actual cash or contractual payment (i.e. HK$20,000 × 6 months = HK$120,000 for the first year and HK$20,000 × 12 months = HK$240,000 each year for year 2 and 3) based on the lease agreement?

> Mr Yim reiterated the IRD's views expressed at the 2017 Annual Meeting, agenda item A1(i), that the implementation of HKFRS 16 should not have any effect on the operation of sections 16 and 17 related to deductions under profits tax. Mr Yim considered that, in the example given, the amount of HK$200,000 charged to the profit and loss account in accordance with HKFRS 16 had been incurred and was deductible under profits tax.

(d) Deductibility of research and development (R&D) expenditure under Cost Sharing Arrangement (CSA) in respect of Intellectual Property (IP) owned by a headquarters

A foreign company has branches in different jurisdictions, including Hong Kong. The company undertakes R&D activities in a number of jurisdictions, to generate IPs. The company has the legal ownership of the IP, and both the head office of the company and the branches will use the IP to generate local revenue – which will be classified as income for local jurisdiction tax purpose. The branches will be allocated the share of R&D expenditure according the extent of its own R&D expenditure incurred as well as the income captured by the branch. The Hong Kong branch is one of the branches that carries out the R&D and report local income for tax purpose.

The Institute would like to clarify with the IRD the following tax treatments:

(i) Whether the Hong Kong branch is eligible for the deduction of R&D expenditure under section 16B as the IP generated is "fully vested" given that the Hong Kong branch and the headquarters are the same legal person, assuming other conditions are satisfied.

> For the treatment of R&D expenditure under a CSA, Mr Chiu suggested that the members of the Institute should make reference to paragraphs 87 to 97 of the Departmental Interpretation and Practice Notes (DIPN) 55. He took the view that it was not clear from the facts of the given scenario that there was a CSA, which carried a specific meaning, in relation to any specific R&D project. He explained that–
>
> - Revenue from IPs generated from R&D activities in Hong Kong, if not otherwise chargeable, would be charged to profits tax under section 15(1)(bc) if the corresponding R&D expenditure had been allowed for deduction.

- Under section 16(1)(gb) of the IRO, R&D expenditure under section 16B (i.e. R&D expenditure incurred by the Hong Kong branch) should be deducted to the extent to which it was incurred in the production of chargeable profits of the Hong Kong branch.

- If the Hong Kong branch did not carry out any R&D activity in Hong Kong, R&D expenditure allocated to the Hong Kong branch would not be considered for deduction.

- If the IPs concerned were used for producing both taxable and non-taxable profits, the R&D expenditure incurred by the Hong Kong branch would only be deductible to the extent that the IPs were used for producing taxable profits.

(ii) Out of the share of R&D expenditure borne by the Hong Kong branch, whether those actual expenditure incurred for the R&D activities carried out in Hong Kong will qualify for 300%/200% enhanced deduction while the remaining share of expenditure for the R&D activities carried out by other branches outside Hong Kong will qualify for 100% deduction, assuming other conditions are satisfied.

Mr Chiu responded that–

- The qualifying expenditure (i.e. expenditure in relation to employees and on consumable items) incurred by the Hong Kong branch, without any recoupment, would qualify for enhanced deductions at 300% or 200% as Type B expenditure, provided that the required conditions in Schedule 45 were satisfied.

- R&D expenditure other than qualifying expenditure incurred by the Hong Kong branch, and R&D expenditure incurred for R&D activities carried out in places outside Hong Kong but allocated to the Hong Kong branch under a CSA would qualify for 100% deduction as Type A expenditure, provided that such R&D expenditure was incurred in the production of chargeable profits of the Hong Kong branch.

Mr Chiu indicated that arm's length transfer pricing rule had to be followed in allocating the R&D expenditure to the Hong Kong branch (i.e. the R&D expenditure allocated to the Hong Kong branch had to be commensurate with the expected benefits to be obtained by it from the R&D activities). Any excessive R&D expenditure allocated would not be allowed for deduction under section 16B.

Agenda Item A2 - Salaries Tax Issues

(a) Double taxation relief for individuals

(i) *Tax credit calculation for individuals*

According to Example 6 of the tax credit calculation under paragraph 132 of DIPN 44 (Revised), the actual number of days that an individual taxpayer spent in Mainland is not to be taken into account when calculating the tax credit limit that the taxpayer is allowed to claim in a tax year. However, some practitioners have encountered cases where the case officers adjusted the gross-up calculation to effectively only allow a pro-rata tax credit amount with reference to the number of days that the taxpayer was physically present in the other territory.

The Institute would like to seek clarification on whether the IRD will adhere to the approach in Example 6 of DIPN 44 (Revised) for similar tax credit claims going forward.

Ms Fong responded that without the full facts given, it would be difficult to comment on the calculation basis adopted in a specific case. She advised that the tax representatives might contact the IRD officers for further clarification.

Ms Fong referred to two articles in a double taxation agreement or arrangement (DTA) as follows–

- the employment income article which provided that the income derived by a Hong Kong resident from an employment exercised in the DTA territory might be taxed in the DTA territory; and

- the methods for elimination of double taxation article which provided that the tax paid in the DTA territory for any income derived by a Hong Kong resident in accordance with the DTA should be allowed as a credit against the Hong Kong tax payable by that resident in respect of the relevant income.

Ms Fong explained that following the provisions in the above two articles, if the tax paid, on the income derived by a Hong Kong resident from an employment exercised in the DTA territory, was calculated in accordance with the DTA, the IRD would follow the approach elaborated in Example 6 of DIPN 44 (Revised) to calculate the tax credit allowable for that resident.

(ii) *Application of Sections 8(1A)(c) and 8(1C) to non-resident taxpayer*

According to the new section 8(1C) under the Inland Revenue (Amendment) (No.6) Ordinance 2018, the exemption claim under section 8(1A)(c) of the IRO does not apply to income derived by a taxpayer from services rendered in a territory with which Hong Kong has a comprehensive double tax arrangement (CDTA). For income derived from services rendered in a territory with a DTA, a Hong Kong resident taxpayer can only claim a tax credit in respect of foreign tax payable on the income recognized under section 50 of the IRO.

In the case where a non-Hong Kong resident person under a Hong Kong employment contract works in a DTA territory of Hong Kong, he pays tax in both Hong Kong and the DTA territory. Not being a Hong Kong tax resident, he is not eligible to claim tax credit under the DTA. The Institute would like to seek the IRD's view on whether this type of taxpayers is eligible for double taxation relief under section 8(1A)(c). If the IRD is of the view that section 8(1A)(c) does not apply, the Institute would appreciate it if guidance and advice on how taxpayers under this type of situation can obtain a relief from double taxation could be provided.

Ms Fong said that a CDTA was intended to provide a comprehensive solution to all tax matters which were within its scope. The international practice was that where a CDTA was in place, relief for foreign tax should be allowed under the CDTA only to the extent contemplated by it. She pointed out that as the tax credit approach was adopted in all of Hong Kong's existing CDTAs, it was important for Hong Kong to adopt the same approach consistently in the domestic legislation as far as cases involving DTA territories were concerned. This sought to ensure that the CDTAs would prevail in case of any conflicts between the provisions in the IRO and those in the CDTAs. Indeed, Hong Kong's CDTA partners expected Hong Kong to provide double taxation relief by way of the tax credit approach as agreed under the CDTAs.

Ms Fong indicated that after enactment of section 8(1C) of the IRO, income exemption under section 8(1A)(c) was limited to cases involving non-DTA territories. She took the following views–

- As a DTA territory of Hong Kong was involved in the case mentioned in the question, the non-Hong Kong resident person was not eligible for double taxation relief under section 8(1A)(c) in respect of the tax paid in that DTA territory.

- If the non-Hong Kong resident person was a resident of the DTA territory, the tax paid in Hong Kong could be allowed as a credit against the DTA tax imposed on that person.

- In case the non-Hong Kong resident person was not covered by the CDTA between Hong Kong and the DTA territory, the taxpayer in the given scenario might still resort to (a) any unilateral relief available from his/her resident jurisdiction; or (b) bilateral relief under the CDTA between his/her resident jurisdiction and the DTA jurisdiction or Hong Kong. As the taxpayer in the given scenario was a non-Hong Kong resident working in the DTA territory under a Hong Kong employment contract, he might be eligible to claim exemption from Hong Kong salaries tax by virtue of sections 8(1A)(b)(ii) and 8(1B) of the IRO (i.e. rendering outside Hong Kong all the services in connection with the employment and services rendered in Hong Kong during visits not exceeding a total of 60 days for the relevant year of assessment).

(b) Taxation of share awards and the related employer's reporting obligation

Would the IRD please confirm the tax treatments of share awards when a change of employment occurred with particular reference to the following cases?

(i) *Case 1*

An employee holding a non-HK employment (non-HK employment A) had been seconded to work in Hong Kong from 1 April 2015 to 31 March 2017 and was subject to Hong Kong salaries tax on a time-apportionment basis during his Hong Kong secondment. He left Hong Kong at the end of his Hong Kong secondment and his employment contract was transferred to another group company outside Hong Kong (non-HK employment B). He was granted restricted share awards on 1 Jan 2016 with a two-year vesting period (i.e. vested on 31 Dec 2017). He spent less than 60 days in Hong Kong during 2017/18.

Would the share awards be taxable in the hands of the taxpayer and why?

Ms Fong said that share awards were taxable perquisites under section 9(1)(a) of the IRO and deemed to accrue to an employee on the last day of employment pursuant to section 11D(b) proviso (ii) even if they were vested after the cessation of employment.

To the question, Ms Fong gave the following response–

- When the restricted share awards were vested on the employee on 31 December 2017, his entitlement to ownership of the share awards gave rise to salaries tax liability in Hong Kong.

- By virtue of section 11D(b) proviso (ii) of the IRO, the restricted share awards were deemed to have accrued on 31 March 2017 (the last day of non-HK employment A) and chargeable to salaries tax in the year of assessment 2016/17, i.e. the year of cessation.

- Assuming that the value of the restricted share awards vested on 31 December 2017 was \$A, the value of share awards chargeable in the year of assessment 2016/17 was calculated as follows–

  $$\$A \times (456/731) \times F$$

  where
  456 = the number of days from 1.1.2016 to 31.3.2017

731 = the number of days during the vesting period from 1.1.2016 to 31.12.2017

F = time apportionment factor in 2016/17, the year of cessation

(ii) *Case 2*

Following case 1, what if there was no change of the employee's employment after the end of his Hong Kong secondment? Would the answer to the question differ?

Ms Fong held the view that if there was no change in the employee's non-HK employment after 31 March 2017, when the restricted share awards were vested on him on 31 December 2017, the value of share awards would be subject to salaries tax in the year of assessment 2017/18 and computed as–

$$\$A \times F^*$$

where

F^* = time apportionment factor in 2017/18, the year of vesting

Ms Fong, however, said that as the employee in the question spent less than 60 days in Hong Kong during 2017/18, he could claim exemption under sections 8(1A)(b)(ii) and 8(1B) of the IRO. Thus, F^* was zero and no part of \$A was subject to salaries tax in the year of assessment 2017/18.

Agenda Item A3 – Transfer Pricing Issues /Country-By-Country Reporting

(a) Determining the "source" of income under the arm's length principle

During the consultation and review of the Inland Revenue (Amendment) (No. 6) Bill 2017 which introduced international transfer pricing (TP) rules into the IRO, there was considerable discussion on how international TP principles would interact with territorial basis of taxation in Hong Kong and "source". While the Government and the IRD consistently stated that the new TP rules would not affect the territorial basis of taxation (see for example paragraph 14 of *Report of the Bills Committee on Inland Revenue (Amendment) (No. 6) Bill 2017* - LC Paper No. CB(1)1140/17-18). The Institute is interested in the IRD's views on determining the "source" of profits attributed to a person in the form of deemed income under the arm's length principle.

The Institute understands that the IRD's view is: "The transfer pricing rules require the computation of income or profits from transactions with associated persons on an arm's length basis for tax purposes. After ascertaining the amount of income or profits, the IRD will apply the territorial source principle of taxation to determine whether and, if so, the extent to which such income or profits arise in or are derived from Hong Kong." According to the Hong Kong case law decisions, the locality or source of profits is a question of fact, based on the nature of the transactions undertaken (see for example *CIR v. Hang Seng Bank Limited* [1991] 1 AC 306, *Nathan v. FCT* [1918] 25 CLR 183, DIPN 21).

Where TP rules impute profits to a taxpayer on an arm's length basis, by definition, these profits have not arisen based on the facts and circumstances of the taxpayer and the nature of their actual transactions as the imputed profits arise from a fiction where the taxpayer is imagined to have transacted on a different, arm's length basis, to the one on which it, as a matter of fact, actually transacted.

The different approaches raise questions as to how will the IRD reconcile these two bases of attributing profits to Hong Kong?

To reiterate, the OECD arm's length approach attributes profits to enterprises based on a determination of the functions performed, assets employed and risks assumed. While the Hong Kong source principle ascribes profits to a Hong Kong source where, as a matter of fact based on the nature of transactions undertaken, the taxpayer has done the things to earn the profit in Hong Kong.

Mr Chiu said that TP and source of profits were two different concepts of taxation. He elaborated that–

- TP required the pricing of transactions between associated persons in accordance with the arm's length principle, and the attribution of profits between the head office and permanent establishments (PEs) or between different PEs in accordance with the separate enterprise principle.

- Source of profits referred to the place where the profits arose in or were derived from.

Mr Chiu further elaborated that the TP rules and the source principle applied at two different stages of the assessment process as follows–
- A person's profits from controlled transactions or dealings should first be computed in accordance with the TP rules.

- After that, the source principle would come into play to determine whether and to what extent the profits arose in or were derived from Hong Kong.

Mr Chiu pointed out that section 50AAF of the IRO applied if there was a transaction or series of transactions between two affected persons (who were associated) pursuant to a condition (the actual provision) which differed from that imposed or made as between independent persons (the arm's length provision), and the actual provision conferred a potential advantage in relation to Hong Kong tax on an affected person (the advantaged person). He indicated that section 50AAF required the advantaged person's profits to be computed on the basis of the arm's length provision, which was to be ascertained by analyzing the economically relevant characteristics of the transaction, having regard to the functions performed, assets used and risk assumed by the advantaged person. Such computation would not affect the contractual obligations of the affected persons under the transaction.

Mr Chiu further referred to section 50AAK of the IRO which provided that the profits of a non-resident person attributable to its PE in Hong Kong had to be determined as if the PE were a distinct and separate enterprise, taking into account of the functions performed, assets used and risks assumed by the person through the PE.

Mr Chiu said that the broad guiding principle would then be applied with a focus on the effective causes, ignoring the antecedent or ancillary matters, in determining the source of the profits computed. The profits would be chargeable to Hong Kong profits tax if they were derived from activities undertaken in Hong Kong, or from activities carried out by a non-resident person through the PE in Hong Kong. He stressed that the caveat in *CIR v HK TVB International Ltd.* [1992] 2 AC 397 remained relevant. That was, it could only be in rare cases that a taxpayer with a principal place of business in Hong Kong could earn profits which were not chargeable to Hong Kong profits tax.

Mr Chiu took the view that, in practice, the exchange of information mechanism could be used to help identifying: the nature of the commercial and financial relations; the functions, assets and risks involved; and the location related to the derivation of the profits in question. He further expressed his view that upfront solutions like bilateral advance pricing arrangements and advance rulings should give taxpayers a sufficient degree of tax certainty.

In response to Mr Tisman's enquiry concerning the application of the principle laid down in the *ING Baring* case, Mr Chiu said that on the assumption that the facts of a case were exactly the same as those of *ING Baring* case, the Court of Final Appeal decision in *ING Baring* case continued to be followed by the IRD.

Ms Yee followed up and sought further clarification of the caveat in *TVBI* case. Mr Chiu replied that the Privy Council decision in *TVBI* case should be read in its proper context. He held the view that if a Hong Kong taxpayer had a branch or dependent agent in a DTA territory, the profits attributable to the activities carried out by that branch or agent would be subject to tax in the DTA territory and Hong Kong would not normally tax such profits. He, however, said that if a taxpayer had operation in Hong Kong without involvement of any an overseas branch or agent, the ascertainment of income source would entail a careful analysis of the facts of the case if the profits were claimed as offshore in nature.

The meeting further discussed the territorial basis of taxation. Mr Ng held the following views–

- In Hong Kong, income was subject to tax according to the territorial source principle while certain income was exempted from tax subject to meeting certain conditions. The source rule should not be regarded as a means to facilitate double non-taxation. Mr Ng asked whether Hong Kong's territorial tax system was a matter of the OECD's concern. He also asked if the OECD and other jurisdictions would respect Hong Kong's territorial tax system, given that Hong Kong had been implementing the four minimum standards of the BEPS package and put in place the TP rules.

- The OECD proposed to revise the international tax framework by the introduction of a number of tax proposals (i.e. Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy (the Programme of Work), commonly known as "BEPS 2.0") which might affect the multinational enterprise groups' decisions on the location of their business activities. In light of the recent international tax development, Mr Ng expressed concerns on how Hong Kong could maintain its competitiveness and avoid being challenged as having harmful tax practice.

Ms Yee and Ms Lee echoed the points and commented that the operation test which underpinned the territorial source principle was consistent with the objective of BEPS Actions 8 to 10 which required the alignment of transfer pricing outcomes with value creation.

CIR responded that–

- The assessment of preferential regimes was conducted by the OECD Forum on Harmful Tax Practices (FHTP) to ensure, among others, that the jurisdictions providing the regimes would require the benefiting taxpayers to carry out their core income generating activities in the jurisdictions. Some of Hong Kong's preferential regimes were assessed by the FHTP and concluded as not harmful. The same conclusion had also been taken by European Union for the purposes of its list of non-cooperative tax jurisdictions.

- The FHTP had once considered whether a general territorial tax system could be considered harmful per se and included in the scope of the FHTP's work. Yet, no consensus had been reached on the issue within the FHTP.

- Hong Kong's position was vulnerable as Hong Kong's tax rate was comparatively low and Hong Kong adopted a territorial tax system. The IRD was keeping a close watch on the FHTP's work.

- Hong Kong taxed income according to the territorial source principle (i.e. profits were taxable if they were derived from real or substantial economic activities conducted in Hong Kong). The broad guiding principle (i.e. what the taxpayer had done to earn the profit in question and where he had done it) was, to certain extent, consistent with the value creation.

Mr Chiu supplemented and gave his observations on the Programme of Work that consisted of a two-pillar approach developed by the Inclusive Framework on BEPS. He elaborated that–

- Pillar 1 sought to undertake a coherent and concurrent review of the profit allocation and nexus rules by reference to the concepts of "user participation" (advocated principally by the UK), "marketing intangibles" (advocated principally by the US) and "significant economic presence" concept (advocated principally by G24).

- Pillar 2 sought to address remaining issues identified by the BEPS project. Pillar 2 provided for the global anti-base erosion rules which include the income inclusion rule and the undertaxed payments rule (which were modelled on the US' Global Intangible Low-Taxed Income (GILTI) and Base Erosion and Anti-Abuse Tax (BEAT) respectively).

Mr Chiu went on to say that the above proposed rules were more than just a focus on the digital economy, but could potentially affect businesses operating internationally across all sectors. He mentioned that the rules were being formulated by the relevant working parties of the OECD and would be finalised in 2020. He reckoned that based on the recommendations regarding Pillar 1 and Pillar 2, the TP guidelines, the Model Tax Convention and the Multilateral Instrument would be revised. He also said that the IRD was keeping a close watch on the international development and the policy bureaux were alert to the impact of the international rules on the effectiveness of the preferential tax regimes.

(b) Application of Section 50AAK on non-resident person

It is increasingly common for businesses to distribute products and services solely through their websites. For many companies with no physical operations, personnel nor facilities in Hong Kong (NR Companies), they will engage Hong Kong companies (HK Companies) to provide business development and marketing services in Hong Kong.

The provision of such services generally require the employees of the HK Company to regularly and actively solicit (e.g. send emails, make telephone calls to, or visit) potential customers in Hong Kong to convince them to buy the NR Company's products or services. The customers will then be directed to conclude a contract with the NR Company online. Contracting can only be done online and must be completed before the goods/ services can be provided by NR Company. The online contract contains standard terms (including pricing) which the employees of the HK Company are not authorized to modify, and are not subject to negotiation with any individual customers. The HK Company and/ or its employees may be remunerated fully/partially based on the revenue the NR Company derived from customers in Hong Kong.

Based on the above arrangement, the Institute would like to ask:

(i) If the NR Company is resident of a jurisdiction with no DTA with Hong Kong, will the HK Company (and/ or its employees) be regarded as habitually playing the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the NR Company under section 7(1) of Schedule 17G to the IRO and consequently be considered as carrying on a trade, profession or business in Hong Kong under section 50AAK(1) of the IRO?

> Mr Tam referred to section 7(1) of Schedule 17G to the IRO which covered the cases where the activities performed by a person in Hong Kong were intended to result in the regular conclusion of contracts with an enterprise that was a non-DTA territory resident person (i.e. where a person in Hong Kong acted as the sales force of the enterprise that is a non-DTA territory resident person). He explained that the phrase "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" was aimed at the situations where the conclusion of a contract was directly resulted from the activities that the person performed on behalf of the enterprise in Hong Kong even though, under the relevant law, the contract was not concluded by the person in Hong Kong. He remarked that such an interpretation was consistent with the Commentary on paragraph 5 of Article 5 of the OECD Model Tax Convention, on which section 7 of Schedule 17G was modelled.
>
> Mr Tam said that the employees of the HK Company in the given scenario approached potential customers in Hong Kong and convinced them to buy the

> products and services of the NR Company. Where the customers were persuaded to purchase the goods or services, they would be directed to conclude the contracts in standard terms online with the NR Company. He further said that by performing such solicitation activities, the HK Company played the principal role leading to the conclusion of the contracts between the customers and the NR Company without material modification by the NR Company. He remarked that the inability of the HK Company to vary the terms of the contracts did not alter the fact that the conclusion of the contracts was the direct result of the activities that the HK Company performed on behalf of the NR Company in Hong Kong. By virtue of section 7(1) of Schedule 17G and section 50AAK(1), the NR Company was taken to have a PE in Hong Kong and was regarded as carrying on a trade, profession or business in Hong Kong.

(ii) If the HK Company's role is limited to undertaking non-client specific general marketing activities only (e.g. distributing promotional materials at exhibitions in Hong Kong), would the answer to question (i) be different?

> Mr Tam replied that the thrust of the issue was whether the activities performed by the HK Company in Hong Kong directly resulted in the conclusion of contracts between the customers and the NR Company, which turned on its own facts. He expressed that if the activities went beyond mere promotion or advertising and lead to the conclusion of contacts, section 7(1) of Schedule 17G would apply to regard the NR Company as having a PE in Hong Kong.

(iii) Will the IRD's view in DIPN 39 be updated in light of the new PE definition (set out in Schedule 17G to the IRO)?

> Mr Tam said that the IRD would update DIPN 39. He mentioned that provisions relating to the PE definition in Schedule 17G and commentary from the latest OECD guidance, if relevant, would be incorporated thereto.

(c) Determining the profits of a non-resident person carrying on business in Hong Kong but having no PE in Hong Kong

The Authorized OECD Approach (AOA) as specified in section 50AAK of the IRO seeks to attribute income or loss to a PE in Hong Kong of a non-resident enterprise as if the PE was a distinct and separate entity (under the separate enterprises principle) with regard to the functions performed, assets employed and risks assumed by the PE.

The Institute would like to ask whether the AOA methodology would also apply to determine the assessable profits of a resident person, whose presence in Hong Kong does not constitute a PE as defined in Schedule 17G to the IRO, but nonetheless is chargeable to tax in Hong Kong under section 14 of the IRO as carrying on business in Hong Kong.

Mr Tam responded that section 50AAK did not limit the application of the provisions in section 14 (i.e. a non-DTA territory resident person having assessable profits though without a PE in Hong Kong would remain chargeable to profits tax).

Mr Tam pointed out that the OECD TP guidance required the alignment of TP outcomes with value creation. He said that the contributions made by an enterprise in a jurisdiction were to be compensated based on the value they created in that jurisdiction. As the IRD saw it, such guidance should be observed irrespective of whether the activities of the non-DTA territory resident person gave rise to a PE in Hong Kong.

Mr Tam remarked that even if section 50AAK did not apply, the computation of the profits of the non-DTA territory resident person was still subject to other TP-related provisions in the IRO (e.g. section 50AAF) and case law principles (e.g. *Petrotim Securities Ltd v Ayres* 41 TC 389). He said that where an abusive profit shifting arrangement was involved, the IRD would invoke section 61A of the IRO to recompute the profits on an arm's length basis (see *CIR v Tai Hing Cotton Mill (Development) Ltd* (2007) 10 HKCFAR 704 and *Ngai Lik Electronics Co Ltd v CIR* (2009) 12 HKCFAR 296).

Mr Tam went on to say that irrespective of whether section 50AAK was applicable, the accounts relating to operations in Hong Kong should form a practical starting point for determining the assessable profits. The accounts should be respected for tax purposes if they reflected an attribution of profits that was consistent with the functional and factual analysis. In any event, section 50AAK and other TP-related provisions/ case law principles could be invoked by the Assessor to make upward adjustments on an arm's length basis to prevent under-attribution of profits or over-attribution of loss. TP-related provisions/ case law principles were not to be used to achieve double deduction or double non-taxation.

(d) Tax treatment of trading stock under amalgamation

The IRD's current stance for amalgamation (without sale of assets) requires trading stock of the amalgamating company to be treated as having realized in the open market for computing its assessable profits in the year of amalgamation. This is similar to the tax treatment for cessation of business under section 15C of the IRO.

Under the new TP rules, specified domestic transactions defined under section 50AAJ of the IRO are exempted from arm's length requirement. Given that amalgamation is between two Hong Kong entities and could be regarded as a "domestic transaction", the Institute would like to know whether the concept of TP rules exemption would apply to this type of amalgamation. In other words, will the IRD accept that the trading stock of the amalgamating company does not need to be transferred at market value for computing its assessable profits in the year of amalgamation?

> Mr Tam replied that amalgamation between two Hong Kong entities, alone, did not constitute a transaction unless there was a sale of goods or assets. Thus, TP rules exemption would not apply to an amalgamation. He pointed out that upon amalgamation under section 685(3)(b) of the Companies Ordinance (Cap. 622), each amalgamating company should be regarded as having ceased to carry on its trade or business on the day immediately before the amalgamation for the purposes of the IRO. He said that pursuant to section 15C of the IRO, the trading stock of each amalgamating company would be taken to have realized at an open market value on the day immediately before the amalgamation. He further said that section 50AAF(8) of the IRO disapplied the TP rules in relation to the trading stock which fell within the ambit of section 15C. Hence, section 50AAJ of the IRO which exempted domestic transaction from the TP rules was not applicable.

(e) Local File (LF) / Master File (MF)

The Institute would like to seek the IRD's clarification on the following issues:

(i) For the LF/MF business size threshold - does it include dividends? What about revaluation gains and other non-operating income?

> Mr Chan responded that for the purposes of the business sized-based LF/MF exemption, the threshold for the entity's revenue referred to the figure reflected in the entity's financial statements for the relevant accounting period. He said that if an income had been recognized in the entity's financial statements, the amount of such income would be taken into account in deciding whether the threshold had been exceeded or not. Mr Chan said that such an income might include dividends, revaluation gains and non-operating income.
>
> Both Ms Lee and Mr Ng followed up. They asked whether the related party transactions or revaluation loss would be taken into account for the purpose of the business-sized base in determining the threshold. Mr Chan replied that the aggregate amount of all kinds of income recognized or the total value of such asset (not the net asset figure) recorded in the entity's financial statements should be taken into account in determining whether the threshold had been exceeded or not.

(ii) If HK entity 1 receives/ pays HK entity 2 an amount for reimbursement of expenses (e.g. HK entity 2 paid the travel expenses and then recharged to HK entity 1) without mark-up, whether this amount is included in the Hong Kong transfer pricing documents (TPD) thresholds for "other transactions"?

> Mr Chan said that the category of "other transactions" under section 5(d) of Schedule 17I to the IRO was a residual category. He pointed out that any controlled transactions not falling within the three categories specified in section 5(a), (b) and (c) of Schedule 17I should be counted in the category of "other transactions". He said that, in the given scenario, the reimbursement transaction was undertaken between two Hong Kong entities. If both entities carried on a trade, profession or business in Hong Kong and were within the charge to Hong Kong tax, the transaction would be a "specified domestic transaction". It would not be covered by the local file of the entities and would be disregarded in determining whether the threshold for "other transactions" was exceeded.

(iii) We understand TP Rule 1 applies to "a transaction or series of transactions" – does this concept also apply in determining TPD thresholds? For example, if a Mainland entity sells goods to HK entity 1, then HK entity 1 sells to HK entity 2. If HK entity 1 does not exceed the size of business threshold while HK entity 2 exceeds, HK entity 2 could be exempted by mean of specified domestic transactions. In this case, would HK entity 2 need to prepare HK TPD?

> Mr Chan replied that the thresholds for the transaction-based LF exemption were expressed in terms of the amounts of "controlled transactions" between associated entities. Series of transactions involving the entities would not be taken into account. He expressed that, in the given scenario, if the sale of goods by HK entity 1 to HK entity 2 fell within the definition of "specified domestic transaction", HK entity 2 would not be required to include such transaction in its local file even if the goods were purchased by HK entity 1 from a Mainland entity.

(iv) The LF/MF is only required to be provided to the IRD upon request - what is turnaround time for the taxpayer to provide the LF/MF to the IRD?

> Mr Chan pointed out that under section 51(4)(a) of the IRO, an assessor might give a notice in writing to a Hong Kong entity requesting it to provide its MF and LF within a reasonable time. He said that the time allowed for an entity to provide the files might vary depending on the circumstances of each case. In any event, section 58C(2)(a) of the IRO required the MF and LF to be prepared within 9 months after the end of the relevant accounting period. He expressed that if the assessor's request was made after the time limit, the Hong Kong entity was expected to provide the files to the assessor without undue delay.

(f) Filing of country-by-country reporting (CbCR)

Under the OECD-recommended CbCR rules, the report should be filed by the ultimate parent entity of a multinational enterprise group (MNE group) in its jurisdiction of tax residence. However, OECD-recommended rules require that, in certain circumstances, other constituent entities in an MNE group are to file a report in their jurisdiction of tax residence (the secondary filing mechanism).

In Hong Kong, CbCR is effective since 1 January 2018. However, Hong Kong's CbC exchange with many jurisdictions would only be effective for accounting periods beginning on 1 January 2019. In the event that there is no automatic exchange arrangement in place between Hong Kong and the jurisdictions in which the ultimate parent entities of the MNE groups are resident for tax purposes, many Hong Kong taxpayers have to perform secondary filing for 2018.

The Institute would like to know whether there is any mechanism that the IRD would consider to minimize the taxpayer's burden.

Mr Chan replied that Hong Kong would ride on the Convention on Mutual Administrative Assistance in Tax Matters (the Convention) and the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports (CbC MCAA) as the main platform for exchange of CbC reports. He said that as the Convention and the CbC MCAA would only take effect in respect of Hong Kong for accounting periods commencing on or after 1 January 2019, to reduce the local filing exposure of Hong Kong-headquartered MNE groups in other jurisdictions, Hong Kong had reached out to its CDTA partners with a view to entering into bilateral arrangements for exchange of CbC reports for accounting periods commencing between 1 January 2016 and 31 December 2018 (Transitional Periods). Mr Chan disclosed that up to the date of this meeting, Hong Kong had made such bilateral arrangements with 14 CDTA partners (i.e. Austria, France, Guernsey, Ireland, Italy, Japan, Jersey, Korea, Malta, Mexico, the Netherlands, New Zealand, South Africa, and the United Kingdom). Hong Kong would continue discussions with other CDTA partners, seeking to conclude as many bilateral arrangements as practicable for the Transitional Periods.

Agenda item A4 - Double Tax Agreements

(a) Tax credit claim under section 50 for royalties

Section 50 of the IRO stipulates that where the income of a Hong Kong resident is subject to tax in both Hong Kong and a jurisdiction that has concluded CDTA with Hong Kong, the Hong Kong resident can credit the tax paid in the other jurisdiction on the relevant income against the tax payable in Hong Kong on the same income.

Section 50AA(2) of the IRO further provides that the amount of any relief from double taxation granted must not exceed the amount of the relief that would be granted had all foreign tax minimization steps been taken.

The Institute would like to seek the IRD's views on the following questions–

Assuming that a Hong Kong taxpayer received royalty from a Mainland resident corporation, the royalty is regarded as onshore sourced and subject to Hong Kong profits tax.

(i) If for some practical reasons (e.g. time constraint), the Hong Kong taxpayer did not apply for a certificate of tax resident status (CoR) for claiming CDTA benefit in Mainland, the royalty withholding tax paid would then be subject to the higher domestic rate of 10% instead of the reduced rate of 7% available under the CDTA. In such circumstances, would the Hong Kong taxpayer be denied any tax credit simply because it did not apply for a CoR in order to minimize the withholding tax paid in Mainland? Or, would the amount of tax credit available to the Hong Kong taxpayer be computed based on 7% instead of 10% of the royalty income from the Mainland resident corporation?

> Mrs Wong said that under section 50AA(2) of the IRO, the amount of any relief from double taxation granted must not exceed the amount of the relief that would be granted had all foreign tax minimization steps been taken. She further explained that pursuant to section 50AA(3) of the IRO, all foreign tax minimization steps were taken only if all reasonable steps were taken under the laws of the foreign territory and the relevant CDTA to minimize the amount of foreign tax payable in the foreign territory in respect of the relevant income, and the reasonable steps included claiming, or otherwise securing the benefit of, relief, deductions, reductions or allowances, and making elections for tax purposes.
>
> Mrs Wong indicated that whether or not a taxpayer had taken "reasonable steps" was to be determined on the facts of each case. The IRD should also take into account factors such as the amount of time, effort and expense involved in pursuing the case with the foreign tax authorities. She pointed out that in case a Hong Kong taxpayer was entitled to enjoy the tax benefits of reduced tax rates under a CDTA but had done nothing to claim or secure such

benefits, the taxpayer could not be regarded as having taken reasonable steps to minimize the foreign tax liability.

Mrs Wong pointed out that, in the given case, the Hong Kong taxpayer did not take any steps to apply for a CoR from the IRD for claiming CDTA benefits in the Mainland. As a result, withholding tax on royalty based on the domestic rate of 10% was paid. She took the view that under such circumstances, provided that the IRD was satisfied that the taxpayer was a Hong Kong resident under the arrangement with the Mainland, the taxpayer was still entitled to claim tax credit under the provisions of section 50 of the IRO. She, however, expressed that the amount of tax credit allowed could not exceed the amount computed on the reduced rate of 7% of the royalty income (i.e. the treaty rate should the taxpayer have taken the reasonable steps to secure the tax benefits from the Mainland tax authority).

(ii) If the Hong Kong taxpayer applied for a CoR in Hong Kong for claiming the CDTA benefit but the IRD rejected the application, the Mainland tax authority may consider the Hong Kong taxpayer was not a beneficial owner of the royalty income. Hence, withholding tax rate of 10% instead of the treaty rate of 7% would apply. Given that the royalty income is chargeable to tax in Hong Kong, would the IRD grant tax credit to the Hong Kong taxpayer? If yes, would the tax credit be calculated based on withholding tax rate of 7% or 10%?

Mrs Wong explained that in accordance with section 50(2) of the IRO, an applicant for a tax credit had to be a Hong Kong resident person during the year of assessment in which the income was earned.

Mrs Wong further explained that, in the given case, if the Hong Kong taxpayer's application for a CoR was rejected by the IRD, the taxpayer was not regarded as a Hong Kong resident. She mentioned that, in such a situation, the Hong Kong taxpayer was not entitled to any treaty benefits under the provisions of the arrangement with the Mainland and a withholding tax rate of 10% instead of the treaty rate of 7% was paid on the royalty income. She took the view that even the royalty income was chargeable to tax in Hong Kong, by virtue of section 50(2), the tax paid by the Hong Kong taxpayer in respect of royalty income in the Mainland could not be allowed as a credit against the tax payable in respect of that income in Hong Kong.

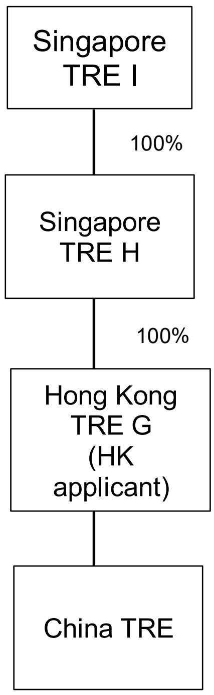
(b) Application of CoR via the "same treaty benefit rule" under Public Notice (2018) No. 9 (PN 9)

Article 3(2) of the Circular of the State Taxation Administration (STA) on Matters Concerning "Beneficial Owners" in Tax Treaties (STA Circular 2018 No. 9) (PN 9) provides that a Hong Kong applicant (HK applicant) will be treated as the beneficial owner (BO) of dividends if:

(i) a shareholder directly or indirectly holding a 100% equity interest of a Hong Kong applicant (a Hong Kong tax resident equity) is a qualified BO of the dividend concerned determined in accordance with article 2 of PN 9; and

(ii) in a multilayer structure, such shareholder and all the intermediate holding entities of the applicant are a resident of a tax treaty jurisdiction which enjoys the same or better treaty benefit with respect of the dividends received from the Mainland as compared to what is entitled by the Hong Kong applicant.

(Example 6 of PN 9 reproduced below for easy reference)



PN 9 requires that, in this example, tax resident entity (TRE) I, TRE H and TRE G would need to obtain a CoR of the relevant tax treaty jurisdictions, i.e., TRE I and TRE H a CoR demonstrating they are residents in Singapore and TRE G demonstrating that it is a resident in Hong Kong.

Considering that the Mainland tax authorities are willing to deem the HK applicant as the BO of the dividends and there is no treaty abuse in setting up the HK applicant, the Institute would like to ask whether the IRD would adopt a flexible approach in processing the CoR application submitted by the HK applicant.

In particular, would the IRD consider waiving the requirement of the HK applicant to produce evidence of its business substance in Hong Kong, provided that the HK applicant can produce evidence that its holding companies (i.e., Singapore TRE I and H in the above example) qualify as BO under PN 9?

In such circumstances, would the fact that the HK applicant is incorporated in Hong Kong justify its being issued a CoR in Hong Kong? It appears to us that this would be the case given that a company which is incorporated in Hong Kong is, by definition, a Hong Kong resident company under the Mainland-Hong Kong CDTA and that the HK applicant in this case would also be deemed a BO under PN 9.

In the 2018 Annual Meeting, we understand that the IRD would study PN 9 and consider the implications with respect to applications for CoRs. When would the IRD expect to release a new version of CoR application form to cope with PN 9?

Mr Chiu gave the following response–

- A CoR was issued to a resident of Hong Kong who required proof of resident status for the purposes of claiming tax benefits under a CDTA. The IRD would consider two separate matters, "resident of Hong Kong" and "entitlement to tax benefits", when processing an application for a CoR. A resident of Hong Kong was generally entitled to tax benefits on dividends under a CDTA if, among other requirements, it was the beneficial owner of the dividends.

- "Resident" and "beneficial owner" were distinct concepts under CDTAs. PN9 only provided for how the "beneficial owner" concept was to be applied under the Mainland's CDTAs with Hong Kong and other jurisdictions. With respect to the HK applicant in the above example, the IRD would take into account the interpretation in PN9 and collect relevant information on its multi-level holding structure so as to consider whether it fulfiled the "beneficial owner" requirement. There however remained the question of whether the HK applicant was a "resident of Hong Kong" to which the Mainland-Hong Kong CDTA applies.

- The principal purpose of CDTAs was to promote, by eliminating cross-border double taxation, exchanges of goods and services, and the movement of capital and persons. It was also a part of the purposes of CDTAs to prevent tax avoidance and evasion.

- To uphold the purposes of CDTAs, the Mainland and other CDTA partners of Hong Kong had over the years expressed strong views that tax benefits under CDTAs should only be available to persons resident in Hong Kong with sufficient economic nexus with Hong Kong. PN9 did not suggest any changes to the "resident" concept in implementing CDTAs. In this regard, it was important for the IRD to act in good faith and adhere to a purposive approach in interpreting "resident of Hong Kong" for the purposes of CDTAs.

- In the case of an applicant of CoR who wished to avail itself of the rules under Article 3(2) of PN9, the IRD would thoroughly examine the relevant facts of the case, including the business substance of the applicant in Hong Kong, in considering whether it was a "resident of Hong Kong" in the light of the object and purpose of the Mainland-Hong Kong CDTA.

Mr Chiu disclosed that the IRD had revised the CoR application form to address the changes introduced by PN9, and were in discussion with the STA on certain administration arrangement on CoR in relation thereto. He mentioned that the IRD would be working closely with the STA with a view to rolling out the revised form as soon as practicable. He said that, in the interim, applicants for CoR who were to claim tax benefits on dividends in the Mainland within the scope of PN9 could provide the relevant facts and circumstances for the IRD to consider their CoR applications. The IRD had further updated its website with some points to note when an application for CoR relating to PN9 was made.

Ms Chan asked whether the IRD, in processing an application for CoR in respect of a DTA with other overseas jurisdiction, would also consider the beneficial ownership requirement by making reference to the interpretation by STA of BO under PN9.

In response, Mr Chiu expressed that the terms of DTAs concluded were part of the tax law in Hong Kong and the IRD was bound to act in accordance with the law. It was up to the treaty partner to determine whether all the relevant conditions were fulfilled and whether the treaty benefits could be granted. Mr Chiu pointed out that the IRD had published some guidance relating to an application for CoR on its website. The IRD would consider, among other things, whether the applicant had any economic substance in Hong Kong; who was the beneficial owner of the income concerned; whether there was any treaty abuse; and hence whether the applicant was entitled to the tax benefits.

CIR supplemented that concerns had been raised about treaty shopping by the STA and the IRD had to act in good faith to fulfil Hong Kong's obligations under the Mainland-Hong Kong CDTA. Therefore, the IRD had to apply caution in deciding whether a CoR could be issued. CIR stressed that an application for CoR would be rejected if the applicant was regarded as only a conduit or paper company.

(c) Comprehensive double taxation arrangement for Hong Kong – Macao

The Institute appreciates that the government will continue to expand Hong Kong's DTA network, especially with the Belt and Road Initiative countries. We also understand that the government has been actively negotiating CDTA with Macao given that there will be increasing businesses and people mobility across the Greater Bay Area. The Institute would like to know the update of the progress in concluding the Hong Kong-Macao DTA, as well as DTAs with other jurisdictions?

Mr Chiu told the meeting participants that Hong Kong and Macao completed the third round of discussions for CDTA in January 2019. He disclosed that besides Macao, Hong Kong was currently negotiating CDTAs with 14 other jurisdictions, namely, Bahrain, Bangladesh, Cambodia, Cyprus, Estonia, Germany, Israel, Maldives, Mauritius, Nigeria, North Macedonia, Norway, Serbia and Turkey. He said that the

Government would continue to identify potential negotiation partners, especially countries along the Belt and Road, with a view to further expanding Hong Kong's CDTA network and bringing the total number of CDTAs to 50 over the next few years.

Agenda item A5 – Departmental Policy and Administrative Matters

(a) Lodgment of profits tax returns and filing deadlines for 2018/19

Would the IRD please share with the Institute the latest statistics on tax return filing and information on the 2018/19 tax filing deadlines?

Mr Yim referred to Appendix A–

- Table 1 showed that 4,000 more returns were issued in the 2017/18 bulk issue exercise and 24,500 returns were not filed by the due dates.

- Table 2 showed the filing position under different accounting codes.

- Table 3 showed the progressive filing results. Mr Yim pointed out that the lodgment rates for "D" code and "M" code returns by the deadline were very unsatisfactory as both had dropped to 77%. He also noted that the graduated lodgment rates worsened and were significantly below the lodgment standards. He, through the Institute, urged tax representatives to improve their performance in the coming year.

- Table 4 was a comparative analysis of compliance with the block extension scheme.

Bulk Issue of 2018/19 Profits Tax Returns

Mr Yim said that the 2018/19 Profits Tax Returns for "active" files were bulk-issued on 1 April 2019. The extended due dates for filing 2018/19 Profits Tax Returns would be–

Accounting Date Code	Extended Due Date	Further Extended Due Date if opting for e-filing
"N" code	2 May 2019 (no extension)	16 May 2019
"D" code	15 August 2019	29 August 2019
"M" code	15 November 2019	29 November 2019
"M" code – current year loss cases	31 January 2020	31 January 2020 (same as paper returns)

(b) Electronic filing of profits tax return

Currently a taxpayer can choose to file profits tax returns electronically provided certain conditions are met. A taxpayer may engage a tax representative to prepare the tax return and computation, but the electronic submission must be done by a director/company secretary/manager of the taxpayer which is not generally welcomed by corporate taxpayers. Only few corporate taxpayers have opted for electronic tax filing as a result.

The IRD's system capability should now be able to accept electronic filing for a taxpayer by a service provider, e.g. filing of CbC reports can now be carried out by a service provider on the taxpayer's behalf.

In this regard, the Institute would like to invite the IRD to actively consider allowing tax representatives to prepare and file profits tax returns electronically on behalf of taxpayers. Would the IRD share an update on its progress in respect of a general application of electronic tax filing?

Mr Yim informed the meeting participants that the IRD was carrying out the Departmental Information Technology Plan to formulate IT initiatives for future years. He said that the Plan covered electronic filing of profits tax return and the development of a Business Portal and Tax Representative Portal. He disclosed that the IRD would consult the stakeholders, including the Institute, in developing the Business Portal and Tax Representative Portal.

PART B – MATTERS RAISED BY THE IRD

Agenda Item B1 – Investigation and Field Audit: Discrepancies Detected by Field Audit

Mr Leung referred the meeting participants to Appendix B which was compiled to illustrate the specific problem areas detected in corporations with tax audits completed during the year ended 31 December 2018 with comparative figures for the years 2016 and 2017 included. He reported that–

- Field Audit teams uncovered discrepancies in 339 corporation cases, of which 276 carried clean auditors' reports.

- The amount of discrepancies detected in the clean report cases accounted for 94% (2017: 92%) of the total discrepancies detected in the year 2018 and total tax of $1,631 million was recovered from these cases.

- Average understatement per clean report case was $38.43 million (2017: $16.37 million) while tax undercharged per clean report case was $5.9 million (2017: $2.6 million).

Mr Leung added that discrepancies uncovered in 2018 resulted mainly from incorrect claims of offshore profits, over-claiming of expenses and understatement of gross profits. In the majority of cases, the discrepancies were detected after examining the business ledgers and source documents.

Referred to the first table in Appendix B, Mr Ng commented that the giving of clean reports by auditors might not have a direct correlation with the discrepancies uncovered by the IRD's tax auditors. Mr Leung agreed and pointed out that, in 2018, no case was considered that the auditor should have detected the irregularities through statutory audit.

Ms Chan knew that the IRD would seek additional information from the taxpayers if the tax returns filed by taxpayers contained irregularities. She mentioned that she had come across a case where no enquiry was raised at the time when the assessment was issued, but enquiry was raised when the tax audit was conducted. In response, Mr Leung replied that the IRD adopted a risk-based approach to select cases for tax audit and it was not uncommon that assessments were issued in accordance with the returns filed first and detailed enquiries, including request for provision of accounting and business records, were raised by the tax auditors when the cases were selected for tax audit.

Agenda Item B2 – Date of Next Annual Meeting

The date would be agreed between the Institute and the IRD in due course.

Lodgement of Corporations and Partnerships Profits Tax Returns

Table 1
Lodgement Comparison from 2015/16 to 2017/18

		Y/A 2015/16	Y/A 2016/17	Y/A 2017/18	Comparison 2016/17 and 2017/18
1.	Returns issued on 1 or 3 April	188,000	184,000	188,000	2%
2.	Returns not filed by due date				
	"N" Code	2,200	2,200	2,600	18%
	"D" Code	6,600	7,200	9,000	25%
	"M" Code	10,500	11,000	12,900	17%
		19,300	20,400	24,500	20%
3.	Compound offers issued	6,600	6,300	7,300	16%
4.	Estimated assessments issued	8,300	9,000	11,300	26%

Table 2
2017/18 Detailed Profits Tax Returns Statistics

	"N"	"D"	"M"	Total
Total returns issued	20,000	66,000	102,000	188,000
Failure to file on time	2,600	9,000	12,900	24,500
Compound offers issued	800	3,200	3,300	7,300
Estimated assessments issued	1,200	4,000	6,100	11,300

Table 3

Represented Profits Tax Returns - Lodgement Patterns

Code	Lodgement Standard	Y/A 2017/18	Y/A 2016/17
D - 15 August	100%	77% (1)	79%
M - 31 August	25%	10%	11%
M - 30 September	55%	14%	17%
M - 31 October	80%	30%	32%
M - 15 November	100%	77% (2)	79%

(1) 33% lodged within a few days before 15 August 2018 (34% lodged within a few days before 15 August 2017 for Y/A 2016/17)

(2) 29% lodged within a few days before 15 November 2018 (30% lodged within a few days before 15 November 2017 for Y/A 2016/17)

Table 4

Tax Representatives with Lodgement Rate of less than 77% of "M" code Returns as at 15 November 2018

1,468 T/Rs have "M" Code clients. Of these, 699 (48%) firms were below the average performance rate of 77%. An analysis of the firms, based on size, is as follows-

		Current Year Performance				Last Year Performance			
	No. of clients per firm	Total No. of firms	No. of firms below the average of 77%	No. of non-compliance cases	% of total non-compliance cases	Total No. of firms	No. of firms below the average of 79%	No. of non-compliance cases	% of total non-compliance cases
Small size firms	100 or less	1,369	651	5,435	70%	1,384	641	5,461	71%
Medium size firms	101 - 300	92	46	2,239	29%	97	44	2,072	27%
Large size firms	over 300	7	2	146	2%	8	2	115	2%
		1,468	699	7,820	100%	1,489	687	7,648	100%

Table 1 [Appendix B]

Analysis of Completed FA Corporation Cases for the years ended 31 December 2016, 2017 and 2018

	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
Auditor's Report = Unqualified	**2016**	**2017**	**2018**	**2016**	**2017**	**2018**	**2016**	**2017**	**2018**
Sales omitted	48	44	65	59,316,705	39,050,545	53,960,621	6,755,119	5,563,507	6,954,336
Purchases overstated	12	15	12	15,088,982	55,609,437	7,727,830	2,626,954	8,347,423	1,240,770
Gross profit understated	34	28	28	89,373,014	121,821,702	98,639,797	14,476,529	18,478,838	6,937,918
Expenses over-claimed	79	107	88	42,027,622	88,978,759	326,952,476	3,512,642	13,247,219	50,197,335
Technical adjustments	79	87	92	215,971,015	34,250,130	77,023,541	34,989,593	4,806,637	11,711,365
Offshore income / profits disallowed	18	18	21	164,997,882	348,858,847	1,670,937,967	25,488,041	59,294,913	276,916,165
Other	78	115	104	99,918,370	167,765,187	74,344,052	14,327,836	25,620,662	11,446,742
TOTAL	348*	414*	410*	$686,693,590	$856,334,607	$2,309,586,284	$102,176,714	$135,359,199	$365,404,631
TOTAL NUMBER OF CASES	265*	301*	276*						
AVERAGE AMOUNT PER CASE				$2,591,297	$2,844,965	$8,368,066	$385,573	$449,698	$1,323,930

FOR AUDIT YEAR ONLY

* in one case there may be more than one type of discrepancy

		Total Discrepancy for All Years			Total Tax Undercharged for All Years		
		2016	**2017**	**2018**	**2016**	**2017**	**2018**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$3,992,788,229**	**$4,927,912,899**	**$10,605,686,545**	**$625,741,686**	**$772,514,422**	**$1,631,374,788**
	AVERAGE AMOUNT PER CASE	**$15,067,125**	**$16,371,804**	**$38,426,401**	**$2,361,289**	**$2,566,493**	**$5,910,778**

	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
Auditor's Report = Qualified	**2016**	**2017**	**2018**	**2016**	**2017**	**2018**	**2016**	**2017**	**2018**
Sales omitted	14	17	12	11,728,283	31,353,279	25,668,951	1,927,593	3,550,667	4,189,451
Purchases overstated	2	1	2	4,138,600	1,993,535	8,483,857	682,869	328,933	1,444,120
Gross profit understated	16	6	18	26,435,919	15,709,868	28,103,809	4,551,295	2,704,564	3,420,563
Expenses over-claimed	16	23	23	4,759,273	18,289,960	13,849,719	584,626	2,227,625	1,928,314
Technical adjustments	18	10	15	11,781,676	3,967,230	3,660,449	1,156,035	657,413	563,219
Offshore income / profits disallowed	4	1	3	3,499,202	-1,087,772	4,943,011	514,143	-361,648	503,538
Other	26	33	26	69,399,172	21,577,332	36,877,590	4,745,171	3,216,549	5,583,779
TOTAL	96*	91*	99*	$131,742,125	$91,803,432	$121,587,386	$14,161,732	$12,324,103	$17,632,984
TOTAL NUMBER OF CASES	70*	66*	63*						
AVERAGE AMOUNT PER CASE				$1,882,030	$1,390,961	$1,929,959	$202,310	$186,729	$279,889

FOR AUDIT YEAR ONLY

* in one case there may be more than one type of discrepancy

		Total Discrepancy for All Years			Total Tax Undercharged for All Years		
		2016	**2017**	**2018**	**2016**	**2017**	**2018**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$535,242,825**	**$454,288,187**	**$692,428,852**	**$74,488,239**	**$63,645,638**	**$105,078,631**
	AVERAGE AMOUNT PER CASE	**$7,646,326**	**$6,883,154**	**$10,990,934**	**$1,064,118**	**$964,328**	**$1,667,915**

TOTAL NUMBER OF CASES 335 367 339

		Total Discrepancy for All Years			Total Tax Undercharged for All Years		
		2016	**2017**	**2018**	**2016**	**2017**	**2018**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$4,528,031,054**	**$5,382,201,086**	**$11,298,115,397**	**$700,229,925**	**$836,160,060**	**$1,736,453,419**
	AVERAGE AMOUNT PER CASE	**$13,516,511**	**$14,665,398**	**$33,327,774**	**$2,090,239**	**$2,278,365**	**$5,122,281**

Extracts of Analysis in Appendix B

		2017	2018
(a)	No. of corporation cases with discrepancies uncovered	367	339
(b)	No. of corporation cases in item (a) carried clean auditor’s reports	301	276
(c)	Total discrepancies detected in all cases	$5,382m	$11,298m
(d)	Total discrepancies detected in clean auditor’s report cases	$4,928m	$10,606m
(e)	Percentage of (d) over (c)	92%	94%
(f)	Total tax uncovered in clean auditor’s report cases	$773m	$1,631m
(g)	Average understatement per clean auditor’s report case	$16.37m	$38.43m
(h)	Tax undercharged per clean auditor’s report case	$2.6m	$5.9m