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

*TaxB 21* *August 2011*

# Tax Bulletin

# 2011

## Annual Meeting

**The Inland Revenue Department**

*and*

**The Hong Kong Institute of Certified Public Accountants**

**2011**

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

**Preamble**

As part of the Institute's regular dialogue with the government to facilitate tax compliance, improve procedural arrangements and to clarify areas of interpretation, representatives of the Institute met the Commissioner of Inland Revenue ("CIR") and members of his staff in February 2011.

As in the past, the agenda took on board items received from a circulation to members of the Institute prior to the meeting. The minutes of the meeting, prepared by the Inland Revenue Department ("IRD") are reproduced in full in this Tax Bulletin and should be of assistance in members' future dealings with the IRD. Part A contains items raised by the Institute and Part B, items raised by IRD.

**List of Discussion Items**

## PART A - MATTERS RAISED BY THE INSTITUTE

### *A1. Profits Tax Issues*

A1(i) Equity linked notes ("ELN")

A1(j) Offshore fund exemption

A1(k) Section 19C(4) and 19C(5) – can taxpayers choose which amounts of tax losses are to be offset first?

A1(l) Distribution of profits received from a partnership

### *A2. Salaries Tax Issues*

A(2a) Simple apportionment approach for splitting source of restricted share income upon change of employment

A2(b) 60-day exemption

A2(c) Implication of Board of Review case D45/09

### *A3. Cross-border Tax Issues*

A3(a) Discussion with State Administration of Taxation ("SAT")

### *A4. Double Tax Agreements*

A4(a) Application of treaty provisions and domestic anti-tax avoidance rules by treaty partners

A4(b) Attributing profits to a permanent establishment in Hong Kong of a non-resident

A4(c) Hong Kong company claiming tax credit under a CDTA

A4(d) Certificate of Hong Kong resident status for use in CDTA countries other than Mainland China

A4(e) Claiming tax deduction or tax credit for foreign withholding tax

A4(f) 183-day exemption from Hong Kong salaries tax

A4(g) Tax credit under Hong Kong salaries tax

A4(h) Mutual agreement procedures under a CDTA

***A5. Departmental Policy and Administrative Matters***

A5(a) Employer's withholding obligation under Hong Kong salaries tax

A5(b) Whether a holdover of the provisional tax can be made based on a later issue or payment dates of a revised section 64(3) assessment

A5(c) Advance ruling

A5(d) Timing of issuing the sample tax return

A5(e) On-line forms/filing

A5(f) Time required for reviewing taxpayer's tax returns

A5(g) Block extension for filing salaries tax returns

A5(h) Filing of employer's returns

A5(i) Lodgment of tax returns and filing deadlines for 2010/ 2011

**PART B - MATTERS RAISED BY THE IRD**

***B1. Investigation and Field Audit: Discrepancies Detected by Field Audit***

***B2. Date of Next Annual Meeting***

**PART C - ANY OTHER BUSINESS**

**Full Minutes**

The 2010/11 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department was held on 11 February 2011 at the Inland Revenue Department.

**In Attendance**

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

| | |
|---|---|
| Ms Ayesha Macpherson | Chairperson, Taxation Committee |
| Ms Florence Chan | Deputy Chairperson, Taxation Committee |
| Mr Peter Yu | Member, Taxation Committee |
| Mr Anthony Tam | Member, Taxation Committee |
| Mr Julian Lee | Member, Taxation Committee |
| Ms Alice Lam | Member, Taxation Committee |
| Mr Peter Tisman | Director, Specialist Practices |
| Mr Steve Ong | Director, Standard Setting |
| Ms Elena Chai | Associate Director, Specialist Practices |

**Inland Revenue Department ("IRD")**

| | |
|---|---|
| Mr Chu Yam-yuen | Commissioner of Inland Revenue |
| Mr Wong Kuen-fai | Deputy Commissioner of Inland Revenue (Technical) |
| Mrs Teresa Chu | Deputy Commissioner of Inland Revenue (Operations) |
| Ms Doris Lee | Assistant Commissioner of Inland Revenue |
| Mr Chiu Kwok-kit | Assistant Commissioner of Inland Revenue |
| Mrs Lai Chi Lai-ming | Assistant Commissioner of Inland Revenue |
| Mr Wong Kai-cheong | Senior Assessor (Research) |

**For Members' note:**

In the process of finalising the minutes, the Institute sought clarification from the IRD on the following issues:

**Agenda item A4(b) Attributing profits to a permanent establishment in Hong Kong of a non-resident**

(i) Further clarification was sought on IRD's response in paragraph two. The Institute asked whether the OECD methodologies for allocating profits to different PEs of an entity are only applicable where the entity concerned is located in a jurisdiction which has entered into a tax treaty with Hong Kong?

IRD's response was in the absence of a CDTA, Rule 5(2) is to be applied in determining the profits of a permanent establishment in Hong Kong.

(ii) Further clarification was sought on IRD's response in paragraph two. The Institute understood that, under the Hong Kong tax law, the taxing person should be the Japanese company as a whole, assuming the company is incorporated in Japan. Therefore, under the Hong Kong tax law, the only income in question for Hong Kong tax purposes should be the stock brokerage commissions earned by the Japanese company, the Hong Kong branch not being a separate taxing person. On the basis of the ING Baring case, the brokerage commissions would be non-taxable offshore income in Hong Kong. Therefore, even though Japan has a tax treaty with Hong Kong and the OECD profit-allocation methodologies require some profits to be attributed to the Hong Kong branch, the Hong Kong branch should nonetheless enjoy the more preferential tax treatment (as explained in paragraph 6 of DIPN 44), i.e., not be chargeable to tax in Hong Kong, under the domestic tax law of Hong Kong.

IRD responded that, if the head office earned profits with the assistance of a PE in Hong Kong and the profits attributable to that head office were accepted as offshore in nature, those profits would not be taxable in Hong Kong, even though the OECD profit allocation methodologies require an attribution of profits to the PE in Hong Kong. However, it should be noted that under the business profits article of the OECD model tax convention, the PE is treated as if it were a separate entity and it is necessary to determine whether appropriate profits have been attributed to the functions performed by the PE. This is not a matter about preferential treatment. However, if the profits attributed to the PE were regarded as sourced and taxable in Hong Kong, this would be by virtue of the Inland Revenue Ordinance and not due to any provisions in a CDTA.

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.
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> 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.
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> 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; <u>and</u>
(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.

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| 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.

**Agenda item A2 - Salaries tax issues**

**(a) Simple apportionment approach for splitting source of restricted share income upon change of employment**

In the case of stock options with a vesting period spanning over a period when an individual changes from a non-Hong Kong employment to a Hong Kong employment or vice versa, it is confirmed in paragraphs 56 and 57 of DIPN 38 that a simple apportionment would apply to split the stock option gains into two portions, one attributable to the period of Hong Kong employment and the other attributable to the period of non-Hong Kong employment.

In paragraphs 66 and 67 of DIPN 38, examples of apportionment are provided for an individual holding a non-Hong Kong employment with restricted shares that are (i) granted prior to and vested during Hong Kong assignment and (ii) granted during and vested after Hong Kong assignment.

Would the IRD confirm if the above simple apportionment approach for splitting the source of stock option income would also be applicable to that of restricted share income, in the case of change of employment (from a non-Hong Kong employment to a Hong Kong employment or vice versa) during the vesting period of the restricted shares?

Mr Chiu advised that paragraphs 56 and 57 referred to situations whereby the stock options were derived from both the non-Hong Kong employment and Hong Kong employment i.e. employment within a group of companies. If the stock options were attributable to a particular source, the question of apportionment would not arise.

Mr Chiu explained that benefits from restricted shares granted to an employee, subject to time basis apportionment of his assessable income, would also be apportioned. The apportionment method, based on the days in Hong Kong in the year of assessment in which vesting took place, was explained at paragraphs 63 and 64 of DIPN 38.

Mr Chiu further explained that for inbound or outbound employees having a non-Hong Kong employment, the apportionment method for share awards was further refined to take into account the days in the vesting period before transferred to or transferred outside Hong Kong. Reference was made to Examples 12 and 13 at paragraphs 66 and 67of DIPN 38.

Mr Chiu summarised that where an employee changed from a Hong Kong employment to a non-Hong Kong employment or vice versa, the stock awards would also be split into two portions, one attributable to the period of Hong Kong employment and the other attributable to the period of non-Hong Kong employment.

**(b) 60-day exemption**

Section 8(1A)(b)(ii) provides exemption from salaries tax in respect of income derived from services rendered by a person who renders outside Hong Kong all the services in connection with his employment. In determining whether or not a person renders all services outside Hong Kong, section 8(1B) provides that no account shall be taken of services rendered in Hong Kong during visits not exceeding a total of 60 days in the basis period for the year of assessment. (This exemption is commonly known as the "60-day exemption".) The Institute would like to seek the IRD's clarification on its general practice in applying the 60-day exemption in cases involving a change of employment during the year of assessment. For example, an employee may have visited Hong Kong during a year of assessment, spending a limited number of days here (i.e., not exceeding 60 days) under an employment. He then returns to Hong Kong to take up another employment. In these circumstances, the Institute would like to know the IRD's view in respect of the tax position of the employee for that year of assessment, and what factors would need to be considered in determining the employee's tax position.

Mr Chiu advised that in Decision *D30/03*, the Board of Review explained that section 8(1B) provided a statutory relief that exempt a person from salaries tax in circumstances where that person's connection with Hong Kong during the tax year was not significant and could be disregarded for assessment purposes. Per the decision, section 8(1B) did not refer to "visits not exceeding a total of 60 days in the basis period for the year of assessment for each separate employment" but to "visits not exceeding a total of 60 days in the basis period for the year of assessment". Further, in *So Chak Kwong v. CIR* 2 HKTC 174, Mortimer J (as he then was) said that the words "not exceeding a total of 60 days" qualified the word "visits" and not the words "services rendered" in section 8(1B).

### (c) Implication of Board of Review case D45/09

The Institute would like to seek the IRD's view on the decision of the Board of Review in the case D45/09. Specifically, the Board in that case reached a conclusion that transit days in Hong Kong would be regarded as days "present in Hong Kong" for the purpose of section 8(2)(j) (which provides exemption from salaries tax in respect of income derived from services rendered as master or member of the crew of a ship, or as commander or member of the crew of an aircraft, who was present in Hong Kong on not more than (i) a total of 60 days in the basis period for that year of assessment; and (ii) a total of 120 days falling partly within each of the basis periods for two consecutive years of assessment, one of which is that year of assessment.) The Institute would like to know if the IRD would consider granting any administrative interpretation/ concession to avoid transit days, where a person may be present in Hong Kong for a few hours only, from being counted towards the 60 or 120 days.

Mr Chiu advised that the IRD agreed with the interpretation of the Board of Review regarding section 8(2)(j). The provision was clear and unambiguous and transit days should be counted as days present in Hong Kong. The IRD would assess air crew or sea crew to salaries tax according to the decision. Ms Macpherson said that it would be difficult to take advantage of the exemption and asked whether the IRD would be prepared to give an administrative concession. CIR replied that he did not see any grounds for doing so.

**Agenda item A3 - Cross-border tax issues**

**(a) Discussion with State Administration of Taxation ("SAT")**

Questions regarding double taxation of income in Hong Kong and Mainland China (e.g., bonus income) were raised in previous annual meetings (2007 agenda item A2(b); 2009 agenda item A4(d); and 2010 agenda item A4(d)(ii)). The IRD indicated that, where sufficient data on actual cases is available, it would consider raising the issue in its annual meeting with the SAT. In this connection, the Institute would like to ask if the IRD could give an update on the discussions with the SAT.

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| CIR advised that the IRD had already raised this issue with the SAT during the annual meeting in November 2010. The SAT was fully aware of the cases of double taxation of bonus income and was considering possible measures to rectify the situation. |

**Agenda item A4 - Double tax agreements**

**(a) Application of treaty provisions and domestic anti-tax avoidance rules by treaty partners**

Hong Kong has recently signed comprehensive double tax agreement/ arrangement ("CDTA") with numerous countries that provide for reduced withholding tax rates on passive incomes and/ or tax exemption on capital gains from disposal of shares in certain circumstances. However, most of these CDTAs also include, in the dividends/ interest/ royalties articles, a provision that requires the recipient of such incomes to be the beneficial owner of the incomes and a limitation of benefits clause that denies the benefits of the relevant article if the main purpose of any person concerned …… was to take advantage of that article. In addition, contracting parties may also apply their domestic laws and measures concerning tax avoidance to deny treaty benefit.

As a result, the contracting parties' interpretation of "beneficial owner" and application of their domestic anti-treaty shopping rules would affect whether Hong Kong residents are eligible for the treaty benefits under a given CDTA. For example, Mainland China has set out its rules on assessing beneficial ownership for the purpose of claiming a treaty benefit under the passive income articles in Guoshuihan [2009] No. 601 and Indonesia has issued a series of anti-treaty abuse regulations that impose various requirements (e.g. a requirement for the claimant to have substance) for enjoying a treaty benefit under an Indonesian treaty.

In this regard, the Institute would like to know the following:

(i) While the Institute understand there may be differences in the interpretation of these anti-treaty shopping rules, the Institute would like to seek clarification from the IRD on its interpretation of "beneficial ownership".

CIR advised that whilst Hong Kong was a common law jurisdiction and the term "beneficial ownership" had a narrow technical meaning in the domestic law, many of Hong Kong's treaty partners would interpret the term in the context of a tax treaty the object and purposes of which included the avoidance of double taxation and the prevention of fiscal evasion. Generally, the "beneficial ownership" limitation would exclude: mere nominees or agents who were not owners of the income; and conduits who, though formal owners of the income, had very narrow powers over the income or did not have the full privilege directly to benefit from the income which rendered the conduits a mere fiduciary or administrator of the income. CIR referred members to the Commentaries on Article 1 of the OECD Model Tax Convention (July 2010 edition).

CIR added that apart from those positions which Hong Kong had stated in the Model Tax Convention, Hong Kong would generally follow OECD's Commentaries and interpretation elaborated in the Model Tax Convention.

(ii) Whether the IRD has any plan to seek the views of the existing contracting parties on their application of the domestic anti-avoidance/ anti-treaty shopping rules in order to provide greater certainty to Hong Kong taxpayers; and whether the IRD would address this issue in future CDTA negotiations.

CIR advised that the IRD would seek the views of existing CDTA partners on the application of domestic anti-avoidance/anti-treaty shopping rules as and when the circumstances warranted.

CIR remarked that each treaty had, as one of its main purposes, the prevention of fiscal evasion, and jurisdictions were more than ever adamant to avoid any double non-taxation brought about or facilitated by the treaties in a bid to protect the tax dollars. There were also sovereign issues sometimes. So the IRD would endeavour to clarify the domestic anti-avoidance/anti-treaty shopping rules in its future CDTA negotiations (the IRD had been doing this for some time in recent negotiations), but there were obvious limitations in what could be done in this respect.

Mr Tam noted that, for a special purpose vehicle established by a Hong Kong company for investments held in the Mainland, the Mainland seemed to have adopted a narrow view in the interpretation of "beneficial ownership" which operated to deny the treaty benefits under the CDTA. CIR said that the SAT had to act cautiously to avoid abuses. However, they were aware of the problem and were reconsidering the issue.

**(b) Attributing profits to a permanent establishment in Hong Kong of a non-resident**

In determining the source of a profit for Hong Kong profits tax purpose, the broad guiding principle is to see what the enterprise has done to earn the profits in question and where the profit-producing operations have been performed. The IRD has also laid down specific sourcing rules for different types of income in revised DIPN 21. For example, apportionment is possible for service fee income (paragraph 46 of DIPN 21) and trading profit is totally sourced in Hong Kong if either the contract of purchase or contract of sale is effected in Hong Kong (point (c), paragraph 23 of DIPN 21).

If a foreign person has a permanent establishment ("PE") in Hong Kong but its financial statements do not disclose the true profits arising in Hong Kong, Inland Revenue Rule 5 ("IRR 5") sets out a general method of determining the Hong Kong sourced profits of such PE by applying the worldwide profit margin to the Hong Kong turnover (worldwide profit margin method).

When the foreign person is a tax resident of a jurisdiction with which Hong Kong has a CDTA, the position taken in DIPN 46 is to consider the general principle adopted by the OECD for attribution of profits to a PE/ transfer pricing purpose, that is to look at primarily the risks and functions taken by the enterprise/ PE in question. Paragraph 32 of DIPN 46 further elaborates that *"when assessing the profits of the permanent establishment of a non-resident enterprise, the Commissioner will examine the separate sources of profit that the non-resident enterprise has derived from Hong Kong"*

In this regard, the Institute would like to seek clarifications of the interaction between the Hong Kong source rule and the OECD profit attribution rule in the following situations:

(i) When the profit of an entity in a CDTA contracting state is derived partly through its PE in Hong Kong (for example service fee income), the profits attributable to the PE should be determined according to the OECD profits attribution rules. What is the IRD's view on this?

Mr Wong advised that where a person had a PE in Hong Kong, the profit of that PE would be assessed in accordance with Rule 5(2) of the Inland Revenue Rules (“IRR”). According to Rule 5(2)(a) of the IRR, where the person kept accounts for his PE in Hong Kong in such a way that his true profits arising in or derived from Hong Kong could be readily ascertained from those accounts, his assessment to profits tax would be computed by reference to the profits disclosed in those accounts. Rules 5(2)(b) and (c) of the IRR further provided that where the person's accounts did not disclose the true profits arising in or derived from Hong Kong, his tax liability would be computed by reference to his total profits wherever made after necessary adjustments in accordance with the IRO. Where it was impracticable or inequitable to do so, Rule 5(2)(d) provided for the computation of profit on a fair percentage of the turnover of the person in Hong Kong.

Mr Wong explained that Article 7(2) of the OECD Model Tax Convention on Income and on Capital (“the OECD Model”) stated that the profits that were attributable to the PE in each contracting state were the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, as if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the PE and through the other parts of the enterprise.

Mr Wong further explained that in principle, the PE in Hong Kong should make up its accounts and report the profits according to the arm’s length principle endorsed by the OECD Model. Thus if a profit of the PE as shown in its accounts was derived from Hong Kong, the profit would be fully charged to profits tax and would not be reduced unless there was an upward profit reallocation adjustment by the tax administration of the other CDTA jurisdiction with which the Commissioner agreed both in principle and in amount. The obligation to provide relief was contained in the Methods for Elimination of Double Taxation Article [see paragraph 38 of DIPN 45].

(ii) A foreign stockbroker with head office located in a country having a CDTA with Hong Kong (e.g. Japan) has a branch in Hong Kong. The Hong Kong branch is responsible for performing marketing activities, taking orders from Hong Kong customers and managing the Hong Kong customer accounts, whereas the head office in the foreign country will execute transactions at the stock exchange in that foreign country based on customer orders received from the Hong Kong branch. Based on the principle laid down in the *ING Baring* case, the entire stock brokerage commission profits derived by the foreign head office will be of a non-Hong Kong source as the stock transactions are executed overseas. However, based on the OECD profit attribution rule, certain amount of commission profits should have been attributed to the Hong Kong branch based on the functions performed by it. In this example, will the IRD accept even if there are profits attributable to the PE in Hong Kong, such profits do not have a Hong Kong source?

Mr Wong advised that in the *ING Baring* case, the Court emphasized the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters. 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.

Mr Wong explained that if the head office of a non-resident enterprise earned profits with assistance of a PE in Hong Kong and the profits attributable to that head office were accepted by the IRD as offshore in nature, those profits would not be taxable. On the other hand, if the profits attributable to that PE in Hong Kong (e.g. as a service provider) arose in or were derived from Hong Kong, such profits should be taxable. The locality of profits of the head office and that of the profits of the PE in Hong Kong should be separately considered and could not be mixed up.

(iii) A foreign stockbroker with the head office located in a country having a CDTA with Hong Kong (e.g. Japan) has a branch in Hong Kong. The Hong Kong branch is responsible for buying/ selling Hong Kong listed securities but supporting functions are performed by the head office. Based on the OECD profit attribution rule, the commission profits that would have to be attributed to the Hong Kong branch should be based on the functions performed by it. In this example, will the IRD accept only the portion of commission profits attributable to the PE in Hong Kong and with a Hong Kong source, as determined according to DIPN 46, instead of the entire commission profits, is subject to profits tax in Hong Kong?

Mr Wong advised that there had been no change in the principle used to ascertain the source of a profit. The broad guiding principle was to see what the enterprise has done to earn the profits in question and where the operations have been performed. As mentioned above, if the profit of the Hong Kong branch was derived from Hong Kong, the profit would be fully charged to profits tax and would not be reduced unless the Commissioner was obligated to make a profit reallocation adjustment under the relevant CDTA. In other words, the full amount of profit reported in the accounts of the Hong Kong branch as stated in the question would be subject to profits tax in Hong Kong without reduction.

Ms Macpherson asked, whether there was inconsistent interpretation in the ascertainment of profit accrued to a PE in Hong Kong between the profit attribution rule where profit should be based on a functional analysis and that of the determination of profit per branch's accounts. Mr Wong explained that there should be no inconsistency because the profit attribution rule should have been adopted in the preparation of the branch accounts.

## (c) Hong Kong company claiming tax credit under a CDTA

Under Article 22 of the Hong Kong CDTAs:

"Subject to the provisions of the laws of … Hong Kong …tax paid in (the other jurisdiction) in accordance with the provisions of this Agreement…in respect of income derived …from sources in (the other jurisdiction) …shall be allowed as a credit against Hong Kong tax payable in respect of that income…"

It is noted that the above article is largely in line with the OECD model, except that the words "from sources" are added in the Hong Kong CDTAs. Where it refers to the same "source" concept in our domestic law, questions arise as to whether taxpayers could seek to claim a tax credit to eliminate double taxation given that Hong Kong does not impose tax on non-Hong Kong sourced profits. In this regard, the Institute would like to seek the IRD's guidance on the meaning of "sources" for the purposes of CDTA.

> CIR advised that the words "sources in [a Contracting Party]" referred to sources of income which were derived from the Contracting Party, e.g. the profits of a PE of a Hong Kong company established in that Party (which is sometimes referred to as the "source state"). It was different from the "source" concept under the territorial taxation system adopted by Hong Kong.
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> CIR further said, in fact, Hong Kong followed the "Elimination of Double Taxation" article (Credit Method) in the OECD Model Tax Convention (Article 23B). The use of the different language, viz. the addition of the words "from sources", would not affect the tax treatment in substance.
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> CIR explained that if a source of income from a Contracting Party was not subject to Hong Kong tax because its locality was outside Hong Kong, then of course no question of credit would arise in respect of the tax paid in that jurisdiction on that income. However, there would still be circumstances where a Hong Kong resident would be taxed in Hong Kong in respect of an income derived from and taxed in another jurisdiction.
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> CIR quoted an example that, Company H was a company incorporated and carried on trading business in Hong Kong. It sold goods to Country A through a representative office established therein. The profit attributable to this office would be regarded as sourced in Country A and subject to tax in Country A. On the other hand, the entire trading profit of Company H would most likely be subject to profits tax in Hong Kong based on the operations test. If there was a CDTA between Hong Kong and Country A, this representative office would be regarded as a PE in Country A and Company H would be able to claim tax credit in Hong Kong in respect of the tax paid on the same income in Country A.

**(d) Certificate of Hong Kong resident status for use in CDTA countries other than Mainland China**

The Institute understands different CDTA countries may have different practices for Hong Kong residents to claim tax benefits. At present, the forms available for corporate and individual taxpayers to apply for a certificate of Hong Kong resident status ("certificate") (i.e. Forms 1313A and 1314A) are specifically for applications made under the CDTA between Mainland China and Hong Kong. Given that the treaty network of Hong Kong is expanding and more CDTAs will become effective in future, it is likely that there would be more applications for a certificate made under CDTAs other than the one with Mainland China.

In this regard, the Institute would like to ask the following:

(i) Whether the IRD can obtain clarification from other CDTA contracting countries as to their operational requirements for accepting Hong Kong tax resident status for obtaining treaty benefits.

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| CIR advised that for the purpose of implementing the CDTAs entered into by Hong Kong, the IRD would liaise with the CDTA partners on details of the administrative procedures shortly before or after the agreements came into operation. These procedures would include certification of residency, which would vary from country to country. |

(ii) If it is necessary to have a certificate, whether the IRD will issue more generic forms for corporate and individual taxpayers to apply for a certificate under all CDTAs. If such generic forms are not made available, by what means can a taxpayer apply for a certificate under CDTAs other than the CDTA with Mainland China.

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| CIR advised that as more and more CDTAs were negotiated and concluded by Hong Kong, there were bound to be differences in the terms and conditions in the agreements concerning residency. For example, in the Hong Kong/Japan agreement, a company was a Hong Kong resident if it had “a primary place of management and control” (which was defined in the Protocol) in Hong Kong, while in the Hong Kong/UK agreement, a company incorporated outside Hong Kong was a Hong Kong resident if it was “centrally managed and controlled” in Hong Kong. On the other hand, in most of the agreements, a company incorporated outside Hong Kong was a Hong Kong resident if it was “normally managed or controlled” in Hong Kong. Therefore, it was not possible to have a generic application form that fitted all. The IRD’s plan was to provide, shortly before or after the relevant agreement came in force, specific forms for specific agreements for the taxpayers’ use. In the meantime, a taxpayer could make an application in writing to the Tax Treaty Section of the IRD giving full information on how it had fulfilled the requisite criteria for Hong Kong residency under the particular CDTA in question. |

[Post meeting note: The IRD announced on 13 July 2011 that with immediate effect, any application for a certificate of Hong Kong resident status under a comprehensive agreement for the avoidance of double taxation signed between Hong Kong and other jurisdictions (apart from the Mainland of China) has to be made on the standard form IR1313B (for a company, partnership, trust or other body of persons) or IR1314B (for individuals). The applicant is only required to provide basic and general information in the first place. After processing the application, the IRD might request further specific information if considered necessary.]

(iii) Generally, the jurisdictions with which Hong Kong has a CDTA would require taxpayers to furnish a certificate for claiming a treaty benefit. However, in some cases, the treaty country would require the taxpayer to (i) ask the IRD to put a stamp on a prescribed form; and/or (ii) ask the IRD to issue a letter confirming that the relevant Hong Kong entity has reported and paid taxes in Hong Kong. In this event, the Institute would like to ask if, normally, the IRD would accede to requests of this nature.

CIR advised that as explained in the reply to (i) above, the IRD would discuss the implementing arrangements with the CDTA partners. Depending on the outcomes of the discussion, the IRD would be in a position to stamp on any prescribed forms and/or issue the required confirmation letters to facilitate Hong Kong residents.

**(e) Claiming tax deduction or tax credit for foreign withholding tax**

As stated in DIPN 28, foreign withholding tax that is charged on the gross amount of income (e.g. interest or royalties) and incurred in the production of profits chargeable to Hong Kong profits tax would be allowed as a deduction under section 16(1). On the other hand, when there is a CDTA between Hong Kong and the jurisdiction from which such income is derived and withholding tax is levied, the CDTA would provide for a relief of double taxation for Hong Kong residents by means of a tax credit against the profits tax payable on such income.

Further, paragraph 6 of revised DIPN 44 on the CDTA between Mainland China and Hong Kong states that Hong Kong adopts the “preferential treatment” principle, i.e. where the comprehensive arrangement and the IRO contain different provisions relating to the same matter, preference will be given to the provisions that are most beneficial to taxpayers.

In the case where a CDTA exists, the Institute would like to seek clarification from the IRD on whether the above “preferential treatment” principle would apply, such that a taxpayer would be given a choice between claiming a tax deduction under section 16(1) and claiming a tax credit under section 50, whichever is more beneficial to the taxpayer.

Mr Wong said the simple answer was yes. Hong Kong adopted the “preferential treatment” principle. Preference would be given to the provisions that were most beneficial to taxpayers.

**(f) 183-day exemption from Hong Kong salaries tax**

It is mentioned in the recent Guoshuifa [2010] No. 75, ("Circular 75") concerning Mainland China/ Singapore CDTA that an individual would qualify as a tax resident of Mainland China for CDTA purpose if he spends one full year in the Mainland. Circular 75 is used to determine whether an individual is a tax resident of Mainland China in the context of other CDTA which has similar article.

The Institute would like to seek the IRD's view as to whether the IRD would accept the 183-day exemption claim lodged by an individual in his Hong Kong individual tax return (as a tax resident of Mainland China), where the individual is a Hong Kong permanent identity card holder who:

(i) is employed by a company located in the Mainland;

(ii) lives with his family in the Mainland;

(iii) obtains a tax resident certificate from the Chinese local tax bureau by reason of staying one full year in the Mainland (but less than five consecutive full years and therefore is not subject to Mainland China individual income tax on his worldwide income); and

(iv) fulfilled the three conditions under the 183-day exemption for employment income in Hong Kong.

Mr Chiu advised that whilst the IRD had taken note of Guoshuifa [2010] No. 75 concerning the CDTA between the Mainland and Singapore, it might not be appropriate for the IRD to make any comments on it.

Mr Chiu explained that in practice, the IRD would not readily accept the 183-day exemption claim lodged by an individual in his Hong Kong Individuals Tax Return and that the taxpayer was a tax resident of the Mainland. The IRD would examine other relevant factors to decide whether the individual could also be regarded as a Hong Kong resident, e.g. he was still ordinarily residing in Hong Kong. If the individual was a resident of both Hong Kong and the Mainland, the tie-breaker rule would be applied to decide ultimately whether the individual was a Hong Kong or Mainland resident.

### (g) Tax credit under Hong Kong salaries tax

It is mentioned in paragraph 114 of DIPN 44 that a tax exemption claim under section 8(1A)(c) generally provides greater tax relief than that provided by tax credit under CDTA.

The Institute requests the IRD to consider illustrating this with numerical examples comparing the tax relief under section 8(1A)(c) with a tax credit. The first example could illustrate where a section 8(1A)(c) claim is more favourable than tax credit and the second example, where a tax credit is more favourable than a section 8(1A)(c) claim.

Mr Wong referred to Agenda Item A4(d) of the 2009 minutes and advised that a similar question was raised in the 2009 meeting. As explained, it would be difficult for the IRD to offer taxpayers suggestions since the facts of each case could be complex with different permutations.

Mr Wong explained that generally, if a taxpayer made a claim under section 8(1A)(c) instead of a tax credit under section 50, he would continue to be granted basic and other allowances in full against his assessable income (after excluding the income derived from an overseas jurisdiction in which foreign tax had been imposed) which was subject to lower marginal rates. In Example 6 at paragraph 132 of DIPN 44, if the individual lodged a claim under section 8(1A)(c), income derived by him from services rendered in the Mainland, which had been subjected to Individual Income Tax, would be excluded from his assessable income. Since the net assessable income (i.e. assessable income after deduction of expenses) was smaller than his personal allowance, the individual would not be subject to salaries tax.

CIR concluded that despite the fact that apparently the exemption under section 8(1A)(c) would produce a favourable result in most cases, a taxpayer still had the option to choose which tax relief was to be pursued to his best advantage under different circumstances.

### (h) Mutual agreement procedures under a CDTA

In agenda item A4(c) of the 2010 minutes, the IRD provided some examples of cases where a request for MAP would be justified. In this regard, the Institute would like to ask:

(i) If the IRD has processed any request for a MAP.

(ii) If so, the nature of the MAP involved.

> Mr Wong advised that the IRD had not processed any request for a MAP at this stage. In reply to a question from Ms Macpherson, Mr Wong replied that a Hong Kong resident had to demonstrate that the actions of one or both of the contracting parties result or would result in taxation not in accordance with the provisions of the CDTA before the IRD could start MAP with the competent authority of the other contracting party.

Further, the Institute would like to seek the IRD's view on the following situation:

(iii) A Hong Kong taxpayer ("HKCo") has sought an advance ruling from the IRD on the transfer price in respect of transactions with its group entity residing in a jurisdiction with which Hong Kong has signed a CDTA (say the Mainland, "PRCCo"). PRCCo then requests an advance pricing agreement ("APA") with the Mainland tax authority regarding HKCo-PRCCo transactions. If the outcome of the APA deviates from the advance ruling made by the IRD, the Institute would like to ask if the IRD would accede to a MAP request made by HKCo.

> Mr Wong advised that a contracting party had to ascertain whether there was a prima facie or justifiable case before entertaining a request for MAP under a CDTA. A person could only request for MAP if the actions of one or both of the contracting parties resulted or would result for him in taxation not in accordance with the provisions of the CDTA.
>
> Mr Wong explained that paragraph 64 of DIPN 45 (Relief from Double Taxation due to Transfer Pricing or Profit Reallocation Adjustments) set out the circumstances in which the Commissioner would not consider there was a justifiable case for MAP.
>
> Mr Wong further explained that in the circumstances mentioned by the Institute, the IRD did not consider that there was a prima facie case for MAP as it was premature to conclude there would be taxation not in accordance with the provisions of the CDTA simply because the outcome of the APA deviated from the advance ruling made.

(iv) It is noted that the Japan DTA and Luxembourg protocol have specified articles for arbitration. The Institute requests IRD to provide more details of the mechanism and whether arbitration articles will be included in future CDTAs.

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| Mr Wong advised that the OECD in its Model Tax Convention issued in July 2008 introduced the arbitration provisions and it was now an international trend to adopt these provisions. These provisions would be adopted in the CDTAs if Hong Kong and its treaty partners both considered it desirable and appropriate to do so. The OECD Model Tax Convention contained a sample agreement for implementing the arbitration provisions, which would form the basis of the IRD's negotiation with Hong Kong's treaty partners. CIR said that, currently, three of Hong Kong's CDTAs contained arbitration provisions. |

## Agenda item A5 - Departmental policy and administrative matters

### (a) Employer's withholding obligation under Hong Kong salaries tax

An employer is required to comply with the withholding requirement under section 52(7) to withhold from making any payment of money or money's worth to or for the benefit of the employees who are about to depart from Hong Kong, for a period of one month from submitting the notice required under section 52(6) (which is the Form IR56G). In relation to this, the Institute would like to clarify the following:

In the case where the employees would exercise stock options or be vested with restricted shares within the one month withholding period, it would be difficult for the employers to comply with the withholding requirement because (i) there is no payment of cash by the employer to the employees and (ii) the transactions of exercise and vesting would be handled directly by intermediates such as banks and brokerage houses. As there is no payment by the employer to the employee, would the IRD accept and/ or agree that the employer is not required to comply with the withholding requirement on the income derived from the stock option exercised or restricted shares vested in these circumstances? If not, can the IRD provide any practical suggestions to the employer for complying with the withholding requirement?

Mrs Lai advised that section 52(7) applied to situations where there was a “payment of money or money’s worth”. It was not restricted to the payment of cash by the employer. The act of payment should not be narrowly interpreted so as to limit it to direct cash payment. If an employer instructed or caused a payment to be made, it was a payment within section 52(7) e.g. an employer instructed the banker to make a payment to the employee.

Mrs Lai explained that section 52(7) did not impose a withholding tax on the payment to be made to the employee. It simply required the employer not to make any payment for a period of one month from the date of the notice given under section 52(6). Section 52(7) provided a mechanism which ensured that the taxes of the employee who was about to leave Hong Kong upon cessation of employment would be settled before his departure.

Mrs Lai suggested that the practical suggestions were: not to make any payment (in money or money’s worth) and not to cause any payment to be made to the employee for a period of one month from the date of the notice given under section 52(6); provide full details of the remuneration to be given to the employee in an IR56G, including share options and share awards, whether vested or not; payment could only be made within one month if a letter of release had been issued by the IRD.

Mrs Lai remarked that in DIPN 38, the reporting requirements on an employer were explained in paragraphs 79 to 83.

The obligation under section 52(6) applies before employees have left Hong Kong. There is no obligation to make a notice under section 52(6) if an employee has already left Hong Kong. If an employer had already complied with the withholding requirement ("the first withholding") upon submitting the Form IR56G in the previous tax year for a departed employee, and is going to file an additional Form IR56G to report the further income payable to the departed employee in the current tax year, it is understood that the IRD requires the employer to withhold the additional income upon submitting the subsequent Form IR56G ("the second withholding"). Legally there is also an argument that there is no statutory obligation for the employer to provide another notice under section 52(6) (using Form 56G) in this case, as the employee has already left. As such there will be no withholding obligation for the employer under section 52(7), as there is no notification under section 52(6). It would appear that the withholding requirement under section 52(7) will only apply when the first Form IR56G is filed, but not that when the additional Form IR56G is to be filed, even if Form 56G is used.

Would the IRD clarify the legal obligation of employers under section 52(6) and section 52(7) in this situation and confirm that employers will still be indemnified under section 52(7) by the IRD, in the event of any proceedings against them for failure to make payment to or for the benefit of the employees concerned during the period of the second withholding?

Mrs Lai advised that as explained above, section 52(7) did not impose a withholding tax. Provisions in section 52(7) would apply if the employer had ceased or was about to cease to employ an employee who was about to leave Hong Kong. Prima facie, section 52(7) would be inapplicable one month after the date on which the first notice under section 52(6) was given in respect of the employee.

Mrs Lai explained that section 52(7) contained no provision on indemnity as claimed. It only provided that compliance with this subsection would constitute a defence in any proceedings against an employer in respect of his failure to make any payment to or for the benefit of the individual during the one-month period.

Mrs Lai further explained that in cases where an amended IR56F or IR56G form was filed in respect of the cessation year (year in which share awards were deemed to have accrued under section 11D(b)(ii)) or where a subsequent IR56B was filed in respect of a year of assessment after the cessation year (year in which stock option was exercised or assigned), the employer should take note that the relevant additional assessment or assessment would be raised with a very short or immediate due date for payment and recovery action would be taken promptly under section 76. An employer who complied with a notice issued under section 76(1) would be indemnified under section 76(2).

Mrs Lai pointed out that section 76 applied to situations where the employee had quitted Hong Kong or the employee was likely to quit Hong Kong without paying his taxes.

**(b) Whether a holdover of the provisional tax can be made based on a later issue or payment dates of a revised section 64(3) assessment**

Under sections 63E/J/O, a taxpayer may apply for holdover of the provisional salaries/ profits/ property tax on the grounds stipulated in those sections, on or before the specified dates. The specified date is the later of:

(i) 28 days before the day by which the provisional tax is to be paid; or
(ii) 14 days after the date of the notice for payment of provisional tax.

The following example is used to illustrate this question. An assessment of HK$10,500,000 was issued and the taxpayer objected to the assessment on the grounds that HK$500,000 being disallowed by the assessor was wrong. As a result of the objection, final tax and the provisional tax related to the item in dispute of HK$500,000 were held over. Subsequently, the assessment was revised under section 64(3) to HK$10,000,000, as the assessor agreed with the taxpayer that the item of HK$500,000 should be an allowable deduction. The revised assessment was issued with final tax and provisional tax demanded on the now revised assessable profit of HK$10,000,000, and the payment dates for the taxes demanded were later than those specified in the original assessment.

The Institute would like to clarify whether the taxpayer can now make a holdover claim based on the later issue or tax payment dates, as specified in the revised assessment, on grounds other than that the assessment is under objection. For example, can the taxpayer now claim for holdover of the provisional tax as demanded by the revised assessment, on the grounds that its estimated assessable profit for the following year is less than 90% of HK$10,000,000 - if the time limit for a holdover claim based on the original assessment has now lapsed?

> Mrs Lai advised that if taxpayers had other grounds to apply for holdover of provisional tax, they should lodge additional holdover claims within the stipulated time rather than waiting for the settlement of their objections. Normally, the IRD did not adjust the due date for payment of the provisional tax when revising an assessment. For purposes of sections 63E/J/O, the date of the original notice for payment of the provisional tax was taken to be "the date of the notice for payment of provisional tax".

**(c) Advance ruling**

Tax representatives note that the IRD is generally very reluctant to give rulings except in very clear cut cases. This is particularly so for ruling applications on capital verses revenue treatments. The Institute considers that this is against the main objectives of the advance ruling service, which are to provide taxpayers with a degree of certainty, promote consistency in the application and minimise disputes between the IRD and taxpayers. These objectives are stated in DIPN 31, with which the Institute agrees.

For ruling applications on capital verses revenue treatments, the IRD often declines to give rulings on the grounds that the applications require the commissioner to determine or establish any question of fact. DIPN 31 makes it clear that the commissioner may decline to make a ruling if the application seeking the ruling would require the commissioner to determine or establish any question of fact. However, the Institute understands that the IRD has declined to rule on the treatment of capital or revenue based on a set of facts stated. It is understood that the tax authorities in other jurisdictions, such as Canada, will give advance rulings on capital versus revenue transactions.

The Institute requests the IRD to clarify its position on this issue.

Mr Wong advised that the perception that the IRD was reluctant to give rulings except in very clear cut cases was not correct. In 2010, the IRD declined only one case where the application involved an issue on capital vs revenue, which was a minor percentage of the overall number of such applications. Although ruling applications invariably contained descriptions of the related facts, very often such descriptions were insufficient for the Commissioner to give a ruling. Ascertainment of facts in, for example, property dealing cases was a long process. Schedule 10 paragraph 2(a) of the IRO clearly stated that the Commissioner may decline to make a ruling if the application required the Commissioner to determine or establish any question of fact. It was inappropriate to compare Hong Kong with other tax jurisdictions.

CIR added that there was no policy to decline applications for a ruling on issues concerning capital vs revenue. Ms Macpherson agreed that tax practitioners should endeavour to provide full facts of the case in order to enable the IRD to make a ruling.

**(d) Timing of issuing the sample tax return**

Currently, profits tax returns are issued to taxpayers at the beginning of April each year in general. In addition, a sample profits tax return, as well as the information about the major changes to the return (if any) for the given year of assessment are posted on the IRD's website around the same time.

It takes time for the tax representatives and their clients to get familiar with the changes to the tax return and in some cases to integrate their tax compliance software with the new design. In order to expedite the return filing for the "N" Code taxpayers within one month from issuance, the Institute would like to ask whether the IRD could issue the sample tax return, together with the explanatory note to the return earlier, say one month before the issue of tax returns in early April each year. This would help improve the efficiency for completing the tax returns for "N" Code taxpayers.

Ms Lee advised that in order not to cause confusion to the public, the sample tax return on IRD's website should be the version in use. To enable tax representatives to get familiar with the changes, the IRD would send, in early March, samples of tax returns (BIR 51 and BIR 52 forms) together with the notes and instructions in pdf format, to those who have registered for email service with the IRD via emails. However, where tax representatives had questions regarding the changes, they should raise these after the new sample tax return is uploaded to the IRD's website.

CIR further advised that tax representatives who have registered for email service with the IRD, and most have now done so, would receive notifications through emails about "What's New" on the IRD's website.

**(e) On-line forms/filing**

The Institute would like to ask:

(i) Whether the IRD could simplify the filing procedures for various forms, e.g. allowing the use of standard on-line forms, which the taxpayer can print off and sign, or where the taxpayer is permitted to sign on a scanned copy. On tax assessments, the Institute would like to ask if they could be made available on-line for the taxpayers or their representatives.

> Mrs Chu advised that over 100 public forms and pamphlets under 12 categories were now downloadable from the IRD website. If registration for *eTax* service had been made, salaries tax assessments on individuals taxpayers would also be made available on-line to the taxpayers but not to their representatives. For taxpayers other than individuals, there was no plan yet to issue assessments on-line.

(ii) When the next phase of the e-corporate tax filing will be rolled out and what feedback there has been from the first phase.

> Mrs Chu advised that the e-corporate tax filing system had been in place for less than a year. The IRD had received about 700 electronic profits tax returns since 1 April 2010. There was no particular feedback from the users. Taking this opportunity, the IRD would like to appeal to the Institute to encourage its members to make more use of the electronic filing system. Any feedbacks were also welcomed.
>
> Mrs Chu pointed out that the IRD would undertake a massive system infrastructure enhancement project in the coming few years. The IRD had no definite plan for the next phase of e-filing for profits tax return for the time being.
>
> Ms Macpherson said the major obstacle that prevented tax representatives from using the electronic filing system was that a tax representative was not allowed to use its own log-in ID to submit the tax returns on behalf of its clients. Mrs Chu replied that it would not be possible to cater for submission of tax returns in this manner without changing the law.

**(f) Time required for reviewing taxpayer's tax returns**

Following the judicial review case Yue Yuen Marketing Company Ltd & Ors v CIR, the Institute would like to seek the IRD's view on what would be considered a "reasonable" time for determining an objection. On a related matter, the Institute would like to suggest that the IRD consider including in its performance pledges the standard/ target time for responding to taxpayers' replies to the IRD's enquiries and for settling disputes.

CIR advised that what was a reasonable time for determining an objection by the Commissioner must be considered in the light of all the circumstances: see *Nina T.H. Wang v. CIR* (1994) 4 HKTC 15 at p. 24 and the *Yue Yuen* judgment itself at para. 48 [HCAL 49/2009]. It was thus impracticable to set down rigid rules for ascertaining what constituted a reasonable time in all possible cases. While the IRD always aimed at processing objections in an efficient and effective manner, this could only be achieved with the cooperation of the taxpayer and his/her representative in providing any further information requested by the Assessor. At present, the IRD's performance pledge already covered replies to notices of objection and processing of objections.

**(g) Block extension for filing salaries tax returns**

The Institute would like to ask if the IRD would consider one of the following options in order to ease the administrative burden of processing monthly extension request for filing salaries tax returns:

(i) Extended block extension – The current block extension scheme extends the time to July 2 for filing forms BIR60. A longer period of time to file the returns would mitigate the need to process additional extension requests.

Mr Wong advised that at the time of completion of his Individuals Tax Return, the taxpayer should have received one copy of the employer's return of remuneration and pensions. Therefore, completion of the Individuals Tax Return, which only involved salaries tax matters, should be relatively simple and straightforward. As a result, it had always been the policy of the IRD not to grant a long period of extension. For represented cases not involving sole proprietorship business accounts, a block extension would be granted to end of June or early July. For those involving sole proprietorship business accounts (irrespective of accounting date), extension would be granted to end of September or early October. The IRD wished to state that it did not have much room to manoeuvre as any further extension would have adverse impact on its assessment and collection programme.

(ii) Subsequent block extension – Currently a single block extension request can be filed by tax practitioners. Further extensions have to be filed individually. A second block extension would mitigate the number of individual extension requests to be processed.

Mr Wong advised that unless there were exceptional circumstances e.g. the taxpayer was in serious illness, no further extension would be allowed. Requests for further extension for filing an Individuals Tax Return would be considered on a case by case basis. A subsequent block extension would not be acceded to.

(iii) Individual extension for multiple months – Currently an individual extension request is generally limited to 30 days. Extending the period of time covered by such an extension request would mitigate the number of extension requests that have to be processed by the IRD.

> Mr Wong advised that since it had not been the intention of the IRD to grant a long extension of time for filing an Individuals Tax Return, requests for an extension of time which exceeded 30 days would not be considered.

**(h) Filing of employer's returns**

It is understood that an employer has to file an IR56B annually for its employees. This includes employees working outside Hong Kong. In addition, the IRO also requires an employer to file an IR56G (and withhold payments) when an employee leaves Hong Kong for more than one month, unless the individual is required in the course of his employment to leave Hong Kong at frequent intervals.

Where an employee is posted overseas and remains an employee of the Hong Kong company, the Institute would like to clarify whether an IR56G (and withholding of payments) is required, or whether an annual IR56B is sufficient. The Institute believes the latter should be sufficient as the individual should be considered as leaving Hong Kong in the course of his employment, but would like to seek the IRD's confirmation of this.

On a related question, if an employee is entitled to treaty benefits under the CDTA between Hong Kong and another jurisdiction, e.g. (a) he is present in Hong Kong for not more than 183 days in any 12-month period, (b) the remuneration is not paid by an employer resident in Hong Kong, and (c) the remuneration is not borne by a permanent establishment which the employer has in Hong Kong, the Institute would like to ask if the employer and employee are required to file employer's return/ individual tax return.

> Mr Chiu advised that in the first case, if the employee posted overseas remained an employee of an employer in Hong Kong, an annual IR56B had to be filed, and this alone would be sufficient.
>
> Mr Chiu explained that in the second case, the employer and the employee were required to file the employer’s return/Individuals Tax Return respectively. The employer’s return was required because the employer was not in a position to ascertain whether the employee was really exempt from Hong Kong tax, e.g. the employee might be regarded as a Hong Kong resident by the Hong Kong Competent Authority under the terms of the relevant CDTA. The Individuals Tax Return was required because of the same reason. In addition, where the employee wanted to make a claim for a tax credit under section 50(9), he would have to do so on the Individuals Tax Return for the relevant year of assessment.

## (i) Lodgment of tax returns and filing deadlines for 2010/ 2011

The Institute would be interested to know the latest statistics on the filing of tax returns and the filing deadlines for 2010/ 2011.

Ms Lee point out that as shown in Table 1, the IRD issued more returns in the 2009/10 bulk issue exercise than in the previous years. Table 2 showed the filing position for the files under different accounting codes. Table 3 showed the progressive filing results. The overall performance was disappointing. Compared with 2008/09, the lodgement rates for both "M" code and "D" code returns by the respective deadlines dropped. Tax representatives were urged to improve their performance. Table 4 was a comparative analysis of compliance with the block extension scheme.

<u>Bulk Issue of 2010/11 Profits Tax Returns</u>

Ms Lee advised that the bulk issue of 2010/11 Profits Tax Returns for "active" files would be made on 1 April 2011. The extended due dates for filing 2010/11 Profits Tax Returns would be:

| Accounting Date Code | Extended Due Date | Further Extended Due Date if opting for e-filing |
|---|---|---|
| "N" code | 3 May 2011 (no extension) | 17 May 2011 |
| "D" code | 15 August 2011 | 29 August 2011 |
| "M" code | 15 November 2011 | 29 November 2011 |
| "M" code – current year loss cases | 31 January 2012 | 31 January 2012 |

## PART B - MATTERS RAISED BY THE IRD

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

Mrs Lai advised that Table 1 in Appendix B was complied to illustrate the specific problem areas detected in corporations with tax audits completed during the year ended 31 December 2010. Comparative figures for the years 2008 and 2009 were included.

Field Audit teams uncovered discrepancies in 272 corporation cases, of which 235 carried clean auditors' reports. Amount of discrepancies detected in the clean report cases accounted for 93% (2009: 94%) of the total discrepancies detected in the year 2010 and total tax of $980 million was recovered from these cases. Average understatement per clean report case was $25.7 million (2009: $13.5 million) while tax undercharged per clean report case was $4.2 million (2009: $2.1 million).

Mrs Lai further said that, in 2010, there was a significant increase in discrepancies detected under the category of offshore income/profits disallowed. Other major discrepancies were found in understatement of gross profits and technical adjustments. In the majority of cases, the discrepancies were detected after examining the business ledgers and source documents.

Table 2 in Appendix B showed a case where it was considered that the auditor of the taxpayer should have detected the irregularities through its statutory audit.

**Agenda Item B2 - Date of Next Annual Meeting**

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

## PART C - ANY OTHER BUSINESS

The Institute informed the IRD that it had set up a Mainland tax subcommittee under the taxation committee in late 2010. The subcommittee's remit was to consider developments in Mainland taxation that could have an impact on Hong Kong businesses and individuals and to establish contacts to liaise with Mainland tax authorities. In view of this development, the Institute requested the IRD to consider inviting views from the Institute when the IRD consulted stakeholders on issues discussed, or for future discussion, at the IRD's periodic meetings with the SAT.

CIR said that the meetings between the IRD and the SAT were essentially technical discussions between the competent authorities. However, where circumstances permitted and it was appropriate to do so, the IRD would be quite prepared to seek views from the taxation committee on matters arising from, or relating to, those discussions.

# Lodgement of Corporations and Partnerships Profits Tax Returns

**Table 1**
**Lodgement Comparison from 2007/08 to 2009/10**

| | Y/A 2007/08 | Y/A 2008/09 | Y/A 2009/10 | Comparison 2008/09 and 2009/10 |
|---|---|---|---|---|
| 1. Bulk issue (on 1 April) | 155,000 | 158,000 | 164,000 | 4% |
| 2. Cases with a failure to file by due date:- | | | | |
| 'N' Code | 1,900 | 1,600 | 1,800 | 13% |
| 'D' Code | 4,600 | 4,900 | 4,100 | -16% |
| 'M' Code | 10,600 | 8,300 | 8,300 | 0% |
| | 17,100 | 14,800 | 14,200 | -4% |
| 3. Compound offers issued | 7,200 | 5,400 | 5,100 | -6% |
| 4. Estimated assessments issued | 6,550 | 5,800 | 5,200 | -10% |

**Table 2**
**2009/10 Detailed Profits Tax Returns Statistics**

| | 'N' | 'D' | 'M' | Total |
|---|---|---|---|---|
| Total returns issued | 18,000 | 50,000 | 96,000 | 164,000 |
| Failure to file on time | 1,800 | 4,100 | 8,300 | 14,200 |
| Compound offers issued | 600 | 1,700 | 2,800 | 5,100 |
| Estimated assessments issued | 600 | 1,600 | 3,000 | 5,200 |

**Table 3**

**Represented Profits Tax Returns - Lodgement Patterns**

| Code | Lodgement Standard | Actual Performance 2009/10 PTRs | 2008/09 PTRs |
|---|---|---|---|
| D - 16 August | 100% | 81% (1) | 82% |
| M - 31 August | 25% | 11% | 12% |
| M - 30 September | 55% | 17% | 18% |
| M - 1 November | 80% | 35% | 36% |
| M - 15 November | 100% | 80% (2) | 83% |

(1) 35% lodged within a few days around 16 August 2010 (34% lodged within a few days around 15 August 2009 for 2008/09 PTRs)

(2) 32% lodged within a few days around 15 November 2010 (32% lodged within a few days around 16 November 2009 for 2008/09 PTRs)

**Table 4**

**Tax Representatives with Lodgement Rate of less than 80% of 'M' code Returns as at 15.11.2010**

1,552 T/Rs have 'M' Code clients. Of these, 701 firms were below the average performance rate of 80%. An analysis of the firms, based on size, is:-

| | | Current Year Performance | | | | Last Year Performance | | | |
|---|---|---|---|---|---|---|---|---|---|
| | No. of clients per firm | Total No. of firms | No. of firms below the average of 80% | No. of non-compliance cases | % of total non-compliance cases | Total No. of firms | No. of firms below the average of 83% | No. of non-compliance cases | % of total non-compliance cases |
| Small size firms | 100 or less | 1,418 | 652 | 5,212 | 70% | 1,422 | 669 | 4,637 | 71% |
| Medium size firms | 101 - 300 | 122 | 45 | 1,915 | 26% | 126 | 52 | 1,798 | 27% |
| Large size firms | over 300 | 12 | 4 | 327 | 4% | 12 | 2 | 143 | 2% |
| | | 1,552 | 701 | 7,454 | 100% | 1,560 | 723 | 6,578 | 100% |

**Table 1** *Appendix B*

**Analysis of Completed FA Corporation Cases for the years ended 31 December 2008, 2009 and 2010**

| | **Number** | | | **Discrepancy Amount by Nature** | | | **Tax Undercharged by Nature** | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Auditor's Report = Unqualified** | **2008** | **2009** | **2010** | **2008** | **2009** | **2010** | **2008** | **2009** | **2010** | |
| Sales omitted | 40 | 37 | 35 | 75,797,914 | 26,238,198 | 39,231,439 | 10,863,854 | 4,491,152 | 5,314,753 | |
| Purchases overstated | 17 | 12 | 9 | 11,047,506 | 12,596,287 | 16,137,588 | 1,631,212 | 2,272,691 | 2,681,964 | |
| Closing stock understated | 1 | 1 | 5 | 214,598 | (6,470,216) | 2,931,306 | 37,555 | 0 | 509,443 | FOR |
| Gross profit understated | 25 | 31 | 35 | 147,112,439 | 108,782,698 | 108,899,917 | 27,248,129 | 17,872,130 | 19,245,306 | AUDIT |
| Expenses over-claimed | 64 | 51 | 55 | 94,006,902 | 66,310,819 | 33,263,505 | 15,940,550 | 10,744,485 | 5,297,220 | YEAR |
| Technical adjustments | 56 | 52 | 70 | 55,908,670 | 23,543,334 | 103,312,165 | 7,726,461 | 3,792,798 | 16,062,359 | ONLY |
| Offshore income / profits disallowed | 16 | 17 | 15 | 192,265,312 | 196,242,025 | 687,681,260 | 29,721,627 | 33,284,970 | 113,737,761 | |
| Other | 49 | 53 | 87 | 80,824,075 | 105,460,897 | 112,919,377 | 12,050,274 | 15,973,551 | 15,598,991 | |
| **TOTAL** | 268* | 254* | 311* | $657,177,416 | $532,704,042 | $1,104,376,557 | $105,219,662 | $88,431,777 | $178,447,797 | |
| **TOTAL NUMBER OF CASES** | 211* | 189* | 235* | | | | | | | |
| **AVERAGE AMOUNT PER CASE** | | | | $3,114,585 | $2,818,540 | $4,699,475 | $498,671 | $467,893 | $759,352 | |
| * in one case there may be more than one type of discrepancy | | | | | | | | | | |
| | | | | **Total Discrepancy for All Years** | | | **Total Tax Undercharged for All Years** | | | |
| | | | | **2008** | **2009** | **2010** | **2008** | **2009** | **2010** | |
| **Other statistics for the above cases:** | **TOTAL AMOUNT** | | | **$3,539,825,437** | **$2,551,595,640** | **$6,040,296,560** | **$568,792,154** | **$398,570,394** | **$980,325,950** | |
| | **AVERAGE AMOUNT PER CASE** | | | **$16,776,424** | **$13,500,506** | **$25,703,390** | **$2,695,697** | **$2,108,838** | **$4,171,600** | |

| | **Number** | | | **Discrepancy Amount by Nature** | | | **Tax Undercharged by Nature** | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Auditor's Report = Qualified** | **2008** | **2009** | **2010** | **2008** | **2009** | **2010** | **2008** | **2009** | **2010** | |
| Sales omitted | 12 | 10 | 5 | 18,884,194 | 14,273,262 | 1,954,675 | 2,908,348 | 2,479,177 | 365,202 | |
| Purchases overstated | 2 | 0 | 1 | 1,930,409 | 0 | 1,497,436 | 337,822 | 0 | 0 | |
| Closing stock understated | 1 | 1 | 0 | 765,579 | 139,932 | 0 | 74,512 | 24,488 | 0 | FOR |
| Gross profit understated | 11 | 8 | 9 | 23,037,758 | 5,290,375 | 18,236,737 | 2,924,905 | 653,385 | 2,915,120 | AUDIT |
| Expenses over-claimed | 15 | 8 | 11 | 20,131,037 | 3,214,532 | 15,310,258 | 2,972,730 | 582,712 | 2,422,734 | YEAR |
| Technical adjustments | 13 | 18 | 6 | 8,805,578 | 9,633,270 | 4,497,427 | 666,972 | 1,591,641 | 465,541 | ONLY |
| Offshore income / profits disallowed | 3 | 0 | 2 | 1,606,856 | 0 | 7,314,612 | 86,075 | 0 | 705,035 | |
| Other | 11 | 12 | 10 | 24,922,492 | 2,299,723 | 17,646,090 | 4,120,183 | 294,497 | 2,820,659 | |
| **TOTAL** | 68* | 57* | 44* | $100,083,903 | $34,851,094 | $66,457,235 | $14,091,547 | $5,625,900 | $9,694,291 | |
| **TOTAL NUMBER OF CASES** | 47* | 40* | 37* | | | | | | | |
| **AVERAGE AMOUNT PER CASE** | | | | $2,129,445 | $871,277 | $1,796,141 | $299,820 | $140,648 | $262,008 | |
| * in one case there may be more than one type of discrepancy | | | | | | | | | | |
| | | | | **Total Discrepancy for All Years** | | | **Total Tax Undercharged for All Years** | | | |
| | | | | **2008** | **2009** | **2010** | **2008** | **2009** | **2010** | |
| **Other statistics for the above cases:** | **TOTAL AMOUNT** | | | **$375,857,787** | **$157,641,033** | **$421,381,642** | **$56,382,636** | **$25,628,675** | **$64,295,339** | |
| | **AVERAGE AMOUNT PER CASE** | | | **$7,996,974** | **$3,941,026** | **$11,388,693** | **$1,199,631** | **$640,717** | **$1,737,712** | |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **TOTAL NUMBER OF CASES** | 258 | 229 | 272 | | | | | | |
| | | | | **Total Discrepancy for All Years** | | | **Total Tax Undercharged for All Years** | | |
| | | | | **2008** | **2009** | **2010** | **2008** | **2009** | **2010** |
| **Other statistics for the above cases:** | **TOTAL AMOUNT** | | | **$3,915,683,224** | **$2,709,236,673** | **$6,461,678,202** | **$625,174,790** | **$424,199,069** | **$1,044,621,289** |
| | **AVERAGE AMOUNT PER CASE** | | | **$15,177,067** | **$11,830,728** | **$23,756,170** | **$2,423,158** | **$1,852,398** | **$3,840,519** |

**<u>Table 2</u>**

**Field Audit case with discrepancy considered detectable through statutory audit**
**For the period from 1.1.2010 to 31.12.2010**

| Item that should be detected by Auditor | Amount of item for audited year that should be detected | Reasons why the item should be detected | Auditor's Report | Profits understated for audited year | Tax undercharged for audited year | Total discrepancy amount for all years | Total tax undercharged for all years |
|---|---|---|---|---|---|---|---|
| Unsubstantiated expenses<br>(2 cases) | $11,017,161 | Year-end adjusting entries were made to charge substantial amounts of purported fees paid for professional services. The adjustments were not supported by any evidence. The accounts of the taxpayer and the purported payees were audited by the same auditor. | Unqualified | $13,083,147 | $2,508,766 | $46,115,537 | $8,002,218 |