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

TaxB 31 *October 2020*

Tax Bulletin

2020

Annual Meeting

The Inland Revenue Department

and

The Hong Kong Institute of Certified Public Accountants

2020
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 2020.

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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2020
ANNUAL MEETING BETWEEN
THE INLAND REVENUE DEPARTMENT AND
THE HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Full Minutes

The 2019/20 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department was held on 15 May 2020 at the Inland Revenue Department.

In Attendance

Hong Kong Institute of Certified Public Accountants

Mr William Chan	Chair, Taxation Faculty Executive Committee
Ms Sarah Chan	Deputy Chair, Taxation Faculty Executive Committee
Ms Agnes Cheung	Member, Taxation Faculty Executive Committee
Mr Patrick Cheung	Member, Taxation Faculty and TP Specialist
Ms Doris Chik	Member, Taxation Faculty
Ms Gwenda Ho	Member, Taxation Faculty Executive Committee
Ms Jo An Yee	Member, Taxation Faculty Executive Committee
Mr Eugene Yeung	Member, Taxation Faculty Executive Committee
Mr Eric Chiang	Deputy 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)
Ms Leung Wing-chi	Assistant Commissioner of Inland Revenue (Acting)
Ms Wong Ki-fong	Assistant Commissioner of Inland Revenue (Acting)
Ms Leung To-shan	Chief Assessor (Tax Treaty)
Mr Chan Sze-wai	Chief Assessor (Tax Treaty)
Mr Leung Kin-wa	Assistant Commissioner of Inland Revenue (Acting)
Ms Hui Chiu-po	Senior Assessor (Research)

Mr Wong Kuen-fai (CIR) welcomed the representatives of the Institute to the annual meeting, in particular Mr William Chan, Chair of the Tax Faculty, and some representatives who joined the meeting for the first time. CIR introduced the IRD officers in attendance. He said that the annual meeting had provided a forum for the Institute and the IRD to exchange views on issues of common interest. He considered that the issues discussed during the meeting should focus on issues of common interest rather than issues that were time-sensitive or issues with changes already taken effect at the time the minutes were published.

Mr William Chan on behalf of the Institute's Tax Faculty thanked CIR for arranging the annual meeting. He said that the Institute always viewed the annual meeting as an important event which offered a valuable opportunity to discuss and clarify issues of common interest. He further said that the Institute and the IRD had all along maintained good communication and relationship. The Institute in fact contacted the IRD, without waiting for the annual meeting, to seek the IRD's clarifications on practical issues which were very useful to the Institute's members. He expressed the Institute's appreciation for the IRD's special arrangement of further extension of filing deadlines to take into consideration that the work schedule of the Institute's members was much affected by the outbreak of COVID-19. He also thanked the IRD's officers who spoke in the tax seminars organized by the Institute in the previous year. The Institute looked forward to continuing the cooperation between the Institute and the IRD in coming years.

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) Tax treatment on preferential regimes

Pursuant to section 16(1A) of the Inland Revenue Ordinance (IRO), the amount of deduction in respect of the sum is to be reduced such that the profits tax payable by the person is increased by reference to the amount of the reduction in the profits tax payable by the corporation in respect of the sum for the year of assessment or any subsequent year of assessment, if the corporation is a qualifying reinsurer/captive insurer (QRe), qualifying corporate treasury centre (QCTC), aircraft lessor or aircraft leasing manager, which is a connected person of the payer. Members note that there are different bases in the market for calculating the disallowable expense. What are the acceptable bases to the IRD? Would the IRD please provide numerical examples to illustrate the acceptable calculation bases for disallowing premium/interest/management fee similar to paragraph 81 of Departmental Interpretation and Practice Notes (DIPN) No. 54, and cover cases where the recipient incurs an adjusted loss for that year of assessment, and where a QRe receives premium from both life insurance business and insurance other than life business?

The IRD responded as follows–

- Section 16(1A) was enacted to prevent tax arbitrage through a transaction between connected persons to achieve a reduction in their aggregate tax liabilities due to tax rate differentiation (i.e. the payer taxed at the normal rate of 16.5% while the recipient taxed at a concessionary rate of 8.25%).

- If the conditions stipulated under section 16(1A) were satisfied, the payer's outgoings and expenses deductible under section 16(1), in respect of a sum (relevant sum) included as assessable profits of a recipient which were chargeable at a reduced rate for a year of assessment, would be reduced by reference to the amount of the reduction in the profits tax payable by the recipient in respect of the relevant sum for the year of assessment and any subsequent year of assessment.

- The expression "for the year of assessment and any subsequent year of assessment" in section 16(1A) implied that when considering the required adjustment of deduction under section 16(1), the payer should consider not only the recipient's profits tax position for the year of assessment in which the relevant sum was incurred or accrued, but also that for any subsequent year of assessment.

- As the IRD saw it, loss occasionally sustained by the recipient for a year of assessment after inclusion of the relevant sum would only defer the taxation of the sum at a reduced rate to a subsequent year of assessment. Thus, it remained necessary for the payer to make an adjustment under section 16(1A) for the year of assessment in which the relevant sum was incurred as an expense. In any event, the IRD might invoke section 61 or 61A to counteract a blatant tax avoidance arrangement that aimed to siphon off profits from a profit making person to a loss making connected person.

- Schedule 3 to the Insurance Ordinance (Cap. 41) required an insurer to disclose in its accounts and returns to the Insurance Authority, in respect of each class of long-term business and general business, (a) the gross premiums receivable distinguishing between the premiums from direct underwriting and those under reinsurance contracts accepted; and (b) all reinsurance premiums payable distinguishing between cessions relating to direct underwriting and retrocessions relating to reinsurance contracts accepted. As such, there should be readily available information for the payer to compute the adjustment required under section 16(1A) in respect of the premiums payable to its connected QRe, even if the QRe was carrying on both a business of life insurance and a business of insurance other than life insurance.

- Since the adoption of a single formula for computing adjustments under section 16(1A) would neither be possible nor desirable, the IRD would take into account all the circumstances of a case before arriving at a fair and reasonable basis to give effect to the provisions in section 16(1A). In the absence of specific circumstances, the approach in Example 12 of DIPN 54 would normally be followed.

Ms Sarah Chan followed up and sought the IRD's further clarification on the bases for computing adjustments under section 16(1A). She said that the Institute's members had practical difficulties in cases, where the loss sustained by the QCTC in current year of assessment in which the profits tax payable was zero; or where the loss amount was carried forward and set off against assessable profits of the QCTC in the current year of assessment in which the effective profits tax rate would be only a few percentage points. In addition, she asked whether there would be a time limitation on the adjustments for the subsequent years of assessment.

Mr Yeung expressed that he had similar concerns and mentioned that a reinsurer would receive premiums from connected companies and unrelated third parties. When computing the adjustment required under section 16(1A), he questioned whether the tax practitioners needed to go into the details of each single reinsurance contract. He continued to say that there might be a case where a reinsurer started to recognize revenue from a life reinsurance contract with a life portfolio started decades well before the enactment of section 16(1A). If the reinsurer was required to make adjustment under section 16(1A) considering not only in the current year of assessment but also back years of assessment, he commented it might not be clear how the adjustments in respect of back years of assessment should be ascertained.

In response, CIR explained that the anti-tax arbitrage rule in section 16(1A) was to prevent tax abuse by connected persons from taking advantage of tax rate differentials. He observed that section 16(1A), which provided the general principle for computing the required adjustments of deduction under section 16(1), was accepted by the Institute's representatives. Since it was not possible to lay down a hard and fast rule for each and every scenario, he said that each case would be considered on its own facts and the specific facts of the case before deciding the most appropriate adjustment. He stressed that any adjustment basis had to follow the general principle in section 16(1A). He took note of the Institute's concerns and indicated that it might not be practical for taxpayers and their tax representatives to trace the records of each contract. He expressed that the IRD would be ready to work with taxpayers and their tax representatives in finding the most appropriate adjustment method.

Ms Agnes Cheung came across cases where the tax position of the Hong Kong connected company of a QCTC would be worse off since the QCTC had its qualifying profits charged at half of the corporate profits tax rate but the Hong Kong connected company's interest deduction was reduced, on the gross basis. Given such practical difficulty encountered by the QCTC and the Hong Kong connected company, Ms Agnes Cheung said that it would be much appreciated if the IRD would consider providing tax guidance, similar to the approach in Example 12 of DIPN 54.

In response, Mr Chiu expressed that the imbalance issue arising from different bases had been considered at the time of drafting the legislation. He remarked that the expression "by reference to the amount of the reduction in the profits tax payable by the recipient" in section 16(1A) was adopted to address the issue. The adjustment for the Hong Kong payer should be based on the tax saving of the recipient, with reference to the reduction in tax rate. Since cases were fact-specific, Mr Chiu considered it difficult to categorically adopt a single formula for computing the required adjustments under section 16(1A). He was of the view that it might not be desirable to provide practical guidance on the calculation bases since the number of QCTCs benefiting from the half-rate tax concession was not significant at that time. It would be more practical to work on a mutually agreeable calculation basis on a case by case basis.

(b) Corporate treasury centre (CTC)

Under the current regime, a QCTC can enjoy 50% of the profits tax rate for the qualifying income from qualifying treasury activities. Qualifying treasury activities include intra-group financing business, corporate treasury service and corporate treasury transaction.

A company carries on intra-group finance lease business. In particular, the leasing company purchases assets (e.g. plant and machinery) for its group companies and rents the assets to the group companies under finance lease arrangements. In return, the leasing company derives interest income from its group companies.

Would such intra-group finance lease business be considered as a qualifying corporate treasury activity and hence the leasing company would be a QCTC and enjoy the preferential tax rate if other conditions are met?

The IRD responded as follows–

- "Corporate treasury activity" was defined under section 14C(1) of the IRO to mean one of the following activities:
  - (a) carrying on an intra-group financing business;
  - (b) providing a corporate treasury service; or
  - (c) entering into a corporate treasury transaction.

- Each of the above-mentioned activities was further defined under section 14C(1) of and Schedule 17B to the IRO.

- As provision of finance lease for purchase of plant and machinery was not an activity or a transaction specified in the definition of any one of the three types of activities mentioned above, it could not be regarded as a corporate treasury activity qualifying for the CTC tax regime. Thus, the leasing company was not a QCTC, even if other conditions were met, unless the safe harbour rule under section 14E was satisfied or the Commissioner's determination under section

14F had been obtained.

In reply to Ms Sarah Chan's question, Mr Chiu confirmed that finance lease business was not regarded as a corporate treasury activity qualifying for the CTC tax regime.

(c) Tax treatment on the direct expenses in relation to revenue recognized according to Hong Kong Financial Reporting Standard (HKFRS) 15

An insurance brokerage company with accounting year end date at 31 December derives commission income from insurance companies for policies placed and pays customer referral commission to unrelated business partners. The insurance brokerage company successfully referred a candidate to an insurance company, and the candidate signed a policy on 1 January 2019 and renewed the policy before the end of the year. The initial referral commission income and renewal commission income of the policy are both recognized in the year of inception of the insurance policy (i.e. 2019). Also, direct commission expenses for business referrals paid/payable in the first year and on renewal of a policy are recognized as expenses in 2019.

(i) In the above scenario, are the renewal commission income taxable and renewal commission expenses deductible in the year of assessment 2019/20, i.e. year ended 31 December 2019, by virtue of sections 14 and 16(1) of the IRO respectively?

The IRD responded as follows–

- As explained in agenda item A1(a) of the 2018 Annual Meeting, the accounting profits, as determined in accordance with HKFRS 15, would be accepted as the assessable profits in most cases for profits tax purposes, except where the case law or the IRO required a specific tax treatment, or where the accounting treatment deviated from established tax principles.

- In the given scenario, on the assumption that the insurance brokerage company had applied the five-step approach under HKFRS 15 to recognize both the initial referral commission income and renewal commission income in its accounts for the year ended 31 December 2019, the income so recognized should form its taxable income for the year of assessment 2019/20 and thus be chargeable under section 14 of the IRO.

- For the deduction of the commission expenses, it was governed by sections 16 and 17 of the IRO which should be read in a negative sense. If the commission expenses were incurred in the year ended 31 December 2019 in the production of the initial referral commission income and renewal commission income both of which being recognized as revenue, they would be deductible in the year of assessment in which the expenses were incurred (i.e. the year of assessment 2019/20).

- For profits tax purposes, the application of the principles of generally accepted accounting principles to the transactions of the trade or business was the starting point for computing assessable profits. In general, financial statements prepared in accordance with generally accepted accounting principles would provide the practical basis for computing assessable profits. Since accrual accounting was the fundamental concept which underpinned the preparation of financial statements, revenue and expenses were recognized even if receipts and payments occurred in a different period. The point at which revenue was recognized was usually the same point at which any related costs were recognized.

Ms Agnes Cheung mentioned that HKFRS 15 concerned the recognition of revenue from contracts with customers and did not apply to deduction of expenses. Given the matching principle, she questioned whether the renewal commission expenses were regarded as "incurred" in the year of assessment 2019/20 if the insurance brokerage company did not receive the demand note for renewal commission payment before the year end date.

In response, Mr Chiu explained that in determining a taxpayer's assessable profits or adjusted loss, the IRD took the approach that the starting point was the accounting profits. He remarked that the deduction of the renewal commission expenses was governed by sections 16 and 17 of the IRO which should be read in a negative sense. He concluded that the tax treatment would not have any conflict with the accounting principles.

(ii) Assuming that the insurance brokerage company does not place any new policies with insurance companies in a particular year (e.g. 2020) and all the commission income and expense mentioned above have already been recognized, taxed and deducted in 2019, are the administrative expenses incurred in 2020 for maintaining the business deductible on the basis that they are incurred in the production of assessable income for prior years?

The IRD responded as follows–

- Section 16(1) provided that outgoings and expenses incurred during the basis period for a year of assessment by a person in the production of its profits chargeable to profits tax for any period should be deducted in ascertaining its profits chargeable for that year of assessment. The deductible outgoings and expenses had to be incurred in producing chargeable profits, be it for the current period or one in the past or future.

- If it was established that the administrative expenses were incurred in 2020 in the production of the chargeable profits of the insurance brokerage company and were not precluded from deduction under section 17, such administrative expenses would be deductible for the year of assessment 2020/21.

(d) Timing and the amount of rental payments qualifying for tax deductions of a lease term under HKFRS 16

The IRD confirmed in the 2017 and 2019 Annual Meeting that implementation of HKFRS 16 Leases would have no effect on the operation of sections 16 and 17 of the IRO related to deductions under profits tax. However, according to our recent communication with the IRD, the IRD would allow deduction claim based on the amounts charged to the profit and loss account which is in line with the accounting treatment. Do taxpayers have a freedom of choice of claiming:

(i) accounting charges (i.e. in the example quoted below, the amounts charged to the profit and loss account for the respective years - the rental expense under Hong Kong Accounting Standard (HKAS) 17 in 2018, and the total periodic expense under HKFRS 16 for 2019 and 2020) or;

(ii) cash outflow/ contractual commitment (i.e. rental payments in the example quoted below) as long as such basis is consistently applied?

If it is not a matter of choice, please advise what the taxpayer is required to do if they have used the less preferred method in the prior year (i.e. for those who have elected early adoption)? Does this involve a reversal of the prior year deduction, claiming a prior year deduction under the preferred method in the next profits tax return to be filed, and following the same basis going forward? Will the IRD issue a DIPN on the tax treatments of new accounting standards such as HKFRS 15 and 16?

<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 for the first 3-months. Assuming that there is no early termination and renewal option for the lease, the below table summarizes Company A's cash outflow and the amounts charged to profit and loss account over the 3-year period under HKAS 17 Leases and HKFRS 16 Leases (see Annex to agenda item A1(d) for more details of the double entries).

<table>
<tr><th>Period</th><th>2018</th><th>2019</th><th>2020</th><th>Total</th></tr>
<tr><td>Cash outflow – rental payment</td><td>HK$180,000</td><td>HK$240,000</td><td>HK$240,000</td><td>HK$660,000</td></tr>
<tr><td colspan="5">Amount charged to profit & loss</td></tr>
<tr><td>Rental expense (HKAS 17)</td><td>HK$220,000</td><td colspan="2">N/A</td><td>HK$220,000</td></tr>
<tr><td>Depreciation of right-of-use asset (HKFRS 16)</td><td rowspan="2">N/A</td><td>HK$207,939</td><td>HK$207,939</td><td>HK$415,878</td></tr>
<tr><td>Interest expense on lease liabilities (HKFRS 16)</td><td>HK$17,746</td><td>HK$6,376</td><td>HK$24,122</td></tr>
</table>

The IRD responded as follows–

- The application of HKFRS 16 in effect required depreciation of right-of-use asset over the life of the lease and interest expense on the lease liability over the lease term. Typical straight-line operating lease expense of the lessee was no longer required. HKFRS 16 should not have any effect on the total amount of cash flows reported but only the presentation of cash flows. It was the IRD's understanding that the lessee had to adopt HKFRS 16 for the annual periods beginning on or after 1 January 2019 on all leases except where the term is 12 months or less and for low-value assets. Therefore, the lessee was not expected to recognize the expenses based on cash outflow / contractual commitment under HKFRS 16.

- As mentioned, deduction of expenses was governed by sections 16 and 17. No inconsistency existed between the application of these two sections and the principle as established in *Secan Limited and Ranon Limited v CIR* [2000] 3 HKLRD 627 that the assessable profits had to be ascertained in accordance with the ordinary principles of commercial accounting as modified in conformity with the IRO. Notwithstanding the change of the accounting standard for lease accounting from HKAS 17 to HKFRS 16, the operation of sections 16 and 17 of the IRO was not affected.

- In the example given, Company A had recognized expense of $220,000 for the year 2018 under HKAS 17 and periodic expenses of $225,685 and $214,315 respectively for the years 2019 and 2020 under HKFRS 16. The deductible expenses for Company A would be $220,000, $225,685 and $214,315 for the years 2018, 2019 and 2020 respectively. The total expenses recognized for the whole lease term were $660,000, which exactly matched with its total contractual payments. Early adoption of HKFRS 16 should not affect the total amount allowable for deduction under the lease term in any circumstances.

- The IRD would like to draw attention again to the explanation given in the agenda item A1(a) of the 2018 Annual Meeting regarding the prior period adjustment on adoption of HKFRS 15, which was also applicable to HKFRS 16. Any adjustment, which satisfied the taxability and deductibility conditions under the IRO, in the retained earnings resulting from the first adoption of a new accounting standard, would be assessable or deductible in the year of assessment in which the prior period adjustment was recognized. In any circumstances, assessments of the prior years, which had become final and conclusive under section 70 of the IRO, would not be revised.

- To facilitate a better understanding of the tax implications of HKFRS 15 and 16, FAQ would be issued. Besides, DIPN 1 upon revision would make references to HKFRS 15.

Ms Ho mentioned that she came across a case where a taxpayer, who chose to early adopt HKFRS 16 in earlier year of assessment, had claimed tax deductions based on the actual cash outflow instead of the amount charged to the profit and loss account.

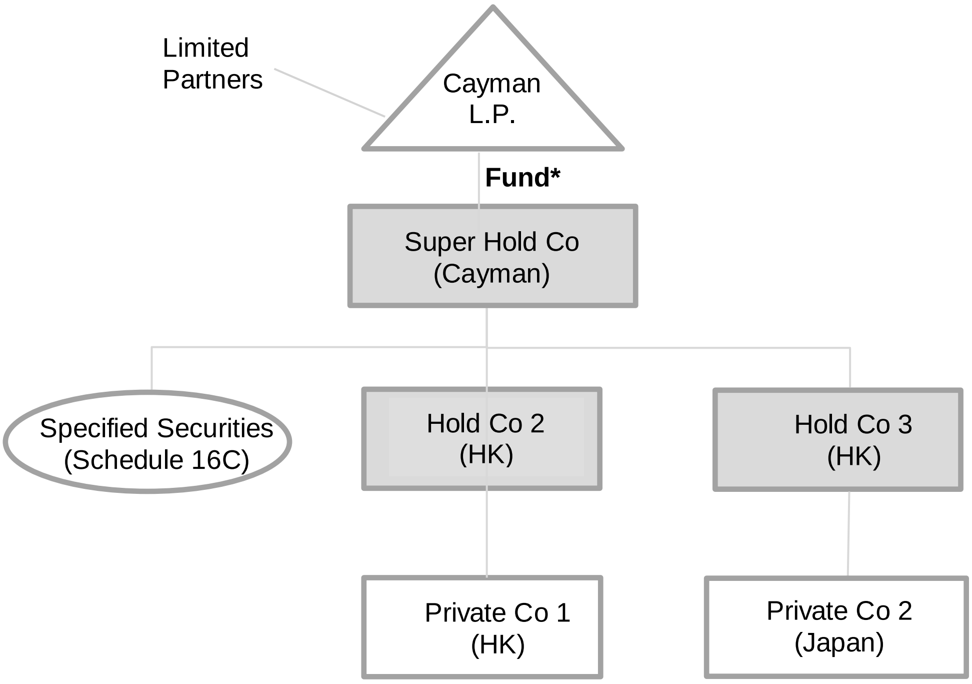
She asked whether the taxpayer was required to lodge a claim to revise the taxpayer's tax position in the earlier year of assessment. She further asked the timeline for the issue of FAQ and DIPN.

In response, Mr Chiu took the view that since it was a matter of timing difference, it might not be necessary to re-open the assessments of the prior years. He indicated that it would be helpful if a reconciliation schedule showing the correct basis and the prior year's upward or downward adjustments, as the case might be, was submitted together with the tax return for the current year of assessment to facilitate checking and assessment. He disclosed that the IRD was in the process of preparing the FAQ and revising DIPN 1 to take into account the new accounting standards and would consult with the Institute.

[Post-meeting note: FAQ and updated DIPN 1, with the Institute's comments incorporated where appropriate, were issued in September 2020.]

(e) Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019 (the "Hong Kong Unified Fund Exemption Regime" or "HK UFE Regime")

Members of the Institute would like to ask questions whether a fund with a complex structure as depicted in the diagram below would be eligible to claim tax exemption under the HK UFE Regime.



** For the purpose of the question, it is assumed that Cayman L.P. satisfies the definition of a "Fund" in section 20AM.*

(i) Global and regional funds often need to comply with the regulatory rules of many countries and such funds may at times not be able to directly hold Schedule 16C assets. The diagram above indicates that the specified securities have to be held by the Cayman LP fund indirectly through the 100% owned Super Hold Co. In such circumstances, would the IRD consider that Super Hold Co, being part of a fund complex structure, would also be itself a "fund", even though it has only one shareholder – such that any gains derived from transactions in the specified securities would be tax exempt?

> IRD responded as follows–
>
> - In the diagram above, Super Hold Co appeared to be an asset holding company. Super Hold Co, wholly owned by Cayman LP fund, was established to hold indirect investments in Private Co 1 through Hold Co 2; Private Co 2 through Hold Co 3; and direct investment in assets of a class specified in Schedule 16C.
>
> - It was doubtful that Super Hold Co could satisfy the three requirements as required in section 20AM(2) (i.e. the "managed as a whole" / "pooling" requirement, the "no day-to-day control" requirement and the "purpose or effect" requirement). It was also not clear whether Super Hold Co undertook to directly engage any activities prohibited in section 20AM(7). In the absence of full details, it would neither be safe nor satisfactory to categorically conclude that Super Hold Co should be a "fund" within the meaning of section 20AM(2).
>
> - Whether an entity was a fund or not was a question of fact. If an entity was a fund, there were legal consequences, including taxation liabilities, tax treaty treatments, AEOI obligations and FATCA obligations. It would be unsatisfactory if an entity was a fund for some purposes, whether under the IRO or not, and not for other purposes. If the fund regime under the IRO was relaxed or amended in any significant manner, Hong Kong had the obligation to bring up the matter to stakeholders, including the EU Code of Conduct Group (Business Taxation), to decide whether the regime remained fully compliant with their requirements.

(ii) Failing (i) above, would the IRD regard Super Hold Co as a special purpose entity (SPE) (despite its holding of the specified securities which are not an investee private company (IPC)) such that Hold Co 2 and Hold Co 3, being held indirectly by the Cayman LP fund, would still qualify as an interposed SPE?

> IRD responded as follows–
>
> - Super Hold Co would fail to meet the definition of SPE in section 20AO(4) if it was not established solely for the purpose of holding and administering one or more IPCs.

- Since Hold Co 2 and Hold Co 3 were not directly owned by Cayman LP (assumed to be a fund within section 20AM) and Super Hold Co was not an SPE, Hold Co 2 and Hold Co 3 were not SPEs as defined in section 20AO(4). It followed that Hold Co 2 and Hold Co 3 were not interposed SPEs as defined in section 20AO(4).

- If tax certainty was required, an application for an advance ruling might be made. The IRD would take into account all the facts and circumstances to decide whether an entity constituted an SPE or an interposed SPE.

(f) Taxability of royalty income for Intellectual Property (IP) generated by Research and Development (R&D) activities under Cost Contribution Arrangement (CCA)

A foreign company has a branch in Hong Kong (HK Branch). Under a CCA, the overseas headquarters undertakes R&D activities outside Hong Kong and the HK Branch undertakes R&D activities in Hong Kong to develop IPs. The foreign company is the legal owner of the IPs whereas the HK Branch is entitled to use the IPs.

Both the foreign company and the HK Branch generate sales from products manufactured utilizing the IPs. In addition, the foreign company generates royalty income from licensing the IPs to overseas third parties for use outside Hong Kong. The foreign company and the HK Branch share the annual total R&D expenditures under the CCA, based on the sales revenue generated from products utilizing the IPs, and the royalty income derived, in their respective territories.

	Foreign company	**HK Branch**
Sales	500	400
Royalty income	100	
R&D expenditure		
- Self-incurred	300	100
- Allocated	(60)	60

Assumptions:
1. *The R&D project is a qualifying project for section 16B purpose.*
2. *The CCA is a qualifying one according to DIPN 55.*
3. *The R&D expenditures borne by the HK Branch under the CCA follow the arm's length transfer pricing principle.*

(i) Given that the R&D expenditures allocation is made having regard to the sales and royalty income of the foreign company and HK Branch in the defined territories, would the IRD still consider the royalty income of the foreign company should be included as the taxable income of the HK Branch under section 50AAK?

(ii) If not, would the foreign company's royalty income be deemed taxable under section 15(1)(bc) because a deduction of R&D expenditure is allowable under section 16B? Please note that the deductible amount is the net amount borne by the HK Branch under the CCA (i.e. $160), which is computed having regard to the nil royalty income of HK Branch and the $100 royalty income of the foreign company.

The situation is the same as above, except that the HK Branch is replaced by a Hong Kong subsidiary of the foreign company. The IPs rights generated under the CCA are co-owned by the foreign company and the Hong Kong subsidiary.

(iii) Would part of the foreign company's royalty income be deemed taxable under section 15F?

(iv) If not, would part of the foreign company's royalty income be deemed taxable under section 15(1)(bc)?

In response to the questions (i) and (ii), the IRD's responses were as follows–

- A development CCA was a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles or tangible assets with the understanding that such intangibles or tangible assets were expected to create benefits for the individual businesses of each of the participants. It was normally entered into among the participants at the outset of the development project and the proportionate shares of contributions to be borne by the participants were determined based on their proportionate shares of **expected benefits**. It seemed that the arrangement mentioned in the question was an internal R&D cost allocation arrangement rather than a CCA as described in DIPN 55 since the shares of R&D expenditures borne by the foreign company (i.e. the head office) and the HK Branch were determined on the basis of their actual sales and royalty income rather than their expected respective shares of benefits. Assuming the subject arrangement was a qualifying CCA according to DIPN 55, the tax treatment of the royalty income was set out in the ensuing paragraphs.

- Under section 50AAK, a non-Hong Kong resident person who had a permanent establishment in Hong Kong was regarded as carrying on a trade, profession or business in Hong Kong for the purpose of charging profits tax. The income or loss of the person that was attributable to the permanent establishment of the person was those that the permanent establishment would have made in circumstances where it was a distinct and separate enterprise that engaged in the same or similar activities under the same or similar conditions; and dealt wholly independently with the person, having regard to the functions performed, assets used and risk assumed by the person through the permanent establishment and through the other parts of the person.

- Based on international tax rules after implementation of BEPS measures, income should be taxed at the place where the value was created and returns from intangibles should accrue to the entities that carried out the development, enhancement, maintenance, protection, and exploitation (DEMPE) functions. So if an IP or know-how was created or developed through an R&D activity of a person carrying on a trade, profession or business in Hong Kong, the royalties derived from licensing such IP or know-how should be regarded as Hong Kong sourced income and hence should be subject to Hong Kong profits tax.

- Given that the HK Branch had undertaken R&D activities in Hong Kong and made value creation contributions to the development of the concerned IPs (i.e. it had performed DEMPE functions in Hong Kong), the HK Branch should be entitled to a share of the royalty income derived from licensing the IPs to third parties by the head office. Under the circumstances, an appropriate portion of the royalty income should be attributable to the HK Branch by virtue of section 50AAK. Such attributed royalty income should also be taken into account when computing the amount of R&D expenditures to be borne by the HK Branch under the CCA in accordance with the arm's length transfer pricing principle.

- Section 15(1)(bc) provided that sums, not otherwise chargeable to profits tax, received by or accrued to a person for the use, or the right to the use, outside Hong Kong of any IP or know-how generated from any R&D activity in respect of which a deduction was allowable under section 16B in ascertaining profits of the person; or for imparting or undertaking to impart knowledge directly or indirectly connected with the use outside Hong Kong of any such IP or know-how, were deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong. Since the HK Branch was entitled to claim deduction of the R&D expenditures under section 16B, the royalty income attributed to the HK Branch as mentioned above should be chargeable to profits tax under section 15(1)(bc).

As regards questions (iii) and (iv), the IRD's responses were as follows–

- If the HK Branch was replaced by a Hong Kong subsidiary, part of the royalty income received by the foreign company should still be attributed to the Hong Kong subsidiary and chargeable to profits tax in Hong Kong, whether under section 15F or 15(1)(bc). The provisions under section 15(1)(bc) or 15F achieved the same result.

Ms Yee expressed the view that her experience had shown that cases were likely to allocate R&D costs on the basis of their sales and sought further clarification whether a qualifying CCA as described in DIPN 55 should be a prerequisite for the R&D cost allocation arrangement.

In response, Mr Chiu said that a CCA was a forward looking contract under which participants' proportionate shares of the overall contributions had to be consistent with the participants' proportionate shares of the total expected benefits to derive from the arrangement. Adjustments for underpayments or overpayments were anticipated by the participants upon entering into the CCA. Mr Chiu held the view that the CCA in the question was not the typical CCA. The answers the IRD provided above were generic and could serve as a general reference. He, however, said that it did not necessarily mean that a CCA had to be a qualifying CCA according to DIPN 55.

Ms Chik followed up and asked for the basis that should be adopted if a portion of the royalty income of $100 in the question was required to be allocated to HK Branch. On the same point, Ms Ho questioned whether a two-step approach should be adopted in allocating expenditures to the HK Branch (i.e. allocating a portion of the royalty income to the HK Branch and then allocating an appropriate portion of R&D expenditures to HK Branch).

Mr Chiu replied that income should be taxed at the place where the value was created and returns from intangibles should accrue to the entities that carried out the DEMPE functions. He said that it was necessary to review the expense allocation formula before deciding whether further adjustments were required.

Agenda Item A2 - Salaries Tax Issues

(a) Greater Bay Area (GBA) tax subsidy

In order to attract talents from Hong Kong and Macau to work in the 9 mainland cities of the GBA, tax subsidies are offered to qualified foreign high-end talents and talents in short who work in the 9 mainland cities in GBA. These tax subsidies are currently non-taxable items in the hands of the recipients for PRC individual income tax purposes. Are the tax subsidies taxable for Hong Kong salaries tax purposes?

The IRD responded as follows–

- Under section 8(1) of the IRO, "income from employment" was chargeable to salaries tax. "Income from employment" was defined under section 9(1)(a) of the IRO to include "any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others".

- It was well settled from court judgments that income chargeable to salaries tax under section 8 was not confined to income earned in the course of employment. It included payments made in return for acting as or being an employee, payments in the nature of a reward for services past, present and future, or inducement to enter into employment and provide future services.

- The GBA tax subsidies was provided by 9 cities in the GBA to high-end talents and talents in short-supply (Relevant Talents) who worked for enterprises or organizations in the cities pursuant to the preferential tax policy promulgated by the Central People's Government. The preferential tax policy applied to certain items of income covered by the Individual Income Tax (IIT) Law of the Mainland including wages and salaries, service fees, royalties and income from business operations. Apart from Hong Kong permanent residents, the preferential tax policy was also available to persons with foreign nationalities. The tax subsidies were the excess of IIT paid by the Relevant Talents in the cities over 15% of their qualifying taxable income. The Relevant Talents receiving the tax subsidies might be under an employment or carrying on a trade, profession or business.

- As the IRD understood, not all the nine cities had announced their rules for implementing the tax subsidies. For the cities the rules of which had been announced, differences were observed in the scope of Relevant Talents and implementation procedures for the tax subsidies.

- If a Hong Kong resident person receiving a GBA tax subsidy rendered outside Hong Kong all the services in connection with the person's employment, the person would be exempted from salaries tax in Hong Kong under section 8(1A)(b)(ii).

- If a Hong Kong resident person under Hong Kong employment or non-Hong Kong employment rendered services both in Hong Kong and the Mainland, the person might be entitled to a GBA tax subsidy if all the qualifying conditions were satisfied. The person was liable to pay IIT in the Mainland if not all the 3 conditions under Article 14(2) of the Comprehensive Double Taxation Agreement (CDTA) between the Mainland and Hong Kong were satisfied. The person was also liable to pay salaries tax in Hong Kong under section 8(1) for Hong Kong employment or section 8(1A)(a) for non-Hong Kong employment.

- Having said that, based on the available information, it appeared that a Hong Kong resident person who was likely to benefit from a GBA tax subsidy should be one who qualified as a Relevant Talent and employed by a Mainland enterprise or organization in any of the nine cities (i.e. having a Mainland employment). In this connection, the IRD had the following views:

  (a) If the Hong Kong resident person rendered all the services in connection with the employment in the Mainland, the person would be exempted from salaries tax under section 8(1A)(b)(ii). As such, the taxability of the tax subsidy would not be an issue.

  (b) If the Hong Kong resident person rendered services in connection with the employment both in Hong Kong and the Mainland, the person would be chargeable to salaries tax in respect of the person's income derived from services in Hong Kong under section 8(1A)(a). Pursuant to Article 14 of the CDTA between the Mainland and Hong Kong, the Mainland would only tax the person's income derived from services rendered in the Mainland. If the person was taxed in the Mainland and Hong Kong on such basis and in the absence of any specific facts, the tax subsidy receivable by the person, whether or not in the nature of income from employment, should be wholly attributable to the person's services in the Mainland. For this reason, it was likely that the tax subsidy would not fall within the charge to salaries tax under section 8(1A)(a).

Mr William Chan expressed concerns that the amount of tax subsidies would affect the calculation of tax credit in Hong Kong. Mr Chiang supplemented that the grant of GBA tax subsidies was subject to approval, i.e. the Hong Kong resident person who qualified as a Relevant Talent had to pay the full amount of IIT first and then applied for tax subsidies in accordance with the arrangements adopted by the relevant authorities in the Mainland. He indicated that under this mechanism, the Hong Kong resident person would obtain tax subsidies a few months later than the date of IIT payment. He asked whether the Hong Kong resident person should first claim tax credit based on the full amount of IIT paid and then notify the IRD of the GBA tax subsidies when received.

Mr Chiu replied that the GBA tax subsidies provided by nine cities in the GBA was not new. The IIT preferential tax policies had been implemented in Shenzhen Qianhai and Zhuhai Hengqin some years ago. He took the view that the GBA tax subsidies were more akin to tax reduction in Hong Kong since the tax subsidies had the effect of reducing the actual IIT liability in the Mainland. On the other hand, Mr Chiu pointed out that even if the GBA tax subsidies were regarded as income from employment, the tax subsidies, being the excess of IIT paid over 15% of taxable income, should represent income attributable to services rendered in the Mainland. Mr Chiu explained that if the tax subsidies were received by a taxpayer some time after tax credits had been granted, causing the amount of tax credits previously granted to become excessive, the taxpayer should notify the IRD within 3 months after the tax subsidies were provided under section 50AA(5) of the IRO.

[Post-meeting note: As of today, all nine Pearl River Delta cities had announced their rules for implementing the tax subsidies.]

(b) Chargeability of termination payment

The Court of Final Appeal handed down its decision on the case of *Commissioner of Inland Revenue v Poon Cho-ming, John* FACV No. 1 of 2019, upholding the Court of Appeal's decision that a Payment in Lieu of Bonus and Share Option Gain arising from a Separation Agreement should not be subject to Salaries Tax. The decision affirms the principles established in *Fuchs v Commissioner of Inland Revenue* (2011) 14 HKCFAR 74 and brings further clarity to the taxation of termination payments.

Would the IRD consider issuing further guidance or a practice note on the taxation of termination payments to broadly explain under what circumstances the IRD would regard a termination payment as taxable?

The IRD responded that the principles applied in both Court of Final Appeal judgments in *Fuchs v Commissioner of Inland Revenue* (2011) 14 HKCFAR 74 and *Commissioner of Inland Revenue v Poon Cho-ming, John* [2019] HKCFA 38 were the same. The cases were decided on their own facts and merits. The Fuchs's case illustrated an instance of chargeability. The Poon's case illustrated an instance of non-chargeability. The applicable principles were broadly summarized under paragraph 21 of the Court of First Instance judgment in *Heath Brian Zarin v Commissioner of Inland Revenue* [2020] HKCFI 330. There was no plan to issue a DIPN on the subject. Employers should continue reporting termination payments in employers' returns. Taxpayers might exercise their objection rights in the event that any part of their termination payments were assessed and they did not agree with those assessments. Decision would be made based on the facts and evidence of each case.

(c) Taxation of discretionary bonus and related employer's reporting obligations

Take the example of an employee holding a non-Hong Kong employment seconded to work in Hong Kong from 1 January 2019 to 31 October 2019. The employee is subject to Hong Kong Salaries Tax on a time-apportionment basis during his Hong Kong secondment. He was relocated outside Hong Kong to another group company on 1 November 2019. He spent less than 60 days in Hong Kong during visits in the year of assessment 2020/21.

His employment contract specifically provides that he would be entitled to a discretionary bonus in each year on account of the following factors:

(i) the individual performance in the relevant financial year;
(ii) the financial result of the group for the relevant financial year; and
(iii) the general economic environment at the time of the award.

Assuming that the employee receives a discretionary bonus of HK$A on 1 May 2020 in respect of financial year of the group ended 31 December 2019.

Would any part of the bonus which only accrues and receives in May 2020 in the above circumstances be taxable for Hong Kong salaries tax purposes? If yes, what is the appropriate and acceptable attribution basis to calculate the taxable amount? What are the reporting obligations of the employer?

The IRD responded as follows–

- In the example, it was not clear whether the discretionary bonus was derived from services rendered in the year of assessment 2019/20 or in the year of assessment 2020/21 or both. If the bonus (which accrued only in May 2020 was received by the employee on 1 May 2020) was derived from services rendered in the year of assessment 2020/21, no salaries tax liability arose since the employee spent less than 60 days in Hong Kong during visits in the year of assessment 2020/21. Thus, the bonus would be exempted under sections 8(1A)(b)(ii) and 8(1B) of the IRO. If the discretionary bonus was derived from services rendered in the year of assessment 2019/20, the bonus would be taxed in the year of assessment 2020/21 (based on the number of days the employee spent in Hong Kong in the year of assessment 2019/20) since the bonus accrued to the employee in the year of assessment 2020/21. Depending on the facts and merits of each case, the anti-avoidance provisions of the IRO might be invoked to tax bonus derived from services rendered in Hong Kong.

- It was noted that complications might arise since section 11D(b) of the IRO provides that income accrued to a person when he became entitled to claim payment. In any event, if entitlement arose after 31 December 2019 (account closing date) but before 1 April 2020, the bonus accrued to the employee during the year of assessment 2019/20 and salaries tax liability arose in the year of assessment 2019/20 though payment was only made in May 2020.

- It was stated in note 5 of the Notes and Instructions for Form IR56B that "(if) the employee is entitled to claim payment of a bonus in respect of a reporting year under the terms of employment, the amount of bonus must be reported in that year irrespective of when it was paid. In all other circumstances the amount of bonus actually paid to the employee during the reporting year must be reported". In this connection, the group company in Hong Kong had to report the bonus in either the 2019/20 or 2020/21 employer's return. A note might be added under item 14 (Remarks) of the employer's return on the number of days the employee stayed in Hong Kong during the year in which the employee rendered services to earn the bonus.

(d) Demand of provisional salaries tax

Effective from year of assessment 2018/19, individual taxpayers who derive income from services rendered in a foreign jurisdiction having a CDTA with Hong Kong and paid taxes in the similar nature of salaries tax in that jurisdiction can only claim a tax credit (and not the section 8(1A)(c) income exemption) if the income is also subject to salaries tax in Hong Kong. However, we note that the IRD had not taken into account the tax credit claimed in 2018/19 in demanding the 2019/20 provisional tax when issuing the 2018/19 notices of assessment. In the past, these individual taxpayers could make a section 8(1A)(c) income exemption claim and when such claim for 2018/19 was accepted by the IRD, the computation of the 2019/20 provisional tax will take into account the amount of income exempted.

It seems that these individuals will also not be able to apply for holdover of provisional salaries tax by virtue of section 63E as eligibility to claiming tax credit in current year is not a ground for applying for holdover of provisional tax under section 63E.

In view of the above, the Institute would like to ask if–

(i) the IRD will take into consideration the amount of tax credit granted in the current year of assessment when computing the provisional salaries tax for the next year of assessment; and

(ii) the IRD will accept, as a concession, an application for holding over provisional salaries tax on the ground that the taxpayer has income derived from services rendered in a jurisdiction having a CDTA with Hong Kong and is entitled to tax credit for the taxes paid in that jurisdiction.

The IRD responded as follows–

- The amount of provisional salaries tax for a year of assessment (Year Y) was, pursuant to section 63C(1) of the IRO, calculated by applying the tax rates specified for Year Y to the amount of the net chargeable income for the preceding year of assessment (Year Y-1). The tax credit for Year Y-1 was, by virtue of section 50(1) of the IRO, allowed as a credit only against the tax payable in Year Y-1. Where foreign tax of Year Y-1 exceeded the tax credit of Year Y-1, the excess was, pursuant to section 50(5), allowed as a deduction in the computation of the net chargeable income of Year Y-1. In this connection, the excess of foreign tax over tax credit for Year Y-1 was taken into account in the computation of the provisional salaries tax of Year Y. However, tax credit for Year Y-1 was not allowed as a credit against the provisional salaries tax for Year Y.

- Section 63E(2) of the IRO set out the grounds for holding over of payment of provisional salaries tax for Year Y. The IRD was not empowered to entertain any holdover claim in respect of any prospective tax credit for Year Y.

Ms Ho was concerned with the hardship suffered by taxpayers if an application for holdover of provisional salaries tax due to tax credit in the current year of assessment was not accepted. She asked if the IRD would consider providing other administrative measures to ease the cashflow pressure of taxpayers. CIR had taken note of the Institute's concerns and expressed that the IRD had to observe the law. He indicated that it would not be possible for the IRD to provide administrative measures unless there was a change in the legislation.

(e) Tax treatment of housing benefits provided to employee by a third party

If a non-Hong Kong employer assigns its foreign employee to work in the office of an unrelated third party client in Hong Kong, the client would provide rent-free accommodation to the foreign employee during the assignment period. Will the rent free accommodation get caught under section 9(1)(b) and deemed income (i.e., rental value) be computed and included in the hands of the employee for salaries tax reporting by virtue to section 9(2) of the IRO?

The IRD responded as follows–

- Section 9(1)(b) of the IRO defined income from employment to include the rental value of any place of residence provided rent-free by the employer or an associated corporation.

- The non-Hong Kong employer in the above-mentioned case assigned its foreign employee to work in the office of an unrelated third party client in Hong Kong which would "provide" rent-free accommodation to the foreign employee during the assignment period. This raised questions why the unrelated client had to do so, and whether it was the non-Hong Kong employer that provided the accommodation to its employee through the unrelated client. The arrangement had to be examined in detail.

- Relevant matters for consideration included: whether the unrelated client provided the housing benefit on behalf of the non-Hong Kong employer; whether there was any recharge of the costs of the housing benefit to the non-Hong Kong employer; whether the non-Hong Kong employer ultimately bore the costs of the housing benefit; and reasons why the unrelated client provided such rent-free accommodation without charging any or full housing cost.

- If the non-Hong Kong employer provided the accommodation to its employee through the unrelated client, the rental value of such accommodation has to be subject to salaries tax under sections 9(1)(b) and 9(2) of the IRO.

Ms Agnes Cheung asked whether tax treatment of housing benefits would be different if the foreign employee of the non-Hong Kong employer accommodated in the unrelated client's staff quarters in Hong Kong during the assignment period in Hong Kong and there was no recharge of the costs of the housing benefit to the non-Hong Kong employer. Mr Chiang also raised concern on the taxability of rent-free place of residence provided by the contracting party to the foreign employee of the other contracting party based on agreed commercial terms of agreement (e.g. global or regional IT consulting services agreement).

In response, Ms Wong said that all the relevant facts had to be considered before a decision could be made. Mr Chiu pointed out that according to section 9(1)(b), income from employment includes the rental value of a place of rent-free residence was provided by the employer or an associated corporation. Hence, the emphasis should lie on the person who provided the rent-free accommodation to the employee. CIR supplemented that taxability of housing benefit was fact-specific and suggested that an application for an advance ruling should be considered if tax certainty was required.

Agenda Item A3 – Transfer Pricing

(a) Section 15F as a specific transfer pricing adjustment

In the IRD's compendium of comments on draft DIPN 59 issued to the Joint Liaison Committee of Taxation, the IRD indicates that where a Hong Kong taxpayer is chargeable to tax in Hong Kong under section 15F in respect of royalty income earned by their non-Hong Kong resident affiliate of a jurisdiction which has concluded a CDTA with Hong Kong, the said affiliate can claim a corresponding adjustment in the jurisdiction of which the affiliate is a resident. Such a claim would be made under the Associated Enterprises article of the CDTA.

Given the above position taken by the IRD, some of our members have taken the view that a section 15F assessment is essentially an application of one of the possible transfer pricing adjustments as envisaged by the BEPS Actions 8-10 2015 Final Reports to a specific set of circumstances as prescribed by section 15F, i.e., section 15F is not a standalone deeming provision divorced from Rule 1 of section 50AAF of the IRO.

That means even without section 15F, a transfer pricing adjustment to the same effect as that allowed by section 15F can in any case be made under Rule 1 under the said specific set of circumstances.

In this regard, would the IRD please comment on the above observation?

The IRD responded as follows–

- The IRD had come across cases where a person had made value creation contributions through performing functions, providing assets and assuming risks in relation to the DEMPE of an IP in Hong Kong while the legal ownership of the IP was taken up by an associate, being a non-Hong Kong resident person, in a no or low tax jurisdiction. Though value creation contributions in relation to the IP were not made by the associate, sums from the use or right to use of the IP accrued to or were received by the associate which paid no or a limited amount of tax in the associate's jurisdiction of residence on the sums. On the other hand, the person in Hong Kong was not assessed to tax in respect of an arm's length return based on the value creation contributions the person made in Hong Kong.

- Section 15F was enacted to tackle the above abusive arrangement by deeming sums from the use or right to use an IP that was attributable to the value creation contributions of a person to be a trading receipt arising in or derived from Hong Kong by the person from a trade, profession or business carried on in Hong Kong. While the arrangement might also fall within the ambit of the general transfer pricing provisions under section 50AAF, section 15F was a standalone deeming provision which applied without relying on any of the provisions in section 50AAF. Thus, a person falling within the provisions of section 15F should take active steps to compute an arm's length return based on the value creation contributions the person made in Hong Kong and declare the arm's length return as assessable profits in the person's profits tax return.

- Co-existence of general and specific provisions was not new in the IRO. To combat an abusive arrangement with specific features, a deeming provision should first be applied.

(b) Whether the IRD would generally follow the guidance on transfer pricing adjustments applicable to intangibles as illustrated in the BEPS Final Reports

In addition, would the IRD generally follow the principles for the application of transfer pricing adjustments as illustrated in "Annex to Chapter VI – Examples to illustrate the guidance on intangibles" of the BEPS Actions 8-10 2015 Final Reports (the Reports can be accessed by the link: https://www.oecd.org/tax/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm)?

Specifically, Example 14 of the Annex illustrates circumstances where a subsidiary performs R&D work under the direction and supervision of a parent company under a service agreement. The service agreement provides that any intangibles derived from the R&D work of the subsidiary will belong to the parent company.

In the circumstances as illustrated in Example 14, any transfer pricing adjustments would generally relate to whether the service fees received by the subsidiary for a year are arms' length and would not affect the entitlement of the parent company to future returns derived from exploiting any intangibles derived from the R&D work of the subsidiary.

In this regard, would the IRD agree that where the subsidiary in Example 14 is located in Hong Kong, section 15F would not be applicable?

The IRD responded as follows–

- Section 15F applied where a person had made value creation contributions for an IP through, among others, assuming risks on the DEMPE of the IP in Hong Kong.

- Example 14 in the Annex to Chapter VI of the BEPS Actions 8-10 2015 Final Reports concerned a situation where the parent company of a multinational enterprise (MNE) group engaged an overseas subsidiary to carry out specific R&D activities at a fee. The parent company was responsible for designing all the group's R&D projects, developing and controlling the related budgets, and monitoring the progress of the projects. The subsidiary company performed R&D activities as directed by the parent company, and was required to report its progress of work to the parent company on a regular basis. The contract between the parent company and the subsidiary company provided that the parent company would bear all risks and costs related to the R&D activities of the subsidiary company, and any IP developed by the subsidiary company would be registered by the parent company.

- In the example, the subsidiary company was more akin to a R&D service provider without assuming any risks in relation to the DEMPE of the IP. Such risks were borne by the parent company through performing important functions relating to the management, design, budgeting and funding of the relevant R&D projects. Hence, section 15F was unlikely to be applicable to the subsidiary company. Profits derived by the subsidiary company from the provision of R&D services were required to be computed in accordance with the arm's length principle under section 50AAF.

- In any event, the IRD would carefully analyze a person's function and risk profile so as to determine whether the person had made any value creation contributions to an IP in Hong Kong and whether section 15F was applicable. Each case should be decided on its own facts and circumstances.

Mr Patrick Cheung followed up and sought the IRD's confirmation that section 15F did not apply to an overseas subsidiary which did not bear any risks on the DEMPE of an IP in Hong Kong.

Mr Chan confirmed in the affirmative. He said that the IRD generally followed the OECD's transfer pricing guidelines. He also referred to two examples after Example 14 in the Annex to Chapter VI of the BEPS Actions 8-10 2015 Final Reports, which illustrated the situations where an overseas subsidiary was not regarded as having made value creation contributions for an IP even though the overseas subsidiary assumed financial risks. He concluded that whether the person had made any value creation contributions to an IP in Hong Kong and whether section 15F was applicable depended on the facts and circumstances of each case.

(c) County-by-country (CbC) reporting – Changes in ultimate parent entity (UPE) during the financial year

A Hong Kong entity has changed UPE twice during the financial year 2019 (i.e. the Hong Kong entity has three UPEs for the financial year 2019). Both former and current UPEs have same financial year end date, say 31 December, and the consolidated revenue of the UPEs in the year 2018 exceeds the threshold. The Hong Kong entity is the only Hong Kong entity of both former and current UPEs. Under these circumstances-

(i) Whether the Hong Kong entity is required to submit CbC notification to the IRD on or before 31 March 2020 in respect of both former and current UPEs?

The IRD responded as follows–

- Section 58H(1) of the IRO required a Hong Kong entity of a reportable group to file a written notice relating to the group's CbC reporting obligation (CbC notification). Under section 58B(1), a Hong Kong entity was defined as a constituent entity that was either resident for tax purposes in Hong Kong or a permanent establishment in Hong Kong, whilst a constituent entity meant, among others, any separate business unit of a group that was included in the consolidated financial statements of the group.

- In the given example, the UPE and in turn the reportable group of the Hong Kong entity was changed twice in the accounting period beginning in 2019 (the 2019 accounting period). Whether the Hong Kong entity was required to submit a CbC notification in respect of each of the former and current groups depended on the accounting standards adopted by the relevant UPE in preparing the group's consolidated financial statements. If the applicable accounting standards required the financial data of the Hong Kong entity to be incorporated into the group's consolidated financial statements on a pro-rata basis, the Hong Kong entity, which would constitute a Hong Kong entity of the group for the 2019 accounting period, would be obliged to file a CbC notification in respect of the group for that period. However, if the applicable accounting standards did not require such a pro-rata incorporation, the Hong Kong entity would not be a Hong Kong entity of the group for the 2019 accounting period and thus had no obligation to file a CbC notification in respect of the group for that period.

- It should be noted that in the example the Hong Kong entity was the only constituent entity of each reportable group in Hong Kong. In most cases, however, a reportable group might have another constituent entity which could be arranged to take up the responsibility for filing the CbC notification after the entity previously responsible for filing the CbC notification ceased to be a Hong Kong entity of the group. With such an arrangement, the Hong Kong entity could be relieved from the notification requirement by virtue of section 58H(3).

(ii) If the answer to the above question is affirmative, since the Hong Kong entity has already been disposed of to a third party, the former UPEs would unlikely provide the group's financial data to the Hong Kong entity for CbC notification and/or for secondary filing purpose, what should the Hong Kong entity do in order to fulfill its CbC filing obligations? Would penalty be imposed on the Hong Kong entity due to the non-compliance?

The IRD responded as follows–

- CbC reporting called for coordination within an MNE group. If the Hong Kong entity was required to file a CbC notification or return in respect of any of the former reportable groups for the 2019 accounting period, the relevant UPE had the obligation to ensure the availability of all necessary information for the Hong Kong entity to comply with the reporting requirements. The UPE should not neglect such obligation even if the entity ceased to be a Hong Kong entity of the reportable group in the accounting period. Since the Hong Kong entity was the only constituent entity of the reportable group in Hong Kong, the entity's failure to file the CbC notification or return would result in non-compliance of CbC reporting by the group in Hong Kong.

- Section 80G(1) of the IRO provided that a reporting entity committed an offence if the entity without reasonable excuse failed to comply with the requirement for filing a CbC notification under section 58H or a CbC return under 58F of the IRO. Whether a reporting entity committed an offence without reasonable excuse depended on the facts and circumstances of each case. The steps taken for compliance by the Hong Kong entity should be relevant factors for consideration.

(iii) On the assumption that the Hong Kong entity could obtain the group financial data of the UPEs, how could the Hong Kong entity notify/submit the CbC return and report to the IRD via the CbC Reporting Portal given that the CbC Reporting Portal only supports one notification/CbC return and report for a financial year?

The IRD responded as follows–

- While the IRD was considering enhancements to the CbC Reporting Portal for accommodating the filing of multiple CbC notifications and returns in respect of the same accounting period, it was envisaged that the cases in which a Hong Kong entity was required to submit more than one CbC notification or return for the same accounting period would be few.

- In the interim, if any Hong Kong entity was required to file multiple CbC notifications or returns in respect of the same accounting period, the entity was advised to approach the Assessor for arrangements via the message box in the CbC Reporting Portal.

(d) Documentary support for the "capital attribution tax adjustment" made in tax returns

Effective from the year of assessment 2019/20, a Hong Kong branch of a non-resident entity (foreign banks in particular) is required to make a "capital attribution tax adjustment" in its tax computations under the 4- or 5-step approach as detailed in DIPN 60 under the Authorized OECD Approach (the AOA).

In this regard, does the taxpayer need to prepare, sign and submit to the IRD a separate tax balance sheet notionally worked on under the 4- or 5-step approach in addition to the financial accounts of the Hong Kong branch, to substantiate the "capital attribution tax adjustment" made in the tax computations?

The IRD responded as follows–

- Section 50AAK required the income or loss of a non-Hong Kong resident person attributable to the person's permanent establishment in Hong Kong to be determined as if the permanent establishment were a distinct and separate enterprise. The purpose of section 50AAK was to prevent under-attribution of profits or over-attribution of loss to a non-resident enterprise's permanent establishment in Hong Kong. As a revenue protection provision, section 50AAK should be read in a negative sense (i.e. only upward adjustments were intended). Downward adjustments would be considered by way of corresponding relief pursuant to the relevant double taxation agreement or arrangement under section 50AAO of the IRO.

- The AOA was a preferred approach to the application of section 50AAK. Under the AOA, a non-Hong Kong resident person had to consider attribution of capital to its permanent establishment in Hong Kong for determining whether the deduction of interest claimed in the computation of the permanent establishment's profits should be restricted. For this purpose, the person was required to draw up a tax balance sheet of the permanent establishment, and retain appropriate documentation to support its compliance with the AOA in respect of the permanent establishment as per Appendix 2 to DIPN 60. The tax balance sheet, together with schedules setting out the details of capital attribution and restriction of interest, were expected to be submitted upon the filing of the profits tax return. The requirement for such information and documents would be provided in the Notes and Instructions for the 2020/21 profits tax return.

(e) Intangible – deductibility of cost incurred for generating IP in Hong Kong

By virtue of section 15F of the IRO, a Hong Kong taxpayer should be rewarded for its DEMPE functions performed in Hong Kong that give rise to IP (including marketing IP such as trademark) held by its overseas associated entities.

Whereas, a Hong Kong taxpayer develops and owns an IP in Hong Kong and derives royalty income from licensing such IP inside and/or outside Hong Kong, the royalty income would be taxable in the hands of the Hong Kong taxpayer for profits tax purposes. However, on the flip side, cost incurred by the Hong Kong taxpayer for developing marketing IP may not be entitled to deduction as this may be perceived as expenditure for creating a capital asset (i.e., the marketing IP).

Can any change or concessionary measures be made to neutralize the taxability (of royalty or deemed royalty under section 15F) and non-deductibility (of cost incurred for creating capital asset)?

The IRD responded as follows–

- Section 15F aimed to bring into profits tax charge income derived from an IP legally owned by a non-Hong Kong resident associate with value creation contributions made in Hong Kong. The relevant IP was no different from any IP developed and owned in Hong Kong, and there was no justification to provide any "concessionary" treatment for expenditure deduction in respect of the relevant IP or depart from existing tax rules. In other words, any expenditure of a revenue nature incurred in the production of chargeable profits would continue to be allowable for deduction under sections 16 and 17 of the IRO.

- If the development of the relevant IP involved any R&D activities, deductions provided under section 16B of the IRO might be allowable. For marketing IP such as trademark, any sums expended for registration of such IP were deductible under section 16(1)(g).

(f) Royalty payments to overseas non-resident

By virtue of sections 15(1) and 20A of the IRO, Hong Kong taxpayers are the tax withholding agents for royalty payments made to the overseas recipients on certain IP, e.g. trademarks, copyrights and etc. The Hong Kong taxpayers are obliged to file tax returns and subsequently remit tax withheld to the IRD on behalf of the overseas recipients. Assuming that the overseas recipient is a related party, are the transactions required to comply with the arm's length requirement, or these transactions could be regarded as specified domestic transactions on the basis that there is no actual tax difference? When would the arm's length requirement apply to the two scenarios stated in section 21A of the IRO, i.e. (i) 100% of the royalty income of the overseas related party be deemed as taxable receipt if the IP was once owned by a Hong Kong taxpayer; and

(ii) 30% of the royalty income of the overseas related party be deemed as taxable receipt, if the IP had never been owned by a Hong Kong taxpayer?

The IRD responded as follows–

- By virtue of section 50AAJ(4) of the IRO, a person in receipt of royalty that fell within section 15(1) was not regarded as having carried on a trade, profession or business in Hong Kong for the purposes of the domestic nature condition under section 50AAJ(3). As the domestic nature condition was not met in relation to the actual provision made or imposed between the overseas recipient and the Hong Kong associate paying the royalty, section 50AAJ(2) would not operate to disapply section 50AAF by taking the actual provision as not conferring a potential advantage in relation to Hong Kong tax. Hence, it was not necessary to consider whether the no actual tax difference condition was met in scenarios (i) and (ii) referred to in the question. In either scenario, section 50AAF was applicable and the income or loss in relation to the royalty transaction should be computed on the basis of the arm's length provision.

- Likewise, the royalty transaction, being a controlled transaction between the overseas recipient and the Hong Kong associate payer, did not fall within the meaning of "specified domestic transaction" as provided under sections 2 and 3 of Schedule 17I to the IRO. The Hong Kong associate payer was required to include the transaction in its local file under section 58C(2) of the IRO.

Agenda item A4 - Double Tax Agreements/ Certificate of Residence / Spontaneous Exchange of Information

(a) Certificate of Residence (CoR) for offshore economic substance (ES) law purposes

Under the ES laws of offshore jurisdictions (e.g. BVI, Cayman Islands, Bermuda), entities that are tax residents in other jurisdictions are not subject to their ES requirements. There are many BVI/Cayman Islands/Bermuda companies carrying on businesses in Hong Kong, including listed companies. These listed companies are managed and controlled in Hong Kong and their group has business substance in Hong Kong. They would need to declare themselves as tax residents in Hong Kong and provide supporting documents according to the offshore economic substance law reporting requirements. According to the guidelines issued by the BVI, Cayman Islands and Bermuda governments, the supporting documents include tax resident certificate, tax assessment, payment of a tax liability etc.

CoR would be a strong proof to these offshore governments in accepting tax residence in Hong Kong, particularly for those entities with tax losses such that they cannot provide tax assessment or tax payment evidence.

On some occasions, a confirmation from the IRD would be required for other business purposes, e.g. an overseas debtor requested the Hong Kong recipient to produce a confirmation for claiming VAT exemption. However, under the current IRD practice, CoR applications for purposes other than claiming tax benefits under tax treaties would not be entertained.

The Institute would like to ask if the IRD could consider issuing a special class of CoR or other documentation proof (e.g. letter stating that the entity is considered to be a Hong Kong tax resident) for serving the offshore ES law purposes or other non-treaty purposes?

The IRD responded as follows–

- The substantial activities requirements had been elevated in importance under Action 5 of the BEPS Project and were then a key factor for the purpose of assessing preferential regimes. The Inclusive Framework on BEPS (Inclusive Framework) had earlier agreed to resume the application of the substantial activities requirements to no or only nominal tax jurisdictions, with a view to ensuring a level playing field between the jurisdictions introducing substantial activities requirements in preferential regimes and those offering a general zero or only nominal corporate tax rate. A no or only nominal tax jurisdiction might exclude an entity from the application of the substantial activities requirements on the grounds that the entity was tax resident in a taxing jurisdiction.

- The IRD was particularly mindful of the suggestion of issuing a special class of CoR or other documentation proof (e.g. letter stating that the entity is considered to be a Hong Kong tax resident) for the purpose of exempting the offshore entity from its obligation regarding substantial activities requirements. The IRD would like to highlight the following concerns:

(a) As the IRD understood, the objective of resuming the application of substantial activities requirements to no or only nominal tax jurisdictions was to prevent the mobile business income derived by an entity from being "parked" in such a jurisdiction unless the core income generating activities are undertaken by the entity or in the jurisdiction. The substantial activities requirements, together with the Global Anti-Base Erosion (GloBE) proposal (i.e. Pillar Two under the Programme of Work for Addressing the Tax Challenges of the Digitalization of the Economy, commonly known as "BEPS 2.0") presently discussed by the Inclusive Framework, aimed to ensure that all internationally operating businesses pay a minimum level of tax. The substantial activities requirements and the GloBE proposal were already / expected to become the international tax standards. Assisting BVI, Cayman or Bermuda entities to get around the substantial activities requirements and to continue sheltering their taxable profits / income without subject to tax anywhere was clearly contrary to the standards and would damage the reputation of Hong Kong as a responsible member of the international tax community.

(b) Hong Kong was subject to the screening exercise by the European Union (EU) for its list of non-cooperative tax jurisdictions. One of the screening criteria (i.e. criterion 2.2) required that "the jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction". To avoid any suspicion raised by the EU that Hong Kong was harbouring such BEPS activities, Hong Kong should not allow any offshore entities to claim tax residence in Hong Kong in the absence of any nexus with Hong Kong.

- In addition, a CoR was an official document issued by the Hong Kong competent authority to a Hong Kong tax resident who required proof of his Hong Kong tax resident status for the purpose of claiming tax benefits under a specific CDTA. It would be against international practice for the Hong Kong competent authority to issue a CoR, in the absence of a CDTA, to such BVI, Cayman or Bermuda entities for the purpose of exempting them from obligations regarding substantial activities requirements. If a CoR was issued in such a manner, it would discredit the Hong Kong competent authority as having failed to adhere to its commitments made during treaty negotiations and Hong Kong's CDTA partners might cease to accept the CoR as a proof of Hong Kong tax resident status.

- Similarly, the Hong Kong competent authority would not issue a CoR to a person who wished to obtain the CoR for the purpose of reclaiming VAT paid in other overseas jurisdictions. As far as we understood, tax authorities of most European countries would normally accept a certified copy of the applicant's Business Registration Certificate in processing the application for VAT exemption. A taxpayer might approach the Business Registration Office and obtain, subject to a fee, a certified copy of Business Registration Certificate to meet the requirements of the overseas jurisdictions.

Ms Sarah Chan, whilst taking note of the IRD's position that a CoR would not be issued unless there were CDTAs with particular jurisdictions, reckoned that it would be much appreciated if the IRD could consider issuing a special class of CoR or other documentation proof to avoid undue hardship to taxpayers. Mr Yeung and Mr William Chan echoed the points made by Ms Sarah Chan. Mr Yeung further commented that his experience had showed that it seemed relatively more difficult to obtain a CoR in Hong Kong than other foreign jurisdictions. He was of the view that it might unnecessarily cause confusion to present a certified copy of the applicant's Business Registration Certificate to the tax authorities of foreign jurisdictions since most foreign jurisdictions recognized "tax registration" mechanism but not "business registration" mechanism.

CIR appealed to the Institute's understanding that the IRD had to exercise caution in deciding whether a CoR could be issued. CIR explained to the Institute's representatives that the IRD, as the competent authority under the CDTAs signed by Hong Kong, had to act in good faith in accordance with the terms of the CDTAs, to uphold the purposes for which the CDTAs were signed (i.e. avoid double taxation and prevent tax avoidance or evasion) and to prevent treaty abuse. If a CoR was issued for serving the offshore ES law purpose or other non-treaty purpose as proposed, it would discredit Hong Kong as having failed to adhere to its commitments made during treaty negotiations. Hong Kong's DTA partners might cease to accept CoR as a proof of Hong Kong tax resident status. CIR stressed that the IRD had to duly consider Hong Kong's reputation and credibility in the international tax community and should avoid any misconception that Hong Kong condoned or assisted any entity in circumventing the substantial activities requirements of other tax jurisdictions. As regards the Institute's call for the issue of documentation proof, CIR pointed out that the documents issued by the IRD could just state the facts of the case (e.g. a confirmation of tax payment). Whether the information on such document was found relevant by other foreign jurisdictions remained a matter for such jurisdictions.

(b) CoR Status

The IRD confirmed in the 2018 Annual Meeting that it committed to provide Hong Kong residents with assistance in claiming tax treaty benefits to which they are entitled under a CDTA. Apart from the Mainland-Hong Kong CDTA, the CoR is generally valid for 1 calendar year. As part of the CoR application process, the applicant would have to demonstrate that it is managed and controlled from Hong Kong, has sufficient economic substance and is the beneficial owner of the treaty benefit for the year(s) concerned.

Members experienced that, as part of their CoR applications, some IRD case officers requested information on applicants' status beyond the year of application.

Based on the above, the Institute would like to ask what would be the relevance of the information in prior years in determining the application year? Is there a change in practice and if so, what is the latest IRD's position on this?

The IRD responded as follows–

- A CoR served to prove the resident status of a Hong Kong resident who wished to claim tax benefits under a CDTA. To prevent treaty abuse and to protect Hong Kong's reputation as a responsible treaty partner, the IRD officers had to be very cautious in deciding whether a CoR could be issued.

- Whether an applicant was a Hong Kong resident under the relevant CDTA was a question of fact, depending on the particular circumstances of each case. When processing an application for CoR, the IRD officer would thoroughly examine the relevant facts of the application and exercise professional judgment accordingly. If the information provided by the applicant was insufficient to determine its resident status, the IRD officer would require the applicant to provide further information to substantiate its claim. The information requested might not be limited to the year of claim. For example, a company submitted an application to the IRD in February 2020 requesting a CoR for the calendar year 2020. At the time of application, the company had not held any board meeting in 2020, but claimed that its business was normally managed and controlled in Hong Kong. To consider the application, the IRD officers might request the company to provide copies of minutes of board meetings held in prior years to ascertain the place in which the company normally exercised its management or control.

- In paragraph 2(a) of Article 10 (Dividends) of the 2017 OECD Model Tax Convention, it was required that a minimum shareholding period (i.e. a 365 day period) be satisfied in order for a company to be entitled to a reduced rate on dividends from a subsidiary. Such provision had been included in a number of CDTAs to be signed by Hong Kong with other jurisdictions. Therefore, information for prior years might be required by the IRD officers to ascertain whether the requirement on holding period had been fulfilled.

- CDTAs were international treaties and Hong Kong had the obligation to administer the terms of the CDTAs in accordance with international law. The IRD, as the competent authority under the CDTAs signed by Hong Kong, had to act in good faith in accordance with the terms of the CDTAs, to uphold the purposes for which the CDTAs were signed (i.e. avoid double taxation and prevent tax avoidance or evasion) and to prevent treaty abuse. Therefore, the IRD officers had to collect relevant information, including information for the year of application and prior years, from the applicants for considering their CoR applications. A CoR could not be issued if it was clear that the applicant would not be entitled to benefits under the relevant CDTA. All along the IRD officers adopted this practice when processing CoR applications and there was no change of practice.

Ms Sarah Chan expressed concerns that the consideration of information for prior years might be challenging for taxpayers, particularly in restructuring cases where the taxpayers relocate their substantive business operations from the Mainland to Hong Kong. She took the view that the information about the taxpayers' operations in the Mainland for prior years might have negative impact on their CoR application in Hong Kong.

In response, Mr Chan reiterated that when processing a CoR application, the IRD officers had to thoroughly examine the relevant facts of the application including information for the year of application and prior years. He pointed out that for the purpose of determining the residence of a company, paragraph 24.1 of the Commentary on Article 4 of the 2017 OECD Model Tax Convention suggested a range of factors that the competent authorities are expected to take into account, including where the meetings of the company's board of directors or equivalent body are *usually* held; and where the chief executive officer and other senior executives *usually* carry on their activities. Paragraph 149 of the Commentary on Article 29 of the Model Tax Convention also explained that the "place of effective management" of a company could be interpreted as being *ordinarily* the place where the most senior person or group of persons (for example the board of directors) made the key management and commercial decisions necessary for the conduct of the company's business. These guidelines were applied in the OECD Secretariat's analysis of the impact of the COVID-19 situation on tax treaties issued in April 2020. Mr Chiu supplemented that the COVID-19 situation would unlikely create any changes to an entity's residence status under a tax treaty. All relevant facts and circumstances should be examined to determine the entity's "usual" and "ordinary" place of effective management, not only those that pertain to an exceptional and temporary period such as the COVID-19 situation.

(c) CoR for SPE under fund structure

Under a private equity (PE) fund structure, it is quite common to use a Hong Kong entity as a SPE to hold the investment, particularly investment in the PRC in view of the treaty benefits under the Mainland-Hong Kong CDTA. Such SPE only acts as an investment holding company and normally does not have business activities other than holding board meetings.

According to the current practice, the IRD generally would not issue a CoR because such SPE does not employ many, if not none, employees or maintain an office in its own name in Hong Kong. Hence, the SPE would not be able to enjoy the treaty benefits, e.g. lower withholding tax rate for the dividends received from the PRC investments.

In order to align with the government's policy of encouraging the asset management industry in Hong Kong, the Institute would like to ask if the IRD would consider the business nexus of the group as a whole for issuing CoR to SPE of a PE fund? Such approach is similar to that for the holding company of a listed group with operations in

Hong Kong as discussed in the 2015 Annual Meeting. SPE could be considered as a Hong Kong tax resident even though it is an investment holding company of other entities of the PE fund group having operations in Hong Kong but it does not have substantial business substance in its own.

The IRD responded as follows–

- If an SPE in the question satisfied the definition of section 20AO(4) and the operation of the SPE was restricted to the holding and administering investee private companies in the capacity of a shareholder, then the place of residence of the SPE generally followed that of the PE fund despite that the SPE might be incorporated, registered or appointed in Hong Kong. The fund structure and their operations as a whole had to be looked at.

- In any case, it should be noted that the issue of a CoR would be refused if the SPE was a mere conduit of an offshore fund. In such a case, the SPE would not be regarded as the "beneficial owner" of the income and/or that the limitation on benefits provisions of the relevant CDTA would apply.

Ms Agnes Cheung had taken note that the HK UFE Regime, which came into operation on 1 April 2019, provided profits tax exemption for funds, whether onshore or offshore. She sought IRD's confirmation whether an SPE owned by an onshore PE fund would be equally regarded as a Hong Kong resident and thus a CoR would be issued to the SPE upon application. She also asked whether the IRD would regard the activities of the fund manager in Hong Kong as the activities of the SPE since the fund management activities of an offshore PE fund were generally delegated to a fund manager in Hong Kong and all the investment management and advisory activities were carried out in Hong Kong.

In response, Mr Chiu said that the place of residence of the SPE, wholly or partially owned by a PE fund, generally followed that of the PE fund. He explained that in deciding whether a CoR could be issued to an SPE, the IRD would thoroughly examine all the facts and circumstances relating to the PE fund and its SPE, including the activities rendered by the fund manager in Hong Kong. He further explained that if the SPE had substantial business presence in Hong Kong with its own central and management control exercised in Hong Kong, then the SPE might be regarded as a Hong Kong resident person, in particular when the fund had a regional investment platform located in Hong Kong.

(d) CoR for individuals

Under the Mainland-Hong Kong CDTA, a Hong Kong "temporary resident" individual refers to one who stays in Hong Kong for (1) more than 180 days during a year of assessment or (2) more than 300 days in two consecutive years of assessment where one of which is the relevant year of assessment.

As it is the IRD's practice to issue a Hong Kong CoR for a given calendar year rather than a year of assessment, the Institute would like to ask the IRD:

(i) if an individual is applying for a Hong Kong CoR for the calendar year 2019, what is the "year of assessment" referred to in (1) above and what is the "relevant year of assessment" referred to in (2) above?

(ii) if an individual spent not more than 180 days in 2018/19 year of assessment, but spent more than 300 days in 2018/19 and 2019/20 years of assessment altogether, will the individual be able to get a Hong Kong CoR for calendar year 2018 or 2020?

(iii) if an individual spent not more than 180 days in 2019/20 year of assessment, but spent more than 300 days in 2018/19 and 2019/20 years of assessment altogether, will the individual be able to get a Hong Kong CoR for calendar year 2018 or 2020?

The IRD responded as follows–

- An individual would be regarded as a Hong Kong resident for the calendar year 2019 under the above 180/300-day test if the individual:

  (a) stayed in Hong Kong for more than 180 days during the year of assessment 2019/20; or

  (b) stayed in Hong Kong for more than 300 days in two consecutive years of assessment where one of which was the relevant year of assessment (i.e. years of assessment 2018/19 and 2019/20 or years of assessment 2019/20 and 2020/21).

- For scenario (ii), while an individual spent not more than 180 days in the year of assessment 2018/19 (i.e. fails to meet the 180-day test for the calendar year 2018), he met the 300-day test for the years of assessment 2018/19 and 2019/20. Thus, the individual would be able to get a Hong Kong CoR for the calendar year 2018. In addition, the individual would also be regarded as a Hong Kong resident for the calendar year 2019 as explained above.

- For scenario (iii), as an individual spent more than 300 days in the years of assessment 2018/19 and 2019/20, the individual would be regarded as a Hong Kong resident for the calendar years 2018 and 2019 as explained above.

(e) Double tax relief for withholding tax on royalty income

Suppose a Hong Kong licensor enters into a licensing agreement with an overseas licensee with royalties for 10 years, say payable at HK$100 per year. The Hong Kong licensor recognizes all the royalty income on this licensing agreement, i.e. HK$1,000, in year one according to HKFRS 15. Tax credit on the withholding tax however can only be claimed after withholding tax is paid, i.e. after the year-end of each year from year one to year ten. Currently, tax credit can be claimed before the end of six years after the end of the relevant year of assessment (i.e. year one in this example).

What would be the double tax relief for the Hong Kong licensor in this example in respect of withholding tax paid for year seven to year ten?

The IRD responded as follows–

- According to the OECD Commentary on "Timing mismatch" (see OECD 2017 Commentary, paragraph 32.8 at page 390), the OECD Model text on methods for elimination of double taxation required that relief be granted where an item of income might be taxed by the State of source in accordance with the provisions of the CDTA. It followed that such relief had to be provided regardless of when the tax was levied by the State of source. Where States linked the relief of double taxation that they gave under the CDTA to what was provided under their domestic laws (as is the case of Hong Kong), OECD considered that these States would be expected to seek other ways (the mutual agreement procedure, for example) to relieve the double taxation which might otherwise arise in cases where the State of source levies tax in an earlier or later year.

- The IRD agreed that double tax relief should always be given whenever possible. Section 50(9) of the IRO provided that a taxpayer might claim for an allowance of tax credit before:

  (a) the end of 6 years after the end of the year of assessment; or

  (b) the end of 6 months after the date on which an assessment was made imposing liability or additional liability to tax in respect of the income on which foreign tax has been assessed, whichever was the later.

- Where a claim for tax credit could not be timely made under section 50(9), the taxpayer might present a case for mutual agreement procedure (MAP) under the relevant CDTA. Under section 50AAB(6) of the IRO, any MAP solution reached should be given effect despite any provision in the IRO.

(f) Revised application form for CoR relating to Public Notice (2018) No.9 (PN9)

In the 2019 Annual Meeting, we were advised that the IRD was in the process of revising the CoR application form to address the changes introduced by PN9 in relation to "beneficial owners" and the IRD was in discussion with the State Taxation Administration on certain administration arrangement. During the transitional period, applications can be submitted in a bundle for multi-level holding structures. The Institute would like to know the progress of the revised application form.

The IRD responded as follows–

- The State Taxation Administration (STA) was still considering the IRD's proposal on a revised application form for CoR and certain related administrative arrangements. The IRD would appreciate the Institute's understanding that it might take some more time before the proposal could be finalized.

- In any case, as announced on the IRD's website, transitional arrangement had been put in place to address the changes introduced by STA Circular 2018 No. 9 (PN9). Persons in a multi-level holding structure who required CoRs for the purposes of PN9 have to submit their CoR applications in a bundle enclosed with a covering letter.

- The revised application form, once finalized, would be uploaded to the IRD's website.

(g) Spontaneous exchange of information (SEOI)

Multilateral Convention on Mutual Administration Assistance on Tax Matters (the Convention) entered into force in respect of Hong Kong on 1 September 2018. By virtue of Article of 28(6) of the Convention, the provisions shall have effect in Hong Kong for administrative assistance, including SEOI under Article 7 of the Convention, related to taxable periods beginning on or after 1 January of the year following the one in which the Convention entered into force, or where there is no taxable period, for administrative assistance related to charges to tax arising on or after 1 January 2019.

(i) As the Convention entered into force in Hong Kong on 1 September 2018, will all tax ruling concluded after 1 January 2019 get exchanged spontaneously (i.e. tax rulings can already be exchanged spontaneously now)?

The IRD responded as follows–

- Generally, the Convention should have effect in respect of Hong Kong for administrative assistance related to taxable periods beginning on or after 1 January 2019, or charges to tax arising on or after 1 January 2019.

- Riding on the Convention, Hong Kong had been conducting SEOI on tax rulings which fell within the six categories required by BEPS Action 5 (see question (g)(ii) below) covering the taxable periods beginning or after 1 January 2019.

(ii) We understand that the spontaneous exchange is only limited to six categories (a) rulings relating to preferential regimes; (b) unilateral advance pricing arrangements and any other cross-border unilateral rulings in respect of transfer pricing; (c) cross rulings providing for a downward adjustment of taxable profits; (d) permanent establishment ruling; (e) related party conduit ruling and; and (f) any other type of ruling that in the absence of SEOI could give rise to BEPS concerns. Members of the Institute would like to know how "rulings" are defined in this context. For example, are they confined to cases where advance rulings or advance pricing arrangements have been sought with the IRD? Will information other than those specified above be exchanged as well, and if so, what are they? Would the IRD provide more guidance on the scope of SEOI on the IRD's webpage or in DIPN 47?

The IRD responded as follows–

- As explained in the 2015 Final Report of BEPS Action 5, a ruling meant "any advice, information or undertaking provided by a tax authority to a specific taxpayer or group of taxpayers concerning their tax situation and on which they are entitled to rely." While this definition was wide and included both general rulings and taxpayer-specific rulings, the framework for compulsory SEOI under BEPS Action 5 only applied to taxpayer-specific rulings which were given either pre-transaction or post-transaction in response to requests by taxpayers.

- In Hong Kong, advance rulings and advance pricing arrangements which fell within the specified six categories were subject to compulsory SEOI. For more details about the scope of SEOI on tax rulings, please refer to DIPN 31 and the application form for advance ruling (IR 1297) and related information sheet (IR1298).

(iii) Is there any SEOI as at now?

The IRD responded that up to the present, the IRD had conducted SEOI in respect of one ruling with one jurisdiction pursuant to the Convention.

Agenda item A5 – Departmental Policy and Administrative Matters

(a) Lodgment of profits tax returns and filing deadlines for 2019/20

Would the IRD please share with the Institute the latest statistics on tax return filing and information on the 2019/20 tax filing deadlines?

The IRD provided four tables at Appendix A in respect of the lodgment statistics for 2018/19 Profits Tax Returns in respect of corporations and partnerships.

- Table 1 showed that 7,000 more returns were issued in the 2018/19 bulk issue exercise and 21,300 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. The lodgment rates for "D" code and "M" code returns by the deadline dropped to 74% and 68% respectively. The graduated lodgment rates worsened and were significantly below the lodgment standards. The IRD, 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.

Extended Due Dates for filing 2019/20 Profits Tax Returns

The 2019/20 Profits Tax Returns for "active" files were bulk-issued on 4 May 2020. The extended due dates for filing 2019/20 Profits Tax Returns would be as follows–

Accounting Date Code	Extended Due Date	Further Extended Due Date if opting for e-filing
"N" code	30 June 2020	14 July 2020
"D" code	17 August 2020	31 August 2020
"M" code	16 November 2020	30 November 2020
"M" code – current year loss cases	1 February 2021	1 February 2021 (same as paper returns)

[Post-meeting note: Upon the Institute's further request, the IRD decided to extend the due dates for filing 2019/20 Profits Tax Returns with accounting date "D" code from 17 August 2020 to 30 September 2020 and those with accounting date "M" code from 16 November 2020 to 30 November 2020.]

(b) Completion of Profits Tax Return - Transactions with non-resident associated persons

In the latest version of Profits Tax Return, a taxpayer is required to report the place of residence of non-resident associated persons if it has transactions with these persons during the basis period. The IRD's guidelines on the completion of Supplementary Form S2 do not contain any definition of "transactions".

In this regard, should transactions which would not result in any impact to the income statement (e.g. interest free loans/advance to overseas group companies, settlement or receipt of payment on current accounts with group companies, expenses paid on behalf of group companies) be reported in the Supplementary Form S2? What are the reporting criteria for activities with associated persons, e.g. if the above intercompany balances remain unchanged throughout the year of assessment, should these "transactions" be reported in the Supplementary Form S2?

The IRD responded as follows–

- The Inland Revenue (Amendment) (No. 6) Ordinance 2018 had codified the rules for making transfer pricing adjustments so that the transactions between associated enterprises would be taxed on the basis that they were effected at arm's length. The relevant transfer pricing rules were set out in Part 8AA of the IRO. In this Part, the term "transaction" was defined in section 50AAI(1) to include any operation, scheme, arrangement, understanding and mutual practice (whether express or implied, and whether or not enforceable or intended to be enforceable by legal proceedings).

- In July 2019, DIPN 59 on Transfer Pricing between Associated Persons was issued. Among other things, paragraphs 43 to 46 of DIPN 59 explained with examples the terms "transaction" and "a series of transactions".

- When completing the Profits Tax Return for 2019/20, a person was required to declare in Item 9.2 of the Profits Tax Return whether the person had transactions with non-resident associated persons during the basis period. If yes, the person was further required to complete Supplementary Form S2 relating to Transfer Pricing and to specify in Section 1.1 the place of resident of the associated persons.

- Supplementary Form S2 should be completed even if the transactions with non-resident associated persons would not result in any transfer pricing adjustments or even if the above intercompany balances remained unchanged throughout the year of assessment since these transactions fell within the definition of transaction under section 50AAI.

(c) Refunds to non-residents

We have encountered cases of Non-Resident Profits Tax Return filing where the IRD issued refund cheques to taxpayer in the name of “HK co for non-resident co”. As the cheques could not be banked in, the taxpayers needed to write a letter to request for the refund cheques to be re-issued to a designated payee. Upon submission of the letter, the IRD would further issue a Letter of Indemnity for the taxpayers’ completion. The process dragged on for more than 4 months.

Currently, the IRD advised that a letter submitted in advance requesting for the refund cheque to be issued to a designated payee would not be entertained. A Letter of Indemnity completed in advance based on the template used by the IRD is also not accepted. While it is obvious that a cheque issued to a taxpayer in the name of “HK co for non-resident co” could not be banked in, the taxpayer has questioned the purpose of the arrangement and subsequently the prolonged process and procedures involved for reissuance of cheques. In this regard, the Institute would like to ask the IRD whether it could arrange to simplify the process for reissuance of refund cheques in order to relieve taxpayers of their administrative burden?

The IRD responded as follows–

- Pursuant to section 20B(2) of the IRO, a non-resident person who received any sums deemed as trading receipts by virtue of section 15 was chargeable to tax in respect of such sums in the name of the payer in Hong Kong. The tax charged should be recoverable from that payer. The notice of assessment would be issued in the name of “HK payer for non-resident person”.

- Under section 79(1) of the IRO, a person, who had paid tax in excess of the amount with which the person was properly chargeable for the year, should be entitled to have refunded the amount so paid in excess, if it was proved to the satisfaction of the Commissioner by a written claim duly made within the specified period.

- Pursuant to section 79(3) of the IRO, where a non-resident person had been assessed in the name of another person under section 20B and the tax so assessed had been paid by the other person, the other person or the non-resident person, but not both, might make a claim under section 79(1) for a refund of tax overpaid.

- In practice, in order to obtain a refund, two conditions had to be satisfied:
  (a) Firstly, it was proved to the satisfaction of the Commissioner that a person had paid tax in excess of the amount with which the person was properly chargeable for that year and the person was entitled to have a refund in the amount so paid in excess under section 79(1) of the IRO (i.e. the notice of assessment and refund of tax (refund notice) is issued by the Commissioner to the claimant with the amount of refund specified).

(b) Secondly, pursuant to section 79(3) of the IRO, a claim was made in writing by either the payer or the non-resident person, but not both, that there was entitlement to a refund of the tax overpaid under section 79(1) of the IRO.

- Given the above interpretation and practice, a letter submitted in advance requesting the refund cheque to be issued to a designated payee could not be entertained unless and until the refund amount could be ascertained by way of the issue of a refund notice.

- Under the existing procedures, either the payer or the non-resident person, upon receipt of the refund notice, wrote to the Commissioner to request the refund cheque to be re-issued to a designated payee. Upon receipt of the request, the IRD would issue a Letter of Indemnity for the designated payee's completion. Upon receipt of a duly completed Letter of Indemnity, a refund cheque would be re-issued to the designated payee.

- To simplify the process, the IRD planned to upload a template of the Letter of Indemnity onto the IRD website. Upon receipt of the refund notice, either the payer in Hong Kong or the non-resident person could download the template for completion. The duly completed Letter of Indemnity, the refund cheque, together with a proper written request for amendment of payee's name, should be sent to the IRD for processing. The IRD believed that the refined procedures would shorten the processing time for the reissuance of refund cheque.

(d) E-filing of tax returns

In agenda item A5(a) of the 2017 Annual Meeting, the IRD advised that extending the e-filing system on individual tax returns (BIR 60) would be part of the IRD's long term business plan. Could the IRD advise the progress of the extension plan/timetable for extending the e-filing system, so that more individuals in Hong Kong can file electronically, including those with income exemption and double tax relief claims?

In addition, the Institute would like to ask if the IRD has any plan to allow tax representatives to e-file their clients' tax returns (BIR60) for their clients?

The IRD responded as follows–

- The Departmental Information Technology Plan of the IRD included the creation of three interconnected portals and login gateways for corporate taxpayers (Business Portal), individual taxpayers (Individual Portal) and tax representatives (Tax Representative Portal). These portals were planned to be rolled out in 2025.

- Before rolling out the Individual Portal, the IRD would enhance the experience of mobile device users of the IRD's existing eTAX services.

- In designing and developing the Tax Representative Portal, the IRD would consider enabling tax representatives to file BIR60 for their clients.

(e) Development of the Business Portal and Tax Representative Portal

In agenda item A5(b) of the 2019 Annual Meeting, the IRD disclosed that the IRD would consult the stakeholders in development of the Business Portal and Tax Representative Portal for profits tax. Could the IRD share any update in this regard?

The IRD responded as follows–

- The IRD planned to launch the Business Tax Portal and Tax Representative Portal in 2025. The Business Tax Portal would facilitate submission of tax returns by businesses together with accounting and financial data and the Tax Representative Portal would enable tax representatives to conduct e-transactions on behalf of their clients, both individuals and businesses.

- In the interim, the existing eTax Portal would be enhanced to cater for submission of financial statements and tax computations in the form of data files. The IRD was working on the taxonomy package for financial statements and tax computations. Consultation would be carried out once the taxonomy package is finalized. The enhanced eTax Portal would be able to accept electronic filing of tax return (BIR51 or BIR52) for a taxpayer by a service provider, subject to the relevant legislative amendments.

PART B – MATTERS RAISED BY THE IRD

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

The IRD provided two tables at Appendix B showing discrepancies detected by field audit.

Table 1
Table 1 was compiled to illustrate the specific problem areas detected in corporations with tax audits completed during the year ended 31 December 2019 with comparative figures for the years 2017 and 2018 included.

Field Audit teams uncovered discrepancies in 367 corporation cases, of which 300 cases carried clean auditors' reports. Amount of discrepancies detected in the clean report cases accounted for 75% (2018: 94%) of the total discrepancies detected in the year 2019 and total tax of $484 million was recovered from these cases. Average understatement per clean report case was $11.27 million (2018: $38.43 million) while tax undercharged per clean report case was $1.6 million (2018: $5.9 million).

In 2019, discrepancies resulted mainly from incorrect claims of offshore profits, omission of sales and over-claiming of expenses. In the majority of the cases, the discrepancies were detected after examining the business ledgers and source documents.

Table 2
Table 2 showed 2 cases in which it was considered that the auditors should have detected the irregularities through statutory audit.

Agenda Item B2 – Date of Next Annual Meeting

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

Annex to agenda item A1(d)

Under HKAS 17, Company A would recognize the rent-free period as a reduction of rental expense over the lease term on a straight-line basis. For the period from January 2018 to March 2018, the Company would recognize:

	Debit	Credit
Rental expense (P&L) (HK$20,000 x 33 / 36) x 3 months	HK$55,000	
Deferred rent (BS)		HK$55,000

For the period from April 2018 to December 2018, the Company would recognize:

	Debit	Credit
Rental expense (P&L) (HK$20,000 x 33/36) x 9 months	HK$165,000	
Deferred rent (BS) (HK$55,000 / 33) x 9 months	HK$15,000	
Bank (HK$20,000 x 9)		HK$180,000

The amount of rental expense charged to profit and loss account for the year ended 31 December 2018 is HK$220,000 (HK$55,000 + HK$165,000) while the actual cash payment made is HK$180,000.

On 1 January 2019, the Company adopts HKFRS 16 to recognize the remaining 2-year lease period as right-of-use asset and lease liabilities*. In accordance with HKFRS 16, the value of right-of-use asset would be reduced by any lease incentives (e.g. rent free period) received.

	Debit	Credit
Right-of-use asset (BS)	HK$415,878	
Deferred rent (BS) (HK$55,000 – HK$15,000)	HK$40,000	
Lease liabilities – short term (BS)		HK$222,254
Lease liabilities – long term (BS)		HK$233,624

* Assuming that Company A applied "modified retrospective approach" and HKFRS 16 C8b(ii) in the calculation of the right-of-use asset and lease liability on the date of initial application. The interest rate implicit in the lease is assumed to be 5%.

During the year ended 31 December 2019, the Company would recognize:

	Debit	Credit
Depreciation - right-of-use asset (P&L) (HK$415,878)/2	HK$207,939	
Depreciation - right-of-use asset (BS)		HK$207,939
Interest expense on lease liabilities (P&L)	HK$17,746	
Lease liabilities (BS)	HK$222,254	
Bank (BS) (HK$20,000 x 12)		HK$240,000

The amount charged to profit and loss account for the year ended 31 December 2019 as depreciation of right–of-use asset and interest on lease liabilities is HK$225,685 (HK$207,939 + HK$17,746) while the actual cash payment made is HK$240,000.

During the year ended 31 December 2020, the Company would recognize:

	Debit	Credit
Depreciation - right-of-use asset (P&L) (HK$415,878)/2	HK$207,939	
Depreciation - right-of-use asset (BS)		HK$207,939
Interest expense on lease liabilities (P&L)	HK$6,376	
Lease liabilities (BS)	HK$233,624	
Bank (BS) (HK$20,000 x 12)		HK$240,000

The amount charged to profit and loss account for the year ended 31 December 2020 as depreciation of right–of-use asset and interest on lease liabilities is HK$214,315 (HK$207,939 + HK$6,376) while the actual cash payment made is HK$240,000.

Lodgment of Corporations and Partnerships Profits Tax Returns

Table 1
Lodgment Comparison from 2016/17 to 2018/19

		Y/A 2016/17	Y/A 2017/18	Y/A 2018/19	Comparison 2017/18 and 2018/19
1.	Returns issued on 1 or 3 April	184,000	188,000	195,000	4%
2.	Returns not filed by due date				
	"N" code	2,200	2,600	3,200	23%
	"D" code	7,200	9,000	7,600	-16%
	"M" code	11,000	12,900	10,500	-19%
		20,400	24,500	21,300	-13%
3.	Compound offers issued	6,300	7,300	9,800	34%
4.	Estimated assessments issued	9,000	11,300	4,600	-59%

Table 2
2018/19 Detailed Profits Tax Returns Statistics

	"N"	"D"	"M"	Total
Total returns issued	22,000	69,000	104,000	195,000
Failure to file on time	3,200	7,600	10,500	21,300
Compound offers issued	2,100	5,000	2,700	9,800
Estimated assessments issued	0	0	4,600	4,600

Table 3

Represented Profits Tax Returns - Lodgment Patterns

Code	Lodgment Standard	Y/A 2018/19	Y/A 2017/18
D - 15 August	100%	74% [1]	77%
M - 31 August	25%	11%	10%
M - 30 September	55%	16%	14%
M - 31 October	80%	32%	30%
M - 15 November	100%	68% [2]	77%

Notes: (1) 31% lodged within a few days before 15 August 2019 (33% lodged within a few days before 15 August 2018 for Y/A 2017/18)

(2) 18% lodged within a few days before 15 November 2019 (29% lodged within a few days before 15 November 2018 for Y/A 2017/18)

Table 4

Tax Representatives with Lodgment Rate of less than 68% of "M" code Returns as at 15 November 2019

1,468 T/Rs have "M" code clients. Of these, 705 (48%) firms were below the average performance rate of 68%. 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 68%	No. of non-compliance cases	% of total non-compliance cases	Total No. of firms	No. of firms below the average of 77%	No. of non-compliance cases	% of total non-compliance cases
Small size firms	100 or less	1,368	657	6,856	67%	1,369	651	5,435	69%
Medium size firms	101 - 300	92	44	2,768	27%	92	46	2,239	29%
Large size firms	over 300	8	4	609	6%	7	2	146	2%
		1,468	705	10,233	100%	1,468	699	7,820	100%

Appendix B [Table 1]

Analysis of Completed FA Corporation Cases for the years ended 31 December 2017, 2018 and 2019

	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature			
Auditor's Report = Unqualified	**2017**	**2018**	**2019**	**2017**	**2018**	**2019**	**2017**	**2018**	**2019**	
Sales omitted	44	65	56	39,050,545	53,960,621	87,277,778	5,563,507	6,954,336	12,402,793	
Purchases overstated	15	12	19	55,609,437	7,727,830	30,670,937	8,347,423	1,240,770	4,581,073	
Gross profit understated	28	28	41	121,821,702	98,639,797	68,371,415	18,478,838	6,937,918	10,127,025	FOR
Expenses over-claimed	107	88	106	88,978,759	326,952,476	76,721,908	13,247,219	50,197,335	9,619,700	AUDIT
Technical adjustments	84	92	96	34,250,130	77,023,541	51,724,969	4,806,637	11,711,365	5,348,928	YEAR
Offshore income / profits disallowed	18	21	22	348,858,847	1,670,937,967	95,199,663	59,294,913	276,916,165	13,345,928	ONLY
Other	115	104	115	167,765,187	74,344,052	130,411,069	25,620,662	11,446,742	17,518,009	
TOTAL	411*	410*	455*	$856,334,607	$2,309,586,284	$540,377,739	$135,359,199	$365,404,631	$72,943,456	
TOTAL NUMBER OF CASES	301*	276*	300*							
AVERAGE AMOUNT PER CASE				$2,844,965	$8,368,066	$1,801,259	$449,698	$1,323,930	$243,145	

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

		Total Discrepancy for All Years			Total Tax Undercharged for All Years		
		2017	**2018**	**2019**	**2017**	**2018**	**2019**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$4,927,912,899**	**$10,605,686,545**	**$3,380,807,219**	**$772,514,422**	**$1,631,374,788**	**$484,329,841**
	AVERAGE AMOUNT PER CASE	**$16,371,804**	**$38,426,401**	**$11,269,357**	**$2,566,493**	**$5,910,778**	**$1,614,433**

	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature			
Auditor's Report = Qualified	**2017**	**2018**	**2019**	**2017**	**2018**	**2019**	**2017**	**2018**	**2019**	
Sales omitted	17	12	11	31,353,279	25,668,951	44,782,052	3,550,667	4,189,451	7,258,723	
Purchases overstated	1	2	4	1,993,535	8,483,857	6,603,750	328,933	1,444,120	655,574	
Gross profit understated	6	18	23	15,709,868	28,103,809	33,132,243	2,704,564	3,420,563	4,742,030	FOR
Expenses over-claimed	23	23	21	18,289,960	13,849,719	6,887,763	2,227,625	1,928,314	875,955	AUDIT
Technical adjustments	10	15	16	3,967,230	3,660,449	12,670,487	657,413	563,219	1,603,781	YEAR
Offshore income / profits disallowed	1	3	1	(1,087,772)	4,943,011	57,332,058	(361,648)	503,538	9,439,789	ONLY
Other	33	26	26	21,577,332	36,877,590	58,017,071	3,216,549	5,583,779	8,804,451	
TOTAL	91*	99*	102*	$91,803,432	$121,587,386	$219,425,424	$12,324,103	$17,632,984	$33,380,303	
TOTAL NUMBER OF CASES	66*	63*	67*							
AVERAGE AMOUNT PER CASE				$1,390,961	$1,929,959	$3,275,006	$186,729	$279,889	$498,213	

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

		Total Discrepancy for All Years			Total Tax Undercharged for All Years		
		2017	**2018**	**2019**	**2017**	**2018**	**2019**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$454,288,187**	**$692,428,852**	**$1,131,854,905**	**$63,645,638**	**$105,078,631**	**$165,748,299**
	AVERAGE AMOUNT PER CASE	**$6,883,154**	**$10,990,934**	**$16,893,357**	**$964,328**	**$1,667,915**	**$2,473,855**

	2017	2018	2019
TOTAL NUMBER OF CASES	367	339	367

		Total Discrepancy for All Years			Total Tax Undercharged for All Years		
		2017	**2018**	**2019**	**2017**	**2018**	**2019**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$5,382,201,086**	**$11,298,115,397**	**$4,512,662,124**	**$836,160,060**	**$1,736,453,419**	**$650,078,140**
	AVERAGE AMOUNT PER CASE	**$14,665,398**	**$33,327,774**	**$12,296,082**	**$2,278,365**	**$5,122,281**	**$1,771,330**

Extracts of Analysis in Table 1 of Appendix B

		2018	2019
(a)	No. of corporation cases with discrepancies uncovered	339	367
(b)	No. of corporation cases in item (a) carried clean auditor's reports	276	300
(c)	Total discrepancies detected in all cases	$11,298m	$4,513m
(d)	Total discrepancies detected in clean auditor's report cases	$10,606m	$3,381m
(e)	Percentage of (d) over (c)	94%	75%
(f)	Total tax uncovered in clean auditor's report cases	$1,631m	$484m
(g)	Average understatement per clean auditor's report case	$38.43m	$11.27m
(h)	Tax undercharged per clean auditor's report case	$5.9m	$1.6m

Appendix B [Table 2]

Field Audit cases with discrepancy considered detectable through statutory audit

For the period from 1.1.2019 to 31.12.2019

Item that should be detected by Auditor	Amount of item that should be detected	Reasons why the item should be detected	Auditor's Report	Profits understated for audit year(s)	Tax undercharged for audit year(s)	Total discrepancy amount for all years	Total tax undercharged for all years
Sales Omitted	$1,642,987	The taxpayer was a trader of foodstuff. It also acted as an agent for other traders in the same industry. In the profit and loss account, all sales and purchases from the trading business were omitted and only agency fee income was recorded.	Unqualified	$1,942,200	$0	$7,124,724	$440,065
Sales Omitted	3,973,116	The taxpayer was a trader in technology field. Sales were recorded in the wrong denomination. For example, sales of US$1,000 were recorded as HK$1,000 instead of HK$7,800. As a result, large credit balance was accumulated in accounts receivable. Unsupported negative adjustments to purchases were also detected.	Unqualified	$802,333	$132,385	$3,480,679	$549,423