Annual Meeting

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 2015.

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

A(1a) New Companies Ordinance
A1(b) Exemption of dividend income under section 26
A1(c) Royalties deemed taxable under section 15(1)(ba)
A1(d) The deeming rate to apply under section 21A(1)(a)
A1(e) Tax treatment of perpetual notes
A1(f) Deduction on specific provisions of a bank’s doubtful loan
A1(g) Balancing adjustments for commercial building allowances
A1(h) Non-demise charter-party agreement for an aircraft

A2. Salaries Tax Issues

A(2a) Taxation of share awards
A2(b)  Tax treatment on benefits-in-kind

A2(c)  "Visitor" status in the application of the “60 days rule"

A2(d)  Disclosure requirements of employer’s returns

A3.  **Cross-border Tax Issues**

A3(a)  The IRD’s responses to the BEPS project

A3(b)  BEPS Action Plan 13 – Transfer pricing documentation

A4.  **Double Tax Agreements**

A4(a)  Assessable gain arising from a conditional right to acquire shares

A4(b)  Foreign tax credit claim of Hong Kong branches of overseas banks

A4(c)  Non-discrimination article and buyer's stamp duty

A4(d)  Relief for double taxation arising from transfer pricing adjustments

A4(e)  Non-resident partnerships

A4(f)  Issuance of Hong Kong certificate of resident status ("CoR") for part-year Hong Kong resident individuals

A4(g)  Application for Hong Kong CoR

A4(h)  Automatic exchange of information

A5.  **Departmental Policy and Administrative Matters**

A5(a)  Sums to be reported in the profits tax return – in respect of non-resident persons (BIR54)

A5(b)  Form IR56M – For Persons Other Than Employees

A5(c)  Field audit and investigation

A5(d)  Handling of tax enquiries and objection cases
PART B - MATTERS RAISED BY THE IRD

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

B2. Profits Tax Issues

B2(a) Filing 2014/15 Profits Tax Return - Fair Value Accounting

B2(b) Format specifications for supporting documents accompanying Profits Tax Return

B2(c) Supporting Schedules

B3. Date of Next Annual Meeting
2015
ANNUAL MEETING BETWEEN
THE INLAND REVENUE DEPARTMENT AND
THE HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Full Minutes

The 2014/15 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department was held on 6 February 2015 at the Inland Revenue Department.

In Attendance

Hong Kong Institute of Certified Public Accountants (“the Institute”)

Ms Florence Chan  Chairperson, Taxation Faculty Executive Committee
Mr Anthony Tam  Deputy Chairman, Taxation Faculty Executive Committee
Mr K K So  Deputy Chairman, Taxation Faculty Executive Committee
Ms Sarah Chan  Member, Taxation Faculty Executive Committee
Mr Curtis Ng  Member, Taxation Faculty Executive Committee
Mr Percy Wong  Member, Taxation Faculty Executive Committee
Mr Peter Tisman  Director, Advocacy and Practice Development
Ms Elena Chai  Associate Director, Advocacy and Practice Development

Inland Revenue Department (“IRD”)

Mr Wong Kuen-fai  Commissioner of Inland Revenue
Mr Chiu Kwok-kit  Deputy Commissioner of Inland Revenue (Technical)
Mr Tam Tai-pang  Deputy Commissioner of Inland Revenue (Operations)
Ms Doris Lee  Assistant Commissioner of Inland Revenue
Ms Maria Tsui  Assistant Commissioner of Inland Revenue
Ms Connie Chan  Assistant Commissioner of Inland Revenue
Ms Mei Yin  Chief Assessor (Tax Treaty)
Ms Hui Chiu-po  Senior Assessor (Research)
Mr Wong Kuen-fai (“CIR”) welcomed the representatives of the Institute to the meeting. He expressed the view that the annual meeting was a platform for the IRD and the Institute to exchange views on areas of common interest. He said that the minutes of earlier meetings showed that discussions had been focused on the administration and operation of the IRD. He, however, remarked that the discussions in recent years were more technically oriented. While appreciating such a change, CIR had concern on the tremendous research efforts his colleagues had made in preparation. On the questions posed by the Institute for the meeting, he observed that there were questions on policy matters, whereas the IRD, as the tax administrator, was not in a position to address. He also considered that it would not be appropriate for the IRD to comment on hypothetical cases which would require a lot of factual assumptions. Further, he noted that one question was on the practice of a Hong Kong tax treaty partner, implying that the other side might take a stance which would deviate from the provisions of the double taxation agreement (“DTA”) which had yet to come into operation. In the absence of details, CIR considered it not appropriate for the IRD to respond as that might mean the IRD echoed the supposition. He pointed out that a proposed agenda item was taken out for that reason.

Ms Florence Chan (“Ms Chan”) thanked the IRD for arranging the annual forum for exchange of views and clarifications of various tax issues. She understood the IRD's concern, saying that the Institute had no objection in taking out the proposed agenda item. As regards the scope of questions, Ms Chan explained that members of the Institute were more familiar with the IRD’s operation compared with earlier years and they were eager to know more about the technical issues and tax treaties arrangements. They were also interested to know the IRD’s plan in addressing the latest international tax developments, like the work of the Organisation for Economic Co-operation and Development (“OECD”) on the Base Erosion and Profit Shifting (“BEPS”) project and automatic exchange of information, so that they could be better prepared. She said the Institute would take CIR’s comments into account when preparing the proposed agenda for the next meeting.

PART A - MATTERS RAISED BY THE INSTITUTE

Agenda item A1 - Profits tax issues

(a) New Companies Ordinance

Following item A1(h) of the 2014 annual meeting, the Institute would like the IRD to offer its view on the relevant tax issues relating to the new court-free regime for corporate amalgamation.

In particular, the Institute would like to seek the IRD's confirmation that the tax effect of an amalgamation is the same as that under the specific private merger ordinances previously effected in Hong Kong and the Universal Succession under foreign laws (see Advance Ruling Case No. 15). This means all the properties, rights and privileges, and all the liabilities and obligations (including the accumulated tax loss, the written down values of capital allowance balances) would be transferred from the
amalgamating entities to the surviving entity as if it had always been the relevant entity.

CIR said that profits tax consequences of a court-free amalgamation under the new Companies Ordinance should not be assumed to be the same as those in specific private merger ordinances previously enacted in Hong Kong and in universal succession cases carried out under foreign laws, including Advance Ruling Case No. 15.

CIR advised that before the specific merger ordinances were enacted or prior to the giving of the advance ruling, the IRD’s view had been sought. In each case, the IRD was satisfied that the amalgamation had not been carried out for the purpose of obtaining tax benefits and agreed that the provisions in sections 61A or 61B were not applicable to the amalgamation. He said that in the absence of any tax motives, the IRD therefore agreed to treat the amalgamated company as if it were the continuation of and the same person in law as the amalgamating companies.

CIR referred to *Hong Kong Company Law 2 – Legislation and Commentary*, published by LexisNexis, in which Tyler and Lo said at Part 13 [554], “On the date of amalgamation, each amalgamating company will cease to exist and the new amalgamated company will take on all benefits and will be subject to all liabilities of the amalgamating companies …….”. He said that the amalgamating companies had ceased and the relevant cessation provisions under the Inland Revenue Ordinance (“IRO”) might be applicable.

CIR noted the Joint Liaison Committee on Taxation (“JLCT”) had expressed concern that uncertainties or adverse tax consequences could possibly arise from a court-free amalgamation under the existing provisions of the IRO. He stated that given that Division 3 of Part 13 of the Companies Ordinance (Cap. 622) was based on equivalent provisions in the Singapore Companies Act, the IRD would consider whether the provisions in section 34C of the Singapore Income Tax Act, which concerned amalgamation of companies, could offer solutions to address the aforesaid concern.

CIR went on to say that in a few applications for advance ruling, the IRD noticed that attempts were made to reduce assessable profits through transfer of losses from an amalgamating company to an amalgamated company in a court-free amalgamation. He emphasised that where appropriate, the IRD would not hesitate to invoke the anti-avoidance provisions in the IRO to combat tax avoidance through an amalgamation which was carried out for the sole or dominant purpose of obtaining tax benefits.

CIR supplemented that the IRD was studying specific tax legislations in Singapore and New Zealand on amalgamation of companies. He confirmed that legislative amendments to the IRO were required to provide tax certainty. In response to Ms Chan’s enquiry, CIR said it would take time to draft the amendments and the legislative timetable was yet to be fixed.
(b) Exemption of dividend income under section 26

Under section 26 of the IRO, a dividend from a corporation which is chargeable to profits tax shall not be included in the profits in respect of which any other person is chargeable to tax.

If Company A only derives capital gains and offshore profits which are not taxable, will it be considered as chargeable to tax under section 26 and hence, the dividends distributed will not be taxable in the hands of its shareholder, Holdco? It is assumed that both Company A and Holdco are carrying on business in Hong Kong.

CIR said that section 14(1) of the IRO charged profits tax on a person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong from such trade, profession or business. Section 26(a) provided the basic exemption for dividends in Hong Kong. He further said that the exemption was confined to dividends received from corporations that were chargeable to profits tax.

CIR explained that Company A had no assessable profits since the gains were capital in nature and the profits were derived offshore. He said that Company A however remained chargeable to profits tax without limiting to any particular basis period since it was carrying on business in Hong Kong and could have assessable profits for some years of assessment in the future. He therefore concluded that the dividend received by Holdco from Company A would be exempt from profits tax.

(c) Royalties deemed taxable under section 15(1)(ba)

Under section 15(1)(ba) of the IRO, royalties received for the use of or right to use certain intellectual properties outside Hong Kong, which are deductible for profits tax purpose by a Hong Kong taxpayer, shall be deemed to be trading receipts derived from Hong Kong by the recipient and chargeable to tax.

If the royalty expense is partly deductible because only a portion is attributable to the earning of chargeable income e.g. onshore income, is the whole amount or only the corresponding amount of royalty receipt subject to tax under section 15(1)(ba)?

CIR advised that if a sum was received by or accrued to a person for the use of or right to use an intellectual property outside Hong Kong and a portion of it was tax deductible in ascertaining the assessable profits of a person, the IRD would take the view that the same portion was subject to tax under section 15(1)(ba) of the IRO.

CIR referred to agenda item A4(c) of the 2006 annual meeting which related to the same issue concerning the apportionment of royalty receipt in contract processing cases where only 50% of the profits were assessed to profits tax. He commented
that there had been no change in the IRD's practice on this matter so far.

CIR urged the practitioners to ascertain carefully whether the royalty was actually paid for the use of or right to use the relevant intellectual property outside Hong Kong. He said that if it was not, the royalty receipt would fall within the ambit of section 15(1)(b). He explained that whether the intellectual property was used or in connection with the right to use outside Hong Kong was a question of fact. He then referred to Turner Entertainment Networks Asia, Inc. for Muse Communication Co., Ltd. v CIR [2012] HCIA 4/2010, where the court explained that the words “for the use of, or right to use” were “ordinary, and not technical, words”, and the word “use” meant “to employ or utilise or otherwise derive benefit from the deployment of something”.

(d) The deeming rate to apply under section 21A(1)(a)

The Institute would like to seek the IRD's view as to the applicable deemed profits rates under section 21A of the IRO for royalties received in the following scenarios:

(i) Company A, a company carrying on business in Hong Kong, has acquired an intellectual property right (“IPR”) from its overseas parent company. The parent company has never carried on business in Hong Kong, and the IPR had previously been self developed by the parent company outside Hong Kong. Upon acquiring the IPR, Company A grants a license to Company B, a Hong Kong trading company, to use the IPR outside Hong Kong. Company B in turn, allows its overseas distributors and contract manufacturers to use the IPR outside Hong Kong for the manufacturing and sales of goods traded by Company B.

According to paragraph 74 of Departmental Interpretation and Practice Notes (“DIPN”) No. 49, the royalties received by Company A would likely be regarded as being offshore sourced, and hence not chargeable to tax in Hong Kong under section 14. This is on the basis that the IPR was purchased by Company A, which then granted a license to Company B for its use outside Hong Kong.

However, based on the IRD’s interpretation that section 15(1)(ba) applies not only to non-residents, but also to Hong Kong residents as an extension to the scope of charge under section 14, Company A would also be chargeable to tax under section 15(1)(ba) where the royalties paid are tax deductible expenses of Company B.

The aforesaid arrangement is depicted in the diagram below:
For royalties charged to tax under section 15(1)(ba), the two statutory deemed profit rates, i.e. 30% or 100% applicable to the different circumstances under section 21A would then be relevant.

The Institute considers that the deemed profit rate of 30%, instead of 100%, as specified in section 21A should apply. This is on the basis that apart from Company A, no one carrying on a trade, profession or business in Hong Kong has at any time wholly or partly owned the IPR in respect of which the royalties were paid. In this context, the fact that Company A, the licensor carrying on business in Hong Kong, owns the IPR should be irrelevant when considering whether anyone at any time has owned the IPR in Hong Kong for the purposes of section 21A. The Institute would like the IRD's views on this.

Ms Lee pointed out that Company A might be chargeable to profits tax under section 14. The royalty received from Company B might be onshore in nature if Company A performed in Hong Kong functions relating to the maintenance, enhancement, protection and exploitation of the IPR. In deciding the source of the royalty income, the IRD would not ignore the facts that: Company A did nothing offshore to generate the royalty it received from Company B; the licensee being Company B was a Hong Kong company; contract rights against Company B could be enforced in Hong Kong; and such royalty remained payable regardless of whether Company B successfully sub-licensed the IPR.

Ms Lee added that practitioners were to recognize that paragraph 74 of DIPN 49 was a general statement and the source of profit in the last analysis was a question of fact depending on the nature of the transaction.

Mr Percy Wong asked what the treatment would be, if Company A were an offshore company with some operations in Hong Kong and Company B were an associate of Company A. Ms Lee said that this would be a different scenario. In the original question Company A was carrying on a business in Hong Kong and the analysis was based on the original assumptions.
Company C is an overseas company with a branch in Hong Kong. Company C has owned a self-developed IPR for many years and the creation and ownership including licensing of the IPR has been wholly undertaken by the head office of Company C outside Hong Kong, i.e. the business activities of the Hong Kong branch have nothing to do with the creation and ownership including licensing of the IPR. Company C now decides to grant a license of the IPR to a Hong Kong subsidiary company for the use of the IPR in Hong Kong, in return for a fee.

The aforesaid arrangement is depicted in the diagram below:

In this scenario, the Institute considers that the licence fee, which is not attributable to the Hong Kong branch, should only be chargeable to tax under sections 15(1)(a) or 15(1)(b).

Furthermore, similar to scenario (i) above, the deemed profit rate of 30% as specified in section 21A should also apply. This is on the basis that the IPR ownership by Company C as the licensor, which carries on business in Hong Kong through a branch at the relevant time, should be ignored when applying the relevant provision of section 21A. The Institute would like to clarify if the analysis would be different if at the time Company C decides to grant the licence to the Hong Kong subsidiary, it had already ceased its branch operations in Hong Kong?

Ms Lee said that Hong Kong Branch and Company C had to be regarded as the same legal entity. She indicated that whether the licence fee was attributable to the Hong Kong Branch or not required a careful analysis of the facts. If the licence fee was not chargeable under section 14, the deeming provisions under section 15(1)(a), (b) and (ba) could be invoked to assess the licence fee accrued to Company C.

Ms Lee pointed out that Hong Kong Branch was carrying on business in Hong Kong. If it was responsible for the enhancement, maintenance, protection and exploitation of an IPR in Hong Kong in respect of which the licence fee was
received from Hong Kong Subsidiary, all of the licence fee received for the use of the IPR in Hong Kong would be charged to profits tax under section 14.

Ms Lee also explained that where Company C and not Hong Kong Branch was responsible for the enhancement, maintenance, protection and exploitation of the IPR, section 15(1)(a), (b) and (ba) could be invoked to assess the sum accrued to Company C from Hong Kong Subsidiary. Hong Kong Subsidiary was an associate of Company C. And Company C carried on business through a branch in Hong Kong and had had owned the IPR. She was of the view that under such circumstances 100% of the licence fee accrued to Company C from Hong Kong Subsidiary would be taken as assessable profits per section 21A(1).

Ms Lee went on to explain that if Company C granted the licence to Hong Kong Subsidiary when it ceased its branch operation in Hong Kong, the deeming provisions under section 15(1)(a), (b) and (ba) would apply. Hong Kong Subsidiary was an associate of Company C. And Company C previously carried on business through a branch in Hong Kong and had had owned the IPR. She considered that in such situation 100% of the licence fee accrued to Company C from Hong Kong Subsidiary would be taken as assessable profits per section 21A(1).

(e) Tax treatment of perpetual notes

Perpetual notes exhibit both debt-like and equity-like features and in the absence of specific legislation or guidance, the tax treatment of such hybrid instrument is often uncertain. Considering many Hong Kong taxpayers issue perpetual notes and the development of Hong Kong’s debt capital market, the Institute would like to know whether the IRD would consider providing more certainty to taxpayers by issuing a DIPN stating its views on the tax treatment of hybrid instruments. It is noted that the Inland Revenue Authority of Singapore, for example, has issued a guide on the income tax treatment of hybrid instruments, in which it had outlined the tax treatment for the distributions on the perpetual notes.

Mr Chiu said that perpetual notes were hybrid instruments which exhibited both debt-like and equity-like features. The special feature of perpetual notes was that they had no maturity date. He said that the IRD as a starting point would consider their nature according to the legal form of the instruments. The IRD in the process would examine the legal rights and obligations created by the instruments. He noted that this approach had been explained in paragraph 20 of DIPN 42.

Mr Chiu explained that the IRD would, in practice, examine the prospectus, offering circular and information memorandum issued in connection with the instruments to determine the exact legal rights and obligations intended to be created between the issuer and the investors.
Mr Chiu pointed out that characteristics of debt included predetermined maturity, principal protection and no profit participation. He was of view that if the perpetual notes contained provisions for the writing down of the principal upon the occurrence of a trigger event and did not have a maturity date, they were more akin to equity instruments.

Mr Chiu stressed that determination of debt or equity was not a mere counting of factors. He said that the ultimate question was whether the advances, analysed in terms of their reality, constituted risk capital entirely subject to the fortunes of the corporate venture or represented a strict debtor-creditor relationship. He explained that the IRD regarded the following factors to be germane to this analysis:

- **Maturity date:** The absence of a maturity date would effectively subject the advances to an uncertain economic climate for an inordinate period and could weigh in favour of identifying the advances as equity.

- **Source of payments:** If the payments by the issuer were to come from net cash flow (after expenses and capital expenditures) and were effectively discretionary, the advances looked like equity.

- **Right to enforce payments:** The lack of legitimate creditor safeguards and the subordination of the repayment obligation to other creditors weighed in favour of characterising the advances as equity.

- **Participation in management:** If the investors could actively participate in the investment or venture funded, the advances appeared more like equity.

- **Status of advances in relation to regular corporate creditors:** If the issuance document unequivocally subordinated any obligation of the issuer to repay to the other debts of the issuer, it demonstrated a characteristic of equity.

- **Intent of the parties:** If the issuer’s intention was to create equity according to the laws of a jurisdiction and had been careful to retain discretion as to whether to make payments, it demonstrated the equity nature of the instruments.

- **Identity or interest between creditor and shareholder:** If advances were in proportion to equity ownership, an equity contribution was indicated.

- **Debt/equity ratio of taxpayer:** If the treatment of the advances as debt would cause the debt/equity ratio to become an untenable ratio, it supported the characterisation of the advances as equity.

- **Ability to obtain credit from outside sources:** If the evidence was that no third party lender would have loaned funds in the relevant amounts on the terms in the agreement (including the long and potentially perpetual terms, the subordination to other debts and the lack of creditors’ remedies), it supported the equity
characteristics of the instruments.

- Use to which advances were put: The use of the interest to make preferred return payments on the advance agreement and the lack of any connection to capital investments demonstrated debt-like characteristics.

- Acceptance of risk: The question whether the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business was another means by which to ascertain the intention of the parties. The long and conditional maturity dates, the subordination to other debt and other factors might evince the uncertainty of repayment of principal: it illuminated the equity characteristics of the advances.

Mr Chiu said the IRD had taken note that the OECD/G20 BEPS Project included an action to neutralise the effects of hybrid mismatch arrangements. He disclosed that when the work of the OECD in this area was finalised and consensus was reached, the IRD would carefully map out the way forward. The IRD would consider issuing a DIPN on the topic if necessary. Prospective issuers might in the interim consider making use of the advance ruling service.

(f) Deduction on specific provisions of a bank’s doubtful loan

Under section 16(1)(d) of the IRO, bad debts and doubtful debts should be deductible to the extent that they are estimated to the satisfaction of the IRD to have become bad. However, under the current assessing practice, it appears that the IRD allows deductions, if at all, only for bad debts of a bank’s business under section 16(1)(d) when the loan is proved to be bad. This means that a tax deduction is not available for specific provisions for loans, even if the amount is being disclosed to the Hong Kong Monetary Authority (“HKMA”) under the “substandard” classification. In view of the above, please advise:

(i) Whether the IRD would consider taking into account the HKMA’s loan classification system in allowing tax deductions for the non-performing categories such as “substandard” and “doubtful”.

Ms Lee pointed out that to qualify for deduction under section 16(1)(d), the debts in question had to be bad debts proved or doubtful debts to the extent that they were respectively estimated, to the satisfaction of the assessor to have become bad during the basis period for the year of assessment in which a taxpayer claimed for such deduction.

Ms Lee explained that in considering the deduction on specific provisions of a bank’s doubtful loan, all relevant factors, including but not limited to the HKMA’s loan classification, would be taken into account. While the HKMA’s loan
classification might serve as a useful reference, it was by no means conclusive. The criteria in the HKMA's loan classification and the criteria under section 16(1)(d) were not the same. She illustrated with an example: delay of repayment, which was an important indicator in the HKMA's loan classification, did not mean that the debts had become bad or doubtful for the purpose of section 16(1)(d). Other facts had to be taken into account.

(ii) What additional evidence is required, without the benefit of hindsight, to demonstrate the required standard under section 16(1)(d) for doubtful debts to be estimated to have become bad.

Ms Lee stated that whether and to what extent that a debt could be said to have become bad had to be decided upon consideration of all relevant facts of the case. As such, the evidence required might vary from one case to another. She elaborated that the assessor might, in general, consider the following information and documents:

- details of steps taken to recover the debt and the outcome;
- particulars of the collateral pledged and its estimated value;
- basis on which the provision was computed;
- the time and quantum of the latest repayment;
- relationship between the debtor and the taxpayer; and
- reasons why the debt was regarded as bad.

CIR supplemented that the above-mentioned information and documents were not exhaustive and only served as an illustration.

Ms Chan said some of her banking clients had been asked to give details of the provisions for doubtful debts almost every year, though it was common for financial institutions to make specific provisions for doubtful debts. Ms Lee suggested that many claims for deduction of doubtful debts were made merely because the debts were classified as "substandard". She explained that for tax purpose, the "substandard" loans under the HKMA's loan classification might not be doubtful debts and that would inevitably lead to the assessors' queries.

Ms Chan asked whether some thought could be given to align the criteria under section 16(1)(d) with the HKMA classification in order that queries would not be raised every year. Ms Lee responded that the IRD could align that with the "bad" and "doubtful" loans.

Ms Lee further explained that, in the HKMA classification system, payment overdue by more than 3 months had to be identified as "substandard", but that did not necessarily mean the loan repayment was doubtful for tax purpose.
She suggested that banks not to claim deduction for “substandard” loans unless they were doubtful debts that had become bad. Ms Chan expressed concern that it might not be easy for the banks to do so in view of huge numbers of loans. Ms Lee indicated that banks kept detailed loan records and should not have difficulties in segregating the “substandard” loans from others.

CIR added that the objective of HKMA's loan classification was for prudent monitoring of loans advanced by banks which was different from that of the IRD as the tax administrator.

(g) Balancing adjustments for commercial building allowances

Sections 35 and 39D of the IRO specify the tax treatments of proceeds arising from the sale of building/structures and depreciable assets. In essence, where the residue of expenditure immediately before disposal/reducing value in the pool exceeds the sales money arising from the disposal, a balancing allowance shall be made. Where the amount of sales money exceeds the amount of the residue/reducing value of the pool, a balancing charge arises. However, there is no provision under the IRO, case law or any DIPNs issued by the IRD that governs the basis in allocating sales proceeds to different types of assets (e.g. commercial building, depreciable assets) for commercial building allowances (“CBA”) and/ or depreciation allowance.

The Institute noted that, in some cases, the IRD proposed to allocate the sales proceeds to each category of assets by reference to the percentage of their respective cost to the total cost. In this regard, the Institute would like to confirm whether it is the basis adopted by the IRD in all applicable cases.

The IRD has mentioned in a previous annual meeting (agenda item A1(e) of the 2007 annual meeting) that should the capital expenditure incurred on construction/residue of expenditure after sale not be readily available, it is the IRD's view and existing practice to deem half of the first assignment price of the relevant building (i.e. the historical cost of the relevant building) in calculating the CBA available to such a subsequent purchaser. The Institute would like to reconfirm that this is still the IRD's practice.

Ms Lee referred to section 38A of the IRO which provided that where assets which qualified for initial or annual allowances under Part 6 were sold together or with other assets in pursuance of one bargain, the Commissioner should, for the purposes of the calculation of the balancing adjustments and having regard to all the circumstances of the transaction, allocate a purchase price to each individual asset.

Ms Lee said that in determining the cost of individual assets sold together for one price, there was no hard and fast rule on how the price had to be allocated to each asset. Valuation reports prepared by the taxpayers might be of relevance. The IRD
would also consider the facts of each case to decide on the most appropriate method. She indicated that if the results were not unreasonable, the IRD might consider allocation by reference to the original cost.

With regard to the cost of construction, Ms Lee confirmed that the IRD’s practice was to treat half of the first assignment price as cost in calculating the CBA to be granted to the subsequent purchaser in the absence of a better alternative.

Mr Ng said that a building was a depreciable asset and had to be depreciated over time. For the purpose of calculating the balancing adjustments, he took the view that it might be more appropriate to subtract the aggregate amount of depreciation from the original construction cost to determine the value of the building which was sold together with other assets, while value of the other assets could be ascertained by way of valuation. Ms Lee disagreed and repeated that a valuation report might be of relevance.

Mr Ng asked whether a consistent approach such as replacement cost or second hand value could be equally applied to a building and other assets sold together for computing the balancing adjustments. Ms Lee welcomed other suggestions on how to allocate the sale proceeds to individual assets sold together as long as the method complied with the law. She said the facts of the case had to be examined before deciding whether a particular method was appropriate.

Mr Anthony Tam also asked whether the IRD would issue a guideline to the assessors on how to apportion the sale proceeds of individual assets sold together for one lump sum. Ms Lee responded that facts were case-specific and it was not desirable to generalise things in a guideline.

(h) Non-demise charter-party agreement for an aircraft

This is a follow-up question on item A3(a) from the 2014 annual meeting.

In the scenario posed in the 2014 annual meeting, the company owns the jet, has full control of the jet at all times (through the crew hired by it, albeit there may not be a strict employer-employee relationship between the company and the crew members), and uses the jet to derive income from its customers or passengers. Furthermore, the company can issue tickets to its passengers. The flights would be cross-border and therefore, would be regarded as international traffic.

It appears to the Institute that section 23C does not require that “a business of operating aircraft” must hold an Air Operators Certificate (“AOC”) in Hong Kong. In any case, the jet would not fly over Hong Kong and so, presumably, there would not be a need to obtain an AOC license in Hong Kong. In addition, the phrase "a business of operating aircraft" is not defined in section 23C(5) and the Institute suggests that it should be accorded its ordinary meaning.
Therefore, the Institute would like to ask:

(i) How would obtaining an AOC for public transport be a relevant consideration, given that "business" is a general term and is not confined to a business involving the general public for tax purposes?

Mr Chiu explained that sections 23C and 23D of the IRO were specific regimes for the ascertainment of the assessable profits of an airline company, resident or non-resident, that performed, as either operator or charterer, air service for the public transport of passengers, mail or cargo.

Mr Chiu pointed out that the definition of "owner" in these two specific regimes covered a person who owned or chartered an aircraft for actual operation of the aircraft whereas the definition of "operation" covered the operating, use or possession of an aircraft. He said that the term "business of an owner of aircraft" specifically excluded a dealing or agency business though "in connection with air transport".

Mr Chiu further clarified that given the international characteristics of airline operations, sections 23C(2A) to 23C(2D) had been enacted to ensure that profits, previously not chargeable to profits tax, would be brought to charge to profits tax if there was an arrangement for double taxation relief under section 49 (i.e. double taxation agreements, air services agreements, etc.) The aim was to tax the income of Hong Kong airlines which was earned from international traffic attributable to an agreement country. He said that relevant carriage shipped in the arrangement territory, relevant charter hire attributable to the arrangement territory and charter hire in respect of an operation of aircraft flying within the arrangement territory would then be charged to profits tax.

Mr Chiu went on to say that international airline operation was highly regulated in order to protect the safety of persons both in the air and on the ground. He noted that the International Civil Aviation Organization ("ICAO") had prescribed a set of standards and recommended practices for flight operations, landing and taking-off procedures of aircrafts. This included professional personnel licensing, flight operations and the related flight crew training, management of airlines, aircraft airworthiness and maintenance standards. He said that Hong Kong registered aircrafts and aircrafts of foreign airlines were required to comply with the ICAO standards. He held the view that an aircraft registered in Hong Kong might not fly for the purpose of public transport unless the operator held an AOC granted by Director-General of Civil Aviation. He added that for the grant of an AOC the Director-General of Civil Aviation would take into consideration of the applicant's previous conduct and experience, his equipment, organisation, staffing, maintenance and other arrangements.

Mr Chiu also added that if a person did not have an AOC (whether issued in Hong Kong or overseas), it showed that the person had not been allowed to
operate aircraft for the purpose of public transport. He pointed out that this was the reason why the specific provisions stipulated in sections 23C and 23D for airline operators should not be applicable to the person’s business undertaking. He said that profits tax should be charged on such business undertaking in accordance with the general charging section (i.e. section 14). He illustrated with an example: a lessor of an aircraft was not an aircraft operator whereas the lessee with an AOC, having actual use and possession of the aircraft for international air transport, was an aircraft operator chargeable to profits tax under either section 23C or section 23D.

(ii) If the jet owner has obtained an AOC in Hong Kong, or a similar licence from an overseas jurisdiction, would the tax position be different, i.e. the jet owner would qualify as a section 23C taxpayer and be eligible for tax depreciation allowance in respect of costs incurred for the jet acquisition?

Mr Chiu stated that fulfillment of AOC requirement was a factor for consideration but was not conclusive. He stressed that all the surrounding facts would have to be considered. He said that if an enterprise provided scheduled air service for the public transport of passengers, mail or cargo, it should be an aircraft operator or airline business. In this regard, air transport service (i.e. contract of carriage) as opposed to pure leasing (i.e. dry or wet leases) should be distinguished. He further said that a scheduled flight was “transportation” where the air passengers had no control over where and when the jet went. He added that for a “non-demise charter” (i.e. wet lease), the lessees enjoyed the use of the jet by giving orders to the crew while the crew remained in control of the jet. For a “demise charter” (i.e. dry lease) as in a self-drive hire, the hirer was in full control of the jet.

Mr Chiu took the view that the mere holding of an AOC, whether issued in Hong Kong or elsewhere, by the jet owner in the hypothetical case was insufficient for the application of either section 23C or 23D.

(iii) If the company operates the jet itself and the customers enjoy the use of the jet only as passengers (like passengers of a hired van/ bus), would the jet be considered as being under a "lease" term under sections 2 and 39E when the jet takes on passengers?

Mr Chiu advised that the IRD would examine all the relevant facts in each case to determine whether a taxpayer was carrying on a business of providing air service of an aircraft operator for public transport. He said that it was, in particular, necessary to examine the person who contracted with the passenger, i.e. whether the contract of carriage was between the operator and the passenger or between the lessor and the passenger. He further said that if the transactions carried out by the company in the hypothetical case given showed the
characteristics of a contract of carriage, i.e. transport service, between the company and the passengers, section 23C or 23D was applicable and the question of “lease” did not arise.

(iv) If the answer to question (iii) is affirmative, would this mean that an owner-cum-operator of a cross-border van/ bus with passengers boarding in Hong Kong and crossing the Hong Kong/ Mainland China border would be denied tax depreciation allowances (assuming the van/ bus is used, principally, in Mainland China, based on mileage records)?

| Mr Chiu explained that if the owner-cum-operator did not lease out its vans or buses to passengers, the question of denial of depreciation allowance under section 39E(1)(b)(i) would not arise. He said that if the owner did lease out its vans or buses which were used wholly or principally outside Hong Kong by a person other than the owner, depreciation allowances would be denied under section 39E. |

| Mr Chiu invited members of the Institute to make use of the advance ruling service where appropriate to address the legal issues arising from seriously contemplated cases. He advised that assumptions made in hypothetical cases might deviate from realities. |

| Ms Chan asked Mr Chiu whether a contract of carriage between an owner of a van and the passengers amounted to a lease. Mr Chiu replied that the term “lease” was defined in section 2 of the IRO. He distinguished that in a lease the lessee took full control and management of a vehicle, while in the public transport a passenger could not be the lessee. Ms Chan further asked whether there was any scope to extend the interpretation of “lease”. Mr Chiu replied in the negative. |
Agenda item A2 - Salaries tax issues

(a) Taxation of share awards

This is a follow-up question on item A2(e) from the 2014 annual meeting. The 2014 question was in turn a follow-up to a question from the 2013 annual meeting.

Based on the IRD’s replies, the value of vested shares, which represented the amount attributable to services under a non-Hong Kong employment after the employee was seconded to work in Hong Kong (the said Value), would be accorded different tax treatments in the 2013 and 2014 scenarios.

In the 2014 scenario, the said Value would be fully taxable with no time-apportionment, whereas, in the 2013 scenario, the said Value, which of the same nature, would be eligible for a time-apportionment claim. This appears to be an anomaly that seems unfair to taxpayers who find themselves in the 2014 scenario, i.e. a localisation of employment that occurred before the year of vesting.

In view of the above, would the IRD consider granting a concession to taxpayers in the 2014 scenario, so that during the non-Hong Kong employment period after the Hong Kong secondment, they can use their actual days-in-days-out to/ of Hong Kong, as the time apportionment factor in scaling down the taxable amount earned by them in that period?

Ms Tsui referred to paragraph 64 of DIPN 38 which, when pointing out that the factual situation between share award and share option was not the same, stated that:

“Share options involving vesting periods may be exercised by an employee a few years after the options are vested. In paragraph 45, a time apportionment factor by reference to the days-in-days-out in the vesting period is adopted for ascertaining the chargeable portion of the gain when the options are exercised. This approach is not suitable for share award cases. If it is accepted that the perquisite accrues at the moment of time of vesting, it is only necessary to apply the time apportionment factor in the year of vesting, i.e. the year that the perquisite accrues to the employee. … The approach to assess shares accruing in a year of assessment by reference to the time apportionment factor for that year is consistent with the (provisions under sections 8(1A) and 11B).”

Ms Tsui advised that share awards were taxable perquisites which accrued to an employee at the time of vesting. As there was no non-Hong Kong employment during the year of assessment 2011/12 (i.e. the year of vesting) in the 2014 scenario, no time apportionment was required as a matter of law.

Ms Tsui further pointed out that the date of commencement of the Hong Kong employment was negotiated between the taxpayer and his employer and once agreed,
the taxation consequence should follow the transaction. She said that the IRD’s duty was to administer the law as it was. The question of fairness was not a justification for granting a concession to taxpayers in the 2014 scenario where the localisation of employment was fixed at a date before the year of vesting.

Ms Tsui said it was worth mentioning where the opposite happened: if the taxpayer in the 2014 scenario spent most of the vesting period working in Hong Kong but only visited Hong Kong for less than 60 days in the year of vesting, his entire share award would not be chargeable to salaries tax.

(b) Tax treatment on benefits-in-kind

We note that more and more companies provide their employees with their own products free-of-charge to promote their brand names (e.g. mobile phone companies providing a free mobile phone, fashion boutiques giving free clothing). The employees are not required to return the products to their employers upon cessation of employment. As the products are not intended for re-sale by the employees, the employers would usually require the employees to undertake that they would solely use the products themselves and would not resell the products to third parties.

We consider that these benefits-in-kind should be treated as non-taxable because (i) they are not cash convertible (i.e. not intended for re-sale) and (ii) they do not represent discharge of the employees’ personal liability (because the employer directly provides the goods to the employees). We should appreciate the IRD’s view on this.

However, if the IRD opines that their resale values are taxable under salaries tax, the values are usually small, and in some cases, it may even be considered to have no resale value because of the undertaking given. In addition, it would be burdensome for employers to keep track and report these benefits in the employer’s returns. If this is the IRD’s position, we would request the IRD to give practical guidance on reporting such benefits in the employer’s returns.

Mr Tam Tai-pang (“Mr Tam”) said case law had established that benefits received in kind, unless covered by specific provisions in the IRO, would be treated as taxable income if they took the form of “money’s worth”. He said that a benefit was regarded as constituting money’s worth if it was capable of being converted into money, through sale or some other means, by the recipient or involved the discharge of a personal liability of the employee.

Mr Tam elaborated that where a benefit took the form of an asset which could be converted into money by sale, the IRD’s basic approach was to take as the amount assessable the sum which the asset might reasonably be expected to fetch if sold in the open market at the time of receipt of the benefit (i.e. the “second-hand” value). He said that benefits which were not convertible into money by sale were sometimes...
convertible by other means and the particular arrangement under which the asset was provided could have a bearing on the taxation consequences. He said that it was not possible to lay down hard and fast rules as regards the chargeability and valuation of the asset. The approach taken would depend on the nature of the benefit and the circumstances under which it was provided.

Mr Tam explained that if an employee in the above question was allowed to use for private purposes the products (which were assets owned by his employer) free of charge, the IRD accepted that the benefit was not chargeable provided that the employee was not in any way able to convert the benefit into money. He was of the view that if ownership of the products was transferred to the employee, which was probably the case, and the employee was not required to return them to the employer upon cessation of employment, the benefit was chargeable to salaries tax at its convertible value at the time of receipt. He remarked that even if the products were not intended for resale by the employee and the employee undertook not to resell the products, these were not conclusive factors that the products were not convertible into money.

Mr Tam said that the IRD was bound to administer the law as it was. He stressed that an employer had the obligation to file proper and correct employer’s returns in respect of remunerations accrued to its employees and to maintain the records required for this purpose. He noted that the employer was in the best position to judge how the records should be kept. He asked the Institute to remind its members that neither the quantum of a taxable remuneration nor the administrative burden on the employer in keeping the records would constitute a sufficient ground to request concessionary treatment.

CIR supplemented that where an employer accounted for the cost of the goods or services provided to its employee which cost would otherwise have to be borne by the employee, the amount of the liability so discharged by the employer would be regarded as constituting money’s worth and thus a chargeable benefit.

Ms Chan commented and Mr So echoed that where the product provided to the employee was a mobile phone and it would become technically obsolete soon, its value could possibly be very low or with no resale value a few years later or at the time of cessation of employment. Mr Anthony Tam also raised concern on the taxability of benefits-in-kind involving consumable products, such as cosmetics. In such case the product was consumed by the employee for business purpose and never returned to the employer, yet the ownership of the product was not transferred to the employee. Mr Ng further questioned where an employee used for business purpose a digital device which he was not allowed to resell and was not returned to the employer when he left employment, whether the timing of chargeability should be at the time of receipt or at the time of cessation of employment.

In response, Mr Tam reiterated that where the employee was only provided with the use of an asset without being able to convert the benefit into money, the benefit would not be chargeable. However, where ownership of the asset would be passed to the
employee, the benefit would be chargeable. CIR added that if the ownership of the asset was passed to the employee at the time of its provision, the benefit was accrued to the employee at the time of receipt of the asset, not when the employment ceased. While the fact that the employee was not allowed to sell the product was a factor for consideration, it was not conclusive. If the convertible value of the product was zero at the time of accrual of the benefit, no chargeable benefit would be assessed.

Mr Tisman said it might not be clear as to when and whether the ownership of a product was passed to the employee. CIR pointed out that it was common that when an employee was allowed to use a product, he was required to sign a letter of acknowledgement of receipt of the product and the related terms. This would serve as a piece of evidence to show when and whether the ownership of the product was passed to the employee.

Mr Chiu supplemented that it would depend on the facts and circumstances of each case. He illustrated with an example: an employee was allowed to use a piece of equipment without the passing of ownership; and somehow he lost that equipment. He pointed out that in such a situation, the IRD would accept that there was no chargeable benefit though his employer chose not to ask the employee to pay any compensation.

Mr Tam concluded by saying that a benefit-in-kind would not be chargeable if the employee could not convert the benefit into money. Otherwise, the benefit-in-kind would be chargeable at its convertible value at the time when the benefit was accrued to the employee.

(c) “Visitor” status in the application of the “60 days rule”

Companies may sometimes send short-term assignees to Hong Kong on employment visas rather than visitor visas. These assignees may have stayed in Hong Kong for not more than 60 days in a given year of assessment. On the basis that these individuals have stayed in Hong Kong for no more than 60 days, we would like to clarify whether the IRD would consider them as “visiting” Hong Kong for the purpose of applying the “60 days rule” and hence, their income would not be subject to Hong Kong salaries tax.

Ms Tsui referred to section 8(1B) of the IRO which provided that in determining whether or not all services were rendered outside Hong Kong, no account had to 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.

Ms Tsui pointed out that the word “visit” was not defined in the IRO and it had to be construed according to its literal meaning which was a short or temporary stay. Whether a stay qualified as a visit was a question of fact. The visa status (employment visa or visitor visa) of the person concerned was not the only relevant factor, nor was it the decisive one. Ms Tsui advised that for guidance, practitioners
might refer to the various decisions by the Board of Review on the subject of “visit”.

(d) Disclosure requirements of employer’s returns

Paragraphs 79 to 82 of DIPN 38 on Employee Share-based Benefits set out the disclosure requirements for Forms IR56E and IR56B regarding the granting of share options in a particular year of assessment. Form IR56G also requests details of outstanding share options upon permanent departure of an employee from Hong Kong. In this regard, we would like the IRD to confirm that disclosure of information on the granting of share options and outstanding share options is not required in Form IR56F?

Ms Tsui stated that the disclosure requirements for Form IR56F were the same as those for Form IR56B. For share options granted during the reporting period covered in Form IR56F, the employer might follow Note 9(c) of the “Notes and Instructions for Forms BIR56A and IR56Bs” for reporting. She told the meeting that the IRD had already updated the “Specimen on Completion of Form IR56F” in the IRD website (IRD Homepage > Tax Information – Individuals/Businesses > Employers > Know more about > Completing and submitting your employer’s return and notification forms > How to complete and when to submit the employer’s returns > Specimen of completed IR56F) to inform employers that they should refer to the instruction in Note 9(c) of the “Notes and Instructions for Forms BIR56A and IR56Bs” when completing Form IR56F.

As regards the outstanding share options, Ms Tsui advised that the employer was not required to report the details in Form IR56F. She, however, emphasised that the employer needed to report in Form IR56B the share option gain accrued to former employees who, after cessation of employment, exercised share options which had previously been granted. She urged employers to refer to Note 9(b) of the “Notes and Instructions for Forms BIR56A and IR56Bs” for detailed instructions.
Agenda item A3 - Cross-border tax issues

(a) The IRD’s responses to the BEPS project

Following the publication of the BEPS Action Plan by the OECD in July 2013, the OECD released the first batch of deliverables of the BEPS project in September 2014. The deliverables released in September cover seven of the fifteen actions of the BEPS Action Plan, including a new recommended approach for transfer pricing documentation and the proposed limitation of benefits provisions/ principal purpose test to be incorporated into a tax treaty.

In this regard, we would like to know the IRD’s response to the BEPS project and, in particular, whether the IRD is considering or anticipating any changes in the legislation and/or practice in Hong Kong in the longer term, as a direct or indirect result of BEPS?

Mr Tam stated that the IRD had taken note that the OECD and G20 countries were working together to adopt a 15-point Action Plan to address BEPS. He said that beyond securing revenues by realigning taxation with economic activities and value creation, the IRD noted that the OECD/ G20 BEPS Project aimed to create a single set of consensus-based international tax rules to address BEPS with a key focus to eliminate double non-taxation.

Mr Tam informed the Institute that when more concrete details and recommendations were made available by the OECD, the Government would need to review the domestic tax regime, including the application of existing taxation principles, provision of tax concessions and enforcement of anti-avoidance mechanism, and assess to what extent Hong Kong could meet the emerging international expectations and standards.

Mr Tam reckoned that from a technical perspective, transfer pricing appeared to be a pressure point since comprehensive transfer pricing provisions had not been enacted and general anti-avoidance provisions were relied upon to resolve transfer pricing issues. He said that Hong Kong’s treaty partners might expect Hong Kong to adopt the latest international transfer pricing standards, including country-by-country (“CbC”) reporting, in dealing with cross-border controlled transactions. He also pointed out that double taxation agreements appeared to be another pressure point. He envisaged that in future tax treaty negotiations, Hong Kong’s treaty partners would request Hong Kong to incorporate the proposed changes under Action 6 to the OECD Model Tax Convention in the tax agreement, so as to prevent treaty abuse and double non-taxation.

Mr Tam further said that in January 2014, the Government briefed members of JLCT on the latest international development in tackling BEPS, and invited members’ views on Hong Kong’s strategic responses thereto on the basis of our existing transfer pricing regulatory framework. He noted that in November 2014, the JLCT gave an
oral report on the deliberations of the subcommittee formed to discuss the implications of the BEPS reports.

Mr Tam told the meeting that it might not be an appropriate time for the IRD to conclude without doing any extensive research and consultations whether legislation and/or practice in Hong Kong should be changed as a direct or indirect result of BEPS.

(b) **BEPS Action Plan 13 – Transfer pricing documentation**

Pursuant to the BEPS Action Plan 13, the OECD Transfer Pricing ("TP") Guidelines will be amended to include the revised standards for transfer pricing documentation with respect to the “master file” (which is to be made available to all relevant country tax authorities) and the “local file” (which is to be provided for the relevant country’s tax authority) and a template for CbC reporting. In this connection, the Institute would like to ask the IRD’s view on the following:

(i) Whether the IRD would incorporate any recommendations contained in BEPS Action 13 – TP Documentation and CbC reporting by making changes to the existing tax law or Hong Kong TP guidance. If so, the Institute would like the IRD to advise the recommendations which would potentially be adopted and provide a prescribed timeline for the implementation.

Mr Chiu stated that whether legislation should be enacted to give effect to the recommendations contained in BEPS Action 13 - TP Documentation and CbC reporting was a matter of public importance which required extensive consultation. He further said that no timeline had been prescribed for implementation of these recommendations in Hong Kong. He welcomed members of the Institute to convey their views to the Government through JLCT.

If the IRD implements CbC reporting, would the IRD indicate:

(ii) what data/ financial items may be requested from taxpayers and how the data would be used (e.g. for risk assessment, profit adjustments or media campaigning);

(iii) whether the IRD will accept the master file or local file TP documentation, prepared in accordance with BEPS Action 13 specifications, for Hong Kong profits tax purposes.

(iv) if the IRD would like to obtain an entity’s master file and CbC reports, whether it would request the documents from the relevant taxpayer or would use the Automatic Exchange of Information mechanism (which is expected to be implemented in Hong Kong in the future) to access the information.
Mr Chiu repeated what had been discussed in agenda item A3(a) above that, before deciding whether Hong Kong could take on board the BEPS recommendations, including the preparation of CbC report, there had to be wide consultations with the stakeholders. He advised that the IRD in the interim would keep track of the development in this area.
Agenda item A4 - Double tax agreements

(a) Assessable gain arising from a conditional right to acquire shares

With respect to an individual’s assessable gain relating to a conditional right to acquire shares granted to an employee holding non-Hong Kong employment during the entire “vesting period”, DIPN 38 sets out that the assessable gain is calculated based on the number of days the employee spent in Hong Kong plus leave days attributable to services in Hong Kong during the vesting period. Paragraph 47 of DIPN 38 also sets out that, where an employee qualifies for full exemption from salaries tax by virtue of section 8(1A)(b)(ii), read together with section 8(1B), during any year of assessment that falls within the vesting period, days spent in Hong Kong in the relevant year(s) of assessment are not taken into account in computing the assessable gain.

In this regard, the Institute would like to confirm whether the IRD would extend the treatment outlined in paragraph 47 of DIPN 38 (i.e. not to include the days spent in Hong Kong when computing the assessable gain) in a similar situation, where an employee’s remuneration is not charged to Hong Kong salaries tax for reason that Hong Kong has no taxing right under the employment income article of a DTA during the relevant year of assessment falling within the vesting period.

Ms Tsui stated that the numerator “days in Hong Kong plus attributable leave during vesting period” used in the formula at paragraph 45 of DIPN 38 was a factual figure. It was used in the administration of the provisions of the IRO and should not be affected by any provisions in a DTA. As explained in paragraph 47 of DIPN 38, where services were rendered during visits not exceeding a total of 60 days in the basis period of a year of assessment, the days concerned were not taken into account in the numerator “days in Hong Kong plus attributable leave during vesting period”.

Ms Tsui illustrated with an example: a taxpayer having a non-Hong Kong employment was given a right subject to conditions to acquire shares in the employer company. He was present in Hong Kong during a 3-year vesting period and he exercised the right on the last day of the vesting period. Details of his stay in Hong Kong during the 3-year vesting period were as follows:

<table>
<thead>
<tr>
<th>Year of Assessment</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Days in Hong Kong plus attributable leave</td>
<td>183</td>
<td>60</td>
<td>300</td>
</tr>
</tbody>
</table>

Ms Tsui said that assuming the days the taxpayer spent in Hong Kong in Year 2 qualified as visits, the number of days that should be included in the numerator “days in Hong Kong plus attributable leave during vesting period” was 483 (183+300).

Ms Tsui pointed out that the Income from Employment Article in a DTA usually provided that remuneration derived by a resident of a Contracting Party in respect of an employment exercised in Hong Kong should be taxable only in the first-mentioned...
Contracting Party if:

(a) the recipient was present in Hong Kong for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the taxable year concerned; and

(b) the remuneration was paid by, or on behalf of, an employer who was not a resident of Hong Kong; and

(c) the remuneration was not borne by a permanent establishment (“PE”) which the employer had in Hong Kong.

Ms Tsui stressed that even if the taxpayer in the example was not charged to salaries tax in Hong Kong by virtue of this article in Year 1, the number of days in the numerator “days in Hong Kong plus attributable leave during vesting period” would remain 483. In other words, the factor for computing the chargeable amount of the share option gain in Year 3 was 483/1095.

Ms Tsui drew the Institute members’ attention that the criteria of being not taxable in Hong Kong were different:

(i) The exclusion of visits not exceeding 60 days in the numerator “days in Hong Kong plus attributable leave during vesting period” reflected the provisions in the IRO which did not assess income derived from services rendered by a person who rendered outside Hong Kong all the services in connection with his employment.

(ii) According to the Income from Employment Article of a DTA, Hong Kong would not give up its taxing right unless all the three conditions were satisfied. Fulfillment of condition (a) alone (i.e. the half year rule) was not sufficient, and the provisions under the IRO would need to be considered for assessing the income in question. In this connection, days of presence in Hong Kong not exceeding 183 were not to be excluded from the numerator “days in Hong Kong plus attributable leave during vesting period”.

(b) Foreign tax credit claim of Hong Kong branches of overseas banks

It was the IRD’s assessing practice to treat the substantial branch operations (such as banks) as a separate person for profits tax purposes (as outlined under Inland Revenue Rule 3(3)). The IRD has recently changed its practice and denied the foreign tax credit claim for certain branches of overseas banks in respect of Mainland withholding tax paid on assessable interest income. This is on the basis that the branch does not qualify as a resident in Hong Kong, under the Mainland-Hong Kong DTA, because the legal entity to which the branch belongs is not “normally managed or controlled in Hong Kong”.

29
In this connection, would the IRD clarify whether it has considered the non-discrimination clauses in the relevant head office double tax treaties with Hong Kong (e.g. Article 23 of the France-Hong Kong DTA, where a French resident bank operates a branch in Hong Kong when compared with the Hong Kong tax liabilities of a Hong Kong-incorporated and resident bank, when they both suffer interest withholding tax in the Mainland). Would the denial of the tax credit of the withholding tax suffered in the Mainland to the Hong Kong branch of French resident bank, for example, be consistent with the non-discrimination clause under the France-Hong Kong DTA?

Mr Chiu clarified that the Non-discrimination Article of the Hong Kong-France DTA in strict terms merely required Hong Kong to treat the PE of a French company as favourable as a Hong Kong company.

Mr Chiu referred to paragraphs 69 and 70 of the OECD commentary on the Non-discrimination Article which suggested that double tax credit was expected to be provided to the Hong Kong branch of a French bank in respect of tax withheld in the Mainland. However, the commentary did recognize that some states could not give credit in such a way and encouraged states to clarify in the DTA. He advised that Hong Kong and France had not clarified.

Mr Chiu said that, under such circumstances, section 50(2) of the IRO, as a matter of domestic law, appeared to take precedence.

Mr Chiu explained that during DTA negotiations, both Hong Kong and France did not consider such situations within the context of the Non-discrimination Article, meaning that there had been no agreement between Hong Kong and France in respect of the provision of tax credit to PEs operating in the other's jurisdiction.

Mr Chiu went on to say that in such triangular cases, Hong Kong needed to seek the agreement of France, without which a tax credit provided by Hong Kong would not be appropriate since there had to be reciprocal treatment in respect of French branch of a Hong Kong bank in similar situations.

Mr Chiu summarised that it would not be appropriate for Hong Kong to take a position without having an agreement reached with France since DTA provisions were expected to operate on a reciprocal basis.

Mr Ng told the meeting that he had come across similar situation where his client lobbied for tax credit to the foreign branches in its home country. However, he was unsure whether his client would be able to claim tax credit under the France-Mainland DTA. Ms Chan pointed out that the profits of the Hong Kong branch of a French bank might not be subject to French tax and hence not getting a tax credit. Mr Chiu said that he needed to clarify with the French side if there was an actual case. In replying to Ms Chan, Mr Chiu said that Hong Kong would need to consider including a provision to clarify such triangular cases in the future DTA negotiations.
(c) Non-discrimination article and buyer's stamp duty

The following jurisdictions have signed DTAs with Hong Kong which contain a non-discrimination clause that applies to all taxes, i.e. the provisions of the non-discrimination article should, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.

- Austria
- Czech Republic
- Guernsey
- Japan
- Jersey
- Korea
- Liechtenstein
- Malta
- Mexico
- Portugal
- Switzerland

Would the IRD indicate whether nationals of the relevant countries (or such other definition as the particular double tax agreement may apply) are exempted from buyer’s stamp duty (“BSD”) and from double ad valorem stamp duty (“DSD”) on their first residential property purchase pursuant to the relevant DTAs?

CIR informed the Institute that all of the above DTAs had been negotiated prior to the enactment of the legislative provisions in the Stamp Duty Ordinance (“SDO”) relating to BSD and DSD. He said that at the time of negotiations, contracting partners could not have any position as to whether BSD or DSD should be covered under the Non-discrimination Article of the relevant DTA. He mentioned that after enactment of the legislative provisions relating to BSD and DSD, the contracting partners had not made any enquiry to the Hong Kong Competent Authority as to whether BSD or DSD should be covered thereunder. CIR held the view that before seeking the view of contracting partners, it might not be appropriate to express a categorical view whether they should be covered or not, in particular in situations where the contracting partner had similar measure to curb property speculations.

CIR clarified that the Non-discrimination Article merely required Hong Kong to treat a national of a contracting party as favourably as a person having the right of abode in Hong Kong or incorporated or otherwise constituted in Hong Kong, in the same circumstances, in particular with respect to residence. He elaborated that the article meant: persons were not in the same circumstances if one person was a resident of Hong Kong and the other was not a resident of Hong Kong. If the foreign national was not a resident of Hong Kong, Hong Kong had no obligation to give same tax treatment to the foreign national as if he was a Hong Kong resident.
CIR concluded that it would not be appropriate for Hong Kong to take a position without having an agreement reached with a contracting partner since DTA provisions were expected to operate on a reciprocal basis.

In reply to a question from Mr Tisman, CIR explained that under the SDO, the buyer who was a Hong Kong permanent resident acting on his or her own behalf in acquiring a residential property would be exempt from payment of BSD while the buyer who was a Hong Kong permanent resident and did not own any other residential property in Hong Kong at the time of acquisition would also be exempt from DSD. CIR said that the definition of “permanent resident” in the SDO was different from the definition of “resident” in the DTA.

Mr Tisman noted that the meaning of “permanent resident” referred to a person’s right of abode in a country. He asked whether, therefore, a national of a contracting party who was merely resident in Hong Kong would be given the same exemption for BSD and DSD as if he were a permanent resident. CIR replied that the question of whether a foreign national was a tax resident of Hong Kong did not hinge on his right of abode in Hong Kong, and for the tax treaty purposes, the definition of “resident” in the provisions of the DTA should prevail. If a foreign national of a DTA jurisdiction, the DTA with which had a Non-discrimination Article that covered all taxes, acquired a residential property in Hong Kong, he had to pay the BSD and DSD unless he was a “Hong Kong permanent resident” under section 29A of the SDO. Ms Chan followed up and asked whether the meaning of “permanent resident” in the SDO had the same meaning given in the IRO. Mr Tam replied in the negative and stated that for the purposes of the SDO, Hong Kong permanent resident mainly included a holder of valid Hong Kong permanent identity card.

Mr Ng asked whether the issue could be raised with the treaty partners, given that there might be cases of potential complaints on tax discrimination in the circumstances mentioned. In response, CIR said Hong Kong would consider raising the issue with the treaty partners in actual cases.

(d) Relief for double taxation arising from transfer pricing adjustments

Article 9 of the comprehensive DTAs that Hong Kong has signed provides a mechanism for relief to be given by a DTA state for the economic double taxation arising from transfer pricing adjustments imposed by the counterparty DTA state. In particular, as elaborated in DIPN 45, where the IRD agrees that the transfer pricing adjustment determined by the competent tax authority is correct both in principle and amount, the relevant assessment of the Hong Kong enterprise will be revised in accordance with Article 9 of the DTA and section 79 of the IRO, to refund the excess tax paid or to reduce the tax that would otherwise be payable on the assessable profits of the Hong Kong enterprise.
In this connection, the Institute would ask the IRD to clarify its view on the following situations encountered by tax practitioners, when applying for the corresponding adjustment relief under Article 9 of the Mainland-Hong Kong DTA.

(i) In certain cases, the amount of additional tax paid by a Mainland enterprise in the Mainland under the transfer pricing adjustment was smaller than the amount of tax refundable to the associated Hong Kong enterprise, due to the difference in the applicable corporate tax rates. For example, the Mainland enterprise was enjoying a tax holiday in the Mainland and, hence, it was subject to Mainland Corporate Income Tax at 12.5% (i.e. 50% of standard tax rate of 25%) on the additional profits made under the transfer pricing adjustments. Meanwhile the associated Hong Kong enterprise applied for a tax refund on the corresponding amount which was taxed at 17.5%/16.5% under the prevailing Hong Kong profits tax rates.

When considering the corresponding adjustment application, the IRD assessors indicated that the IRD would not agree to refund to the Hong Kong enterprise, an amount which is more than the amount of additional tax paid by the Mainland enterprise.

It is the Institute's view, however, that as long as the IRD is satisfied that the transfer pricing adjustment determined by the Mainland tax authority is correct in principle and amount, the IRD should refund the tax paid by the Hong Kong enterprise on the same profit, and the applicable tax rates should be irrelevant when considering the application. Would the IRD clarify its position in such situations?

Ms Lee emphasized that where the Commissioner agreed that the transfer pricing adjustment made by the Mainland tax authority to increase the taxable income of a Mainland enterprise was correct both in principle and in amount, the relevant assessment of the Hong Kong associated enterprise would be revised in accordance with the relief provision in paragraph 2 of Article 9 (Associated Enterprises) of the Mainland-Hong Kong CDTA and section 79 of the IRO. She explained that according to that Article 9, the IRD was to make an appropriate adjustment to the amount of the tax charged on the relevant profits. The revised assessment would be based on the assessable profits after transfer pricing adjustment and calculated in accordance with the IRO. She said that it would likely result in the reduction of profits tax, and any excess tax paid would then be refunded to the Hong Kong associated enterprise accordingly.

Ms Lee added that the IRD, on the whole, failed to see the relevance of the tax rates imposed in the Mainland on the transfer pricing adjustment it made.

(ii) When considering the corresponding adjustment application, it appears that the IRD assessors tend to focus on analysing and challenging the profitability of the
Hong Kong enterprise. It is the Institute’s view that the IRD should focus its review on whether the Mainland transfer pricing adjustment is correct in principle and amount, rather than other aspects of the Hong Kong enterprise that should be conducted under a separate review, if required. Given the above, would the IRD advise the main areas of review when it considers the corresponding adjustment applications?

Ms Lee explained that in considering whether the primary adjustment made by a DTA partner was correct both in principle and amount, an assessor had to examine all the circumstances of the case including the profitability of the Hong Kong enterprise and its associates. She pointed out that the purpose of the examination was to ensure the profits allocated to the Hong Kong enterprise reflected arm’s length pricing among the parties concerned.

Ms Lee indicated that the main areas of review would vary depending on the facts and circumstances of each case. She said that the assessor, in general, would:

(a) analyse particulars of business operations and business activities of the Hong Kong enterprise and the overseas associated enterprise, in particular those gave rise to the profits claimed to be doubly assessed;

(b) examine details of major transaction flows between each relevant enterprise and significant transfer pricing arrangements or practices adopted: for this purpose, relevant enterprises might not necessarily be restricted only to the Hong Kong enterprise and the overseas associated enterprise which was subject to transfer pricing adjustment by the DTA partner;

(c) study documents relating to similar dealings on arm’s length by the Hong Kong enterprise, as well as relating to pricing policies, product profitability and profit contribution of each relevant party;

(d) look into documents establishing reasons for selecting particular pricing methodologies before any primary adjustment made by the DTA partner, and the methodologies adopted by the DTA partner with the reasons for its selection.

Ms Lee went on to say that when conducting such an examination, the assessor required an understanding of how each group enterprise contributed to the overall trading activities of the group. Representatives of Hong Kong enterprise were to explain exactly what the Hong Kong enterprise did and how other group enterprises were involved, in order to assist the assessor to consider where the relevant risk lay. Such an analysis was the most critical part of any transfer pricing report. She remarked that without a full understanding of what a Hong Kong enterprise did, it was impossible to make a valid assessment of whether it received an arm’s length reward. She suggested that representatives were to
ensure that the analysis had been prepared with substantial input from the staff in the business of the Hong Kong enterprise who had day to day experience of operating the relevant functions in Hong Kong.

Ms Lee stressed that the analysis prepared by representatives had to describe what activities the Hong Kong enterprise performed, where those activities took place, who bore what risks and who got what reward. Such information would be helpful in considering the relative weight and importance of those activities in earning profits for the Hong Kong enterprise and the group.

(iii) It appears to practitioners that a number of reviewers (assessors/ senior assessors/ chief assessors) are involved in reviewing a corresponding adjustment application. As a result, it is observed that there may be some inconsistencies on the focus of the review and in the information requests, which can prolong the review process and lead to certain amount of confusion for practitioners and taxpayers. The Institute would like to seek the IRD's clarification on its standard review procedures, e.g. the level of approval required, in this regard.

Ms Lee emphasised that it was within the Commissioner’s prerogative to set procedures. She clarified that in the course of processing an application for adjustments, the case would be monitored and reviewed by senior officers according to laid down procedures. In the event that no agreement could be reached with the taxpayer on the appropriate amount of corresponding adjustment, the Hong Kong resident enterprise might initiate the Mutual Agreement Procedure under the respective DTA.

Ms Lee said that there were, at the time, just a few cases where an appropriate adjustment was sought under the Associated Enterprise Article of a DTA. She considered that members of the Institute, therefore, should not have concern that cases were not timely processed, in particular when they were closely monitored by the senior management.

CIR supplemented that different levels of officers reviewed those cases according to laid down procedures to ensure that they were in good progress and that consistent transfer pricing methodologies were adopted.

(e) Non-resident partnerships

A Hong Kong company paid royalties for the use of intellectual property in Hong Kong to a US fund that was set up as a partnership in the US. The partnership is treated as a fiscally transparent entity for US tax purposes. The partners of the partnership consist of both individuals and corporations that are residents of different jurisdictions. What approach would the IRD take to determine the applicable withholding tax rate(s) on the royalties paid by the Hong Kong company to the US partnership? Would the
IRD look through the US partnership and consider whether each of the partners was eligible for a reduced treaty withholding tax rate (if any) on the royalties, under the respective tax treaties between Hong Kong and the jurisdictions in which they were resident? More guidance from the IRD for Hong Kong companies on the withholding tax and tax filing in situations like the above would be welcome.

Mr Chiu advised that similar questions had been raised at the 2012 (agenda item A4(d)) and 2013 (agenda item A4(a) & (b)) annual meetings. He explained that in the commentary on Article 1 of the OECD Model Tax Convention (MTC 2014 condensed version), the OECD had expressed its view on the application of DTA to partnerships. He referred to MTC's paragraph 6.4 at page 49 stating that where income had "flowed through" a transparent partnership to the partners who were liable to tax on that income in the State of their residence then the income was appropriately viewed as "paid" to the partners since it was to them and not to the partnership that the income was allocated for purpose of determining their tax liability in their State of residence. Hence, the partners, in these circumstances, satisfied the condition, imposed in several articles, that the income concerned was "paid to a resident of the other Contracting State". He said that the conditions which the income be paid to, or derived by, a resident should be considered to be satisfied even where, as a matter of domestic law of the State of source, the partnership would not be regarded as transparent for tax purposes, provided that the partnership was not actually considered as resident of the State of source.

Mr Chiu elaborated that the IRD would generally adopt the OECD approach and accept applications for treaty benefits under the relevant DTA by partners of a fiscally transparent partnership, provided that (i) the formulation of the article on royalties adopts "paid to a resident of the other Contracting Party"; (ii) the partnership was not considered as a resident of Hong Kong; (iii) all partners were residents of DTA jurisdiction(s); and (iv) the relevant DTA jurisdiction adopted a similar approach as Hong Kong. He said that different treaty rates might be applied if the rates as provided in the relevant DTAs were different. In that case, all four tests mentioned above should be applied individually to each and every partner of different DTA jurisdictions in which they were charged to tax in respect of his share of the royalties arising in Hong Kong.

Mr Chiu also explained that it was incumbent upon the US partnership in the case mentioned, if it intended to enjoy the reduced tax rate provided in the relevant CDTAs, to inform the Hong Kong payer: (i) its status as a fiscally transparent entity with supporting documents; (ii) the details of its partners and their resident status; and (iii) the respective profit-sharing ratio of each partner. He said that the Hong Kong payer could in turn write to the IRD, with tax resident certificates issued by the relevant DTA jurisdictions and other relevant information, to confirm whether the claim was acceptable. He advised that if the IRD accepted the claim, the Hong Kong payer and the recipient would be informed accordingly. The Hong Kong payer could then withhold payment at the reduced tax rate.
Mr Chiu took the view that in cases where the Hong Kong payer was not certain of the resident status of the partners and the withholding tax rate to be applied, or where the IRD had not allowed the Hong Kong payer to withhold payment at the reduced tax rate, the Hong Kong payer should deduct the withholding tax at the normal rate as required under the provisions of the IRO.

Mr Chiu informed the Institute that when lodging the tax return (i.e. BIR54), the Hong Kong payer should provide details of the nature and amount of the sum accrued to or received by the recipient, state the country/territory of which the recipient was a resident and enclose documentary evidence in support of the resident status of the recipient in any event.

As regards the “look through” approach, Ms Sarah Chan asked how many layers the IRD would look through if a partner in the partnership was another partnership. Mr Chiu responded that the IRD would generally look through two layers of partners in a fiscally transparent partnership. Ms Sarah Chan further asked how to deal with a multi-layered partnership structure. Mr Chiu replied that he was unable to comment further in the absence of details.

Ms Chan noted that all four tests mentioned above should be applied individually to each and every partner in every layer. Mr Chiu confirmed in the affirmative. Ms Chan asked whether the IRD would only look at the partnership level when one of the four tests could not be met. Mr Chiu answered that the IRD would decline the partner’s application for treaty benefits under the relevant DTA if one of the four tests could not be met.

(f) **Issuance of Hong Kong certificate of resident status (“CoR”) for part-year Hong Kong resident individuals**

An individual is a tax resident of a treaty jurisdiction (e.g. France) and has been working outside his state of residence. The individual was transferred by his employer to work in Hong Kong on 1 January 2014 and then seconded to work in the Mainland on 15 October 2014. The individual ceased his French residency on 1 November 2014.

According to the Mainland-Hong Kong DTA, he qualifies as a Hong Kong tax resident for the year of assessment 2014-15, as he has spent more than 180 days in Hong Kong for that year. For the purpose of claiming a tax exemption on the employment income derived from the Mainland under the Mainland-Hong Kong DTA, the individual would like to apply for a CoR from the IRD.

In the above scenario, we would like to seek the IRD’s view on:

(i) whether the IRD would issue a CoR for the whole year of assessment 2014-15 to the above individual; and
(ii) if the IRD considers that the individual is a French resident from January to October 2014 and a Hong Kong tax resident from November to December 2014, would the IRD issue a CoR to the individual specifying the period in which the individual was regarded as a Hong Kong tax resident?

Ms Mei advised that paragraph 1(2)(ii) of the Resident Article (i.e. Article 4) of the Mainland-Hong Kong DTA provided that the term “resident of Hong Kong” meant an individual who stayed in Hong Kong for more than 180 days during a year of assessment. She said that in the present case, an individual who stayed in Hong Kong for more than 180 days during the year of assessment 2014/15, would be regarded as a resident of Hong Kong under the Mainland-Hong Kong DTA for the calendar year 2014. Upon receipt of application for CoR under the Mainland-Hong Kong DTA, a CoR for the calendar year 2014 would be issued to that individual.

Ms Mei added that the individual in this case was a tax resident of France. She drew the members’ attention to paragraph 23 of the DIPN 44 in respect of the Mainland-Hong Kong DTA, which stated that:

“However, where the individual concerned is also a permanent resident of a third State and makes investment or carries on business in the Mainland, it is known that the Mainland will apply any treaty signed between China and the State of which that individual is a permanent resident. If there is no such treaty, the Mainland would consider to apply its relevant domestic laws.”

Ms Mei advised that although that individual was regarded as a resident of Hong Kong under the Mainland-Hong Kong DTA, the Mainland might apply the Mainland-France DTA in dealing with his income derived from the Mainland.

In reply to a question raised by Mr Ng, Ms Mei confirmed that only the calendar year 2014 but not the period of stay would be specified in the CoR issued to that individual.

(g) Application for Hong Kong CoR

Practitioners have observed that the IRD’s stance on issuing CoRs has become much more stringent. Specifically, where taxpayers have demonstrated that the board meetings have exercised control of a company in Hong Kong, the IRD officers have refused to issue a CoR on the following grounds:

• Although the board meetings were held in Hong Kong, many of the board members do not have a place of residence in Hong Kong and they spent too little time in Hong Kong; or
Although the board meetings formulated the company's policies/strategies, their implementation was carried out outside Hong Kong.

In this connection, the Institute would like to seek the IRD's view on the factors to be considered in determining the place of management or control for a non-Hong Kong incorporated company. Specifically, as the IRD is aware, there are many Hong Kong listed companies whose business operations are in the Mainland. Being an investment vehicle of the listed group, the listed company does not necessarily have as many business activities as the operating entities. Further, board members of the listed company usually have dual or multiple roles in the group and, therefore, would spend most of their time in managing the operating entities. However, while they are outside Hong Kong, they are managing the operating entities' business and not exercising their management or control of the listed company. It appears that when the IRD officers review the applications, they seem to confuse the listed company's business as an investment holding and listed vehicle with the group's business as a whole.

Further, in most of the DTAs signed by Hong Kong, a company is regarded as a Hong Kong tax resident (i) if it is incorporated in Hong Kong; or (ii) if incorporated outside Hong Kong, it is normally managed or controlled in Hong Kong. Practitioners have recently come across situations where detailed information is requested for Hong Kong incorporated companies applying for the CoRs. Would the IRD clarify the reasons for requesting such detailed information.

In responding to the questions raised in item A4(e) of the 2014 annual meeting, the IRD confirmed that the business registration was not a conclusive factor in determining whether a company is managed or controlled in Hong Kong. Despite this clarification, practitioners are still encountering situations where the IRD officers refuse to issue a CoRs, on the basis that the relevant taxpayer had not performed the business registration in Hong Kong. In this regard, the Institute would like to clarify whether the IRD has modified its view or practice in this regard.

With reference to item B3 of the 2014 annual meeting which related to the application for CoR, Mr Chiu indicated that the IRD would also consider the beneficial ownership. In this connection, the Institute would like to seek the IRD's clarification on the reasons for so doing. Specifically, as the Commissioner rightly pointed out at the meeting, the provision of a CoR does not guarantee that a claim to benefits under the relevant DTA will be successful. It is up to the tax administration of the treaty partner to determine whether all the relevant conditions are fulfilled and whether the benefits can be granted. The Institute is of the view that in considering a CoR application, the IRD should focus on examining whether the applicant is a Hong Kong resident under the relevant DTA. The issue of whether the applicant has the beneficial ownership of the sum for which the DTA benefit is sought, should be considered by the relevant DTA partner.

Mr Chiu reckoned that whether a non-Hong Kong incorporated company was normally managed or controlled in Hong Kong was a question of fact, depending on particular circumstances of each case. There was no exhaustive list of the factors to
be considered. He elaborated that the factors that would be taken into consideration include: nature of business operated by the company; the mode of operation; whether the company had a permanent office in Hong Kong; whether the company employed staff in Hong Kong; whether Hong Kong was the place where its board of directors met to formulate the central policy of its business, make its strategic policies, choose business financing and evaluate business performance; whether Hong Kong was the place where decisions by top management were implemented, etc.

Mr Chiu advised members of the Institute should take note that DTAs were international treaties and Hong Kong had the obligation to administer the terms of the DTA in accordance with international law. He said that the IRD, as the competent authority under the DTAs signed by Hong Kong, had to act in good faith in accordance with the terms agreed under the DTAs, to uphold the purposes for which these DTAs were signed (i.e. avoid double taxation and prevent fiscal evasion) and to prevent treaty abuse. He pointed out that these were the reasons why, in processing applications for CoR, the IRD had to collect detailed information of Hong Kong incorporated companies and also to ascertain beneficial ownership so as to prevent treaty abuse and to protect Hong Kong’s reputation as a responsible treaty partner.

Mr Chiu went on to say that in order to ensure Hong Kong had sufficient safeguards against treaty abuse and streamline the information gathering process, the application forms for CoR in respect of company incorporated in or outside Hong Kong had been amalgamated and released recently, effective 1 February 2015 [IR1313A (for Mainland-Hong Kong DTA) & IR1313B (other than Mainland-Hong Kong DTA)].

Mr Chiu indicated that in the DTAs signed by Hong Kong, the term “resident of Hong Kong” included a company incorporated in Hong Kong. He, however, pointed out that if such company was only a conduit or paper company, it would not be regarded as the beneficial owner of passive income (e.g. dividends, interest and royalties) in accordance with the provisions of the DTAs. He remarked that in processing applications for CoR, if the IRD came across any application which was obvious or there were reasonable grounds to suspect that the applicant was not the beneficial owner of the income in question, the IRD had the responsibility to gather further information in order to be satisfied that the provisions of the DTA had been duly complied with.

Mr Chiu emphasised that in determining whether a company was managed or controlled in Hong Kong, the IRD’s stance that business registration was not the conclusive factor remained unchanged. He, however, advised members of the Institute should take note that Hong Kong’s DTA partners took a strong view, which was not wrong, that a company without commercial substance in Hong Kong should not be entitled to any treaty benefits under DTAs. Mr Chiu therefore encouraged the Institute’s members to advise their clients that treaty abuse would not be tolerated by Hong Kong’s DTA partners.
Ms Chan sought clarification of the IRD’s view on what constituted commercial substance in Hong Kong. She mentioned that there could be a case of, for example, a holding company which held a group of companies with operations in Hong Kong, but did not employ any staff in Hong Kong. In response, Mr Chiu confirmed that the group as a whole would be looked at. In his view, the holding company would probably be considered as a Hong Kong tax resident even though the holding company did not have any staff in Hong Kong but the whole group had operations in Hong Kong. Mr Chiu, however, said that the IRD had come across situations whereby some treaty partners adopted the same approach while others took a different view. Ms Chan concurred and said that some countries would only look at the holding company itself.

(h) Automatic exchange of information

The Institute would like to ask about the next steps and timetable in relation to the policy proposal for the introduction of automatic exchange of information in Hong Kong.

CIR informed the Institute that Hong Kong had indicated to the Global Forum on Transparency and Exchange of Information for Tax Purposes its support for implementing the new global standard on automatic exchange of information on a reciprocal basis with a view to commencing the first information exchange by the end of 2018, the latest timeline allowable by the Global Forum, on the condition that Hong Kong would put in place necessary domestic legislation by 2017.

CIR indicated that in order to allow the reporting financial institutions in Hong Kong to collect information in 2017 for reporting to the IRD in 2018, it was anticipated that a legal framework had to be ready by 2016. He pointed out that the Government had a very tight time schedule in this respect. He said that before introducing the legislative amendment Bill to the Legislative Council, the Government would further consult with stakeholders. He disclosed that the Financial Services and the Treasury Bureau had already conducted the first round of consultation in late 2014 and was planning to hold the second round in early 2015 after gaining some insight into this new international standard.
Agenda item A5 - Departmental policy and administrative matters

(a) Sums to be reported in the profits tax return – in respect of non-resident persons (BIR54)

Section 15 of the IRO deems certain income, not otherwise chargeable to Hong Kong profits tax, as taxable trading receipts. Sections 15(1)(a), (b) and (ba) are specifically on royalty and licence fee payments for intellectual property. Sums that fall within the scope of these subsections “received by or accrued to” the person and not otherwise chargeable to profits tax will be deemed to be their taxable trading receipts.

According to section 20B(3) of the IRO, where a person in Hong Kong (referred to as “HK Payer”) pays or credits to a person any sums deemed by sections 15(1)(a), (b) or (ba) to be Hong Kong-sourced taxable receipts, the HK Payer is required to withhold from those sums, as much as sufficient to meet the amount of tax liability. He should also report the sums and assessable profits in the “profits tax return - in respect of non-resident persons”, i.e. BIR 54, on behalf of the recipient.

It is very common that licensors require advance payments from the licensees. In the books of the HK Payers, such payments are recorded as advance payments and will be charged (accrued) to their income statements for each accounting period on an appropriate basis over the term of the licence agreements. We note that currently there are different bases of reporting adopted by HK Payers.

The first category of HK Payers reports the licence fees and royalty payments in the BIR54 on an accrued basis. This practice is cost efficient since it saves the Hong Kong withholding agent the extra effort of keeping track of the sums reported to the IRD that are different from the sums charged to the income statements. Furthermore, the reported figures could be readily cross-referenced to the amounts charged to the audited financial statements, which minimises the chance of errors and omissions. It also avoids the need to reopen prior year assessments if the advance payments are refunded by the recipients.

The second category reports all advance payments in the BIR54, since, technically speaking, the royalty and licence fee payments will be subject to profits tax upon payment, notwithstanding that they may not have actually accrued to the recipients.

In this connection, we should like to seek the IRD’s confirmation that it accepts an accrual filing approach for reporting licence fees and royalties, provided that it has been consistently applied by the Hong Kong withholding agent.

Mr Tam advised that a similar question was raised under item A1(f) of the 2009 annual meeting and the IRD’s stance on this issue had not changed since then. He pointed out that the words “received by or accrued to” were used in sections 15(1)(a), (b) and (ba) and a tax liability would arise when one of the two conditions was satisfied. He concluded that royalty income would be taxable when paid or accrued whichever was
earlier and the HK Payer had to report the income earned in the “Profits Tax return – in respect of Non-Resident Persons” (i.e. BIR54) accordingly.

(b) **Form IR56M – For Persons Other Than Employees**

The Institute notes that in item A5(b) of the 2004 annual meeting, the Commissioner indicated that requests for completion of IR56M were sent under cover of IR6036A carrying the title “Remuneration paid to persons other than employees”, and under section 51(4)(a) of the IRO. However, we note that the relevant Form IR6036A does not mention the due date for the submission of Forms IR56M. In the absence of a specified due date, and given that section 51(4)(a) requires a person to furnish requested information within such reasonable time as stated in the notice, we should like to ask what the IRD considers to be a reasonable time for the submission of Forms IR56M. Would the IRD also clarify its current practice in enforcing the submission of Forms IR56M?

Mr Tam said that Form IR56M was a form designed to facilitate the reporting of remuneration paid to persons other than employees (i.e. non-employees), such as payments paid to consultants, agents, brokers, freelance artistes, entertainers, sportsmen, writers, freelance guides, and sub-contractors. Forms IR56Ms were sent with Forms IR6036B and IR6036C under the cover of Form IR6036A. Form IR6036B was a declaration form in reply to Form IR6036A and Form IR6036C provided notes on how to complete Form IR56M.

Mr Tam pointed out that Forms IR6036B and IR56Ms would normally be sent (under the cover of Form IR6036A) together with the bulk issue of Forms BIR56A and IR56B in early April each year, if the companies or employers had lodged these forms in previous years. It was stated on Form IR6036A that the bundle of Forms IR6036B and IR56Ms should be submitted together with the separate bundle of BIR56A and IR56Bs. Therefore, IR6036B and IR56M had the same submission due date as Forms BIR56A and IR56Bs (i.e. within 1 month from the date of issue) and the same due date should likewise apply to odd issues.

Mr Tam further advised that if Form IR6036B and, where applicable, Forms IR56Ms, were not duly received with Form BIR56A within the 1-month deadline, a reminder requiring a reply within 3 weeks would be sent. If a reply remained outstanding, a formal notice might be issued to require the person concerned to provide the required information. The assessor might also consider disallowing the relevant expenses in computing the assessable profits of the company.

Ms Chan asked when Forms IR56Ms should be submitted. Mr. Tam replied that IR56Ms had to be submitted together with Form IR6036B (the declaration form), unless the taxpayer submitted Form IR6036B and declared that it was not required to file any IR56M.
(c) Field audit and investigation

The IRD was one of the first government departments to offer performance pledges to the public. It welcomes any comments or suggestions that the public may have on the way in which these services are delivered. According to its performance pledge dating from April 2014, for processing of field audit and investigation (“FAI”) cases, the standard response time is within two years after receipt of substantive information in relation to the initial investigation enquiry.

The IRD also publishes an annual report, which, inter alia, provides readers with the annual results of FAIs, in terms of the number of cases completed and back tax and penalties assessed. In order to enable the public to have better understanding on how FAI services have been delivered, would the IRD consider releasing the following information for readers’ easy reference:

(i) The movement of FAI cases, i.e. the number of FAI cases brought forward from the previous year, the number of cases started during the year, the number of cases completed during the year, and the number of cases carried forward to the following year; and

(ii) an aging analysis of unresolved cases as at the year end.

We believe that the disclosure of the above information, in particular the aging analysis, will be useful to readers.

---

Mr Tam advised that in promoting transparency of the work of FAI, the IRD provided relevant and useful information about FAI function readily available to taxpayers and their representatives through various means including the publication of annual reports, DIPNs and the penalty policy. Besides, detailed analyses of completed corporation cases illustrating the specific problem areas and the nature of major adjustments were provided to the Institute annually.

Mr Tam pointed out that the annual reports provided readers with useful information to measure the effectiveness of the FAI function through key performance indicators. He stressed that the IRD did not see the additional benefit of providing further information about the movement or aging analysis of unsettled FAI cases. In particular, the duration of a tax audit depended on, among others, the complexity of the audit issues, the taxpayer’s cooperation, and the completeness and accuracy of the taxpayer’s records. He emphasised that effective communication and taxpayer’s cooperation in ascertaining his true assessable profits at the earliest possible time would certainly help speed up audit process. The IRD would continue making every effort to conduct audits within a reasonable timeframe and maintaining an internal system to continually monitor the performance of audits to ensure they were conducted in a timely and professional manner.
(d) Handling of tax enquiries and objection cases

Practitioners have recently come across some objection cases that have continued for a very long time in the IRD Appeals Section, although, they consider, the taxpayers have provided the information requested on a timely basis; and some other cases involving numerous rounds of enquiries to the taxpayers. In a few cases, further enquires were issued to the taxpayers more than one year after they had furnished their replies to the IRD.

While we understand the IRD has its performance pledge on replies to notices of objection (12 to 18 working days) and on processing of objections by the assessing officer (within four months from receipt of notices of objection), we would ask the IRD to clarify its policy on:

(i) the time frame for settling objection cases with taxpayers in the IRD Appeals Section; and

(ii) the IRD’s response time with respect to a reply furnished by a taxpayer in objection cases.

Mr Chiu informed the Institute that the Appeals Section’s policy was to resolve objections against tax assessments consistently with the law through civil procedures, whether by agreement or through litigation. He said that the aim of the policy was to make sure that tax objections were conducted in a way that was professional and effective, supporting the IRD’s objectives to close the tax gap and to provide taxpayers with a clear understanding of the law. He pointed out that the Appeals Section operated its processes consistent with this aim and appeals officers having any involvement with the resolution of objections were fully aware of this aim.

Mr Chiu pointed out that in processing objection cases, appeals officers might have further discussions with the taxpayers to try to resolve the dispute. Usually these discussions would be with the appeals officer with the power to make the decision. He further indicated that agreement might be reached as a result of the discussions and the objection settled. He pointed out that many disputes were resolved in this way.

Mr Chiu added that the appeals officer would seek to establish and understand the relevant facts in any objection as quickly and efficiently as possible. He said that a non-confrontational approach was likely to help identify and establish relevant facts. He, however, pointed out that where needed, the appeals officer would make use of its statutory information seeking powers in the IRO to obtain the relevant facts and documents quickly and efficiently.

Mr Chiu went on to say that under section 64(3), an objection could be formally
settled by an agreement between the Commissioner and the taxpayer at any time before a determination by the Commissioner. He stressed that settlement was particularly useful in cases where the same issue had been decided upon by the courts (e.g. claim for depreciation allowance in respect of machinery or plant provided for free to a party outside Hong Kong). He suggested that practitioners in those cases should take the initiative to explain to their clients that the IRD was acting according to the law as interpreted by the courts and invite their clients to withdraw their objections instead of insisting on a determination from the Commissioner.

Mr Chiu took the view that imposing on the Appeals Section a time frame for processing of objections and a response time to reply might not be appropriate and fair since cases processed by the Appeals Section were relatively complex and in many cases involving more than one single year with many connected entities inside and outside Hong Kong.

Mr Chiu urged practitioners to liaise closely and in a timely way with appeals officers, provide them with all the necessary information and avoid withholding of information that might not be favourable to their clients. He stressed that through mutual co-operation between practitioners and the IRD, the resolution process for objections should speed up. CIR reiterated that if practitioners came across any long-running cases, it would be better for them to communicate with the case officers before a determination was made.

(e) Interest imposed by the IRD upon issuance of the notice of revised assessment

Practitioners have come across cases where an unconditional holdover of salaries tax in dispute was approved by the IRD under an objection, and the objection was ultimately settled by the IRD with the tax on the sum (“Sum A”) in dispute totally discharged. As the tax in dispute was discharged, judgment interest would not be imposed.

However, during the objection period, taxpayers received a post-departure income (“Sum B”) that was not related to the tax in dispute. In revising the assessment to settle the objection, Sum B was also taken into account. Under the revised assessment, the final tax liability was reduced by the tax on Sum A, but was increased by the tax on Sum B. As a result, judgment interest was imposed on the tax on Sum B.

This appears to be unfair to the taxpayer, as the taxpayer was not late in reporting and paying the tax on Sum B. Moreover, the situation could have been avoided had the objection been settled first, and a separate additional assessment raised on the post-departure income. Would the IRD give practical guidance on how similar cases could be handled to avoid such situations arising?
Ms Tsui stated that the nature of the powers and duties of the Commissioner under section 64(2) of the IRO was to review and revise the assessment and this required him to perform an original and administrative, not an appellate and judicial, function of considering what the proper assessment should be. She explained that the Commissioner acted *de novo*, putting himself in the place of the assessor, and formed, as it were, a second opinion in substitution for the opinion of the assessor per *Mok Tsze Fung v Commissioner of Inland Revenue* [1962] HKLR 258.

Ms Tsui further said that after *Shui On Credit Co Ltd v Commissioner of Inland Revenue* (2009) 12 HKCFAR 392 and *Aviation Fuel Supply Company v Commissioner of Inland Revenue* (judgment handed down on 15 December 2014 FACV No. 14 of 2013), it should be clear that the Commissioner was entitled to make an assessment on an entirely different basis from the original assessment that was under objection.

Ms Tsui went on to say that when entertaining objection to an assessment, the Commissioner was entitled to take into account post-departure income that came into existence after the assessor made the assessment in the first instance. She pointed out that the Commissioner had unfettered discretion to exercise his power under section 64(2) to confirm, reduce, increase or annul the assessment objected to. She said that where a revised assessment was to be issued under section 64(3), any necessary adjustment to the assessment would only be made after the subject taxpayer had agreed with the Commissioner as to the amount at which such person is liable to be assessed. In this connection, she concluded that the subject taxpayer should be well aware of the subsequent imposition of judgment interest on tax attributable to the post-departure income in question.

Furthermore, Ms Tsui pointed out that the suggestion of raising a separate additional assessment on the post-departure income was not agreeable in situations like bankruptcy (effect on proof of debt), death of the subject person (proviso (c) to section 54 limitation period) or time-bar where sections 64(3) and 64(4) permitted the Commissioner to adjust beyond the 6-year limit the assessment objected to on an entirely different basis taking into account any income that transpired after the assessment was made in the first place.

Finally, Ms Tsui pointed out that where the IRD found it necessary and for revenue protection purposes, the assessor might, before the objection was settled, raise additional assessment on the taxable income which came to light only after the objection was lodged.

(f) **Lodgment of tax returns and filing deadlines for 2014-2015**

The Institute would be interested to know the latest statistics on the filing of tax returns and the filing deadlines for 2014-2015.
Ms Lee referred the meeting to four tables. Table 1 showed that the IRD issued some 7,000 more returns in the 2013/14 bulk issue exercise and some 18,500 returns were not filed by the due dates. Table 2 showed the filing position under different accounting codes. Table 3 showed the progressive filing results. She pointed out that though there was a slight improvement in the lodgment rate from 78% to 80% for “D” code returns by the deadline, the overall performance was still far from satisfactory and the progressive lodgments remained significantly below the lodgement standards. She urged tax representatives to improve their performance in the coming years. Table 4 was a comparative analysis of compliance with the block extension scheme.

**Bulk Issue of 2014/15 Profits Tax Returns**

Ms Lee said that the 2014/15 Profits Tax Returns for “active” files would be bulk-issued on 1 April 2015. The extended due dates for filing 2014/15 Profits Tax Returns would be:

<table>
<thead>
<tr>
<th>Accounting Date Code</th>
<th>Extended Due Date</th>
<th>Further Extended Due Date</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>if opting for e-filing</td>
</tr>
<tr>
<td></td>
<td>(no extension)</td>
<td></td>
</tr>
<tr>
<td>“D” code</td>
<td>17 August 2015</td>
<td>31 August 2015</td>
</tr>
<tr>
<td>“M” code</td>
<td>16 November 2015</td>
<td>30 November 2015</td>
</tr>
<tr>
<td>“M” code - current year loss cases</td>
<td>1 February 2016</td>
<td>1 February 2016</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(same as paper returns)</td>
</tr>
</tbody>
</table>
PART B – MATTERS RAISED BY THE IRD

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

Ms Connie Chan referred the meeting to Appendix B which was compiled to illustrate the specific problem areas detected in corporations with tax audits completed during the year ended 31 December 2014. Comparative figures for the years 2012 and 2013 were included.

Ms Connie Chan reported that Field Audit teams uncovered discrepancies in 371 corporation cases, of which 289 carried clean auditors’ reports. She reported that the amount of discrepancies detected in the clean report cases accounted for 85% (2013: 79%) of the total discrepancies detected in the year 2014 and total tax of $452 million was recovered from these cases. Average understatement per clean report case was $12.61 million (2013: $12.53 million) while tax undercharged per clean report case was $1.6 million (2013: $1.8 million).

Ms Connie Chan noted that discrepancies in 2014 resulted mainly from incorrect claims of offshore profits, technical adjustments and understatement of gross profits. She said that the discrepancies in the majority of cases were detected after examining the business ledgers and source documents.

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

Agenda Item B2 – Profits Tax Issues

(a) Filing 2014/15 Profits Tax Return - Fair Value Accounting

Ms Lee explained that as an interim administrative measure, the IRD had agreed to accept 2013/14 profits tax returns in which the assessable profits were computed on a fair value basis, pending review of the *Nice Cheer* judgment, in particular whether there should be a change in law to allow continuation of the mark-to-market practice.

Since the review was still in progress, Ms Lee informed that the IRD was prepared to extend the interim measure to the filing of 2014/15 profits tax return, accepting the returns in which the assessable profits were computed on a fair value basis.

Ms Lee said that the IRD similarly agreed to re-compute the 2014/15 assessable profits computed on a fair value basis if the taxpayers subsequently adopted the realisation basis. She, however, emphasised that any request for re-computation had to be made within the time limits laid down in sections 60 or 70A of the IRO.
(b) Format specifications for supporting documents accompanying Profits Tax Return

Ms Lee said that the IRD had published on the “Tax Representatives’ Corner” of its website the guidelines specifying the preferred format for the supporting documents to be filed with each profits tax return. She further said that those specifications would facilitate the process of imaging the supporting documents. On behalf of the IRD, she appealed to tax practitioners for their assistance and co-operation to observe these guidelines when they prepared the supporting documents accompanying profits tax return.

(c) Supporting Schedules

Ms Lee noted that some practitioners, in filing profits tax returns, were supplying less than adequate supporting schedules, in particular the schedule to show what was included in the “cost of sales”. She said that this inevitably led to additional enquiries. She urged practitioners to provide sufficient supporting schedules, including a breakdown of the “cost of sales”, in filing returns.

Agenda Item B3 – Date of Next Annual Meeting

The date would be agreed between the Institute and the IRD in due course.
### Lodgement of Corporations and Partnerships Profits Tax Returns

#### Table 1
Lodgement Comparison from 2011/12 to 2013/14

<table>
<thead>
<tr>
<th>Comparison</th>
<th>Y/A 2011/12</th>
<th>Y/A 2012/13</th>
<th>Y/A 2013/14</th>
<th>and 2013/14</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Bulk issue (on 1 / 2 April)</td>
<td>172,000</td>
<td>179,000</td>
<td>186,000</td>
<td>4%</td>
</tr>
<tr>
<td>2. Cases with a failure to file by due date:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>'N' Code</td>
<td>2,100</td>
<td>2,100</td>
<td>2,200</td>
<td>5%</td>
</tr>
<tr>
<td>'D' Code</td>
<td>5,100</td>
<td>5,600</td>
<td>6,000</td>
<td>7%</td>
</tr>
<tr>
<td>'M' Code</td>
<td>9,200</td>
<td>10,000</td>
<td>10,300</td>
<td>3%</td>
</tr>
<tr>
<td>Total</td>
<td>16,400</td>
<td>17,700</td>
<td>18,500</td>
<td>5%</td>
</tr>
<tr>
<td>3. Compound offers issued</td>
<td>6,600</td>
<td>7,000</td>
<td>7,100</td>
<td>1%</td>
</tr>
<tr>
<td>4. Estimated assessments issued</td>
<td>6,100</td>
<td>6,800</td>
<td>7,100</td>
<td>4%</td>
</tr>
</tbody>
</table>

#### Table 2
2013/14 Detailed Profits Tax Returns Statistics

<table>
<thead>
<tr>
<th>'N'</th>
<th>'D'</th>
<th>'M'</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total returns issued</td>
<td>19,000</td>
<td>61,000</td>
<td>106,000</td>
</tr>
<tr>
<td>Failure to file on time</td>
<td>2,200</td>
<td>6,000</td>
<td>10,300</td>
</tr>
<tr>
<td>Compound offers issued</td>
<td>1,700</td>
<td>2,300</td>
<td>3,100</td>
</tr>
<tr>
<td>Estimated assessments issued</td>
<td>0</td>
<td>2,600</td>
<td>4,500</td>
</tr>
</tbody>
</table>
### Table 3
Represented Profits Tax Returns - Lodgement Patterns

<table>
<thead>
<tr>
<th>Code</th>
<th>Lodgement Code</th>
<th>Standard</th>
<th>2013/14 PTRs</th>
<th>2012/13 PTRs</th>
</tr>
</thead>
<tbody>
<tr>
<td>D - 15 August</td>
<td>100%</td>
<td>80% (1)</td>
<td></td>
<td>78%</td>
</tr>
<tr>
<td>M - 31 August</td>
<td>25%</td>
<td>11%</td>
<td></td>
<td>12%</td>
</tr>
<tr>
<td>M - 30 September</td>
<td>55%</td>
<td>16%</td>
<td></td>
<td>17%</td>
</tr>
<tr>
<td>M - 31 October</td>
<td>80%</td>
<td>34%</td>
<td></td>
<td>34%</td>
</tr>
<tr>
<td>M - 15 November</td>
<td>100%</td>
<td>80% (2)</td>
<td></td>
<td>80%</td>
</tr>
</tbody>
</table>

(1) 33% lodged within a few days around 15 August 2014 (31% lodged within a few days around 15 August 2013 for 2012/13 PTRs)

(2) 29% lodged within a few days around 17 November 2014 (30% lodged within a few days around 15 November 2013 for 2012/13 PTRs)

### Table 4
Tax Representatives with Lodgement Rate of less than 80% of 'M' code Returns as at 17 November 2014

1,512 T/Rs have 'M' Code clients. Of these, 703 firms were below the average performance rate of 80%.

An analysis of the firms, based on size, is:-

<table>
<thead>
<tr>
<th></th>
<th>Current Year Performance</th>
<th>Last Year Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No. of firms</td>
<td>No. of firms</td>
</tr>
<tr>
<td></td>
<td>80%</td>
<td>below the average of</td>
</tr>
<tr>
<td>Small size firms</td>
<td>100</td>
<td>1,380</td>
</tr>
<tr>
<td>Medium size firms</td>
<td>101 - 300</td>
<td>121</td>
</tr>
<tr>
<td>Large size firms</td>
<td>over 300</td>
<td>11</td>
</tr>
<tr>
<td></td>
<td>1,512</td>
<td>703</td>
</tr>
</tbody>
</table>
### Analysis of Completed FA Corporation Cases for the years ended 31 December 2012, 2013 and 2014

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales omitted</td>
<td>69</td>
<td>61</td>
<td>37</td>
<td>132,533,189</td>
<td>55,326,747</td>
<td>31,108,124</td>
<td>20,031,579</td>
<td>8,713,787</td>
<td>4,727,649</td>
</tr>
<tr>
<td>Gross profit understated</td>
<td>35</td>
<td>36</td>
<td>34</td>
<td>99,805,280</td>
<td>90,151,459</td>
<td>64,547,176</td>
<td>16,616,245</td>
<td>15,464,587</td>
<td>10,131,742</td>
</tr>
<tr>
<td>Expenses over-claimed</td>
<td>82</td>
<td>63</td>
<td>80</td>
<td>88,219,800</td>
<td>43,991,496</td>
<td>46,929,926</td>
<td>13,848,632</td>
<td>6,775,030</td>
<td>7,544,015</td>
</tr>
<tr>
<td>Technical adjustments</td>
<td>88</td>
<td>68</td>
<td>81</td>
<td>85,014,811</td>
<td>32,181,178</td>
<td>65,600,001</td>
<td>11,362,598</td>
<td>4,051,208</td>
<td>7,195,118</td>
</tr>
<tr>
<td>Other</td>
<td>94</td>
<td>67</td>
<td>97</td>
<td>74,324,527</td>
<td>205,676,841</td>
<td>144,069,989</td>
<td>11,386,574</td>
<td>27,478,223</td>
<td>15,054,183</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>410*</td>
<td>321*</td>
<td>365*</td>
<td>$1,190,861,110</td>
<td>$618,432,275</td>
<td>$512,679,168</td>
<td>$186,690,015</td>
<td>$89,785,159</td>
<td>$56,633,174</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales omitted</td>
<td>16</td>
<td>13</td>
<td>21</td>
<td>16,542,085</td>
<td>5,002,676</td>
<td>36,827,424</td>
<td>2,696,337</td>
<td>1,133,565</td>
<td>5,998,958</td>
</tr>
<tr>
<td>Purchases overstated</td>
<td>1</td>
<td>8</td>
<td>3</td>
<td>48,809,945</td>
<td>38,973,634</td>
<td>23,121,689</td>
<td>8,049,671</td>
<td>4,765,589</td>
<td>3,749,552</td>
</tr>
<tr>
<td>Gross profit understated</td>
<td>14</td>
<td>23</td>
<td>12</td>
<td>19,262,247</td>
<td>4,468,953</td>
<td>4,784,884</td>
<td>3,147,040</td>
<td>777,310</td>
<td>715,371</td>
</tr>
<tr>
<td>Expenses over-claimed</td>
<td>17</td>
<td>17</td>
<td>16</td>
<td>30,638,891</td>
<td>23,095,029</td>
<td>5,947,539</td>
<td>4,775,282</td>
<td>3,551,692</td>
<td>1,120,652</td>
</tr>
<tr>
<td>Technical adjustments</td>
<td>4</td>
<td>3</td>
<td>4</td>
<td>12,908,977</td>
<td>25,223,332</td>
<td>88,707</td>
<td>2,078,838</td>
<td>4,382,568</td>
<td>113,823</td>
</tr>
<tr>
<td>Offshore income / profits disallowed</td>
<td>17</td>
<td>28</td>
<td>30</td>
<td>8,731,869</td>
<td>44,133,052</td>
<td>48,229,547</td>
<td>1,100,449</td>
<td>5,434,416</td>
<td>7,338,308</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>83*</td>
<td>118*</td>
<td>113*</td>
<td>$176,546,696</td>
<td>$148,061,678</td>
<td>$120,997,903</td>
<td>$28,378,106</td>
<td>$21,553,360</td>
<td>$19,365,530</td>
</tr>
</tbody>
</table>

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

**Other statistics for the above cases:**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>TOTAL AMOUNT</strong></td>
<td>$6,568,698,928</td>
<td>$3,107,109,918</td>
<td>$3,644,386,335</td>
<td>$1,048,880,535</td>
<td>$437,941,363</td>
<td>$451,579,567</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>AVERAGE AMOUNT PER CASE</strong></td>
<td>$23,048,066</td>
<td>$12,528,669</td>
<td>$12,610,333</td>
<td>$3,680,283</td>
<td>$1,765,893</td>
<td>$1,562,559</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Other statistics for the above cases:**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>TOTAL AMOUNT</strong></td>
<td>$955,934,619</td>
<td>$850,178,043</td>
<td>$660,427,336</td>
<td>$156,530,715</td>
<td>$120,671,657</td>
<td>$104,948,232</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>AVERAGE AMOUNT PER CASE</strong></td>
<td>$19,152,589</td>
<td>$9,885,791</td>
<td>$8,853,992</td>
<td>$3,010,206</td>
<td>$1,403,159</td>
<td>$1,279,856</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Total Discrepancy for All Years**

<table>
<thead>
<tr>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>$7,564,633,547</td>
<td>$3,957,287,961</td>
<td>$4,304,813,661</td>
</tr>
<tr>
<td><strong>AVERAGE AMOUNT PER CASE</strong></td>
<td>$22,446,984</td>
<td>$11,848,168</td>
</tr>
</tbody>
</table>

**Total Tax Undercharged for All Years**

<table>
<thead>
<tr>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,205,411,250</td>
<td>$558,613,020</td>
<td>$556,527,799</td>
</tr>
<tr>
<td><strong>AVERAGE AMOUNT PER CASE</strong></td>
<td>$3,576,888</td>
<td>$1,672,494</td>
</tr>
</tbody>
</table>
### Table 2 (Appendix B)

**Field Audit case with discrepancy considered detectable through statutory audit**

For the period from 1.1.2014 to 31.12.2014

<table>
<thead>
<tr>
<th>Item that should be detected by Auditor</th>
<th>Amount of item for audited year that should be detected</th>
<th>Reasons why the item should be detected</th>
<th>Auditor’s Report</th>
<th>Profits understated for audited year</th>
<th>Tax undercharged for audited year</th>
<th>Total discrepancy amount for all years</th>
<th>Total tax undercharged for all years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Understatement of sales and overstatement of purchases (1 case)</td>
<td>$11,238,261</td>
<td>The taxpayer is a frozen food trading company. Apparent discrepancies were found between the amounts of sales and purchases per ledgers and the audited accounts submitted. The taxpayer confirmed that there were no audit adjustments made.</td>
<td>Unqualified</td>
<td>$15,104,019</td>
<td>$2,492,163</td>
<td>$62,586,521</td>
<td>$10,471,375</td>
</tr>
</tbody>
</table>
### Extracts of Analysis in Appendix B

<table>
<thead>
<tr>
<th>Description</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) No. of corporation cases with discrepancies</td>
<td>334</td>
<td>371</td>
</tr>
<tr>
<td>uncovered</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) No. of corporation cases in item (a) carried</td>
<td>248</td>
<td>289</td>
</tr>
<tr>
<td>clean auditor’s reports</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Total discrepancies detected in all cases</td>
<td>$3,957m</td>
<td>$4,305m</td>
</tr>
<tr>
<td>(d) Total discrepancies detected in clean</td>
<td>$3,107m</td>
<td>$3,644m</td>
</tr>
<tr>
<td>auditor’s report cases</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e) Percentage of (d) over (c)</td>
<td>79%</td>
<td>85%</td>
</tr>
<tr>
<td>(f) Total tax uncovered in clean auditor’s report</td>
<td>$438m</td>
<td>$452m</td>
</tr>
<tr>
<td>cases</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(g) Average understatement per clean auditor’s</td>
<td>$12.53m</td>
<td>$12.61m</td>
</tr>
<tr>
<td>report case</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(h) Tax undercharged per clean auditor’s report</td>
<td>$1.77m</td>
<td>$1.56m</td>
</tr>
<tr>
<td>case</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>