Mr Chu Yam-yuen ("CIR") welcomed the representatives from the Institute to the meeting. CIR said he treasured the annual meeting as a platform for maintaining an active dialogue with the profession to resolve issues of common interest. Ms Macpherson thanked the IRD for arranging the annual meeting. The Institute also viewed the annual meeting as an important event which offered a valuable opportunity to clarify technical issues which were of great importance to members of the Institute and the business community in general.

PART A - MATTERS RAISED BY THE INSTITUTE

Agenda item A1 - Profits tax issues

(a) Proposed new accounting models for leases

In August 2010, the International Accounting Standards Board ("IASB") issued an exposure draft ("ED") of accounting for leases. The ED, if adopted, will become the new International Financial Reporting Standard ("IFRS") for leases which will have significant impact on accounting for both lessee and lessor. For example, it is proposed in the ED that the distinction between operating and finance leases be eliminated by using one model for all leases. Under the proposed models, the lessee would recognise an asset for its right to use the underlying (leased) asset and a liability for lease payments whereas the lessor would apply either the derecognition approach or the performance approach to account for the lease, depending on whether there is transfer of significant risks or benefits of the underlying asset to the lessee.

If the ED becomes the final standard without any changes, numerous profits tax issues would arise that need to be addressed. For example, what will be the tax treatments of (1) imputed interest income/expenses recognised by the lessor/ lessee; (2) the gain or loss on disposal of asset recognised by the lessor under the de-recognition approach; (3) the treatments of depreciation allowances for the assets involved under the de-recognition approach and (4) the amortisation expenses (instead of rental expenses) recognised by the lessee in its P&L, etc.

Does the IRD have any plan to identify and review the potential tax issues arising from this ED and to issue some guidance to taxpayers when the final standard becomes effective? (As to the timing, the IASB plans to publish the final standard in June 2011, although its effective date has yet to be determined.) Given the potential tax impact of changes in financial reporting standards, would the IRD consider the need, generally, to issue guidance upon implementation of such changes?

Ms Lee advised that the proposed changes of the ED were significant and would have impact on the financial reporting for both lessees and lessors in substantially all lease transactions. It was yet to be seen whether all the proposals would be adopted as they stood in the light of the comments received. The effective date of the final standard was also yet to be determined. As such, the IRD considered that it was too early and premature to identify and review the potential tax issues arising from the ED at the moment. As a matter of principle, the IRD would take into account the contractual rights and liabilities and where a conflict arose between the legal form of a transaction and its economic substance, it was the IRD's view that the legal form would always prevail for taxation purposes. That said, the IRD would keep in view the development of the new accounting standard as well as review the tax issues and issue guidance, if considered necessary, at the appropriate time.

Mr Ong pointed out that the consultation period on the ED had just ended and the IASB was considering the comments received.

(b) Characterisation of assets

The Institute issued the Deferred Tax: Recovery of Underlying Assets (amendments to HKAS 12) in December 2010. The amendment provides a practical solution to the problem by introducing a presumption that recovery of the carrying amount of an asset which is measured using the fair value model in HKAS 40 Investment Property will, normally be, through sale. According to paragraph 51C of the amendment, the presumption is rebutted when the investment property is depreciable and is "held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale".

The Institute would like to seek the IRD's view as to whether, where this amendment has been made and adopted by taxpayers, taxpayers will be seen as having the intention to sell the property if the accounting of deferred tax is measured to reflect the tax consequence of the sale of the asset.

Ms Lee advised that the accounting treatment of deferred tax relating to an investment property was not a decisive factor in determining the exact nature of the investment property for tax purposes. In the suggested case, there may be inconsistent accounting and tax treatments where the taxpayer had on the one hand adopted the amendments to HKAS 12 in measuring the deferred tax based on the rebuttable presumption that the carrying amount of the investment property would be recovered entirely through sale but had on the other hand excluded the revaluation gain from the computation of profits tax on the basis that it was intended to be held as a long term investment. The IRD would take into account all relevant facts and circumstances, including the accounting treatment, in deciding whether the investment property was a capital or trading asset. Ms Lee reiterated that the IRD would look at the badges of trade in the determination of such kind of cases.

Following the decision made by the Court of Final Appeal in the Secan case, the IRD has adopted the view that assessable profits must be ascertained in accordance with the ordinary principles of commercial accounting (Departmental Interpretation and Practice Notes ("DIPN") 40 and 42 refer). However, in paragraph 23 of DIPN 42, the IRD indicates that the accounting treatment, by itself, cannot operate to change the character of an asset from investment to trading and vice versa, although the accounting treatment is one of facts to be considered. Given these comments, the Institute would like to seek the IRD's view on the implications to the assessing practice arising from this amendment to the IFRS. Specifically, whether (i) the property will be regarded as a "trading asset" where the deferred tax is measured reflecting the tax consequences that would arise on recovering that carrying amount entirely by sale; and (ii) if the answer to (i) is in the affirmative, whether the revaluation gain (which is unrealised, and can never be realised if the property is not sold) will be taxed at the time when it is recognised in the profit and loss account.

Ms Lee said as explained in the first part, the IRD would consider all the relevant facts and circumstances in determining the nature of the investment property for tax purposes.

Ms Lee elaborated that if the property was a trading asset, it should have been measured at the lower of cost and net realisable value ("NRV") and hence no revaluation gain should arise.

If an "investment property" was considered to be held for trading, it should have been accounted for under HKAS 2: Inventory and measured at the lower of cost and NRV. Reference was made to paragraphs 8 and 9 of HKAS 2 which respectively stated that inventory included land and other property held for resale and that inventory was measured at the lower of cost and NRV. As such, there would be no question of revaluation gain.

If an "investment property", for which a revaluation gain was made for each of the years before disposal, was subsequently determined to be a trading asset upon its disposal, the full amount of profit (being the selling price less the original costs and related expenses) would be assessable in the year of sale. The revaluation gains would not need to be assessed in the interim years.

Ms Lee concluded that, whether a property was a trading stock or an investment, and whether revaluation gains in respect thereof were recognised in the profit and loss accounts or not, no profit would be assessed until the property was disposed of.

(c) Tax treatment for actuarial losses from defined benefit schemes

As a result of the revision of HKAS 19 in December 2007, actuarial gains or losses from a defined benefit scheme may be recognised by an employer in other comprehensive income ("OCI") instead of the profit and loss account. While revised DIPN 23 on recognised retirement schemes states that the net total made up of the items specified in HKAS 19 (including actuarial gains and losses), and charged as an expense to the employer's profit and loss account, will be allowed for deduction for profits tax purpose (subject to the 15% limit), revised DIPN 23 does not address

whether a similar tax treatment will be applied to the actuarial gains or losses recognised in OCI (as the DIPN was issued before the revision of HKAS 19). It has come to the Institute's attention that there are currently different practices within the IRD in dealing with the deductibility of actuarial losses recognised in OCI. Below are some examples of the different treatments encountered so far:

(i) The actuarial losses were treated as non-deductible as no actual payment was made. Some assessors have indicated that this treatment is consistent with the deduction for ordinary/ special contribution, which is allowed on a paid basis only.

(ii) The actuarial losses were treated as non-deductible as they were regarded as a provision for special contribution.

(iii) The actuarial losses were treated as fully deductible, as the actuarial gains were fully taxable in previous years.

(iv) The actuarial losses were treated as deductible, but subject to the 15% limit, as they were regarded as a specific provision for ordinary contribution (i.e. same treatment as those actuarial losses recognised in the profit and loss account).

The Institute would like to know whether the IRD is planning to set out a standard tax treatment on actuarial losses (and gains) recognised in OCI and provide clarification to taxpayers by updating DIPN 23.

Discussion withheld. CIR advised that the IRD needed more time to study the issue. A written reply would be given by the IRD later on.

[Post meeting note: The IRD has revised its assessing practice on the tax treatment for defined benefit retirement schemes, particulars of which have been uploaded to the IRD's website.]

Mr Ong left the meeting after the discussion of items A1(a) to A1(c).

(d) Interaction of section 23B, section 15(1)(d) and section 14

By way of reference to a taxpayer carrying on business as an owner of ship in Hong Kong within the meaning of section 23B of the Inland Revenue Ordinance ("IRO") and the taxpayer, being the legal owner of a ship, charters out the ship to another person who will not navigate the ship mainly within Hong Kong waters or between Hong Kong waters and trade river limits. As such, the charter hire income of legal ship owner would not be relevant sums within the terms of section 23B.

However, while the ship under charter hire is ocean-going, the ship does call at Hong Kong ports. Furthermore, the charter party agreement contains no provision to restrict the charterer to use the ship anywhere in the world, i.e., the charterer has a right to use the ship in Hong Kong and actually used the ship in Hong Kong when the ship called at Hong Kong ports.

The Institute would like to clarify:

(i) Whether, despite the charter hire income not being caught by section 23B, the income of the legal ship owner could nonetheless be caught by section 15(1)(d), on the basis that the charterer has a right to use the ship in Hong Kong or the charterer actually used the ship in Hong Kong when the ship called at Hong Kong ports? If on the other hand, the shipping income of a person falls within the ambit of section 23B, but is not chargeable under this section (e.g. the ship calls at Hong Kong ports to deliver goods or passengers, but takes no Hong Kong uplifts), whether it is correct to say that the chargeability of the same would not need to be looked at again under section 14? The same issue also arises in relation to sections 23C and 23D, and the Institute would like to seek IRD's advice on this issue in respect of these sections.

Mr Wong Kuen-fai ("Mr Wong") explained that the crux of the question was whether the person was carrying on business as an owner of ships. This was basically a question of fact to be decided on the peculiar facts of individual cases. If a person carried on business as an owner of ships, section 23B would apply to the exclusion of section 15(1)(d) and section 14(1). This was also the case for sections 23C and 23D where the question was whether the person was carrying on business as an owner of aircraft.

(ii) The general interaction of other specific sections of the IRO (e.g., sections 23, 23A and 24) with the general charging section of section 14 and the deeming provision of section 15.

Mr Wong further explained that in general, for the special categories of taxpayers, sections 14 and 15 were subject to the provisions of the specific mini-tax regimes. This followed the principles enunciated in *CIR v Far East Exchange Ltd* (1979) 1 HKTC 1036 at 1065 – 1066 and *CIR v Carlingford Life and General Assurance Co Ltd* (1989) 3 HKTC 229. Where the tests prescribed in the specific regimes were not satisfied (e.g. the test under section 24(2)), it remained a question of fact to be decided on the normal charging provisions as to whether the profits should be assessable.

Ms Chan noted that, if a person carried on the business as an owner of ships whereby section 23B was applicable, then it would not be necessary to consider the chargeability again under section 14. CIR said the chargeability under section 14 was relevant if the person was not carrying on a business as an owner of ships.

Mr Lee asked if it was possible for a single legal entity to operate separate lines of business, one of which constituted the business of an owner of ships, such that the assessable profits of the entity were determined in accordance with both sections 14 and 23B. CIR agreed that this would be the proper tax treatment in the scenario described.

(e) Research and development expenditure under section 16B

(i) Section 16B provides that research and development ("R&D") expenditure related to a trade, business or profession is deductible. The deductible R&D expenditure could be in the form of (i) payments to an approved research institute; or (ii) expenditure incurred by taxpayers themselves.

Consider the situation of a Hong Kong company engaging a third party in Mainland China, not being an approved R&D institute, as its service provider to do R&D for it based on its instructions and guidelines. All R&D benefits and results belong to the Hong Kong company, which is fully chargeable to tax in Hong Kong on its profits. Under these circumstances, the Institute would like to clarify whether the IRD would consider that the Hong Kong company has incurred the R&D expenditure itself, by way of paying service fees to the service provider in Mainland China, and therefore, the expenditure is considered to be tax deductible under the second limb, without relying on the first limb of section 16B.

Mr Wong advised that section 16B(1) permitted deduction of (a) payments made by a person to (i) an approved research institute for R&D related to his trade, profession or business; or (ii) an approved research institute, the object of which was the undertaking of R&D related to the class of the person's trade, profession or business; and (b) expenditure incurred by a person on R&D related to his trade, profession or business.

Mr Wong explained that the proper interpretation of section 16B(1)(b) was that it should refer to expenditure on in-house R&D activities undertaken by the person himself. It did not include payments to a service provider, which was not an approved research institute. Otherwise, that would lead to an absurd and inconsistent result when looking at the entire section 16B. Taking such interpretation would render paragraph (1)(a) otiose.

CIR added that the crux of the issue was who conducted those R&D activities. Payments to an outsourced service centre, even though it was engaged by the person to carry out the required R&D activities, would not qualify for deduction under section 16B if the service centre was not an approved research institute. There were differences in the respective rights and obligations between the engagement of a service centre and the undertaking by the person himself in carrying out the R&D activities. It was a matter of degree whether R&D activities would be regarded as "undertaken by the person himself".

Ms Chan commented that, if such a narrow interpretation was adopted, it would create anomalies whereby a claim for deduction under section 16B might be disallowed if the person made limited use of certain services provided by a service provider in carrying out the required R&D activities, instead of undertaking those activities himself. The expenditures on R&D activities incurred, if not allowable for deduction under section 16B, would likely be disallowed for deduction under sections 16 and 17 because of their capital nature. Mr Lee questioned that the Law Draftsman would have drafted the provisions differently if it was intended to bring into the requirement that deduction was only allowable for expenditures incurred in respect of R&D activities being "undertaken by the person himself", instead of the

present wording, which literally required the same be “incurred by the person [i.e. the taxpayer]. In his view, Mr Lee considered that sections 16B(1)(a) and (1)(b) were not mutually exclusive, as they referred to the types of “payments made, and expenditure incurred” that were allowable by the preamble of section 16(1), and that it would be sufficient for claiming a deduction if the R&D expenditures incurred were "related to that trade, profession or business" as provided in section 16B(1)(b). He asked whether it would be acceptable if the R&D activities were undertaken by, for example, a common law agent or an overseas university, where all the expenditure and risks were borne and assumed by, and all the benefits belonged to, the taxpayer. He believed, under common law principles, what the agent or university did and caused were all attributed to the taxpayer without the need to refer to section 16(1). Ms Chan asked whether a deduction would be denied if e.g., just some laboratory testing were to be outsourced.

CIR concluded that the IRD had to apply the law as it stands. The legal opinion obtained by the IRD was that section 16B(1)(b) should be interpreted in such a way to allow only expenditures incurred on R&D activities which were "undertaken by the person himself". This would be the interpretation adopted by the IRD. Where a minor part of the R&D activities was sub-contracted out, the overall R&D activities might still be regarded as being undertaken by the taxpayer himself – the issue being a matter of fact and degree. In reply to Ms Macpherson, CIR agreed to give some guidelines on what amounted to “activities undertaken by the person himself”.

(ii) Section 16B(2) states that *“Where any payment or expenditure to which this section refers is made or incurred outside Hong Kong and the trade, profession or business in relation to which it is so made or incurred is carried on partly in and partly out of Hong Kong, the deduction allowable under this section shall be such part of the amount which would otherwise be allowable as is reasonable in the circumstances.”*

Some practitioners have expressed the view that the way sub-section 2 is phrased does not appear to be very clear. Firstly, it may not be clear as to what is meant by expenditure being “incurred outside Hong Kong”. For example, while the expenditure is paid to the service provider outside Hong Kong in Mainland China in (i) above, in a sense the expenditure could also be said to be incurred by the Hong Kong company in Hong Kong. Furthermore, it may not also be clear whether merely by virtue of engaging a service provider in Mainland China to do R&D work on its behalf, the company in (i) above would be regarded as partly carrying on its trade or business outside Hong Kong. If so, any R&D expenditure, if regarded as being incurred outside Hong Kong, would then potentially be subject to an apportionment under section 16(B)(2) - despite the fact that the Hong Kong company’s profits may be fully chargeable to tax in Hong Kong. Therefore, the Institute would like to clarify whether, in general, so long as a company’s profits are fully chargeable to tax in Hong Kong, the related R&D expenditure, wherever incurred, is fully tax deductible under section 16B(2). If this is the case, it would be helpful if the IRD could issue written guidelines.

Mr Wong advised that following from (i) above that section 16B(1)(b) referred to a taxpayer's expenditure on in-house R&D activities, the phrase "incurred outside Hong Kong" in sub-section (2) referred to the expenditure on R&D activities which were carried out by the taxpayer outside Hong Kong, e.g. where the taxpayer set up its own R&D facilities in the Mainland.

Whether a person carried on his trade, profession or business partly in Hong Kong and partly out of Hong Kong was a question of fact and degree. More specifically, the IRD looked at whether the profits were fully chargeable to tax in Hong Kong and, in general, a person would not be regarded as deriving profit partly out of Hong Kong solely because he engaged a service provider outside Hong Kong.

Mr Wong said the IRD's practice was to seek apportionment of R&D expenditures under section 16B(2) only where a person's profits were partly chargeable to tax in Hong Kong. If a person's profits were fully chargeable to tax in Hong Kong, the full amount of R&D expenditures, where other conditions in section 16B were satisfied, would be allowable for deduction.

(f) Source rule for guarantee fees derived by non-financial institutions

As indicated in point 6 of paragraph 54 of revised DIPN 21, the source for guarantee/ underwriting fees received by financial institutions is determined by looking at whether the relevant risk is evaluated and borne by the Hong Kong institution. However, it is not clear from revised DIPN 21 whether the source of guarantee fees derived by non-financial institutions is determined in a similar way. An example is guarantee fees received by a parent from its subsidiary for providing corporate guarantee for the subsidiary's bank borrowings.

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

(i) Whether the source rule on guarantee fees for financial institutions as indicated in revised DIPN 21 also applies to non-financial institutions.

Ms Lee advised that source of profits was a question of fact depending on the nature of the transaction. The ascertainment of the source of profits also required an accurate legal analysis of the transaction. The broad guiding principle was that one looks to see what the taxpayer has done to earn the profits in question and where he has done it.

Ms Lee further explained that DIPN 21 only stated that a "principal" consideration of the source of guarantee fee for financial institution was whether or not the risk under the guarantee fee was evaluated and borne by the financial institution. Whether such "principal" consideration was equally applicable to non-financial institutions depended on whether they had the same legal rights and obligations; and whether they had the same operations and effective causes that produced the guarantee fee in question. CIR added that if non-financial institutions bore the same risk and were operated under the same circumstances as that of financial institutions, the source rule on guarantee fees for financial institutions could also be applied to non-financial institutions.

(ii) If not, what is the IRD's view in determining the source of guarantee fees derived by a person other than financial institutions, in particular, what are considered as the "relevant profit generating activities" in determining the source of such guarantee fees.

Whether the IRD will provide clearer guidance to taxpayers by further revising DIPN 21.

Ms Lee advised that in the generality of cases, the IRD would take into account the evaluation and undertaking of risk by the taxpayer in determining the source of guarantee or underwriting fees. But in extreme cases such as *Kwong Mile Services Ltd v CIR* [2004] 3 HKLRD 168 where the profit did not arise from the underwriting arrangement but from the marketing activities, the proper approach was to focus on the relevant principles, instead of formulating rules on the 'relevant profit generating activities' for a particular type of income or profit. As Bokhary PJ pointed out in *Kwong Mile*, the "situations in which the source of a profit has to be ascertained are too many and varied for a universal judge-made test…".

(g) Taxation of rental income

Based on DIPN 21, rental income from operating leases on assets that are based outside Hong Kong, i.e., real estate property, are considered to be offshore sourced and not taxable in Hong Kong. However, practitioners have recently come across situation where the case assessor sought to determine the source of rental income by adopting the "operation test" (i.e. how and where the lessor/ tenant was solicited and lease/ tenancy agreement was effected). In this regard, the Institute would like to seek the IRD's clarification whether there's been a change of policy in relation to the taxation of rental income from operating leases.

Ms Lee explained that there was no change in the IRD's policy in determining the locality of rental income from real property. In the generality of cases, the IRD regarded the locality of rental income from real property to be the place where the property was located (paragraph 45(a) of DIPN 21). However, source of profits was a question of fact depending on the nature of the transaction. The broad guiding principle, attested by many authorities, was that one looks to see what the taxpayer has done to earn the profits in question and where he has done it. Reference was made to paragraphs 17(d) and (f) of DIPN 21 (Revised 2009). Depending on the facts and circumstances of individual cases, the IRD may need to obtain further facts to ascertain the real nature of the income and its source, despite the label given to it.

Mr Tam asked what if other services were required to be rendered in Hong Kong in connection with the earning of rental income in respect of a property located in the Mainland. CIR said it was a matter of fact and degree to determine whether the segregation of service income from the rental income would be necessary. In reply to a question of whether tax credit would be given to cases involving possible double taxation between Hong Kong and the Mainland in the quoted example, due to withholding tax being imposed on service income, CIR said regard would be had to the double tax agreement entered into between Hong Kong and the Mainland to determine the proper tax treatments on the relevant income concerned and then to consider matters relating to double tax credit.

(h) Taxation of interest from cash pooling arrangements

The Institute would like to seek the IRD's clarification on the determination of the source of interest income arising from cash pooling arrangements. Under a cash pooling arrangement, generally, group entities remit their excess cash into a centralised pool which is managed by a designated group entity (usually the group treasurer entity). The cash pool arrangement is made in order to (i) better manage excess cash; and (ii) derive interest income at a preferential rate. Since the cash pool arrangement is no different from a "simple loan arrangement", the "provision of credit" test has been adopted in determining the source of interest income arising from the cash pooling arrangement. However, practitioners have recently come across cases where assessors sought to assess interest income arising from cash pooling arrangements on the basis that:

- the excess funds have arisen from the taxpayer's Hong Kong-sourced trading transactions; and/or
- the taxpayers are not required to do anything outside Hong Kong and, therefore, adopting the "operation test" the interest income should be Hong Kong sourced.

In this respect, the Institute would like to seek the IRD's clarification on its assessing practice for interest income arising from cash pooling arrangements; specifically, whether the "provision of credit test" or "operation test" should be used in determining the source of the interest income.

Mrs Chu advised that in general, the "provision of credit test" was applicable to a company other than a financial institution where mere lending of the company's own surplus funds was involved. For cases other than simple loan arrangement, like the one in *Orion Caribbean Limited v CIR* (4 HKTC 432), the proper test to determine the source of interest income was the "operation test", i.e. "one looks to see what the taxpayer has done to earn the profit in question and where he has done it". This assessing practice would not be altered on the determination of the source of interest income arising from cash pooling arrangements.

Mrs Chu further explained that whether the provision of a loan constituted a simple loan arrangement was a question of fact. In the case of individual companies within the group, it was likely that the "provision of credit test" would apply to the interest income derived by them from the passive lending of their surplus funds. But for the treasurer company of the group, it was not uncommon that more active management of the excess funds of the group was involved and if so, regard would be had to the operations of the company to determine the source of the interest income.

The Institute would also like the IRD's views on the cash pooling arrangement of a company with branches in different jurisdictions. For example, a company has a branch in Hong Kong and another one in a foreign jurisdiction ("X"). Each of the branches of the company has an account in USD with the respective local branches (i.e. in Hong Kong and X) of a bank. It is agreed between the bank and the company that in computing the interest payable/ receivable by the bank, the bank would net off the balances of both bank accounts standing at the end of each interest period and

charge interest at market rate if the balance is a debit (i.e. due from the company) or credit interest if the balance is a credit (i.e. due to the company). If it is an income, it would be credited to the account with a debit balance. If it is a charge, it would be debited to the account with a credit balance.

In relation to this, the Institute would like to ask the following questions:

(i) Would the IRD assess and allow the interest income and expense of the Hong Kong branch from the aforesaid arrangement?

Mrs Chu advised that the Hong Kong branch of a company (other than a financial institution) was exempt from payment of profits tax on the interest income derived from the bank, subject to section 2(2) of the Exemption from Profits Tax (Interest Income) Order 1998. On the other hand, interest expenses incurred by the Hong Kong branch from the arrangement would be deductible if sections 16 and 17 of the IRO were satisfied. The IRD's views and practices relating to the deductibility of interest expenses as specified under sections 16(2), 16(2A) to 16(2C) of the IRO were summarized in DIPN No. 13A.

(ii) If yes, how much of the interest income and expense would be assessed and allowed? Would it be the amount credited/ charged by the bank or computed otherwise?

Mrs Chu advised that the amount of interest income to be assessed, subject to the Exemption from Profits Tax (Interest Income) Order 1998, was that accrued to the Hong Kong branch and derived from Hong Kong. The amount of interest expense to be allowed is that incurred by the Hong Kong branch where the requirements of sections 16 and 17 of the IRO were satisfied.

(iii) How does IRD consider the BNP case law, which is not applied in practice, impacts on the aforesaid arrangement?

Mrs Chu explained that it was incorrect to say that the *BNP* case (2 HKTC 139) was not applied in practice. The case concerned the deduction claim of "interest expense" charged by the head office of BNP, a multi-national bank, to its Hong Kong branch on the latter's retention of its own profits. The facts in that case were quite peculiar where there was no actual lending at all. It was held that no interest was incurred by the bank. The judgment in *BNP* would apply to cases which have similar facts.

Mrs Chu said in contrast to the *BNP* case, under the cash pooling arrangement as described, it was the company (not a branch) which would derive interest income from or pay interest expense to the bank, a third party. As the facts were entirely different and not comparable, the IRD considered that the *BNP* case would not have any direct impact on the taxation of the cash pooling arrangement.

(i) Equity linked notes ("ELN")

Questions on the tax treatments of equity linked notes were raised in the 2008 and 2009 annual meetings with the IRD. The Institute considers that the position is still unclear and wishes to raise follow up questions:

(i) The IRD previously replied that if the ELN is a "certificate of deposit" ("CD"), the discount would be treated as interest income and that even if the ELN does not fall within the definition of CD, the discount (or part of it) might be interest income. The Institute considers that this creates uncertainty. Firstly, whether an instrument is technically a CD for tax purposes is quite often difficult to determine in practice. Secondly, the reference to "part of it" and "might be" are ambiguous. The Institute would like to ask the IRD if it would consider the full amount of discount of an ELN to be interest income and, if not, whether it plans to issue written guidelines to advise on the tax treatments of ELNs.

Mr Chiu advised that unlike CD, ELN itself was not a term defined in the IRO. The term ELN itself was only a label and the rights and obligations may vary from one to another. It was therefore not practical for the Department to issue guidelines.

(ii) The IRD also previously commented that a hybrid instrument is, in legal form, a single instrument and it will look to the legal form rather than the accounting treatment to ascertain its nature and the appropriate tax treatment. In the case of ELNs, the Institute would like to ask the IRD to advise whether it will treat the return from an ELN as wholly made up of interest, despite its accounting treatment.

Mr Chiu advised that in the 2009 meeting the Department had already explained that while the host contract and the embedded derivative would be accorded the same tax treatment, there was no suggestion that the return on an ELN could not be dissected into interest and other types of income.

In reply to Mr Lee's question whether part of the price should be attributed to the option embedded in an ELN, Mr Chiu explained that regard would be had to the terms of the instrument and facts of the case. Mr Chiu also explained that a discount in a zero rated bond could be interest whereas in other cases it represented compensation for additional commercial risks. Mr Lee asked whether the IRD would follow the principle in *Lomax v. Peter Dixon* 25 TC 353. Mr Chiu confirmed that the case would remain a good authority.

Ms Chan asked whether different tests of source could be applied to different parts of a dissected instrument. Mr Chiu said that, as indicated in DIPN 42, since only one instrument was involved, the same test of source should be applied and all the profits derived from the instrument would either be on-shore or offshore.

(j) Offshore fund exemption

Broadly, the offshore funds exemption operates to exempt offshore funds from profits tax in Hong Kong where the fund is a non-resident person and derives its profits from specified transactions carried out through or arranged by specified persons. Based on experience, practitioners are given to understand that the IRD is of the view that, where a fund invests in a non-specified transaction that is not an incidental transaction, only profits from the non-specified transactions would be subject to profits tax in Hong Kong (to the extent that they are Hong Kong sourced and not otherwise exempt). Profits from specified transactions will remain exempt under the exemption. In this regard, the Institute would like to seek the IRD's clarification on its position with the application of section 20AC(3) of the IRO.

CIR said that the understanding was not correct.

CIR elaborated that section 20AC(3) provided that exemption to the non-resident person (in the context of section 20AC(1)) did not apply if at any time during a year of assessment the person carried on any trade, profession or business in Hong Kong involving transactions other than the specified transaction or transactions incidental to the specified transaction.

CIR further explained that the exemption criteria was clearly explained in paragraph 22 of DIPN 43 that "to qualify for exemption, a person has to satisfy two conditions:

(a) he is a non-resident person; and

(b) he does not carry on any trade, profession or business in Hong Kong involving transactions other than the specified transactions (carried out through or arranged by specified persons) and transactions incidental to the carrying out of the specified transactions."

(k) Section 19C(4) and 19C(5) – can taxpayers choose which amounts of tax losses are to be offset first?

The following example is used to illustrate a question on section 19C:
Company A has carried on a trade on its own account since 1 December 2008, and was also a partner in a partnership business for the year ended 31 December 2009.

Company A's own tax losses or assessable profits for the two relevant years are as follows:
Year ended 31 December 2008: losses of HK$800,000
Year ended 31 December 2009: assessable profits of HK$200,000

Company A's share of the tax losses of the partnership business is as follows:
Year ended 31 December 2009: losses of HK$200,000

Company A then withdrew from the partnership effective 1 January 2010. In this case, can Company A opt to set off its share of the partnership loss of HK$200,000 against its own assessable profits for the year ended 31 December 2009 of HK$200,000 first, thus leaving intact its own tax losses of HK$800,000 brought forward from the year ended 31 December 2008 – to be carried forward to the years subsequent to 31 December 2009.

Practitioners take the view that section 19C(5) specifies that a corporation's share of the tax losses of a partnership is to be set off against the assessable profits of the corporation for the same year, and it is only when there is no such set off or when there is a balance after such a set off that the tax losses are to be carried forward in the tax return of the partnership. Therefore, in the above example, section 19C(5) would allow Company A to set off its share of the partnership losses of HK$200,000 against its own assessable profits of the same amount for the year ended 31 December 2009. This is the case despite the fact that section 19C(4) would also allow Company A to set off its own tax losses of HK$800,000 brought forward from the year ended 31 December 2008 against its own assessable profits of HK$200,000 for the year ended 31 December 2009. Since there is no provision stating which one of these two subsections takes precedence over the other, taxpayers should be allowed to make a choice as to which tax losses they wish to utilise first.

Given that, if Company A is not allowed to set off its partnership losses, as suggested, its share of the partnership losses would lapse, or be lost, upon its withdrawal from the partnership. The Institute requests IRD's comments on the view above.

CIR advised that normally, the IRD would first set-off the corporation's loss brought forward from previous years as the loss was readily available in the file when the assessment was made by the Assessor. After all, this should have no effect on the taxpayer. Company A's share of loss in the partnership in the example given would not lapse upon its withdrawal from the partnership.

(l) Distribution of profits received from a partnership

Section 26(b) of the IRO provides that no part of the profits or losses of a trade, profession or business carried on by a person who is chargeable to tax shall be included in ascertaining the profits in respect of any other person who is chargeable to tax. The distribution of profits received from a partnership chargeable to profits tax should therefore be excluded in computing the chargeable profits/ income of its partners under section 26(b).

The Institute would like to seek the IRD's confirmation that the distribution of profits from a partnership received by a partner (the partner carries on business in Hong Kong) is not taxable in the hands of the partner, even though the partnership is not chargeable to tax in Hong Kong and hence strictly speaking section 26(b) does not apply.

A partnership is a separate "tax entity" under sections 2 and 22(1). If a partnership carries on business in Hong Kong and derives Hong Kong sourced profits from that business, the partnership will be subject to profits tax. On the other hand, if the partnership does not carry on business in Hong Kong and/ or it does not derive Hong Kong sourced profits, it is not subject to profits tax. The receipt of profit distribution by a partner from a partnership, a separate "tax entity", which may or may not be chargeable to tax in Hong Kong (depending on whether conditions under section 14 apply), is similar to receiving dividends by a shareholder from a company who may not be chargeable to Hong Kong tax (and hence strictly speaking section 26(a) does not apply). The Institute understands that the IRD does not tax dividend income, irrespective of whether the dividend paying company is chargeable to Hong Kong tax or not.

The Institute would like the IRD to confirm the above tax treatment and analysis.

Mrs Chu advised that section 14 of the IRO stipulated that all Hong Kong-source profits (excluding profits arising from the sale of capital assets) of any trade, profession or business carried on in Hong Kong were chargeable to tax, unless they came within the exemption regimes – section 26 was one of them.

Mrs Chu said it was not correct to say that the IRD did not tax dividend income, irrespective of whether the dividend paying company was chargeable to profits tax. Corporations and partnerships were required to report the amounts of dividends received under the relevant part of the tax returns for scrutiny by the Assessors. Where necessary, the Assessor would take appropriate steps to ascertain the eligibility of the income for exemption before agreeing to its exclusion from assessable profits. The same would also apply to any profits received from a partnership.

Mrs Chu further explained that very often, dividend income/distributions from a non-Hong Kong corporation/partnership that did not qualify for exemption under section 26 were not taxed in the hands of the recipient as they were offshore in nature and thus fell outside section 14.

In reply to Ms Chan, Mrs Chu summarised that where section 26 did not apply, only those dividend income that was sourced in Hong Kong would be assessed under section 14. Ms Lee added that 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). However, the number of such cases was very insignificant.