Budget proposals

2010 - 11

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

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Table of contents

Introduction - Hong Kong’s current position

1. The indications are that Hong Kong's economy is beginning to recover. Compared with 2008, the decline in GDP in real terms moderated from 7.8% in the first quarter to 3.6% in the second quarter and 2.4% in the third quarter. On a seasonally adjusted quarter-to-quarter basis, GDP increased in real terms by 3.5% in the second quarter of 2009 and a further 0.4% in the third quarter. The government has significantly reduced its projection of overall negative growth in the economy in 2009, from between -5.5% and -6.5%, estimated in May 2009, to a figure of -3.3% quoted in December 2009. Unemployment has moderated slightly and the activity in the property and stock markets, particularly in the second half of 2009, make it unlikely that the 2009-10 outturn will reach the HK$39.9 billion deficit projected in the 2009 budget speech. The Hong Kong stock market had raised the largest amount of funds through IPOs of any market in the world in 2009, ahead of New York and Shanghai.

2. Notwithstanding the signs of an improving economy in Hong Kong, given the continuing sluggishness of the economies of the United States and Europe, and the quantity of short-term money coming into Hong Kong, there remains a risk of market volatility and bubbles in asset prices.

3. While Hong Kong retains a relatively simple, low-rate tax system, from a tax perspective there has been some erosion of competitiveness as other jurisdictions have sought to attract more business through changes in their tax regimes. For example, Singapore has reduced its corporate profits tax rate from 26% in 2000 to 17% in 2010 and other jurisdictions have also reduced profits tax rates. Some of Hong Kong’s competitors are prepared to provide specific incentives to attract particular kinds of business or even individual companies. While we are not advocating this policy, Hong Kong needs to look at how its effective rates of tax compare with competing locations.

4. By comparison Hong Kong has only tinkered with its tax regime and incentives over the past years and, in practice, the value of incentives and concessions that were introduced some years ago has diminished over time due to, e.g., changes in business practices, without any corresponding updating of, or increased flexibility in the tax regime.

5. The administration of the tax regime, including decisions at the board of review (“BOR”) and the courts, and their interpretation by the Inland Revenue Department (“IRD”), has had a significant impact on the way the concepts of “source” of profits and employment income are applied. The practical outcome has been to reduce the number of successful claims for offshore profits and employment, which has in turn increased the effective rate of tax for some taxpayers. It has also resulted in professional advisers advising their clients to locate certain types of business elsewhere, rather than in Hong Kong, to the detriment of Hong Kong’s economy.

6. It is often noted that Hong Kong has a narrow salaries tax base. It also has a fairly narrow profits tax base as most of the profits tax is paid by a limited number of companies. In the Financial Secretary's 2010-11 budget consultation, it was indicated that most small businesses pay little or no tax. For example, in the year of assessment 2007-08, the top 1200 taxpaying corporations paid 72.6% of profits tax out of more than 79,000 taxpaying corporations. It is in Hong Kong's interests, therefore, to expand investment from new and value added businesses and to expand the number and range of businesses that contribute to profits tax revenue.

7. There is a growing sense of uncertainty within the community about Hong Kong’s long-term role and direction, and whether there is an over-reliance on areas of business that have been Hong Kong’s economic strengths in the past, but which are now becoming,

or could in the future become, less competitive. These include logistics, supporting services for manufacturing, as well as financial and professional services. While the identification by the government of new industries in which Hong Kong has the potential to excel, as highlighted in the 2009 policy address, is a positive move, the Institute considers that more needs to be done to formulate and set out Hong Kong's long-term strategic aims and goals. This may require further discussion to be conducted within the community. Tax incentives and other measures should be considered as part of the framework of support for Hong Kong's chosen economic direction.

Summary of measures proposed

Tax rates and allowances

1. Corporate profits tax rate: Reduce corporate profits tax rate to 16% in 2010-11, with further progressive reductions to 15% over time.

2. Allowances for salaries tax and personal assessment: Support for families and middle-income group as follows:

   (a) Increase annual allowances by 20% for children, dependent parents, grandparents, brothers, sisters and disabled dependants.
   (b) Increase the limit on the deduction for elderly residential care expenses by 20%.
   (c) Increase the duration of the home loan interest deduction from 10 years to 15 years.
   (d) Allow deductions for private medical insurance, subject to a HK$12,000 annual cap per person.

Enhance competitiveness in the tax system

3. Source of profits: Introduce clear, appropriate criteria for determining the source of profits in the Inland Revenue Rules under the Inland Revenue Ordinance.

4. Source of employment income: Refer to the place where services are rendered as the test for determining the source of employment income. Further, where the 60-day exemption is not applicable, allow apportionment on a "days in days out" basis by reference to the place where the services are rendered.

5. Finalisation of tax affairs: Increase certainty through the following measures:

   (a) Reduce the statutory time bar to three years.
   (b) Accord a statement of loss the same status as a notice of assessment.
   (c) Deem a tax return as final if no enquiry on it has been raised within 12 months from lodgement.

6. Transfer pricing: Introduce comprehensive transfer pricing rules, including legislation and arrangements for advance pricing agreements.

7. Group loss relief: Introduce a group loss relief system.

8. Loss carry-back: Introduce loss carry-back provisions.

Support for pillar and new industry sectors

9. Financial services:

   (a) Extend the rules relating to the exemption from profits tax for qualified offshore funds.
   (b) Introduce further incentives for the fund management and insurance sectors.
   (c) Introduce appropriate tax legislation to facilitate development of Islamic finance products.

10. Innovation & technology:

   (a) Adopt "place of use" to determine source of royalty income.
   (b) Cap the taxation of gains on disposals of intellectual property rights.
   (c) Expand Hong Kong's network of double taxation agreements to enable taxpayers to obtain, inter alia, more favourable withholding tax rates.

(d) Offer unilateral tax credits for withholding tax on royalties where no double taxation agreements exists.
(e) Allow "super deductions" (i.e. more than 100%) for research and development expenditure.

11. Producer and professional services:

(a) Grant a 10% concessionary profits tax rate for regional offices in Hong Kong.
(b) Exempt interest received by regional offices (except for financial institutions) on loans made to overseas associates.
(c) Allow Hong Kong taxpayers involved in import processing arrangements overseas, to apportion their profits and to claim depreciation allowances on plant and machinery.

PART A: Tax rates and allowances

Profits tax rate

1. Given the current improvement in Hong Kong's economy and with a view to improving Hong Kong's competitiveness, the Institute recommends that the corporate profits tax rate for 2010-11 be reduced slightly from 16.5% to 16%. The profits tax rate for unincorporated businesses (i.e. the standard rate) should remain at 15%.

2. The Institute supports the proposal in the 2007-08 policy address to progressively reduce the rate of corporate profits tax to 15%. Against the background of the international trend to lower rates of corporate taxes, and given the increasing regional competition for investment, we suggest that a study be conducted of Hong Kong's overall tax competitiveness, in order to assess whether it is appropriate for Hong Kong to reduce the profits tax rate to below 15%. The study should include a comparison of the corporate tax rates in other jurisdictions. It should examine not only the headline rates, but also effective rates of tax, taking into account incentives and concessions, as it is the overall impact of tax that investors assess when making investment decisions.

Support for families and middle-income group

3. To provide more support for families and the middle-income group, we propose the following increases in tax allowances/deductions for salaries tax and personal assessment:

   (a) Increase annual allowances for dependants, by 20%, that is:

      (i) the annual child allowance and additional allowance in the birth year of a child; and

      (ii) the allowance and additional allowance for dependants including parents, grandparents, brothers, sisters and disabled dependants.

   (b) Increase the deduction limit for elderly residential care expenses, by 20%.

   (c) Increase the maximum number of years for claiming home loan interest from 10 years to 15 years. Although the amount of home mortgage debt in Hong Kong is comparatively low, as are current interest rates, this measure can help to provide greater assurance to home owners given the increasing volatility of property values.

   (d) Allow deductions for contributions to private medical insurance policies, subject to a cap per person of HK$12,000 per year. This could help to expand private insurance coverage, pending the resolution of the long-term healthcare reform and funding arrangements.

PART B: Enhancing competitiveness in the tax system

<u>Determination of source of profits</u>

<u>Issues</u>

4. Hong Kong's tax system is based on the territorial principle, with only the Hong Kong sourced profits of a business carried on in Hong Kong being liable to tax. The simplicity of this has been important for Hong Kong's reputation as an international business centre.

5. Apart from the benefits of a simple tax system, businesses want to be able to plan with certainty in their tax affairs. However, there is currently significant uncertainty in the practical application of Hong Kong's "source principle" in relation to profits and employment income. This is of concern because the principle of levying tax only on profits or income arising in or derived from Hong Kong is a fundamental part of the tax regime, which has added to the attraction of using Hong Kong as a base for doing business in the Mainland and the region generally.

6. However, uncertainty has developed over time, due to the absence of clear statutory guidelines on the rules for determining source, coupled with differing interpretations of BOR and court decisions by the IRD, taxpayers and tax representatives, and changing IRD practices. The recent publication of the revised Departmental Interpretation and Practice Notes ("DIPN") No. 21, "Locality of Profits", highlights the problem. Although DIPNs are an expression of IRD practice and have no binding force in law, during the updating of DIPN 21, practitioners expressed serious concerns about certain proposed revisions, which appeared to enshrine practices and interpretations that had emerged over time, but which were not necessarily consistent with the understanding of case law generally-accepted by practitioners. In a nutshell, some of these more recent practices adopted by assessors were themselves seen by practitioners as being part of the problem. However, upon publication, the final version of the revised DIPN 21 did not differ substantially from the draft version, which had given cause for concern. In our view, prompt action is required to address a number of uncertainties. Highlighted below are some areas of uncertainty, which are further explained in **Appendix 1**:

   (a) "Operations test" and "totality of facts" approach.

   (b) Antecedent and incidental activities.

   (c) Agency principle.

   (d) Manufacturing profits and depreciation allowances for plant and machinery.

   (e) Reinvoicing.

<u>Measures proposed</u>

The Institute recommends the following measures:

<u>Inland Revenue Rules</u>

7. In order to deal with the uncertainties referred to above, we consider it is time to codify the tests for determining the source of profits. This could be effected by the introduction of appropriate amendments to the Inland Revenue Rules ("IRRs"). In this respect it should be noted that Lord Bridge in the *Commissioner of Inland Revenue ("CIR") v. Hang Seng Bank* ("*Hang Seng Bank")* set out guidelines for the determination of the source of

many types of profits. Adopting such guidelines in the IRRs would help restore certainty in the vast majority of cases and significantly enhance Hong Kong's reputation as a jurisdiction where the tax legislation is open to clear and certain interpretation.

8. Lord Bridge's comments can be summarised as follows:

Type of Income	**Location**
Service fee income	The place where the service is rendered
Manufacture of goods	The place where the manufacturing takes place
Letting of property	The place where the property is let
Lending of money	The place where the money is lent
Dealing in commodities or securities by buying and selling	The place where the contracts of purchase and sale are effected

Manufacturing profits and depreciation allowances

9. In relation to Mainland manufacturing operations and the current differential treatment accorded to import and contract processing, we believe there is need for a review of the original aims and objectives of the 50:50 profits tax apportionment arrangements, as they no longer seem to be serving their original purpose. The Institute believes that, as a matter of policy, import processing should enjoy the same treatment as contract processing in order to provide a continuing level of support for Hong Kong manufacturers.

10. As regards depreciation allowances ("DAs") for plant and machinery ("P&M"), in response to an invitation from the Legislative Council Panel on Financial Affairs, the Institute recently made a submission on the impact of section 39E of the Inland Revenue Ordinance ("IRO"). In that submission, which is copied at **Appendix 2**, the Institute called for allowing DA claims for P&M lent to Mainland factories under import processing arrangements. As the submission states, if this is not considered appropriate, then section 16G of the IRO should be amended to allow claims for a full deduction in respect of such P&M.

11. Therefore, either:

(a) the IRD should immediately grant full DAs to legitimate import processing arrangements that fulfil the required criteria. Logically, if import processing is treated on the same footing as contract processing, where a Hong Kong taxpayer is liable to be taxed on all of its profits, that taxpayer should be able to claim full DAs on its P&M;

or

(b) the IRO should be amended. The definition of "excluded fixed assets" under section 16G, relating to capital expenditure on the provision of a prescribed fixed asset, should be changed to exempt P&M located outside Hong Kong, which is owned by a Hong Kong entity and used for generating profits chargeable to tax in Hong Kong. The relevant P&M would thus fall outside the ambit of section 39E.

Determination of source of employment income

Issues

12. When DIPN 10, "The Charge to Salaries Tax", was undergoing revision a few years ago, similarly to the recent revision of DIPN 21, practitioners expressed concern about differences between the IRD and tax representatives in their respective understanding and interpretation of the relevant case law. The publication in 2007 of a revised DIPN 10 also failed to fully resolve doubts about the circumstances in which employers and employees could successfully make claims for an offshore employment. The Institute believes that the current approach in DIPN 10 does not reflect developments in actual human resource practices, where mobility of human resources is the norm.

13. If Hong Kong wishes to remain as a major location of choice for regional headquarters of multinational corporations, there needs to be greater clarity and certainty in the rules for determining the taxability of income of employees who need to travel frequently (see also paragraph 46 below).

Measures proposed

14. In order to address the uncertainty, the Institute recommends a change in approach to determining the source of employment income. Section 8 of the IRO should be amended, such that the source of employment income is determined by the place where services are rendered, rather than by where individuals are technically employed. The former approach is commonly adopted in other international business centres.

15. Under this proposal, the basic "60-day exemption" for visits to Hong Kong would remain. However, where a person's visits to Hong Kong exceed 60 days, apportionment should apply on a "days in days out" basis, by reference to the place where the services are rendered.

Finalisation of tax affairs

Issues

16. Taxpayers should be entitled to a timely resolution of their tax affairs for each year. The finalisation of tax affairs within a reasonable period of time would improve certainty for taxpayers and, hence, help to increase the competitiveness of Hong Kong's tax regime.

Measures proposed

The Institute recommends the following measures:

17. The statutory time limit for reopening an assessment should be shortened from the current six years to, say, three years, for cases not involving fraud (cases involving fraud should retain a ten-year limitation period). A shorter time limit is preferred as it improves certainty. A number of jurisdictions, including Australia and United States, adopt a shorter time limit than Hong Kong.

18. Statements of loss should be issued within a definite period of time, and should be accorded the same status as a notice of assessment. Under the current legislation and practice, taxpayers are uncertain as to whether their losses are available for setting off against future profits. The issues involved are illustrated in the case of *CIR v. Common Empire Limited*.

19. A tax return should be deemed to be final, if the IRD has not raised an enquiry within, say, 12 months from the date when the tax return is lodged. Under the existing "Assess First, Audit Later" assessing practice, a taxpayer's tax affairs for a particular year of assessment may not be finalised until the six-year statutory time limit has lapsed. Moreover, the IRD can issue "protective assessments" prior to the expiry of the statutory time limit. As a result, a taxpayer's affairs could remain unresolved for far longer than the statutory period. In the United Kingdom, for example, the tax authority has made a commitment that tax returns can normally be regarded as final if no enquiry has been initiated on a tax return within 12 months of its being filed.

Transfer pricing regime

Issues

20. With governments around the world taking steps to establish comprehensive rules on transfer pricing, Hong Kong risks being disadvantaged if it does not follow suit. By not being in a position to effectively prevent revenue leakage through transfer pricing, and not being able to allow businesses operating on a cross-border basis offsetting adjustments when their profit allocations between Hong Kong and other jurisdictions are adjusted by revenue authorities in those other jurisdictions, Hong Kong risks appearing unresponsive and less attractive as a business hub. The risk of taxpayers facing double taxation is very real if appropriate rules are not put in place. This will impact negatively on Hong Kong's reputation as a business-friendly location.

21. While transfer pricing issues are routinely raised by the IRD during field audits, cases have revealed that the current legislative provisions, such as section 20 of the IRO, cannot adequately address the relevant issues. This was demonstrated in the recent court case of *Ngai Lik Electronics Company Ltd v. CIR ("Ngai Lik")*, where the IRD had to invoke the anti-avoidance provisions in section 61A to defeat certain group transfer pricing arrangements.

22. Since *Ngai Lik*, the IRD has issued DIPN 46, "Transfer Pricing Guidelines – Methodologies and Related Issues"*.* While this is helpful, it does not change the law and simply reflects IRD practice. Both the DIPN and *Ngai Lik* case give rise to a number of questions and uncertainties, some of which, in our view, need to be resolved by giving legislative backing to transfer pricing rules. Some of these areas of uncertainty are outlined in **Appendix 3**.

Measure proposed

23. In light of the above, the Institute proposes that transfer pricing in Hong Kong needs to be put on a firmer footing. A more comprehensive set of transfer pricing rules should be developed, including the introduction of specific legislative provisions on transfer pricing, and arrangements for advance pricing agreements, in line with many overseas tax jurisdictions.

Group loss relief

Issue

24. For commercial reasons, many businesses operate in the form of a group of companies, to diversify the risk of different types of operations and activities, or diversify the risk of operating in different locations, or for other legitimate reasons. In group situations, some companies within the group may record allowable losses, whilst others have taxable profits. In most other advanced tax jurisdictions, the tax legislation provides for a form of group loss relief, whereby a company with a loss can transfer that loss to a profitable company within the group, thus bringing the overall tax burden of the group into line with the net tax profits of the group.

25. The government has stated that such systems are open to abuse and would also require complex legislation. However, many jurisdictions have operated group loss relief for significant periods of time without any obvious drawbacks. The United Kingdom, United States, Australia and Singapore, for example, operate group loss relief systems, without any reports of major abuse.

Measure proposed

26. The Institute considers that a form of group loss relief could be introduced in Hong Kong to provide a simple, but much needed, measure of relief to corporate groups.
Anti-avoidance provisions could also be introduced to prevent abuses, such as specifying an appropriate definition of a group (for example, the relevant companies having to be 90% owned by the same parent company) and stipulating that losses can only be transferred to offset current profits, without any carry back of losses to the previous years' profits of other companies within the group.

Loss carry-back

Issue

27. At present, if a company incurs an allowable tax loss in any year, that allowable tax loss can only be carried forward for setting off against subsequent profits of that company. Unlike many other advanced tax jurisdictions, Hong Kong does not operate a system of loss carry-back. The absence of loss carry-back provisions can accentuate the effects of fluctuation in a company's economic results, particularly during economic downturns, and can contribute to cash flow problems experienced by companies.

28. At the present time, the IRD, as a result of their interpretation of the decision in the case of *CIR v Secan Ltd. & Anor*, may seek to tax unrealised profits due to the accounting reporting requirements under which unrealised profits appear in the accounts of companies.

29. Although it is a fundamental principle of tax law that unrealised profits should not be taxed until realised, the IRD interprets the *Secan* decision such that unrealised profits are taxable if they are recorded in a company's audited accounts. Thus it is possible for a company with an unrealised profit at one year end to be taxed on it, only for the company to discover in the next year that, rather than a profit, there is in fact, a realised loss. Under Hong Kong's current system, while the unrealised profit will be taxed in Year 1, the realised loss in Year 2 can only be carried forward to be set off against future profits.

30. In other jurisdictions this is not necessarily a problem as, by having loss carry-back provisions, the realised loss can be carried back and set off against the unrealised profits taxed in the previous year. The United States, United Kingdom and Singapore are among the jurisdictions with provisions for loss carry-back.

Measure proposed

31. In light of the above, we recommend that the government consider the introduction of loss carry-back provisions in Hong Kong.

PART C: Tax measures to support pillar and new industry sectors

Financial services

Issues

32. Financial services constitute a pillar industry and are a cornerstone of Hong Kong's economy. We have to ensure that Hong Kong remains alert to the competition from other jurisdictions in the region. As Hong Kong's competitors make concerted efforts to attract specific industries, such as asset management, businesses in these subsectors may decide to relocate or not to establish in Hong Kong in the first place. Other related businesses may also follow suit. Hong Kong could be caught unaware if it does not monitor the situation and take appropriate action to retain and attract a full range of financial service providers.

33. We propose, therefore, that additional measures be introduced to further enhance Hong Kong's status as a global financial centre, given the competition from other emerging asset management centres. These should include measures to expand concessions for existing financial services industries and also to facilitate and attract new types of businesses in this sector.

Measures proposed

34. To encourage offshore funds to invest in Hong Kong, the government should consider measures to extend the offshore fund exemption rules and ensure that the income generated from the normal operations of an offshore fund is covered. Measures to be explored should include:

    (a) allowing offshore funds to use Hong Kong-based trustees,

    (b) relaxing the exemption restriction on offshore funds investing in offshore private companies other than property holding companies,

    (c) extending the definition of "specified transactions" to include income from certain fixed income financial instruments as qualified transactions,

    (d) including interest income as income from specified transactions, rather than income from incidental transactions which is subject to a cap of 5% of total income from specified and incidental transactions, and

    (e) expanding the list of specified stock and future exchanges to include Mainland exchanges.

35. Furthermore, it is an opportune time to consider some longer-term initiatives for the financial services sector, including:

    (a) providing an exemption for Hong Kong resident funds, similar to that currently granted to offshore funds, thus providing a level playing field for both onshore and offshore funds,

    (b) reviewing the existing interest expense deduction rules to encourage international companies to use Hong Kong as their "cash pooling hub"; and

    (c) reviewing the existing charging section, that is, section 23 of the IRO for life insurers, as the current provision is no longer in line with the development of the industry. For instance, income relating to the investment portion of unit link products should not be included as insurance premiums for computing the 5% deemed assessable profits.

36. Hong Kong should encourage the development of an Islamic finance market by introducing tax legislation to ensure a level playing field between Islamic finance products and conventional products, taking care to avoid any distortions from a tax perspective.

Innovation and technology

Issues

37. Given Hong Kong's aim to establish a more knowledge-based economy and to develop certain new industries, as outlined in the chief executive's policy address, it needs to be considered whether the existing tax regime sufficiently supports this policy direction.

38. Current concessions are not particularly favourable, either for encouraging more research and development ("R&D") activities to be done in Hong Kong or for facilitating Hong Kong to become a hub for the ownership and licensing of intellectual property ("IP"). Meanwhile other jurisdictions are also actively developing similar business areas, e.g., innovation and technology, and cultural and creative industries.

Measures proposed

The Institute proposes that the current tax concessions in relation to IP be extended. The following measures should be considered (together with suitable anti-avoidance provisions):

39. "Place of use", should be adopted instead of the place of acquisition and grant of a licence or right of use, to determine the source of royalty income. Where a taxpayer has a financial interest in the use of the licensed property, adopting place of use (i.e., where the IP is exploited) is supported by the cases of *HK-TVB International v. CIR* ("*HK-TVBI*") and *ING Baring Securities (Hong Kong) v. CIR* ("*ING Baring*"). The existing test poses difficulties in practice where the acquisition, grant and use of a right take place in different locations.

40. Disposals of IP rights are specifically treated as trading receipts under section 16E of the IRO and, as such, are fully taxable without any reference to the quantum of the expenditure deducted on acquiring them. This is against the principle of Hong Kong's tax system not to tax capital gains. Further, this treatment is inconsistent with gains on the disposal of R&D rights, which are currently taxed, but capped at an amount equal to the prior year deductions claimed by the taxpayer on the rights disposed of. Therefore, the Institute considers the gain on the disposal of IP rights should be taxed only up to the amount of deductions allowed previously in respect of the relevant IP.

41. It is recommended that the 100% deduction for the cost of acquiring IP should not be restricted to patents and know-how but should be extended to other assets (for example, trademarks, copyrights, brand names, licensing rights). This is in line with the basic principle that tax relief should be available for assets used to generate profits that are subject to tax. Australia, Singapore, United Kingdom and United States, amongst other jurisdictions allow deductions for IP assets in addition to patents and know-how.

42. In respect of withholding taxes paid on royalties, we recommend that the government continue its efforts to expand Hong Kong's network of double taxation agreements ("DTAs"). Normally under a DTA, taxpayers can enjoy either a lower rate of withholding taxes, or no withholding taxes. Where no DTA exists, we propose that a unilateral tax credit be granted for all foreign tax paid on royalties that are subject to tax in Hong Kong.

43. While we note that, in the 2009-10 policy address, the government announced an allocation of HK$200 million to launch an "R&D Cash Rebate Scheme", in our view, this scheme does not go far enough, in terms of both the overall amount available and the other restrictions applicable to the scheme. To promote R&D, the Institute recommends that super deductions (i.e., more than 100%) be allowed for R&D expenditure, subject to a suitable definition of what constitutes R&D. This is done elsewhere to encourage R&D

activities. For example, Australia, Singapore, the Mainland and United Kingdom all offer bonus deductions for R&D expenditure.

Producer and professional services

Issues

44. Additional tax incentives should be offered to consolidate Hong Kong's position as a platform for doing business in the region and internationally. Hong Kong still retains a competitive edge in some sectors because of its infrastructure, including its financial and legal frameworks, and pool of skilled manpower. However, other factors, such as high land and labour costs, coupled with other negative perceptions, such as concerns over poor air quality, declining standards of English and skill shortages in certain fields, are eroding Hong Kong's advantages. Further strengthening Hong Kong's role as a preferred location for regional operations will help support the economy over the longer term and create more jobs for professionals and other personnel.

Measures proposed

45. While some of the following measures have been proposed by the Institute in previous budget submissions, we take this opportunity to repeat them as we believe that they remain relevant and merit serious consideration:

    (a) Concessionary tax rate for management fees received from overseas associates

    A concessionary rate of 10% for profits tax should be granted to regional offices/ headquarters in Hong Kong in respect of management and consultancy income derived by the Hong Kong entity from associated entities overseas. Any concerns about potential abuse of this relief could be dealt with through appropriate anti-avoidance provisions (e.g., by suitably defining the term "associated entities overseas").

    (b) Tax exemption for interest received on loans made to overseas associates

    Hong Kong is well equipped to be a regional centre to handle the financial management of overseas associates within a group of companies. However, as financial margins are usually thin, tax measures could provide a further incentive for international businesses to establish their treasury function in Hong Kong.

    Currently section 15(1)(f) of the IRO, deems the interest derived from Hong Kong by a corporation carrying on a trade or business in Hong Kong to be subject to profits tax at the standard corporate rate. We recommend that, other than in the case of financial institutions, the interest received by regional offices from loans made in Hong Kong to their overseas associates be exempted from profits tax.

46. As the ability to re-locate skilled and experienced personnel is important to encourage businesses to use Hong Kong as a base for regional offices/ headquarters, the Institute recommends a change in the way in which employment income is taxed (see details in paragraphs 14 to 15).

47. To support Hong Kong's manufacturing operations, the treatment of contract/ import processing should be reviewed. In particular, the review should consider the apportionment of profits where part of the manufacturing takes place outside Hong Kong, and also the grant of DAs for P&M used outside Hong Kong (see details in paragraphs 9 to 11).

Hong Kong Institute of Certified Public Accountants
January 2010

Appendices

Appendix 1: Areas of uncertainties in DIPN 21

Appendix 2: Submission on depreciation allowances for profits tax in respect of plant and machinery under Inland Revenue Ordinance (Cap. 112)

Appendix 3: Areas of uncertainties in DIPN 46

Areas of uncertainties in DIPN 21

(a) “Operations test” and “totality of facts” approach

The broad guiding principle for determining the locality of profits, as stated by Lord Bridge in the *Hang Seng Bank* case is that “one looks to see what the taxpayer has done to earn the profit in question”. This is known as the “operations test” and has been elaborated in other cases, such as *HK-TVBI* and, more recently in the Court of Final Appeal case of *ING Baring Securities (Hong Kong) Ltd. v. CIR*. In *ING Baring*, Mr Justice Ribeiro PJ pointed out that “[T]he focus is therefore on establishing the geographical location of the taxpayer’s profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions. Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer’s business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of section 14 [of the IRO]”.

The revised DIPN 21 refers to the comments of Ribeiro PJ and similar comments from Bokhary PJ in *Kwong Mile Services Ltd. v. CIR* who, referring to the judgment of Lord Nolan in *CIR v. Orion Caribbean*, pointed to the importance of “focusing on effective causes without being distracted by antecedent or incidental matters”.

This contrasts with the previous version of DIPN 21, which based on the Court of Appeal decision in *CIR v. Magna Industrial Co. Ltd. (“Magna”)*, referred to a “totality of facts” test for determining locality of profits and was criticized by practitioners for straying from the broad guiding principle referred to above. In *ING Baring*, Ribeiro PJ challenged the BOR’s analysis on the grounds that “the Board apparently believed that in order to ascertain the source of the disputed profits, it had to investigate every facet of the Taxpayer’s business so that it could engage in a qualitative assessment of the relative importance of its various operations, choosing ‘the more important things done’ towards the generation of those profits as the criteria for determining geographical source. That is not the approach mandated by the authorities and places an erroneous emphasis on matters properly regarded as antecedent or incidental to the profit-generating operations."

While the revised DIPN 21 improves clarity in some areas and has dropped specific reference to the "totality of facts" test, it nevertheless still quotes the passage from Litton VP in *Magna* that gave rise to the concept of "totality of facts". This is likely to perpetuate uncertainty in the future. The revised DIPN also goes on to state (at paragraph 56): “It has to be emphasised that the information seeking power entrusted to the Assessor under section 51(4) has not been restricted or reduced in any way after *ING Baring”*.

It therefore seems unlikely that the approach of the IRD will change substantially from that adopted under the previous version of the DIPN. The clear implication in the revised DIPN that the application of *ING Baring* is restricted to brokerage cases tends to confirm this. This view, however, is at odds with the interpretation by taxpayers and tax representatives. We consider the *ING Baring* decision has a wide application to the determination of the source of profits and that the suggestion that the decision turned on its own facts is not tenable on a careful reading of the case. The Institute’s position is given further credence by *Ngai Lik*, in which the Court of Final Appeal referred to *ING Baring* as authority on a general point regarding source of profit. However, given the cost of pursuing a case, potentially all the way to final appeal, it is unlikely that the IRD’s view will be challenged unless the sums at stake are very large.

(b) Antecedent and incidental activities

In the light of the above, the determination of whether certain activities are to be regarded as “antecedent or incidental” will be very important. It is noted that in *Datatronic v. CIR (“Datatronic”)*, the BOR considered that the activities performed in the Mainland by the Hong Kong taxpayer were significant and could be attributed to the taxpayer’s profits. On appeal, on the other hand, the courts took the view those activities were merely antecedent or incidental. The DIPN does not provide much practical guidance on this area.

(c) Agency principle

The revised DIPN brings in the agency concept for the first time. It acknowledges the judgment of Lord Millett NPJ in *ING Baring* that it was not necessary to establish agency in the full legal sense and that it was sufficient if a transaction was carried out on the taxpayer’s behalf and for his account by a person acting on his instructions (paragraph 58). However, the DIPN then says that “[t]he Department is of the view that the act of any person carried out overseas should not be readily attributed to a taxpayer in Hong Kong. In *ING Baring,* Lord Millet NPJ agreed with Barma J and firmly rejected the proposition that ‘commercial reality’ dictated that the source of the profits of one member of a group of companies could be ascribed to the activities of another” (paragraph 59).

While Lord Millet noted that “the profits which are potentially chargeable to tax are the profits of the business of the company which carries it on; and the source of those profits must be attributed to the operations of the company which produced them and not to the operations of other members of the group”, he then went on to say that “In considering the source of profits … it is not necessary for the taxpayer to establish that the transaction which produced the profit was carried out by him or his agent in the full legal sense. It is sufficient that it was carried out on his behalf and for his account by a person acting on his instructions. Nor does it matter whether the taxpayer was acting on his own account with a view to profit or for the account of a client in return for a commission. … [W]here the taxpayer employs others to act for him in carrying out a transaction …, the taxpayer’s profit is earned in the place where they carry out his instructions whether they do so as agents or principals”.

However, the DIPN also attempts to confine Lord Millet’s latter comments to the business of stockbrokers.

(d) Manufacturing profits and depreciation allowances for plant and machinery

Following the Privy Council case of *Hang Seng Bank*, there was a period of certainty regarding the source of trading and manufacturing profits. The DIPN 21, issued at that time, greatly assisted taxpayers understanding of the source of profits. However, the interpretation of subsequent court decisions introduced a significant degree of uncertainty into the IRD’s practice and administration of the law, which was also reflected in the IRD’s subsequent interpretation of DIPN 21, in respect of, for example, offshore manufacturing claims involving the use of processing agreements with factories in the Mainland. Unfortunately, the revised DIPN 21 has not helped to improve the level of clarity and certainty in this area.

In *Hang Seng Bank*, Lord Bridge, envisaged that there should be an apportionment of profits where the source of profits appeared to have more than one locality. For the sake of the administrative convenience of all parties, for some years the IRD has agreed a 50:50 apportionment of profits for Hong Kong companies manufacturing in the Mainland under “contract processing” arrangements (that is, 50% of their profits are regarded as earned offshore and so not taxable in Hong Kong). However, in recent years, as a result of changing government requirements in the Mainland, most manufacturing in the Mainland by Hong Kong entities is now conducted using “import processing” arrangements, which entails the setting up of a separate legal entity to undertake the manufacturing. Notwithstanding the similarity in substance between contract processing and import processing, Hong Kong companies engaged in the latter are not able to claim 50:50 apportionment. The IRD takes the view that, given the legal form adopted by import processors, technically speaking, the Hong Kong company is a trading entity that trades with the Mainland manufacturer. In our view, this does not accord with the real commercial situation.

This issue was highlighted in *Datatronic.* While, in that case, the judgment in the Court of First Instance recognised the importance of substance over form and allowed the taxpayer, which operated an import processing arrangement, to apportion its profits on a 50:50 basis, the Court of Appeal, for various reasons, found against the taxpayer.

On a related matter, the IRD also allow manufacturers engaged in contract processing to claim 50% of the DAs for P&M used in the Mainland factories. Meanwhile, manufacturers engaged in import processing are not only denied apportionment of profit, but they are also not permitted to claim any DAs for P&M used in the Mainland. So they suffer a double financial blow. In the IRD’s view this is mandated by section 39E of the IRO. This section was originally introduced as an anti-avoidance provision but is now interpreted as denying DAs for leased P&M used outside of Hong Kong. (The broad definition of “leasing” in section 2 of the IRO means that P&M loaned to the Mainland factory may be caught by that definition.) We believe that this was not the intended effect of this section when it was first introduced.

(e) Reinvoicing

The “safe harbour” rules for “re-invoicing centres” in the previous version of the DIPN have been removed in the latest version. Under these arrangements, previously, profits booked to a re-invoicing centre would not be taxed, provided activities carried out in Hong Kong were limited to certain defined tasks. However, now the IRD will examine the nature of the operations carried out by the re-invoicing centre, and the types of risk assumed by it, to determine whether they constitute services or trading chargeable to tax in Hong Kong. It seems, therefore, that the IRD will adopt a “substance over form approach” in such cases, which contrasts with the “form over substance” approach adopted with import processing. This also creates uncertainty regarding which approach will be adopted and in what circumstances.

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

Appendix 2

By email (yhcheung@legco.gov.hk) and by fax (2121 0420)

8 December 2009

Our Ref.: C/TXP(4), M67123

Hon. Chan Kam-lam, SBS, JP
Chairman, Panel of Financial Affairs
Legislative Council Building
8 Jackson Road
Central
Hong Kong

Dear Mr. Chan,

Depreciation allowances for profits tax in respect of plant and machinery under Inland Revenue Ordinance (Cap. 112)

The Hong Kong Institute of CPAs ("Institute") would like to thank the panel for the invitation to comment on the above issue.

Inland Revenue Ordinance ("IRO") section 39E was introduced as an anti-avoidance provision for defeating opportunities for tax deferral through various forms of plant and machinery leasing. Section 39E(1)(b) operates to deny depreciation allowances for leased plant and machinery ("P&M") used outside Hong Kong. However, given its increasingly wide application, the provision now impacts unfavourably upon genuine businesses which are required to use P&M outside of Hong Kong to generate profits that are chargeable to tax in Hong Kong.

The examples below are three of many that could be cited to illustrate the potential negative impact of section 39E on genuine businesses and, ultimately also, Hong Kong's competitiveness. They relate to processing trade, trading companies, and container leasing:

<u>Processing trade arrangements</u>

Processing trade arrangements between a Hong Kong company and a Mainland processing factory may be in the form of contract or import processing arrangements. Although different in legal form[1], the two kinds of arrangement are generally considered to be similar in substance.

Whereas previously contract processing arrangements were commonplace, import processing is now the norm for Hong Kong taxpayers manufacturing in the Mainland, due to the requirements of the Mainland authorities, and not, for example, as a result of tax planning by Hong Kong taxpayers. In both contract and import processing arrangements, it is not uncommon for a Hong Kong company to loan the P&M to the Mainland

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[1] Contract processing involves a single legal entity with operations in Hong Kong and the Mainland, whereas for import processing, in form a separate legal entity is established in the Mainland, which enters into a contract with the Hong Kong entity.

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processing factory, while ownership remains with the Hong Kong company. This is the case particularly with moulds. According to the terms of the processing arrangement, the manufactured items are produced solely for export only, i.e., the P&M is used solely for the production of products that belong to the Hong Kong company and so for the generation of profits that are chargeable to tax in Hong Kong.

Given that Hong Kong levies tax on the basis of the source of profits, in relation to contract processing, the Inland Revenue Department ("IRD"), as a matter of administrative convenience, accepts a fixed apportionment of profits on a 50:50 (Hong Kong/offshore) basis. In these situations, the IRD also allows taxpayers to claim half of the depreciation allowances on their P&M used in the Mainland. However, in the case of import processing arrangements, the IRD treats the Hong Kong taxpayer as a trader, not involved in any manufacturing, and the Mainland manufacturing entity as an independent business. Consequently, the IRD does not accord the Hong Kong taxpayer the same 50:50 apportionment, nor does it allow half of the deprecation allowances to be claimed. A Hong Kong import processor, therefore, is liable to be taxed on all of its profits and cannot obtain any depreciation allowances for its P&M located in the Mainland factory, thus bearing a double burden.

--- The Institute first raised this issue in an annual meeting with the IRD in 2004 and we reiterated and elaborated on our concerns in the 2006 -2009 annual meetings (see the references in the Appendix). In our view, where a taxpayer owns P&M and uses this to generate income that is chargeable to tax in Hong Kong, depreciation allowances should be granted, in accordance with the basic principle of allowing taxpayers to get relief for costs incurred in generating revenue. On this basis, it would be equitable for taxpayers involved in import processing to be granted the full depreciation allowances.

As regards granting depreciation allowances on administrative basis, the IRD has expressed concern about possible practical and technical difficulties, such as that:

(i) the P&M may be subsequently sold or transferred to other parties;

(ii) depreciation allowances on the same P&M may be claimed by other entities;

(iii) the P&M may be used to manufacture goods sold other than to the Hong Kong entity. (An ability for the Mainland entity to sell goods in the domestic market would mean that the P&M may not be used exclusively to generate profits chargeable to tax in Hong Kong.)

The Institute has suggested that audited accounts and management representation letters could be used to verify continuing ownership of the P&M. Other documents could be referred to show that there is no right to sell goods domestically under the import processing contract.

Despite the availability of supporting documents, particularly the audited accounts, which are, for example, commonly accepted in fulfilment of a company's regulatory and filing requirements, and also the fact that any abuses or misrepresentations by taxpayers would be subject to penalty provisions under the IRO, it seems the IRD remains concerned that there may be other administrative problems yet to be identified.

The prevalence of import, rather than contract, processing arrangements in respect of Mainland manufacturing, means that fewer and fewer Hong Kong-based companies can now obtain the benefit of 50:50 profits tax apportionment, and hence also half of the depreciation allowances for P&M. For Hong Kong import processors, which are taxed on all of their profits and receive no depreciation allowances for P&M, manufacturing in the Mainland is likely to become increasingly non-viable in its present form. Ultimately, they may have little choice but to relocate their business to other jurisdictions that are actively encouraging investment and prepared to adjust to the commercial realities of cross-border and international business.

Trading companies

The above issue of moulds located in Mainland factories extends beyond processing trade arrangements. Some Hong Kong companies trade custom-made goods that are manufactured solely for them by an overseas supplier on an "arm's length basis". In such cases, customised moulds may be provided by the Hong Kong company to the supplier in order to manufacture the custom-made goods. Section 39E would also operate to deny depreciation allowances for these moulds should they be placed at the suppliers' factories outside of Hong Kong. This gives rise to similar questions regarding the long-term viability of operating these businesses in Hong Kong.

Container leasing

Businesses with mobile assets are also affected by section 39E, such as container leasing. Such businesses derive income from rental of the containers. The taxability of such income is usually determined with reference to the location of the assets. However, it is also argued that the rental income could be taxed based on where the leasing contract is entered into. If the business is carried on and managed in Hong Kong, the leasing contract would normally be considered as entered into in Hong Kong and, accordingly, the rental income would be subject to Hong Kong tax. However, should the income be treated as being chargeable to tax in Hong Kong, section 39E would work to deny the depreciation allowances in respect of the containers located outside Hong Kong.

This is a relevant factor in leasing businesses being advised to set up in other jurisdictions rather than Hong Kong, which is clearly to Hong Kong's economic detriment. When decisions are made to locate businesses elsewhere, Hong Kong loses not only the immediate economic benefits deriving from those specific businesses, but also the spin off activities to which they give rise.

The Institute notes that in the 1998 version of the Departmental Interpretation and Practice Notes ("DIPN") 21 - *Locality of Profits*, it is stated, in paragraph 20, that, where section 39E of IRO operates to disallow depreciation allowances in respect of leased P&M, the income from leasing such P&M will generally be regarded as non-taxable. However, this is purely an administrative concession and, in fact, reference to this particular concession has been removed from the revised DIPN21, just issued on 4 December 2009. It is, therefore, uncertain whether the concession will continue to be granted in the future.

Way forward

In relation to processing arrangements and to the type of trading company described above, if the IRD's continuing reservations prevent its agreeing to grant any administrative concession in respect of depreciation allowances, then the Institute would advocate amending the law. We would propose that section 16G of the IRO, relating to prescribed fixed assets, be amended to remove from the definition of "excluded fixed assets", P&M provided to Mainland factories by related Hong Kong companies. This could be made subject to conditions to prevent abuse. Were this amendment to be made to section 16G, section 39E would no longer be applicable. This would allow full tax deductions for P&M expenditure incurred by taxpayers involved in the Mainland processing trade. This amendment would appear to us to be justified, and so worthy of consideration, on the basis of commercial considerations and improving Hong Kong's competitiveness.

As regards the broader issue of the impact of section 39E on other legitimate businesses, global trade has changed markedly since this section was enacted in 1986, and subsequently amended in 1992 and, as a result, it now creates an impediment for a range of business actvities to be conducted in Hong Kong, in ways that were not foreseen when it was first introduced. Under the circumstances, we would suggest that there is a need to conduct a comprehensive review of the aims and objectives, and the practical implications, of this section of the IRO. It seems clear to us that, at the very least, it needs to be substantially rewritten to confine its effect to addressing the mischief that it originally sought to prevent.

If you have any questions on the Institute's submission, please do not hesitate to contact me on 22877084 or at peter@hkicpa.org.hk.

Yours sincerely,

Peter Tisman
Director, Specialist Practices

PMT/EC/ay
Encl.

Related discussions on section 39E of the IRO from the annual meeting minutes between the Institute and IRD

- 2004, Agenda item A2(e), Section 39E application to a Hong Kong taxpayer's plant and machinery used by its wholly-owned subsidiary company in the Mainland
  Link: http://www.hkicpa.org.hk/file/media/section5_membership/Professional%20Representation/tb14.pdf

- 2006, Agenda item A4(a), Applicability of Section 39E on contract processing and import processing arrangements
  Link: http://www.hkicpa.org.hk/file/media/section5_membership/Professional%20Representation/tb16.pdf

- 2007, Agenda item A3(b), Plant and machinery used in import processing
  Link: http://www.hkicpa.org.hk/file/media/section5_membership/Professional%20Representation/tb17.pdf

- 2008, Agenda item A3(b), Plant and machinery used in import processing
  Link: http://app1.hkicpa.org.hk/publications/bulletins/tax/tb18.pdf

- 2009, Agenda item A3(a), Depreciation on plant and machinery used in import processing trade
  Link: http://www.hkicpa.org.hk/file/media/section5_membership/Professional%20Representation/tb19.pdf

Appendix 3

Areas of uncertainties in DIPN 46

(a) DIPN 46 indicates that generally the IRD will apply the principles in the OECD transfer pricing guidelines, except where they are incompatible with express provisions of the IRO. However, the IRD is not bound to follow the OECD guidelines and it is not clear where and when they may decide to deviate from them. It is also not clear where the IRD consider the OECD guidelines are inconsistent with the provisions of the IRO.

(b) The DIPN does not cover global trading arrangements for financial services, but only trading and manufacturing. In contrast, the OECD guidelines provide for the allocation of profits between different markets in the financial service sector.

(c) The "safe harbour" of a mark up of 5%-10% on costs for intra-group services, which was accepted in the previous version of DIPN 21, is no longer a given, and each case will be looked at on its own merits.

(d) The guideline indicates that transfer pricing issues can apply to both international and domestic transactions. However, no relief for transfer pricing adjustments can be given, except through a DTA. While DTAs have provisions for revenue authorities to discuss adjustments, this does not guarantee that they will agree. For international transactions outside the framework of a DTA or domestic transactions between related parties, there is a risk of double taxation if adjustments are made. Particular issues may also arise with the Mainland-Hong Kong DTA as there is still not total clarity in relation to who can benefit from the DTA given that, for example, Hong Kong and the Mainland have different concepts of residence for corporations.

(e) It is not clear that the IRD can use sections 16 and 17 of the IRO to make transfer pricing adjustments, as these sections do not seem to authorise the IRD to disallow deductions on the basis that particular amounts of expenditure are regarded as excessive or not at arm's length. While the "arm's length" principle is the main basis for making adjustments under DIPN 46, it is not specified anywhere in domestic legislation, unlike, for example, the relevant legislation in the United Kingdom. In *Ngai Lik* the IRD successfully invoked the anti- avoidance provision under section 61A to tackle a transfer pricing issue. However, section 61A may be applied only where the sole or dominant purpose of a particular transaction is to avoid tax.

(f) Potential penalties for transfer pricing adjustments are potentially much higher in Hong Kong than elsewhere. Under section 82A of the IRO, penalties could be up to 300% of unpaid tax, compared with 100% in the UK, 75% in Australia and 50% in the Mainland.