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

TaxB 25 *October 2014*

Tax Bulletin

2014

Annual Meeting

The Inland Revenue Department

and

The Hong Kong Institute of Certified Public Accountants

2014
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 February 2014.

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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The 2013/14 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department was held on 14 February 2014 at the Inland Revenue Department.

In Attendance

Hong Kong Institute of Certified Public Accountants ("the Institute")

Ms Florence Chan	Chairperson, Taxation Faculty Executive Committee
Mr Anthony Tam	Deputy Chairman, Taxation Faculty Executive Committee
Mr K K So	Deputy Chairman, Taxation Faculty Executive Committee
Mr Eric Ho	Member, Taxation Faculty Executive Committee
Mr Curtis Ng	Member, Taxation Faculty Executive Committee
Mr Percy Wong	Member, Taxation Faculty Executive Committee
Mr Peter Tisman	Director, Specialist Practices
Ms Elena Chai	Associate Director, Specialist Practices

Inland Revenue Department ("IRD")

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 Doris Lee	Assistant Commissioner of Inland Revenue
Ms Mecky Go	Ag. Assistant Commissioner of Inland Revenue
Ms Connie Chan	Assistant Commissioner of Inland Revenue
Ms Mei Yin	Chief Assessor (Tax Treaty)
Ms Hui Chiu-po	Senior Assessor (Research)

Mr Wong Kuen-fai ("CIR") welcomed the representatives from the Institute to the meeting and introduced the IRD officers in attendance, in particular three new officers. CIR expressed that the annual meeting offered a valuable opportunity for the IRD to have a dialogue with the Institute. Ms Florence Chan ("Ms Chan") thanked the IRD for arranging the annual meeting. The Institute considered that the issues discussed during the annual meeting were very useful to tax practitioners as well as the business community in general. The meeting then commenced discussion of the agenda.

PART A - MATTERS RAISED BY THE INSTITUTE

Agenda item A1 - Profits tax issues

(a) Source rule for determining dividend income

In item A(1)(l) of the 2011 meeting, the IRD stated that "where section 26 did not apply, only those dividend income that was sourced in Hong Kong would be assessed under section 14… the determination of source of dividend income would be relevant in corporations which were exempt from the payment of profits tax (e.g. under the offshore funds exemption regime)."

In this regard, the Institute would like the IRD to elaborate on the general source rule for determining the locality of dividend income received from a corporate entity and profit distribution received from a non-corporate entity such as a partnership or a trust.

CIR explained that profits derived from a trade, profession or business carried on in Hong Kong were chargeable under section 14 if the source of the profits was located in Hong Kong. He said that dividend income sourced in Hong Kong would be assessable under section 14 if section 26 did not apply. He emphasized that the ascertainment of income source would entail a careful analysis of the facts of each case, without being distracted by antecedent or incidental matters.

CIR elaborated that if the dividends or distributions were received by a person from the mere holding of an investment or an interest in an entity which operated its business outside Hong Kong, the dividends or distributions would not be chargeable to profits tax since the source of the dividends or distributions was likely to be offshore per *Nathan v FCT* 25 CLR 183. He said that the taxability of dividends or distributions might depend on the place of the business operations of the investee entity, or the place where the investee entity derived the profit out of which the dividends or distributions were paid.

CIR added that if the dividends or distributions were derived from services rendered in Hong Kong, the dividends or distributions would be assessable under section 14 if section 26 did not apply. He illustrated with an example: taxable profits from an asset management business carried on in Hong Kong would include the management fees and performance fees (carried over from year to year following the closing of an investment) though they might be payable in the form of dividends or distributions. He explained that the dividends or distributions were sourced in Hong Kong since they were derived from asset management services rendered in Hong Kong.

In reply to a question raised by Ms Chan, CIR explained that the dividends or distributions derived from an asset management business carried on in Hong Kong would be taxed under section 14 at the shareholders' level if section 26 did not apply.

Ms Chan asked for the IRD's view on the source of dividend income received by the investment holding company not in the case of an asset management business. Ms Lee replied that if the investor company did not actively take part in the operation of the investee company, the taxability of dividend income might depend on the place of operation of the investee company.

Mr Chiu added that section 26 did not apply to overseas corporations which were not chargeable to tax. He said that dividend income derived from overseas corporations with little business operation in Hong Kong might not be taxed in the hands of the shareholders since the business operation of the overseas corporations was substantially offshore.

(b) Characterisation of the returns earned from equity-linked notes ("ELNs")

In the Board of Review decision D32/12, the IRD successfully argued that the ELNs in question were not a loan arrangement and the source rule for determining the return earned by the taxpayer from the ELNs was essentially the "contract effected" test.

It appears that the position taken by the IRD in D32/12 was a departure from its previous position (items A(1)(d) and A(1)(c) of the 2008 and 2009 meetings refer). Previously, the IRD indicated that an ELN (with terms similar to those of the case D32/12) would normally be regarded as a certificate of deposit or a loan arrangement. As such, the return earned from such ELN would, in full or in part, be regarded as interest in nature.

The Institute would like to know whether the IRD has changed its position with the approach taken by the IRD in D32/12 as its latest assessing practice. If so, the Institute would also like the IRD to confirm that any loss suffered by such an ELN holder on the ELN redemption would likewise be revenue loss arising from the ELN contract, and therefore deductible, where the ELN contract is Hong Kong sourced.

Mr Chiu explained that, as the IRD understood it, an ELN was a structured product that combined a debt instrument with an option. He elaborated: (a) in a bull ELN, the investor bought a note and at the same time wrote a put option, believing that the underlying share price would remain stable or go up at the time of valuation; and (b) in a bear ELN, the investor predicted that the underlying share price would remain stable or fall and wrote a call option while buying a note.

Mr Chiu said that the return of an ELN was usually determined by the value of a single stock, a basket of stocks, or an equity index at a future valuation date and there was no guarantee that a return would be obtained from the ELN and in extreme cases, the entire investment might be lost.

Mr Chiu further explained that the return payable for the ELN was determined at a specific time on the valuation date, irrespective of the fluctuations in the underlying stock price before or after that specific time. He said that the return was strictly predetermined by the terms specified in the ELN and the amount received would not be more than the amount specified even if the performance of the underlying stock exceeded expectation.

Mr Chiu advised that depending on the specified terms, the ELN being a hybrid instrument could well constitute a certificate of deposit or a loan as a whole.

Mr Chiu pointed out that the decision of the Board in D32/12 was fact specific though the finding of facts was not clearly spelt out. He said that the gains or losses in that case resulted mainly from options embedded in ELNs.

Mr Chiu concluded that the answer to the question was that the IRD had not changed its position.

(c) Guidance on tax implications of share-based payments

The Institute notes that the tax implications of share-based payments continue to be of concern to taxpayers. Following item A1(e)(iv) of the 2013 meeting, the Institute would like to ask whether it would be updating the website with the discussions that took place in the 2013 meeting.

Apart from advance rulings for individual cases, the Institute would like to repeat that it would be helpful to have Departmental Interpretation and Practice Notes ("DIPN") that provide details of the amount and timing of tax deductions for different share-based payments, and would like to know if the IRD has current plans to issue a DIPN.

Ms Lee said that the IRD had revisited the issues concerning deduction of share-based payments and had published on its website a revised position for group recharge arrangement in March 2012. She noted that the IRD’s position was accepted by taxpayers and many of the disputed cases had since been resolved along the revised stance. She explained that: the share-based payment deduction was not, at the time, an issue of great concern to taxpayers at large; there was no imminent need to issue a DIPN on the subject; and the IRD would continue to disseminate its latest views on the issue through FAQs or Tax Representatives’ Corner on its website. She pointed out that the FAQs on share-based payment transactions had recently been updated to incorporate the results of discussions that took place in the 2013 meeting.

(d) Adjustment of recharge amount to market circumstances

In item A1(e)(i)(c) of the 2013 meeting, the IRD said that if the market value of the shares on the vesting date was lower than the agreed recharge amount, a company could have acquired the shares from the open market at a cheaper cost to discharge its obligation to its employees. To safeguard the company's interest, it was expected that a commercially-realistic recharge agreement would allow an adjustment of the recharge amount based on the market circumstances. The payment of the recharge without regard to market circumstances might indicate an excessive deduction claim.

In general, the recharge amount is based on conditions agreed between the two companies and they are free to agree whether to include the adjustment clause in the agreement. The absence of the clause may not mean the agreement is commercially unrealistic. If the recharge amount is at arm's length, it should be deductible as long as it has been incurred.

The Institute would welcome the IRD's observation on this view.

Ms Lee concurred that in the absence of an adjustment clause it did not necessarily mean that the recharge agreement was commercially unrealistic. She pointed out that if the payment of a recharge was substantially above the market price of the shares concerned, without regard to the market circumstances, it might well indicate that the amount was not at arm’s length. She reiterated that while the excess (i.e. recharge over market price) arose from normal fluctuation of share price might generally be accepted, the IRD would reject cases where the recharge was blatantly above what would be reasonable and commercial for acquiring the shares from an open market.

(e) Deductibility of share-based payment if the subsidiary ceases business

A group with a parent and subsidiary company has an employee stock option plan. The subsidiary grants its parent's share options to the subsidiary's employees with a vesting period of three years.

The subsidiary ceases business after the end of the second year. The subsidiary recorded a recharge due to the parent in the first two years prior to cessation, and no payment was made in the third year. Therefore, the recharge amount cannot be claimed as a post cessation payment.

In this case, the Institute would like to ask what would be the tax implications.

Ms Lee said that in the above scenario, the terms and conditions of the stock option plan were unknown. She pointed out that the employees’ right to the unvested share options in the event of cessation of the subsidiary’s business was entirely unclear. She said that in case no early vesting was allowed and the share options would lapse upon cessation of the subsidiary’s business, the subsidiary would not be entitled to the deduction of the recharge as it did not incur a liability for the provision of share benefits to the employees (i.e. the employees had no right to exercise). She added that if the employees were given a compensation in lieu of rights, legal or beneficial, in the unvested share options or the right to early exercise the unvested share options in the year of cessation, the subsidiary might be allowed deduction of the portion of recharge attributable to the exercised options in that year. She noted that cessation arrangement varied from case to case and the exact tax treatment would depend on the agreed terms and rights of the employees in an arrangement.

In reply to Mr Anthony Tam's follow-up question regarding compensation in lieu of rights, Ms Lee said that the terms agreed and the rights of an employee might have been specified in the company's circular, internal memo, the employee's appointment letter or some other documents.

(f) Deductibility of share-based payment in service fees

For commercial reasons, the employment of senior employees in a group may be centralised at an employing company. The employees provide services to other operating companies within the group. The employing company charges the operating companies service fees for this arrangement. Service fees are calculated on cost reimbursement or cost plus, based on the costs incurred by the employing company.

Where the employing company operates a share-based scheme, the service fees charged during the vesting period would include a share-based expense recognised by the employing company.

The Institute would like to know whether the tax adjustment based on the IRD's stated position during the vesting period would have to be made at both the employing and operating companies (i.e., only allowing the amounts recharged on the date of vesting, and not when the amounts were actually recharged).

Ms Lee advised that the fair value of the share option/ award recognised as an accounting expense in the accounts of the employing company was not an outgoing or expense already incurred under section 16(1). She pointed out that this was the reason why tax adjustment should be made for the employing company to reflect the proper timing and amount of deduction based on the IRD's stated position during the vesting period.

Ms Lee added that no tax adjustment would be made for the operating company if the service fees were based on costs incurred by the employing company or calculated on a cost-plus basis provided the mark-up, if any, was at arm's length and not excessive.

(g) Share-based payments in a single company situation

The IRD’s position is that if an entity fulfils its stock option or share award granted to its employees by issuing new shares, the share-based expense recognised in the profit and loss account would not be deductible. The IRD follows the authority in *Lowry v Consolidated African Selection Trust Ltd.* [1940] 23 TC 259. It considers that the issue of new shares involves a movement in the entity's equity reserve account and is not an "outgoing" or "expense" for the purpose of section 16(1) of the Inland Revenue Ordinance (“IRO”).

Where, on the other hand, a listed single company (e.g. a US-listed company operating a branch in Hong Kong) incurs costs in acquiring its own shares from the market as treasury stock, and uses the acquired treasury stock to grant the stock option or share award to its employees, could the IRD confirm that the expense would be deductible?

Ms Lee advised that the Hong Kong branch of the US-listed company in the example quoted would be allowed a deduction of the expense incurred.

Ms Lee further said that where the company was a Hong Kong incorporated company, the shares it bought back would be treated as cancelled under the Companies Ordinance. She explained that under such circumstances, as the shares bought back had been cancelled, the subsequent issue to its employees was a new issue of shares. She concluded that the cost of the treasury shares was not an "outgoing" or "expense" for the purpose of section 16(1) of the IRO.

(h) Any corresponding amendments to the IRO as a result of the enactment of a court-free procedure for amalgamation of companies under the new Companies Ordinance

The New Companies Ordinance (“CO”) will take effect on 3 March 2014. The changes made in the CO include those relating to the amalgamation of companies within a group. Briefly, the new CO provisions allow the “merging” of two or more Hong Kong companies, subject to certain conditions being satisfied (e.g., only applies to companies limited by shares). Due to various commercial reasons, it is believed that some taxpayers may opt for “merger” in carrying out their group restructuring exercises.

The Institute would like to seek the IRD's view on the tax implications relating to amalgamations. For example, would amalgamation result in the transfer of tax losses from the amalgamating entity (i.e., the entity that would cease to exist) to the amalgamated entity (i.e., surviving entity); treatment of tax-depreciable assets "transferred" from the amalgamating entity to the surviving entity; and whether stamp duty exemption will be available where Hong Kong real properties/stock are involved etc.?

CIR informed the Institute that the IRD was studying the relevant tax issues relating to the new court-free regime for corporate amalgamation. He welcomed members of the Institute to identify the relevant tax issues and to offer their views and proposed solutions. He suggested that taxpayers might in the interim seek an advance ruling under section 88A on how any provision of the IRO would apply to a company amalgamation.

Mr Chiu added that there were specific tax legislations in Singapore and New Zealand on amalgamation of companies. He explained that the IRD had to address a number of tax issues, such as late filing of return by the amalgamating entity, the penalty issue and tax reserve certificate issue. He said that a change in law might be required to provide tax certainty.

Mr. So noted that the abolition of par value of shares under the new CO would have implications for section 45 of the Stamp Duty Ordinance. CIR confirmed that this was also being looked at.

CIR invited the Institute to provide a paper on the issue and the IRD would then take on board the Institute's proposal in the policy decision.

(i) The IRD's assessing practice in respect of unrealised profits after the decision of *Nice Cheer* by the Court of Final Appeal

Based on the response to the question about profits tax assessments raised in the Legislative Council on 4 December 2013, the Institute notes that "the IRD is studying the *Nice Cheer* judgment in detail and examining such matters as scope of application of the relevant principles and actual practice." In this regard, the Institute would like to ask when the IRD expects to complete this process and whether it is envisaged that changes will need to be made to DIPN 42?

Mr Chiu advised that the Financial Services and Treasury Bureau ("FSTB") and the IRD were studying the matters arising from the CFA judgment in *Nice Cheer* but the study might not be completed before the end of the second quarter. He said that the IRD was seriously considering a change in law to allow taxpayers to continue their existing mark-to-market practice.

Mr Chiu pointed out that after the Court of Final Appeal had given its judgment in *Nice Cheer*, a number of financial institutions approached the IRD, expressing their concern about the impact of the judgment on their 2013/14 profits tax returns. They claimed that substantial costs had to be incurred if profits computed on a fair value basis were to be recomputed on a realisation basis. Mr. Chiu disclosed that financial institutions through their representatives had enquired whether the IRD could accept 2013/14 profits tax returns based on financial statements which adopted fair value accounting.

Mr Chiu said that the IRD had conveyed the concern of the stakeholders to FSTB. He said that after considering the problems encountered by taxpayers and their representatives, the IRD was ready to accept 2013/14 profits tax returns in which the assessable profits were computed on a fair value basis. He requested taxpayers and their representatives to take note that this was an interim administrative measure.

Mr Chiu agreed that the IRD would give guidance on its website to taxpayers as to how they should prepare their 2013/14 tax returns and tax computations.

Ms Chan asked whether the proposed administrative measure applied to other companies, not limited to financial institutes. In response, Mr Chiu said that the proposed measure would apply to all companies in Hong Kong, but should not constitute as an excuse to apply time extension for filing returns.

[Post-meeting note: The IRD subsequently announced the administrative measure on its website on 4 March 2014 (http://www.ird.gov.hk/eng/tax/bus_fva.htm).]

(j) Application of section 61B

Does section 61B of the IRO apply to a change in the indirect shareholding in a corporation with accumulated tax losses?

For example, Company A holds the shares of Company B which in turn holds the shares of Company C (which is the company with accumulated tax losses). If there is a change in the shareholding of Company A (instead of Company B) and as a result, profits have been received by or accrued to Company C, will section 61B be invoked to disallow the set off of the tax losses against the profits of Company C?

Mr Tam Tai-pang ("Mr Tam") explained that section 61B would be invoked where there was a change in the shareholding in a corporation and as a direct or indirect result of the change, profits had been received by or accrued to that corporation and the sole or dominant purpose of the change was for the purpose of utilizing losses sustained by the corporation to avoid tax liability of that corporation or any other person.

Mr Tam explained that while the words "any change in the shareholding in any corporation" in section 61B were potentially very wide in scope (e.g. changes in beneficial interest could be included), the IRD would normally regard it as a change in shareholding if shares were transferred from one person to another person.

Mr Tam noted that tax losses in the given example were sustained by Company C and profits were then accrued to Company C after a change of shareholding in Company A, the ultimate holding company. He said that section 61B would not normally be invoked against Company C as the IRD would consider that there was no change in Company C's shareholding.

Mr Tam pointed out that the IRD might look into the case if necessary to ascertain whether the change in shareholding of Company A and the accrual of profits to Company C constituted transactions within the ambit of sections 61 and/ or 61A. He said that the IRD might also consider invoking sections 61 and/or 61A to counteract the tax benefit obtained by any relevant person if that was the case.

Agenda item A2 - Salaries tax issues

(a) Proportionate benefit based on the years of service

In item A2(a)(ii) of the 2013 annual meeting, the IRD advised that if an individual worked for a United States ("US") employer and later changed to a Hong Kong employer, upon the termination of the employment with the Hong Kong employer, the amount received that was attributable to the voluntary contribution paid by the Hong Kong employer, and which exceeded the proportionate benefit, was taxable if the employee had worked for less than 10 years for the Hong Kong employer. The formula to calculate the proportionate benefit (i.e., the portion of the accrued benefits exempted from salaries tax) would use the number of completed months of service with the Hong Kong employer.

In the global business environment, it is common for multinational groups to relocate employees to different jurisdictions, with employment switching between different group companies. For example, an employee of a Hong Kong group company may be relocated to Singapore under the employment of the Singapore group company.

Would the IRD consider granting a concession to deem the employment period with other overseas group companies as within the number of completed months of service in the proportionate benefit formula?

Ms Go referred to item A2(a)(ii) of the 2013 annual meeting, saying that where there had been a transfer of benefits from a scheme operated by a previous employer to the current employer’s scheme, the service with the previous employer that had been recognised by the present scheme as qualifying service with the current employer could be taken into account in calculating the completed months of service for calculation of the proportionate benefit under section 8(5) of the IRO (i.e. paragraph 27 of DIPN 23 applied). She pointed out that in other cases, the employment period with previous employer, including overseas group companies, would not be counted as the number of completed months of service in the proportionate benefit formula.

Ms Go explained that the Hong Kong employer and overseas group companies, though within the same group, were separate legal entities and it was the choice of the taxpayer and the employer(s) as to how the employment arrangement/relocation was to be structured. She said that if an employment was switched between different group companies but the above condition was not fulfilled, the IRD would not see it proper to include the employment period with other overseas group companies in the number of completed months of service in the proportionate benefit formula.

(b) Taxation of pension benefits under a Comprehensive Double Taxation Agreements ("CDTA")

In a number of CDTAs that Hong Kong has concluded, the taxing rights to pension benefits are exclusively allocated to the source state. For example, Article 17 of CDTA between Hong Kong and the United Kingdom ("UK") states that:

“Pensions and other similar remuneration (including a lump sum payment) arising in a Contracting Party and paid to a resident of the other Contracting Party in consideration of past employment or self-employment and social security pensions shall be taxable only in the first-mentioned Party.”

However, as noted in paragraph 19 of the 2010 Organisation for Economic Co-operation and Development ("OECD") commentary concerning the taxation of pensions, “a mere reference to a pension “arising in” a Contracting State could be construed as meaning either a pension paid by a fund established in that State or a pension derived from work performed in a State.”

As such, the OECD commentary suggests that “States using such wording should clarify how it should be interpreted and applied.” In this regard, the Institute would like to know what the IRD’s interpretation of the term “arising in” in this context is and whether the IRD would approach the relevant CDTA partners with a view to reaching a consensus on the interpretation.

Ms Mei advised that if a particular term used in a CDTA was not defined therein, then the term would have the meaning that it had at the time under the law of Hong Kong for the purposes of the taxes to which the CDTA applied.

Ms Mei explained that in determining the source of pension (i.e. whether the pension arose in Hong Kong), the IRD would regard the situation of the fund from which the pension was paid as the decisive factor. She said that this did not necessarily mean the place where the assets comprising the fund were physically situated but the place where the fund was managed and controlled. She added that pension attributed to services rendered outside Hong Kong would be excluded from assessable income in any event because of the provisions in section 8(2)(ca).

Ms Mei referred to Hong Kong’s CDTAs, saying that the taxing right over pensions and other similar remuneration was usually given to the resident jurisdiction but the Administration would seek to obtain exclusive taxation right over pensions and other similar payments made under an arrangement in which individuals might participate to secure retirement benefits and which was recognised for tax purposes (i.e. a recognised retirement scheme) in Hong Kong.

Ms Mei pointed out that in negotiations of CDTAs, Hong Kong's position had been clearly explained to the treaty partners and the IRD so far was not aware of any cases whereby double taxation arose because there was conflict of source over pensions or other similar income.

(c) Deemed vesting of stock awards upon departure from Hong Kong

According to DIPN 38, taxpayers that permanently depart from Hong Kong may prior to their departure, elect to have a notional exercise of the share options granted, so as to finalise their Hong Kong salaries tax liabilities. DIPN 38 further states that if, subsequently, the gain in respect of the actual exercise, assignment or release is less than the amount assessed in respect of the notional exercise, the IRD will favourably consider any application for appropriate amendment and re-assessment.

The Institute would like to know whether the IRD would consider extending the above approach to a deemed vesting of share awards on departure. If not, the Institute would ask the IRD to explain the difference in the approaches.

Mr Chiu informed the meeting that a similar question was raised under item A2(b) of the 2009 annual meeting and the IRD's stance on this issue had not changed since then.

Mr Chiu explained that an election to assess share awards under the back-end approach on a notional basis upon the taxpayer's permanent departure from Hong Kong was in essence an agreement that bound the taxpayer and the IRD regarding the valuation of share award benefits which accrued in the year of cessation of employment in Hong Kong. He emphasized that assessments needed to have finality. He reminded that when deciding whether to make the election, both sides should accept the consequences and once the election was made and an assessment was raised, a subsequent request to revise the assessment would not be entertained unless the objection to the assessment was within the statutory time limit. He added that the IRD would not raise an additional assessment in such a situation even if the value of shares subsequently vested in the taxpayer had increased.

Mr Chiu further explained that taxation of share awards and share options were different. He pointed out that share awards were taxable perquisites under section 9(1)(a) and deemed to accrue on the last day of employment pursuant to section 11D(b) proviso (ii) even if they were vested after the cessation of employment. He also pointed out that share option gains were assessed under section 9(1)(d) and the Court of First Instance, in *CIR v Sawhney* [2006] 3 HKLRD 21, ruled that salaries tax assessments should be raised in the years in which the taxpayer exercised his share options notwithstanding his employment had ceased. He explained that it would not be inappropriate in view of this judgment to accept a revision of the assessment of share option benefits assessed on a notional basis upon the taxpayer's permanent departure from Hong Kong.

(d) Taxation of employee share awards

DIPN 38 on Employee Share-based Benefits has a general comment (in paragraph 61) that share award benefits would generally be taxed at vesting, which is defined as entitlement of ownership "free of all conditions", but there is no further elaboration on what "conditions" means.

It is common among private companies that the employer will grant shares of the company to its key executives, or offer to sell the shares of the company to them at the fair market value on the date of offer. The executives' rights with respect to the shares will be the same as other shareholders and there will not be any forfeiture risks. However, when they cease employment with the company they are required to sell their shares back to the company at the prevailing fair market value. Against this background, the Institute would like to ask:

(i) Whether the IRD will consider the requirement to sell back the shares to the company upon cessation of employment a "condition", such that the "back end approach" will be applied to tax the share awards based on the fair market value at the date of disposal? Or will the "upfront approach" be applied, such that any appreciation in share value from the date of grant to the date of disposal would be considered as capital gain and not subject to salaries tax?

Mr Chiu explained that for salaries tax purposes, the time at which the shares accrued to the employee could be determined by reference to the terms of the share award plan. He said that which assessing approach, upfront or back end, should be adopted would depend on when the employee was regarded as fully entitled to ownership of the shares and had the rights of a normal shareholder. He highlighted the relevant factors included: whether he was registered as a shareholder; whether he was allowed to vote in the general meeting; whether he was entitled to receive dividends; and whether he was allowed to pledge the shares to banks for loan, etc.

Mr Chiu said that before deciding which assessing approach was applicable, the IRD would consider all the facts and circumstances of the case. He said that the upfront approach would generally be more appropriate if the employee had all the rights of a normal shareholder at the time of grant except the requirement to sell the shares upon cessation of employment and there would not be any forfeiture risks.

Mr Chiu added that employers could consider applying for an advance ruling in respect of the salaries tax treatment of employee share-based benefits should they intend to have more tax certainty.

(ii) In some cases, the shares will bear a remote forfeiture risk, namely, the shares will be forfeited only if the employment is terminated for "cause" (e.g., gross misconduct, committing criminal offence, etc.). In some tax jurisdictions (e.g., the US), this is not considered a "substantial risk of forfeiture" and hence, the taxing point will not be deferred. Will the IRD adopt the same approach to tax the share awards upfront, or will it consider the forfeiture risk upon termination of employment for cause to be a "condition" (albeit remote) which has to be uplifted before the taxing point arises?

Mr Chiu pointed out that the same rationale as stated in item A2(d)(i) above would follow. He said that the upfront approach should generally be applied if the employee had acquired full economic benefits and ownership of the shares at the time of grant except subject to forfeiture risk that was remote or a contingency.

Ms Chan asked the IRD for an example of forfeiture risk that was remote or a contingency. Mr Chiu responded that committing criminal offence might be a case where the forfeiture risk could be regarded as being remote or a contingency. He suggested that employers should consider applying for an advance ruling to have more tax certainty as the scheme would apply to all entitled employees.

(e) Taxation of share awards and the related employer’s reporting obligations

The Institute welcomes the IRD’s clarifications on tax treatments of share awards in the situation where the taxpayer changed the employment status during the vesting period and would like to seek further clarifications from the IRD on the following questions (Item A2(b) of the 2013 annual meeting refers):

(i) Time apportionment factor to be used

The IRD indicates that in the year of assessment in which the share awards are vested, a time apportionment factor will be used to determine the taxable share awards related to the vesting period during which the taxpayer was still under non-Hong Kong employment.

The Institute would like to ask what would be the time apportionment factor F for the following scenario:

An employee with a non-Hong Kong employment had been seconded to work in Hong Kong since 1 January 2008. His employment is localised and changed to a Hong Kong employment on 31 March 2011. He was granted restricted share awards on 1 January 2009 with a three year vesting period (i.e., they vested on 31 December 2011).

Ms. Go said that if the value of the vested shares was assumed to be $A, the split and the taxable amounts in the year of assessment 2011/12 would be computed as follows:

Vesting period	No. of days	Types of employment	Taxable share awards
01.01.2009 – 30.03.2011	819	Non-HK employment	$A x 819/1,095
31.03.2011 – 31.12.2011	276	HK employment	$A x 276/1,095

Ms Go clarified that the share awards as perquisites were vested and accrued in the year of assessment 2011/12. She pointed out that the case was different from Example 1 in item A2(b) of the 2013 annual meeting since the employee in the present case had no non-Hong Kong employment during 2011/12. She added that any income accrued during the period from 1.4.2011 to 31.12.2011 was not eligible for time apportionment and thus the time apportionment factor (F) was not relevant. She therefore concluded that the amount of the value of the vested shares was fully taxable unless the provisions of sections 8(1A)(b)(ii) and 8(1B) were satisfied.

(ii) Employer’s reporting obligations

In example 2, the IRD indicates the amount of share awards apportioned to the vesting period prior to the taxpayer's Hong Kong assignment is not taxable. As a follow-up question, the Institute would like to clarify with the IRD whether the portion attributable to services rendered under the non-Hong Kong employment prior to the Hong Kong assignment is required to be reported in any employer's returns (i.e. the portion that the IRD indicated to be non-taxable).

Ms Go explained that, as the share award benefits were regarded as income within the definition of the term in section 9 of the IRO, the employer’s obligations in respect of share awards and other employment income under section 9 were the same. The reporting requirements on an employer in respect of share-based benefits were further elaborated in paragraphs 79 to 83 of the DIPN 38.

Ms Go pointed out that when an employer commenced to employ in Hong Kong an individual who was or was likely to be chargeable to salaries tax, the employer, within three months of the date of commencement of such employment, had to notify the Commissioner in writing of, amongst other things, the individual’s terms of employment. The employer could use form IR56E as a notification. If the employee had already participated in a share award plan prior to commencement of employment in Hong Kong, the employer was required to report details of the plan together with other terms of employment to the IRD though the share awards had not yet vested. When vested, the employer was required to report the gross amount of share award benefits in IR56 form applicable to the case or by way of a written notification of amendment to the IR56 form previously filed. To the extent that exemption / time apportionment was available, this would be addressed on the tax return - individuals of the employee concerned.

Agenda item A3 - Cross-border tax issues

(a) Whether a non-demise charter-party agreement for an aircraft constitutes a "lease" arrangement under section 39E(1)(c) of the IRO

Consider the situation where a private jet is owned by either a Hong Kong incorporated company or an overseas company that is normally managed or controlled in Hong Kong. The pilot and other crew members of the private jet are hired by the jet owner through an arrangement with an independent service provider. The jet owner then enters into non-demise charter-party agreements with the Mainland customers on a flight or time charter basis, i.e., it is the jet owner who operates and uses the aircraft through the pilot and crew members hired by it and the Mainland customers only enjoy the use of the aircraft as passengers. The private jet is the only asset owned by the jet owner and all income earned by the jet owner is from non-demise charter-party agreements with the Mainland customers.

Under the charter-party agreements, there will be flights commencing from an airport in the Mainland and other jurisdictions which have concluded CDTAs with Hong Kong (but no flights commencing from Hong Kong). However, under section 23C of the IRO, the private jet owner would be deemed to have derived relevant sums in respect of flights commencing from the Mainland and the other jurisdictions and, therefore, would be chargeable to tax in Hong Kong (subsections (2A), (2B) and (4) of section 23C refer). This is on the assumption that the relevant non-demise charter-hire income is regarded by the overseas jurisdictions as profits from international traffic and, therefore, exempted from tax in the jurisdictions concerned under the relevant CDTAs.

On the basis that the private jet owner is chargeable to tax in Hong Kong, under section 23C, the Institute would like to know whether in the circumstances the private jet owner would qualify for tax depreciation allowances in respect of costs incurred for the acquisition of the jet.

It appears to the Institute that section 39E(1)(c) of the IRO may not be applicable to deny claims for tax depreciation allowances. This is because, at all times, it is the private jet owner who operates and uses the aircraft and the Mainland customers are more passengers than lessees. One would not normally say that a passenger is the lessee of a taxi hired by the passenger.

The Institute would welcome the IRD's view on the above.

Mr Chiu advised that section 23C applied to a person who carried on a business as an owner of aircraft (i.e. an operator of aircraft, owned or chartered). He said that the term "owner" was defined to include a charterer under a charter-party and the words "business as an owner of aircraft" were defined to mean a business of chartering or operating aircraft. He added that generally an aircraft registered in Hong Kong might not fly for the purpose of public transport unless the operator held an Air Operators Certificate ("AOC") granted by the Director-General of Civil Aviation.

Mr Chiu explained that if the lessee under a lease of an aircraft was not an operator of a Hong Kong aircraft as defined in section 39E(5) of the IRO, the aircraft owner who incurred capital expenditure on the provision of the aircraft would not qualify for depreciation allowances in respect of the costs incurred for the acquisition of the aircraft pursuant to section 39E(1)(c) of the IRO.

Mr Chiu noted that in the hypothetical case given, the jet owner: was not an operator of a Hong Kong aircraft; did not employ the crew; and was not the carrier that issued the air waybill or airline ticket. He said the facts suggested that the jet owner should be a special purpose vehicle for holding the aircraft as an equipment under a lease within the meaning of the term as extended by section 2 and the private jet owner should be denied depreciation allowances.

Mr. Chiu went on to say that since the jet owner was not an operator of international traffic, it should not be entitled to treaty benefits under: the Shipping and Air Transport Article of a CDTA; the Avoidance of Double Taxation Article of an Air Services Agreement; or under the Avoidance of Double Taxation Article of an Airline and Shipping Income Agreement. He explained that withholding taxes would be collected by Hong Kong's treaty partners under the Royalties Article of a CDTA if industrial, commercial or scientific equipment were included thereunder.

Mr Ng commented that aircraft operators operating private jets between Hong Kong and China might not be issuing tickets. Ms Chan also commented that it was not uncommon for the provision of crew members through an outsourcing arrangement with an independent service provider. She took the view that it did not necessarily mean that the jet owner was not an aircraft operator for tax purposes.

Mr Chiu emphasized that section 23C would not be applicable unless the "owner" carried on business as an aircraft operator. He pointed out that the aircraft operator being the holder of AOC would "generally" be permitted to operate the public transport flight. He explained that section 23C defined the term "owner" to include a charterer of an aircraft under a charter party and the aircraft operator, carrying on a business of operating aircraft, "chartered in" an aircraft under a lease arrangement. He further elaborated that the non-demise charter party included the lease of an aircraft without the crew. He held the view that since the jet owner did not carry on a business as an aircraft operator, section 23C had no application and depreciation allowance on capital expenditures incurred on the acquisition of an aircraft would be denied if the aircraft was used by a lessee not being an operator of a Hong Kong aircraft.

(b) Whether income from a non-demise charter-hire is profits from the operation of ships or aircraft under the relevant clause of the CDTAs

Generally, under the CDTAs that Hong Kong has concluded with other jurisdictions, a Hong Kong resident would be exempted from tax in the jurisdictions concerned in respect of profits from the operation of ships or aircraft in international traffic.
The question is whether income from a non-demise charter-hire of ships or aircraft, like

that of the jet owner in A3(a) above, would be regarded as profits from the operation of ships or aircraft in international traffic.

Paragraph 5 of the 2010 OECD commentary concerning the taxation of profits from shipping, inland waterways transport and air transport, states that “[p]rofits obtained by leasing a ship or aircraft fully equipped, crewed and supplied must be treated like profits from the carriage of passengers or cargo. Otherwise, a great deal of business of shipping or air transport would not come within the scope of the provision. However, Article 7, and not Article 8, applies to profits from leasing a ship or aircraft on a bare boat basis except when it is an ancillary activity of an enterprise engaged in the international operation of ships or aircraft.”

Therefore, it appears from the OECD commentary that income from a non-demise charter-hire would be treated as profits from the operation of ships or aircraft in international traffic (assuming the ships or aircraft are not operated solely in a contracting state).

However, based on the specific facts of a case, the Mainland's State Administration of Taxation ("SAT") appears to have taken a different view from paragraph 5 of the OECD commentary. Circular Guoshuibanfa [2011] No. 34 reported a tax controversy case in this regard. The case involved a company in the Weihai city of Shangdong Province (“W Company”) leasing a ship on a non-demise basis from a Korean company. The issue in dispute was whether the Korean company should be exempted from tax in the Mainland in respect of the non-demise charter-hire income received from W Company under the relevant clause of the Korea-China CDTA as profits derived from the operation of ships in international traffic.

The court upheld the decision of the relevant tax authority of the Mainland that by merely chartering the only ship it owned on a non-demise basis, the Korean Company did not carry on any international transport business.

As such, the court held that the relevant charter-hire income could not be regarded as being income incidental to the carrying on of an international transport business by the Korean Company and, therefore, could not be exempted from tax in the Mainland, under Article 8 of the Korea-China CDTA.

This view appears to be different from that expressed in the above quoted passage from the OECD commentary, which apparently treats non-demise charter-hire income itself as profits from the carriage of passengers or cargo, thereby not subjected to the incidental or ancillary test applicable to bare boat chartering.

In this regard, the Institute would like to know what the IRD’s view is in relation to a non-resident aircraft owner receiving non-demise charter-hire income from flights commencing from Hong Kong, i.e., whether the income would be exempted from tax in Hong Kong under the relevant CDTA (assuming the aircraft owner is a resident of a jurisdiction which has concluded a CDTA with Hong Kong based on the OECD model treaty convention).

Were SAT to take the view that income from non-demise chartering of an aircraft was not profits from the carriage of passengers or cargo, the private jet owner in A3(a) above would be liable to tax in the Mainland, i.e., not exempted from tax under the Mainland-Hong Kong double tax arrangement ("Mainland-HK DTA"). In such an event, the Institute would like to know what the IRD would do if the private jet owner were aggrieved by the SAT not exempting it from tax in the Mainland and initiated the mutual agreement procedure in Hong Kong under the Mainland-HK DTA .

Separately, if based on the view of the SAT discussed above, the non-demise charter hire income of the jet owner in A3(a) above from flights commencing from the Mainland were not exempted from tax in the Mainland under the Mainland-HK DTA, would the relevant income still be taxed in Hong Kong under section 23C(2A) of the IRO? If so, would there be any tax credit in Hong Kong for the taxes paid in the Mainland. The Institute would like to clarify, as there are views that the relevant income would be taxed in Hong Kong under section 23C(2A) of the IRO, regardless of whether the relevant income were exempted from tax under the Mainland-HK DTA.

Mr Chiu advised that under the Shipping and Air Transport Article of the CDTAs concluded by Hong Kong, the place of residence of the enterprise generally had exclusive taxing right over profits derived from the operation of aircraft in international traffic. He said that the IRD basically followed the interpretation in paragraph 5 of the commentary at page 175 which read: “profits obtained by leasing an aircraft on charter fully equipped, crewed and supplied must be treated like the profits from the carriage of passengers or cargo”. He further said that this was subject to the condition that the enterprise carried on an international transportation business. He referred to paragraph 1 of the commentary which clearly read: “The object of paragraph 1 concerning profits from the operation of ships or aircraft in international traffic is to secure that such profits will be taxed in one State alone.”

Mr Chiu pointed out that, as explained in A3(a) above, there was no evidence that the jet owner was an international traffic operator. He therefore took the view that its profits would not be regarded as profits from the operation of aircraft in international traffic, including the profits allegedly from a non-demise charter-party.

Mr Chiu explained that profits from equipment leasing should be assessed under section 14 and not under section 23C. He said that the profits should have a Hong Kong source if: fund raising was carried out in Hong Kong for acquisition of the aircraft; the structuring of the aircraft investment was carried out in Hong Kong; the documentation was prepared in Hong Kong; the rental for use of the aircraft was collected in Hong Kong; and the monitoring of the aircraft and associated risks was done in Hong Kong.

Mr Chiu further explained that if the jet owner was a Hong Kong resident per the Mainland-HK DTA and its profits were chargeable to profits tax, then it would be given double tax relief in respect of any withholding tax imposed by SAT on the rental from the leasing of the aircraft.

Mr Chiu added that though the IRD should not be in a position to comment on the Mainland’s tax treatment of the Korean company in question, the IRD did not see that the SAT had departed from the international consensus on the interpretation of the Shipping and Air Transport Article.

(c) Mutual agreement procedure ("MAP") request and double tax relief for Mainland tax paid

An investment fund sets up a Hong Kong incorporated company as a special purpose vehicle ("SPV") to invest in shares of non-property holding companies in the Mainland. The Hong Kong company derived gains from disposal of such Mainland shares but claimed exemption from Mainland tax on such gains under the Mainland-HK DTA (i.e. the 25% direct and indirect shareholding threshold and the 12-month look-back period requirements are met). Hong Kong profits tax has been paid on the gains derived from disposal of the Mainland shares as they are considered as trading gains and the offshore funds exemption is not applicable. The application for tax exemption on capital gains under the Mainland-HK DTA is under review by the Mainland tax authority and after more than two years from the end of the year of assessment concerned, SAT invokes general anti-avoidance rules to disallow the treaty benefit claim, on the basis that the Hong Kong SPV does not have any substance and was set up for treaty-shopping purpose. Against this background, the Institute would like to get the IRD's views on the following issues:

(i) Assuming that the Hong Kong SPV does have considerable substance in Hong Kong, will the IRD entertain the taxpayer's request for MAP in this case?

Ms Mei advised that given the facts of the case, SAT might have taken the view that the Mainland-HK DTA had been abused. She took the view that if that was the situation, it would not be improper for the SAT to invoke anti-avoidance measures as permitted under the Miscellaneous Provisions Article of the Mainland-HK DTA.

Ms Mei mentioned that if the Hong Kong SPV presented his case to the Hong Kong competent authority for MAP, the Hong Kong competent authority would examine the facts of the case to decide whether there had been any taxation not in accordance with the provisions of the Mainland-HK DTA.

Ms Mei added if the grievance appeared to the Hong Kong competent authority to be justified or the IRD was not able to arrive at a satisfactory solution, the Hong Kong competent authority would endeavor to resolve such case by MAP with the SAT.

(ii) On the other hand, if no MAP is initiated by the taxpayer or the taxpayer's request for MAP is not accepted by the IRD, and the taxpayer eventually pays Mainland tax on the gains, will the Mainland tax paid be allowed to be credited against the

Hong Kong profits tax payable on the gains?

Ms Mei explained that in the case quoted, if no MAP was initiated by the taxpayer or the taxpayer’s request for MAP was not accepted by the IRD, it would imply either the Mainland’s interpretation was accepted by the taxpayer or the IRD agreed with the Mainland’s interpretation. She said that in such a case the taxpayer would not be able to benefit under the Mainland-HK DTA and all the provisions including the Article on elimination of double taxation would not be applicable to the taxpayer. She pointed out that the enterprise income tax paid by the Hong Kong incorporated company in respect of the gains derived from the disposal of the Mainland shares would not be allowed as a credit against its Hong Kong tax payable in respect of the same profit in particular when the claim was outside the time limit laid down in section 50(9).

(iii) If the answer to (ii) is "yes", how can the taxpayer get relief from double taxation, in practice, given the two-year time limit for foreign tax credit claims under section 50(9) of the IRO has passed?

While Ms Mei recognised the answer to (ii) was "no", she remarked that similar questions were raised in the 2010 annual meeting at items A4(b)(iii) and (v), as recorded on pages 22 to 24 of the minutes of that meeting.

Ms Mei said that according to paragraph 32.8 at page 316 of the OECD commentary on “Timing mismatch”, 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. She said that such relief had to be provided regardless of when the tax was levied by the State of source. She added that if 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), these States, as OECD saw it, would be expected to seek other ways, such as the MAP, to relieve the double taxation which might otherwise arise in cases where the State of source levied tax in an earlier or later year.

Ms Mei said the IRD agreed with the spirit of the OECD that double tax relief should always be given whenever possible, although taxpayers should have the responsibility to lodge the MAP application as soon as they were aware of the possibility of adjustments being made by other States. She added that where relief was no longer available under section 50(9) of the IRO, in bringing up the matter, taxpayers should explain why they had failed to lodge the foreign tax credit claim in time.

Agenda item A4 - Double tax agreements

(a) Profits attributable to permanent establishment ("PE")

Item A4(e) of the 2013 annual meeting refers. The IRD stated that "[i]f the profits were attributable to the Hong Kong PE, then the profits if sourced in Hong Kong would be assessed to profits tax even though the profits were not recognised in the accounts of the Hong Kong PE."

A follow up question is what would be the tax position if the profits, albeit Hong Kong sourced under the tax law of Hong Kong, were not attributable to the Hong Kong PE of the non-resident in the example?

Mr Tam said that the right to tax Hong Kong sourced profits might be restricted by the provisions of a CDTA. He explained that according to the Business Profits Article of the CDTA, an enterprise of a treaty partner would only be subject to taxation in Hong Kong if it carried on business in Hong Kong through a PE which was defined in the Permanent Establishment Article of the CDTA. He added that if the profits included items of income which were dealt with separately in other Articles then the provisions of those Articles (i.e. the Dividends Article, the Interest Article, the Royalties Article, the Capital Gains Article and the Other Income Article) would not be affected by the provisions of the Business Profits Article. He gave an example: royalties derived by an enterprise of a treaty partner without a PE should be dealt with under the Royalties Article instead of the Business Profits Article.

(b) Residence of an overseas company with a branch in Hong Kong

In Item B3 of the 2013 annual meeting, the IRD advised that, for the purposes of the Mainland-HK DTA and with immediate effect, as a result of the IRD's change in interpretation, the management or control, as a whole, of an overseas bank with a branch in Hong Kong, rather than the management or control of the Hong Kong branch alone, have to be exercised in Hong Kong for such an overseas bank to qualify as a Hong Kong resident.

The Institute would like to ask:

(i) whether, as a general principle, DIPN 44 will apply to CDTAs other than that with the Mainland as long as the articles in these CDTAs are the same as those in the Mainland-HK DTA. In particular, whether the IRD will determine the residence of an overseas bank with a branch in Hong Kong, for the purposes of CDTAs other than that between Hong Kong and the Mainland, according to the principle in DIPN 44, as clarified in item B3 of 2013 meeting;

Mr Tam advised that under the Mainland-HK DTA, the IRD would consider the management or control of the bank as a whole in deciding whether an overseas bank was “normally managed or controlled in Hong Kong”. He added that the same principle would be applicable to other CDTAs with the same definition for Hong Kong resident.

(ii) in respect of an overseas company, other than a bank, with a branch in Hong Kong, how would the IRD determine its residence in Hong Kong for the purposes for CDTAs, including that between Hong Kong and the Mainland?

Mr Tam explained that in deciding the residence of an enterprise incorporated or established overseas, including an overseas company, the IRD would consider the management or control of the enterprise as a whole (i.e. whether the enterprise incorporated or established overseas was “normally managed or controlled in Hong Kong”). He said that the same approach would be adopted in the interpretation of all the CDTAs with the same or similar definition for Hong Kong resident.

(c) Tax resident certificates issued by the treaty partners

Practitioners have come across real cases where the tax resident certificates issued by some of Hong Kong's treaty partners do not specify the period in which the applicants are considered to be a tax resident of their countries. For example, practitioners have seen a certificate issued by the HM Revenue & Customs in the UK with the following wording: “I certify that to the best of the HM Revenue & Customs’ knowledge, [ABC Company], as at today’s date, is a resident of the United Kingdom in accordance with the Convention in force between the UK and Hong Kong.”

The Institute would like to seek the IRD's view on whether:

(i) it will accept such certificate as a proof of residency for the year of assessment concerned;

Mr Chiu advised that if a resident of a treaty partner intended to apply for treaty benefits under the terms of a CDTA, the IRD expected that the resident of the treaty partner to provide a resident certificate in relation to the period or year in or over which the relevant profit, income or gain was derived from Hong Kong.

Mr Chiu said that it was the IRD’s understanding that HMRC would issue a certificate of residence (“CoR”) which certified that a person was resident for a certain period, so long as the period did not end later than the date of issue.

Mr Chiu mentioned that where Hong Kong’s treaty partners did not specify the related period or year in their resident certificates, the IRD in practice, after considering the facts of the case, including the quantum of the treaty benefits, would consider not to reject the claim if the resident certificate was issued within a reasonable time with respect to the related period or year. He said that such a certificate would be accepted as a proof of residency for the related period or year. To facilitate processing of claims for treaty benefit, Mr Chiu on behalf of the IRD urged taxpayers to request Hong Kong's treaty partners to specify the period covered when applying for CoRs.

(ii) the taxpayer/ treaty benefit claimant in such cases needs to apply for a certificate from the treaty partner for each year of assessment where treaty benefit is claimed.

Mr Chiu advised that the IRD expected the resident of the tax treaty partner to provide a resident certificate that would cover the period(s) or year(s) in or over which the relevant profit, income or gain was derived from Hong Kong. He said that the IRD in any event would be ready to consider accepting a resident certificate issued within a reasonable time after the end of the related period(s) or year(s).

(d) Duplicate copy of tax resident certificates

The IRD presently issues tax resident certificates under each CDTA to a taxpayer once a year and does not allow any issuance of duplicate copies of the same certificate.

It is noted that when taxpayers lodge the claim for preferential tax treatment under a CDTA in certain countries (e.g. Indonesia), some tax bureaus in those country collect the original certificate without returning it to the taxpayers. This causes inconvenience to the taxpayers who need to present the same certificate to other tax bureaus in that country for a similar claim.

The Institute notes that for CEPA certificates, for example, the Trade and Industry Department will issue duplicate copies of the certificates upon written application. Would the IRD consider issuing duplicate copies of tax resident certificates upon written application, in order to assist Hong Kong taxpayers who encounter the practical problem explained above?

Ms Mei said that the IRD would issue a CoR to a Hong Kong resident as a proof of residence status under the relevant CDTA. She said that only one CoR would generally be issued to an eligible applicant in respect of each CDTA for each calendar year of claim.

Ms Mei pointed out that the IRD had sought clarification with Indonesia regarding the claiming of preferential tax treatment under the Hong Kong-Indonesia CDTA. She informed the Institute that in 2013 the Indonesian competent authority clarified in writing that if a Hong Kong resident claimed tax treaty relief in Indonesia from more than one Indonesian tax office for a particular year, he could get authenticated copies of the CoR from the Indonesian tax office which held his original CoR and then submitted the authenticated copies to other Indonesian tax offices. She said that in view of such an arrangement, the Hong Kong resident would not need any duplicate CoR from the IRD for claiming tax treaty relief in Indonesia.

Ms Mei further said that the IRD had notified the treaty partners about our practice and had publicized the same on IRD's website. She noted that the prevailing practice had been working smoothly and in case of need, the IRD would seek clarification with the treaty partners and to update its website as appropriate. Having said that, she added that the IRD would consider issuing a duplicate CoR provided that a justifiable case was made out in writing.

(e) Tax resident certificates for companies without business registration in Hong Kong

Practitioners have recently come across situations where the IRD officers have refused to issue a certificate on Hong Kong tax resident status on the basis that the overseas incorporated company has not performed business registration in Hong Kong. In determining the residency of a non-Hong Kong-incorporated company for the purposes of applying a CDTA, the overseas company needs to demonstrate the location of its management and control. However, whether or not a company needs to conduct business registration is determined by whether or not it has a place of business in Hong Kong, which is a different test from "management and control". The Institute would like to seek the IRD's clarification as to:

(i) whether it will issue a certificate on Hong Kong tax resident status only to companies that are registered in Hong Kong

CIR advised that the criteria for determining whether a non-Hong Kong incorporated company was regarded as a resident of Hong Kong was specified in the CDTA concluded by Hong Kong. He said that the "normal management or control" test was generally adopted (i.e. a non-Hong Kong incorporated company would be regarded as a Hong Kong resident if the place of its management or control was in Hong Kong) with deviations in a few CDTAs.

CIR explained that to determine the place where a non-Hong Kong incorporated company exercised its management or control, a number of factors would be considered (e.g. nature of business operated by the company, mode of operation, whether it had a permanent office or employed staff in Hong Kong, and whether Hong Kong was the place where its board of directors met to formulate policy, etc.).

CIR said that the IRD as a starting point would examine whether the non-Hong Kong incorporated company carried on any business in Hong Kong by checking whether it had filed any application for business registration. He explained that the Business Registration Ordinance required every person who carried on a business in Hong Kong to apply for business registration within 1 month from the date of commencement of the business. He said that if the non-Hong Kong incorporated company did not apply for a business registration in Hong Kong, it might fail to establish that it carried on a business in Hong Kong.

CIR further explained that the IRD might decline issuing the tax resident certificate if the evidence indicated that the overseas incorporated company was a conduit or was actually managed or controlled outside Hong Kong. He added that if the non-Hong Kong incorporated company however could demonstrate that its management or control was in Hong Kong, the IRD might regard it as a Hong Kong resident and issue a resident certificate despite the fact that it had no business registration in Hong Kong.

CIR emphasized that the IRD under all circumstances would act in good faith in fulfilment of its obligation as a treaty partner. He assured that the IRD was committed to providing Hong Kong tax residents with assistance in claiming all the benefits they were entitled to under a CDTA but a CoR might be refused where it was clear that the person would not be entitled to those benefits.

Mr Ng mentioned that there were cases where, although taxpayers provided full justification that they were managed and controlled in Hong Kong, they were issued a CoR only from the date that they obtained a business registration. This could give the impression to taxpayers that business registration was the decisive factor. Mr Anthony Tam concurred that residence was often taken as starting from the date of the business registration certificate. They wondered whether some IRD officers were taking the view that business registration was the decisive factor in determining the residence status.

Mr Chiu emphasized that business registration was not a conclusive factor. He explained that whether a company was managed and controlled in Hong Kong was a question of fact. He added that if management and control were exercised by directors in board meetings, the relevant locality was where the board meetings were held. Mr Chiu asked Mr Ng to provide details of the cases quoted so that the IRD could look into the matter.

(ii) if the answer to (i) is in the affirmative, the legal justification for such view.

CIR told the meeting that the question was not applicable as the answer to (i) was in the negative. As explained in (i) above, whether a non-Hong Kong incorporated company had registered with the Business Registration Office was one of the factors that the IRD would consider in determining its resident status.

Agenda item A5 - Departmental policy and administrative matters

(a) Charging provisional tax not based on the assessable profits of the preceding year

Practitioners had encountered instances where the provisional tax charged for a year was not based on the assessable profits of the preceding year, even where the provisional tax was not in respect of the first two years of the business commencement.

This apparently occurred where it was believed by the assessors from newspaper reports or other sources that the company's profit level in the current year would likely be much higher than that of the preceding year, e.g., a large property development project was sold in the current year.

It is generally understood that according to section 63H(1) of the IRO, provisional tax for a year is charged based on the assessable profits of the preceding year, subject to subsections (1A), (2), (3) and (4). It appears that the IRD can either assess the provisional tax, under sections 63H(1), (1A) and (2); or estimate the provisional tax, under the circumstances in sections 63H(3) or (4).

Some practitioners consider that sections 63H(5),(6),(7),(7A) and (8) govern only the administrative procedures or technical matters that the IRD needs to follow when it assesses or estimates the provisional tax under sections 63H(1) to (4).

The Institute would like to know:

(i) under what circumstances would the IRD consider charging provisional tax that is not based on the amount of the assessable profits of the preceding year, other than the circumstances in sections 63H(3) and (4); and

Ms Lee explained that under section 63G, every person who was chargeable to profits tax in respect of a year of assessment was liable to pay provisional profits tax in respect of that year of assessment. She elaborated that under section 63H(1), the provisional profits tax in respect of any year of assessment was payable at the standard rate by reference to the amount of assessable profits for the year preceding the year of assessment but after setting off any loss available for set off in the current year of assessment. She emphasized that provisional profits tax was generally based on the amount of assessable profits for the preceding year. She however pointed out that the phrase “by reference to” in section 63H(1) did not mean “equal to” and when assessing the provisional profits tax, the assessor would turn to the assessable profits of the preceding year for information.

Ms Lee stressed that where a taxpayer considered that the provisional tax charged was excessive, an application might be made to the Commissioner for holding over the whole or part of the provisional tax until the final assessment in the following year pursuant to section 63J.

Mr Tisman asked what other circumstances were to be taken into account in assessing provisional profits tax. Ms Lee gave examples of cases where there was a change of accounting date and where there was an amalgamation.

(ii) the legal basis for doing so.

Ms Lee replied that the IRD did not see that section 63H(1) restricted it to charge the provisional profits tax on exactly the same amount of the assessable profits for the preceding year.

(b) Exemption from annual tax filing

In a standard letter to taxpayers for temporary exemption from annual tax filing, the IRD requests the taxpayer to notify them once they have derived assessable profits before loss set off. Taxpayers notify the IRD and complete tax returns and, if the taxpayers still have tax losses after set off against assessable profits, the IRD will issue another exemption letter. This exercise is repeated until the taxpayer derives net assessable profits. Would the IRD consider amending its standard letter such that the taxpayer needs to notify the IRD only when the taxpayer has derived net chargeable profits?

CIR advised that it was the practice of the IRD not to call for the annual submission of profits tax returns where the trade, profession or business carried on did not give rise to assessable profits or where the trade, profession or business had not commenced or had ceased and not recommenced. He reminded that a taxpayer was required to notify the Commissioner once it had derived assessable profits before loss set off. He explained that the requirement facilitated the IRD to demand for provisional profits tax and would also cater for situations where losses in prior years had not been agreed.

Mr Ng mentioned a case regarding a client which still had a loss after set-off against assessable profits year after year. He asked whether the IRD would improve its mechanism. Mr Chiu replied that the IRD would review the matter upon provision of details.

(c) Issuance of additional assessments on exercise of stock options where notional exercise has been elected

Practitioners have come across cases where, even though the individual taxpayers had elected for notional exercise of their stock options/ deemed vesting of their share rewards in their individual tax returns and settled the related salaries tax liabilities when they permanently departed from Hong Kong, additional assessments were still issued by the IRD to the individuals upon receipt of the additional employers' returns filed by the employers when the options were exercised/ share awards were vested. As a result, an objection is required to be lodged to the IRD to cancel the additional assessments.

In this regard, the Institute would like to check if there is any existing mechanism or system within the IRD to keep track of the said elections made by individuals who have permanently departed from Hong Kong, so as to avoid the issuing of unnecessary additional assessments.

Ms Go said that the IRD kept a register for leaving Hong Kong cases. She explained that there was also a mechanism in place that election forms for notional exercise of share options / deemed vesting of shares were kept and retrieved. She added that procedures were laid down on how to deal with these cases in order to avoid the raising of additional assessments upon the employer's subsequent reporting of the gains realised by / shares vested in former employees. CIR said that if additional assessments had been issued in any such cases, these were isolated instances only.

Ms Go further said that the IRD officers would be reminded to follow the relevant procedures properly.

(d) Unilateral relief claim

Under a Hong Kong employment, if services are provided partly outside Hong Kong and part of the income has already been charged to tax in an overseas jurisdiction, the employee may claim exemption from salaries tax for income relating to services rendered in that jurisdiction.

The Institute understands that the IRD, in practice, allows the exemption of the income taxed in the overseas jurisdiction by applying the formula based on the number of calendar days spent overseas, but not working days. If the overseas jurisdiction calculates the taxable income based on the number of working days in that jurisdiction, would the IRD consider following the same basis (i.e., counting working days, rather than calendar days) in calculating the exempt income for salaries tax?

Ms Go advised that, as pointed out under item A2(c) in the 2010 annual meeting, the use of calendar days as the basis of computing income derived from services rendered in a territory outside Hong Kong under section 8(1A)(c) had been consistently adopted by the IRD. She explained that as a rule of law, apportionment of income should be based on the total number of days in the year (i.e. 365 or 366 days as appropriate). She said that in the absence of express contractual terms, income was regarded as having accrued day to day under the Apportionment Ordinance (Cap 18). She therefore concluded that apportionment had to be based on the number of days inside and outside Hong Kong.

Ms Go pointed out that the calendar day basis was commonly adopted by other tax jurisdictions and consistent with the standard used by the Hong Kong Board of Review in determining the tax liabilities of a person. She therefore said that the IRD did not see the need to change the standard practice in processing the exemption claims under the IRO even if an overseas jurisdiction might adopt different basis to consider its own claims.

(e) Tax audit cases

The Institute would like to ask if the IRD would consider setting out its area(s) of focus for conducting tax audits in the coming fiscal year. This may encourage taxpayers to conduct self reviews and make voluntary disclosures. Further, the Institute would like to ask if the IRD could share any general insights and thoughts from recently-concluded tax audit cases.

Ms Connie Chan advised that field audit or investigation was normally initiated where characteristics or indications of non-compliance were present. She said that the IRD would continue to focus audit activities on high risk areas including heavily qualified auditors' reports, persistent failure to lodge, or late lodgment of tax returns, failure to keep proper business records, significant transactions with related parties in low / no tax jurisdictions, poor results not consistent with industry norms, sustained losses or fluctuating profits and losses with growing sizes of businesses. She emphasized that taxpayers should have the personal knowledge and means of reporting the correct amounts of income / profits and that it would be in the taxpayers' own interests to take the initiative and engage the services of representatives, where necessary, to ascertain the amounts of assessable profits understated if they noticed that their tax affairs were not in order. She said that the IRD strongly encouraged taxpayers to make prompt, full and frank disclosure of all material information to facilitate the computation of assessable profits. She reminded that the attitude of and the remedial actions taken by the taxpayers were among the major factors to be considered when imposing penalties.

Ms Connie Chan explained that field audit activities covered a broad spectrum of taxpayers from individuals to businesses. She said that it was difficult, if not impossible, to share in overall terms the insights from a wide range of audits recently conducted as compliance risks and behavior varied across different segments of taxpayers. She referred to the specific problem areas detected in tax audits of corporations, set out in Item B1, which might assist members of the Institute to focus their attention during the course of their statutory audits and when drawing up profits tax computations.

(f) Lodgment of tax returns and filing deadlines for 2013-2014

The Institute would be interested to know the latest statistics on the filing of tax returns and the filing deadlines for 2013-2014.

Ms Lee referred the meeting to four tables. Table 1 showed that 7,000 more returns were issued in the 2012/13 bulk issue exercise and nearly 18,000 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. She pointed out that the overall performance was very unsatisfactory given that the lodgment rate for "D" code returns by the deadline dropped to 78% while that for "M" code returns remained at 80%. She also noted that the progressive lodgments were significantly below the lodgment standards. She urged tax representatives to improve their future performance. Table 4 was a comparative analysis of compliance with the block extension scheme.

Bulk Issue of 2013/14 Profits Tax Returns

Ms Lee said that the 2013/14 Profits Tax Returns for "active" files would be bulk-issued on 1 April 2014. The extended due dates for filing 2013/14 Profits Tax Returns would be:

Accounting Date Code	Extended Due Date	Further Extended Due Date if opting for e-filing
"N" code	2 May 2014 (no extension)	16 May 2014
"D" code	15 August 2014	29 August 2014
"M" code	17 November 2014	29 November 2014
"M" code – current year loss cases	2 February 2015	2 February 2015 (same as paper returns)

PART B – MATTERS RAISED BY THE IRD

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

Ms Connie Chan referred the meeting to Appendix B which was compiled to illustrate the specific problem areas detected in corporations with tax audits completed during the year ended 31 December 2013. Comparative figures for the years 2011 and 2012 were included.

Ms Connie Chan went on to say that Field Audit teams uncovered discrepancies in 334 corporation cases, of which 248 carried clean auditors' reports. Amount of discrepancies detected in the clean report cases accounted for 79% (2012: 87%) of the total discrepancies detected in the year 2013 and total tax of $438 million was recovered from these cases. Average understatement per clean report case was $12.53 million (2012: $23.05 million) while tax undercharged per clean report case was $1.8 million (2012: $3.7 million).

Ms Connie Chan noted that discrepancies in 2013 resulted mainly from incorrect claims of offshore profits, overstatement of purchases and understatement of gross profits. She said that the discrepancies in the majority of cases were detected after examining the business ledgers and source documents.

Ms Connie Chan also referred the meeting to Table 2 in Appendix B. She considered that the auditor of the taxpayer in one case should have detected the irregularities through statutory audit.

Agenda Item B2 – Taxation of Hong Kong Investment Managers/ Advisors

Mr Chiu explained that the IRD had examined the taxation affairs of a few Hong Kong investment managers or advisors who offered professional services in Hong Kong to hedge funds or private equity funds established outside Hong Kong. He said that while the IRD accepted the hedge funds and private equity funds fell within the offshore fund regime in the IRO, the IRD took the view that the Hong Kong investment managers or advisors should be remunerated on an arm's length basis (i.e. the Hong Kong investment managers or advisors should be adequately compensated for their services). He disclosed that the IRD found, in the few cases, the management and performance fees paid to the investment managers or advisors were computed on a cost-plus formula, far below the arm's length rate, even though the investment managers or advisors performed significant functions and bore significant risks in generating the profits of the hedge funds or private equity funds.

Mr Chiu further explained that while hedge funds and private equity funds might differ in their investment strategies, their structures were similar and most were organized as partnerships. He explained that when the funds' investments yielded a positive return, both limited and general partners received income, as the value of their share of the fund increased. He further explained that the compensation structures might vary from fund to fund but the standard pay formula was called “2 and 20” (i.e. the lead fund managers took 2% of the fund’s assets each year as a management fee, and 20% of the total profits as a kind of performance bonus).

Mr. Chiu said the IRD recognised that carried interest might be first received as income by the lead fund manager who was located outside Hong Kong or received as income by the general partner. He reiterated the IRD expected that the investment managers or advisors in Hong Kong should be adequately remunerated after taking into account the functions, assets and risks attributed to the Hong Kong operation.

Mr Chiu went on to say the IRD agreed that the place where Hong Kong investment managers or advisors rendered their services should be closely studied before deciding the extent to which the management fees or performance fees attributable to the Hong Kong investment managers or advisors should be charged to profits tax (i.e. whether the arm’s length management fees or performance fees should be wholly assessable).

Mr Chiu suggested that members of the Institute who advised investment managers or advisors on fee structure should take note that the pricing of management fees or performances fees paid to the Hong Kong investment managers or advisors should be based on an arm’s length rate.

Agenda Item B3 – Application for Certificate of Resident Status

CIR told the meeting that the IRD would like to explain to members of the Institute the way applications for certificate of resident status (“CoR”) were processed and the obligations imposed on Hong Kong under the CDTAs.

CIR said that a person who was a resident of Hong Kong within the meaning of the relevant CDTA might be entitled to claim relief from certain taxes of a treaty partner (either by way of relief at source or refunds of tax already paid) if certain criteria were met. He said that in assessing whether the person was entitled to such relief, the tax administration of the treaty partner receiving the claim might require the Hong Kong competent authority to issue a CoR to certify that the person was a resident of Hong Kong.

CIR emphasized that while the IRD was committed to providing Hong Kong residents with assistance in claiming all the benefits they were entitled to under a CDTA, the IRD might refuse to issue a CoR if it was clear that the person would not be entitled to those benefits. He explained that there might be cases where the person would not be able to obtain a CoR because the person did not fulfil the criteria of the particular Article under which benefits were intended to be claimed. He pointed out that it was vitally important for the IRD to uphold the terms and purpose of Hong Kong’s CDTAs by not issuing CoRs to those who were clearly not entitled to relief from foreign taxes since the IRD had to act in good faith according to the terms of CDTA.

CIR further explained that if the IRD had reason to believe that a person would not be entitled to benefits, the IRD might request further information from the person before deciding whether a CoR could be issued. He added that where it was not clear whether a person would be entitled to benefits, the IRD might need to exchange information with the other treaty partner to help the treaty partner come to an informed decision as to whether benefits could be granted.

CIR indicated that the provision of a CoR would not guarantee that a claim to benefits under the relevant CDTA would be successful. He explained that it would be up to the tax administration of the treaty partner to determine whether all the relevant conditions were fulfilled and whether benefits could be granted. He further explained that in any case where a resident of Hong Kong believed the tax administration of the treaty partner had wrongly denied him benefits to which he should be entitled, the IRD would consider engaging with that tax administration under the MAP for the relevant CDTA.

CIR said that in deciding whether a CoR could be issued, the IRD might require the applicant to provide a certain amount of information when making a request. He informed the meeting that the IRD would consider revising the application forms for CoR to ensure that the application process remained efficient and that treaty partners would regard Hong Kong as having enough safeguards to prevent treaty abuse.

Ms Chan raised the question on what factors the IRD should take into account in deciding whether a CoR would be issued. Mr Chiu replied that the IRD would consider the beneficial ownership and whether there was an abuse of the CDTA. He added that a Hong Kong company which was a conduit might not be regarded as a Hong Kong resident.

Mr Anthony Tam asked whether a CoR would be issued to a paper company. Mr Chiu replied that since such companies did not carry out any business activities, CoR would not be issued. Ms Lee added that the IRD had to act in good faith in fulfilment of its obligation under a CDTA and a CoR application would be rejected if a paper company was incorporated in Hong Kong merely to obtain treaty benefits.

Ms Chan noted that different treaty partners might look at different things to establish residency and she asked whether it would be possible to have a CoR for the purposes of one CDTA while not having a CoR for another CDTA. Mr Chiu said that this might be possible in theory, but it would be unlikely in practice. He said that reference could be made to the commentary in the OECD model tax convention.

Agenda Item B4 – Date of Next Annual Meeting

The date of the next annual meeting would be agreed between the Institute and the IRD in due course.

Lodgement of Corporations and Partnerships Profits Tax Returns

Table 1
Lodgement Comparison from 2010/11 to 2012/13

		Y/A 2010/11	Y/A 2011/12	Y/A 2012/13	Comparison 2011/12 and 2012/13
1.	Bulk issue (on 1 / 2 April)	168,000	172,000	179,000	4%
2.	Cases with a failure to file by due date:-				
	'N' Code	1,900	2,100	2,100	0%
	'D' Code	4,600	5,100	5,600	10%
	'M' Code	8,900	9,200	10,000	9%
		15,400	16,400	17,700	8%
3.	Compound offers issued	5,600	6,600	7,000	6%
4.	Estimated assessments issued	6,000	6,100	6,800	11%

Table 2
2012/13 Detailed Profits Tax Returns Statistics

	'N'	'D'	'M'	Total
Total returns issued	19,000	58,000	102,000	179,000
Failure to file on time	2,100	5,600	10,000	17,700
Compound offers issued	1,700	2,300	3,000	7,000
Estimated assessments issued	0	2,400	4,400	6,800

Table 3
Represented Profits Tax Returns - Lodgement Patterns

		Actual Performance	
Code	Lodgement Standard	2012/13 PTRs	2011/12 PTRs
D - 15 August	100%	78% [(1)]	80%
M - 31 August	25%	12%	11%
M - 30 September	55%	17%	17%
M - 31 October	80%	34%	34%
M - 15 November	100%	80% [(2)]	80%

(1) 31% lodged within a few days around 15 August 2013 (34% lodged within a few days around 15 August 2012 for 2011/12 PTRs)

(2) 30% lodged within a few days around 15 November 2013 (30% lodged within a few days around 15 November 2012 for 2011/12 PTRs)

Table 4
Tax Representatives with Lodgement Rate of less than 80% of 'M' code Returns as at 15 November 2013

1,526 T/Rs have 'M' Code clients. Of these, 684 firms were below the average performance rate of 80%.
An analysis of the firms, based on size, is:-

		Current Year Performance				Last Year Performance			
	No. of clients per firm	Total No. of firms	No. of firms below the average of 80%	No. of non-compliance cases	% of total non-compliance cases	Total No. of firms	No. of firms below the average of 80%	No. of non-compliance cases	% of total non-compliance cases
Small size firms	100 or less	1,396	631	5,373	69%	1,398	646	5,448	69%
Medium size firms	101 - 300	117	50	2,121	27%	115	49	2,133	27%
Large size firms	over 300	13	3	289	4%	11	3	336	4%
		1,526	684	7,783	100%	1,524	698	7,917	100%

Table 1 [Appendix B]

Analysis of Completed FA Corporation Cases for the years ended 31 December 2011, 2012 and 2013

	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
Auditor's Report = Unqualified	**2011**	**2012**	**2013**	**2011**	**2012**	**2013**	**2011**	**2012**	**2013**
Sales omitted	42	69	61	53,386,046	132,533,189	55,326,747	5,984,227	20,031,579	8,713,787
Purchases overstated	13	22	13	30,184,316	31,379,475	21,236,604	4,878,078	4,253,167	3,584,851
Gross profit understated	29	35	36	84,801,142	99,805,280	90,151,459	10,808,430	16,616,245	15,464,587
Expenses over-claimed	78	82	63	85,763,465	88,219,800	43,991,916	10,782,119	13,848,632	6,775,030
Technical adjustments	80	88	68	61,121,856	85,014,811	32,181,178	8,908,455	11,362,598	4,051,208
Offshore income / profits disallowed	13	20	13	121,529,355	679,584,028	169,867,530	20,244,418	109,191,220	23,717,473
Other	78	94	67	148,985,403	74,324,527	205,676,841	21,910,249	11,386,574	27,478,223
TOTAL	333*	410*	321*	$585,771,583	$1,190,861,110	$618,432,275	$83,515,976	$186,690,015	$89,785,159
TOTAL NUMBER OF CASES	240*	285*	248*						
AVERAGE AMOUNT PER CASE				$2,440,715	$4,178,460	$2,493,679	$347,983	$655,053	$362,037

FOR AUDIT YEAR ONLY

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

		Total Discrepancy for All Years			Total Tax Undercharged for All Years		
		2011	**2012**	**2013**	**2011**	**2012**	**2013**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$3,128,304,734**	**$6,568,698,928**	**$3,107,109,918**	**$502,706,126**	**$1,048,880,535**	**$437,941,363**
	AVERAGE AMOUNT PER CASE	**$13,034,603**	**$23,048,066**	**$12,528,669**	**$2,094,609**	**$3,680,283**	**$1,765,893**

	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
Auditor's Report = Qualified	**2011**	**2012**	**2013**	**2011**	**2012**	**2013**	**2011**	**2012**	**2013**
Sales omitted	9	16	13	5,524,645	16,542,085	5,002,676	684,626	2,696,337	1,133,565
Purchases overstated	1	1	8	619,277	39,652,682	7,165,002	109,805	6,530,489	1,508,220
Gross profit understated	12	14	23	25,211,810	48,809,945	38,973,634	3,966,081	8,049,671	4,765,589
Expenses over-claimed	7	16	17	4,820,821	19,262,247	4,468,953	221,930	3,147,040	777,310
Technical adjustments	14	15	26	9,825,491	30,638,891	23,095,029	1,666,856	4,775,282	3,551,692
Offshore income / profits disallowed	5	4	3	47,638,540	12,908,977	25,223,332	8,307,655	2,078,838	4,382,568
Other	14	17	28	15,559,517	8,731,869	44,133,052	2,567,318	1,100,449	5,434,416
TOTAL	62*	83*	118*	$109,200,101	$176,546,696	$148,061,678	$17,524,271	$28,378,106	$21,553,360
TOTAL NUMBER OF CASES	47*	52*	86*						
AVERAGE AMOUNT PER CASE				$2,323,406	$3,395,129	$1,721,647	$372,857	$545,733	$250,620

FOR AUDIT YEAR ONLY

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

		Total Discrepancy for All Years			Total Tax Undercharged for All Years		
		2011	**2012**	**2013**	**2011**	**2012**	**2013**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$604,348,303**	**$995,934,619**	**$850,178,043**	**$98,746,514**	**$156,530,715**	**$120,671,657**
	AVERAGE AMOUNT PER CASE	**$12,858,475**	**$19,152,589**	**$9,885,791**	**$2,100,990**	**$3,010,206**	**$1,403,159**

TOTAL NUMBER OF CASES	287	337	334

		Total Discrepancy for All Years			Total Tax Undercharged for All Years		
		2011	**2012**	**2013**	**2011**	**2012**	**2013**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$3,732,653,037**	**$7,564,633,547**	**$3,957,287,961**	**$601,452,640**	**$1,205,411,250**	**$558,613,020**
	AVERAGE AMOUNT PER CASE	**$13,005,760**	**$22,446,984**	**$11,848,168**	**$2,095,654**	**$3,576,888**	**$1,672,494**

Table 2 [Appendix B]

Field Audit case with discrepancy considered detectable through statutory audit
For the period from 1.1.2013 to 31.12.2013

Item that should be detected by Auditor	Amount of item for audited year that should be detected	Reasons why the item should be detected	Auditor's Report	Profits understated for audited year	Tax undercharged for audited year	Total discrepancy amount for all years	Total tax undercharged for all years
Understated sales	$1,074,274	The taxpayer is a trader of mobile phones and other electronic devices. Some of its customers settled by installments. Sales invoices were issued to customers at the full prices (deposits and balances) but the deposits were not reported as income.	Qualified (on stock)	$1,878,018	$309,873	$6,594,708	$1,111,564

Extracts of Analysis in Appendix B

		2012	2013
(a)	No. of corporation cases with discrepancies uncovered	337	334
(b)	No. of corporation cases in item (a) carried clean auditor's reports	285	248
(c)	Total discrepancies detected in all cases	$7,565m	$3,957m
(d)	Total discrepancies detected in clean auditor's report cases	$6,569m	$3,107m
(e)	Percentage of (d) over (c)	87%	79%
(f)	Total tax uncovered in clean auditor's report cases	$1,049m	$438m
(g)	Average understatement per clean auditor's report case	$23.05m	$12.53m
(h)	Tax undercharged per clean auditor's report case	$3.7m	$1.8m