



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

*TaxB 22 April 2012*

# **Notes of meeting on tax policy**

**Financial Services and the Treasury Bureau (Treasury Branch)  
and  
Hong Kong Institute of CPAs**

2011

**Notes of meeting between the Financial Services and the Treasury Bureau  
(Treasury Branch)  
and the Hong Kong Institute of CPAs on Tax Policy Matters, 2 December 2011**

**Attendees:**

Financial Services and the Treasury Bureau (Treasury Branch) ("FSTB")

Miss. Cathy Chu, Deputy Secretary  
Ms. Shirley Kwan, Principal Assistant Secretary  
Ms. Joan Hung, Assistant Secretary  
Miss. Fiona Chau, Assistant Secretary

Inland Revenue Department ("IRD")

Mr. Richard Wong, Deputy Commissioner (Technical)

Hong Kong Institute of CPAs ("Institute")

Mrs. Ayesha Lau, Chair, Taxation Committee  
Ms. Florence Chan, Deputy Chair, Taxation Committee  
Mr. Anthony Tam, Member, Taxation Committee  
Mr. Peter Tisman, Director, Specialist Practices  
Ms. Elena Chai, Associate Director, Specialist Practices

The Institute had proposed the meeting to discuss tax policies, which the Institute had in the past raised with the Government through its budget submission and related proposals, and also to supplement the annual meeting the Institute held with the IRD, which focused on issues relating to tax administration and practice. The Institute hoped that this meeting would help to establish an ongoing dialogue with the policy bureau.

Below is a summary of the items discussed, which covered, amongst other things, questions about uncertainty in the tax system and the need to retain a competitive tax regime.

**Uncertainty in the tax system**

The Institute explained that there was currently uncertainty in the practical application of the fundamental principle of "source" in relation to profits and employment income. Uncertainty was also created because of the length of time that some cases, particularly loss cases, could take to be finalised. Businesses sought certainty in their tax liabilities which, in its own way, was as important as the quantum of tax they would eventually need to pay.

1. Source of profits/ employment income

The Institute explained that tax practitioners expressed concern about increasing difficulty in advising clients whether the clients' profits would be treated as being derived in or from

Hong Kong, or offshore profits, and, similarly, as to the tax status of some of their employees with regional responsibilities.

In relation to profits tax, practitioners considered that, in the case of *ING Baring Securities (HK) Ltd. v. CIR*, the court of final appeal ("CFA") made it clear that the test for determining the source of profits was to identify the geographical location of the taxpayer's profit-producing transactions, and the court distinguished such transactions from activities that are "antecedent or incidental" to those transactions. However, the IRD's revised departmental interpretation and practices notes no. 21 (DIPN 21), *Locality of Profits*, did not elaborate on what should be regarded as "antecedent or incidental". In addition, it remained unclear whether the "totality of facts" approach to determining the source of profits could be applied in future. DIPN 21 also referred to the agency principle, which was discussed in the *ING Baring* case, but it was not clear when and how the principle would be applied.

In view of uncertainties such as these, the Institute suggested codifying certain basic rules on the source of profits as a way of addressing some of the ambiguities in the regime. The Institute gave some possible examples.

As regards the source of employment income, in the case of *CIR v. Goepfert*, the court had specified three principal tests as being relevant to determining whether a salaries tax payer should be regarded as employed in Hong Kong or outside of Hong Kong. However, in practice various other factors were sometimes taken into account, which had resulted in uncertainty.

Deputy Commissioner (Technical) ("DCIR") noted that court decisions on the issue of source in relevant common law jurisdictions remained persuasive in Hong Kong. FSTB believed that it would be difficult to provide an exhaustive list of factors in the law and that codification of rules on source could lead to inflexibility.

FSTB suggested that the Institute provide further examples to illustrate the typical uncertainties faced by businesses when interpreting the source principle. FSTB would consider asking IRD to provide more guidance, possibly in the form of FAQs.

## 2. Finalisation of tax affairs

The Institute recommended that the statutory time limit for reopening an assessment should be shortened from the current six years, noting that in a number of other jurisdictions the limitation period was three or four years. Greater certainty would be helpful, in particular for loss cases, where the six-year limitation period did not apply. Some loss cases could remain open for more than ten years if no profits were made.

## The Need for a Competitive Tax System

The Institute opined that, although Hong Kong had low rates of tax, other jurisdictions were progressively reducing their tax rates and measures were being taken to accommodate new business models and/or incentives were being offered, which could tilt the balance in favour of those places, when businesses were deciding where to locate in the region. It was important for the tax system to be in alignment with Hong Kong's overall macro-economic goals. The Institute believed certain specific tax incentives could help reduce the cost of doing business and enable Hong Kong to retain its competitiveness.

### 3. Group loss relief/ loss carry back

The Institute indicated that group loss relief and loss carry-back were effective tax measures, which helped bring down the overall tax burden of group companies, in line with the overall profits of the group, and smooth the effects of economic fluctuations on cash flows.

FSTB advised that, in response to a question asked in the Legislative Council on 16 March 2011, the Government had made clear its position that these measures would not be introduced as they would complicate the tax system. FSTB said that these proposals had in fact been raised in the past Budget consultations, and the Government had upheld the same position. FSTB pointed out that the World Bank rated Hong Kong as the second best location in the world in terms of the ease of doing business (and the third best jurisdiction in terms of ease of paying taxes). The Institute noted the Government's position but said it may continue to advocate these measures, as some form of group loss relief and/ or loss carry-back existed in a number of jurisdictions internationally and it was important for Hong Kong to stay competitive.

### 4. Transfer pricing regime

The Institute considered that Hong Kong needed a statutory transfer pricing regime, as the existing provisions in the Inland Revenue Ordinance ("IRO") were insufficient to allow corresponding/ compensating adjustments to prevent revenue leakage and double taxation. Without a more extensive transfer pricing regime, the IRD would not have a basis for making corresponding adjustments in Hong Kong, where transfer pricing adjustments were made in other jurisdictions that did not have a comprehensive double tax agreement ("CDTA") with Hong Kong, such as Canada or the United States. This could result in double taxation. The IRD's DIPN 46 on transfer pricing was a practice note only and did not have the force of law.

DCIR pointed out that not all jurisdictions had introduced transfer pricing legislation. In Singapore, for example, there were guidelines only. FSTB explained that the merits of introducing law in this area had to be considered carefully. There was a question of whether the law would need to be updated frequently to accommodate new business

developments. Given the difficulties in Europe, timing could also be an issue. At this juncture, the bureau would be focusing its efforts on expanding the network of CDTAs and also examining the possibility of advance pricing arrangements, which was a more positive approach.

#### 5. Double taxation agreements

The Institute thanked FSTB for inviting views on potential partners for future CDTA negotiations. The Institute expressed support for the bureau's successful efforts in expanding the network of CDTAs.

FSTB informed that the phase one peer review report from the Global Forum on Transparency and Exchange of Information for Tax Purposes of the Organisation for Economic Co-operation and Development ("OECD") had been quite positive about Hong Kong. However, a marker had been put down for the phase two review, to start in late 2012, about the lack of a framework for standalone Tax Information Exchange Agreements ("TIEAs") in Hong Kong. The Commissioner of Inland Revenue had indicated that he would discuss the issue with the Legislative Council and stakeholders' views would also need to be canvassed. The OECD took the view that it should be up to the negotiating parties to decide on whether to have a CDTA or a TIEA.

The Institute said that, if TIEAs were to be permitted, Hong Kong should ensure that any decisions on whether to opt for a CDTA or a TIEA in particular cases would be made in Hong Kong's best interests. FSTB said that the Hong Kong business community should consider lobbying other jurisdictions to enter into CDTAs with Hong Kong, as governments elsewhere might need to justify giving benefits to Hong Kong businesses at a time when their domestic economies were facing difficulties.

Regarding implementation issues with new CDTAs, the bureau indicated that IRD would be prepared to take these up with the relevant CDTA partners.

#### 6. Sector specific measures

The Institute said that tax practitioners felt Hong Kong was losing ground in certain areas, such as fund management, aircraft and container leasing, logistics (port services), etc. There was a risk that Hong Kong could lose market share until there was no longer a critical mass to attract the relevant industries to come here, resulting in possible long-term damage to the economy. For instance, it was noted that the denial of depreciation allowances for plant and machinery under section 39E of the IRO had a large impact on companies that needed to make significant and regular investments in moulds, which they loaned to their manufacturing subcontractors located outside Hong Kong. Another example was the asset management industry, which could obtain more attractive tax incentives elsewhere, including Singapore.

FSTB fully appreciated that tax was important for Hong Kong's competitiveness and for attracting talent. For this reason, the bureau canvassed the views of other bureaux, particularly in the context of the budget, on the need for tax measures in relation to their own policy areas. In considering proposals, the Government would also study what was being done in those areas in other markets and seek input from stakeholders. A recent example of this was the bill on deduction for capital expenditure incurred on the purchase of certain intellectual property rights.

#### 7. Review of the tax system

The Institute proposed that consideration be given to setting up a tax policy and research unit within the Government to study tax developments in other jurisdictions on an ongoing basis and make recommendations to ensure that Hong Kong's tax system retained its competitiveness. This would also help to ensure that the tax system was in alignment with the Government's wider policy objectives. FSTB expressed doubt whether setting up the said tax policy and research unit would add to the overall efficiency and effectiveness of the system, particularly given that mechanisms already existed for seeking views from relevant policy bureaux and stakeholders on new tax measures and initiatives on respective policy grounds. In terms of working with other policy bureaux to ensure that tax policy/ measures were in line with wider economic/ social goals, FSTB emphasised that a lot of liaison and cross-bureaux work was already being done.

#### 8. Future meetings

FSTB indicated that they welcomed views from the Institute at any time and that they were agreeable to holding future meetings to continue the dialogue on tax policy issues.