



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

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2007

Annual Meeting

The Inland Revenue Department

and

The Hong Kong Institute of Certified Public Accountants

2007
ANNUAL MEETING BETWEEN
THE INLAND REVENUE DEPARTMENT AND
THE HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Preamble

As part of the Institute's regular dialogue with the government to facilitate tax compliance, improve procedural arrangements and to clarify areas of interpretation, representatives of the Institute met the Commissioner of Inland Revenue ("CIR") and members of her staff in January 2007.

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

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Full Minutes

The 2006/07 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department was held on 26 January 2007 at the Inland Revenue Department.

In Attendance

Hong Kong Institute of Certified Public Accountants (the Institute)

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|----------------------|-------------------------------------|
| Ms Yvonne Law | Chairman, Taxation Committee |
| Dr Stella Cho | Deputy Chairman, Taxation Committee |
| Mr David Southwood | Deputy Chairman, Taxation Committee |
| Ms Florence Chan | Member, Taxation Committee |
| Ms Ayesha Macpherson | Member, Taxation Committee |
| Mr Peter Tisman | Director, Specialist Practices |
| Ms Elena Chai | Manager, Specialist Practices |

Inland Revenue Department (IRD)

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|--------------------|---|
| Mrs Alice Lau | Commissioner of Inland Revenue |
| Mr Chu Yam-yuen | Deputy Commissioner of Inland Revenue (Technical) |
| Mr So Chau-chuen | Assistant Commissioner of Inland Revenue |
| Mrs Teresa Chu | Assistant Commissioner of Inland Revenue |
| Mrs Jennifer Chan | Assistant Commissioner of Inland Revenue |
| Mr Chiu Kwok-kit | Assistant Commissioner of Inland Revenue |
| Mr Yim Kwok-cheong | Senior Assessor (Research) |

Mrs Alice Lau (CIR) welcomed the representatives from the Institute to the meeting. CIR expressed that the annual meeting was a valuable occasion for the Institute and the IRD to sit down and discuss issues of common concern. By the annual meeting, misunderstanding as to the interpretation and application of the tax law could be avoided. Minutes of the annual meeting also served to provide useful information to members of the Institute. Ms Law thanked CIR for meeting her and other members of the Taxation Committee of the Institute. She said that the Institute also treasured the annual meeting as a useful contact between the Institute and the IRD. Ms Law appreciated that, while a straightforward answer might not arise for every issue discussed, both the Institute and the IRD would hope to achieve the function of the annual meeting as a channel of communication between the two bodies.

PART A - MATTERS RAISED BY THE INSTITUTE

Agenda Item A1 - Profits Tax Issues

A1(a) Tax treatment of undissected lump sum receipt/payment

The Institute would like to seek guidance from the IRD as to how an undissected lump sum payment or receipt (comprising capital and revenue elements) should be treated for Profits Tax purposes under the Inland Revenue Ordinance ("IRO").

Given the fundamental distinction between revenue and capital items under the IRO, the Institute would like to enquire as to the appropriate Profits Tax treatment for a lump sum receipt or payment that could not reasonably or reliably be separated into revenue or capital portions.

Two possible examples to illustrate this point would be:

- (i) Termination of a swap transaction: upon early termination of a swap transaction, the participant in the swap agreement was entitled to receive or required to pay a lump sum to the counter-party (usually a financial institution) to the swap. Often, since it involved proprietary information, which the counter-party owned, the participant would receive notification only in respect of the total amount payable or receivable from the counter-party without a breakdown of the underlying interest and principal components. In this context, it was not possible for the participant to reliably ascertain the respective revenue and capital portions of the total amount of the receipt or payment.

- (ii) Termination of a lease agreement: upon the early termination of a lease contract requested by the lessor, it was common for the amount payable upon termination to be communicated to the lessee as a total lump sum figure, without reference to its components (e.g. compensation for the loss of revenue, compensation for agreeing to terminate the contract early). In this context, it was sometimes not possible for the lessee to reliably calculate the respective revenue and capital portions of the total payment.

Mr Chu advised that the tax treatment of a receipt or a payment would depend on its nature. To consider whether a sum or any part thereof received or paid by a taxpayer was on capital account, it was necessary to examine the terms of the agreement pursuant to which the sum was received or paid, the taxpayer's purpose of entering into the agreement and the circumstances leading to its receipt or payment.

Mr Chu explained that whether a sum contained both a capital and a revenue component was a question of fact. If it did contain both ingredients, one would expect the quantum of the two to be clearly identifiable for proper reporting in the relevant tax returns. The fact that the sum might be arrived at by reference to certain capital and income calculations did not necessarily mean that the sum comprised the two components and needed to be dissected for tax purposes. Moreover, the fact that the lump sum was a revenue receipt in the hands of the recipient did not necessarily mean that the payer was able to claim it as a deductible expense.

Mr Chu further explained that in the first example involving an early termination of a swap transaction, it would depend on the nature of the taxpayer's business and its intention in entering into the swap transaction in the first place. Where a swap was used for hedging purposes, the nature of the asset or liability hedged had to be considered in conjunction. Where the swap was used for other purposes, unless the facts showed that the lump sum contained both capital and revenue components, the badges-of-trade test would be applied and the sum would not be dissected. In the second example involving termination of a lease agreement, again it would depend on the length of the unexpired lease contract and other facts such as the circumstances leading to the termination. However, the fact that the payment was made by reference to certain loss of revenue did not necessarily make the payment a revenue expense. For a lessee, where the lease had only a few more months to run, the sum received was more likely to be of revenue nature.

Ms Macpherson said that the facts in the first example were quite common, where no breakdown was available for the principal and interest elements of a lump sum received or paid. She asked how the respective amounts of the principal and interest elements could be worked out in such circumstances. Dr Cho said that a transaction could be regarded as containing principal and interest elements and warranted an apportionment. In such cases, a basis of apportionment had to be adopted.

Mr Chu advised that some Australian cases had demonstrated that the determination of the capital or revenue nature of a compensation payment was a fact-weighting exercise. Ms Law asked if it was the IRD's view that a lump sum payment generally would not be apportioned. CIR advised that the nature and the related tax treatment of a payment nevertheless had to be determined by the peculiar facts of each case. Practitioners should provide sufficient information to the IRD in support of an apportionment claim on a payment made or received.

A1(b) Deductibility of interest expenses for shipping and aircraft businesses

The taxation of profits derived from shipping and aircraft businesses was governed by section 23B and sections 23C and 23D of the IRO respectively. Under these provisions, the assessable profits of a shipping/aircraft business were ascertained by apportioning the total shipping/aircraft profits by reference to the ratio of the "relevant sums" to the total shipping/aircraft income. Section 23E further provided that the total shipping/aircraft profits might be adjusted to correspond as far as possible to the requirements of the IRO.

In relation to the application of the above provisions (i.e., sections 23B, 23C, 23D and 23E), the Institute would like to seek the IRD's view as to whether section 16(2) of the IRO should apply in ascertaining the total shipping/aircraft profits.

This issue was of particular relevance to non-resident shipping and aircraft businesses, which were managed and controlled outside Hong Kong. Given the international nature of shipping and aircraft businesses, the bulk of their business activities were carried out outside Hong Kong and their loan financing was commonly raised outside Hong Kong. Funding might be obtained from financial institutions and non-financial institutions from all around the world including, in particular, from non-Hong Kong group companies. Similarly, any surplus cash was routinely placed on deposits with banks outside Hong Kong. Overseas bank deposits generating non-assessable interest income might be used as a security for the borrowings of the shipping and aircraft businesses.

Given the nature of the borrowing and financing activities for shipping and aircraft businesses as outlined above, it would seem to be unduly onerous to apply the rules in section 16(2) of the IRO to these businesses (in particular sections 16(2)(c) and 16(2)(d)).

Mrs Chu said that section 16(2) was enacted following the abolition of Interest Tax and as a specific anti-avoidance measure in relation to interest deductions under Profits Tax. Provisions like section 16(2)(c) and (d), in conjunction with section 16(2A), targeted commonly adopted tax avoidance schemes that took advantage of the special tax regime of Hong Kong, which did not bring into the tax net most of the offshore interest income and allowed generous exemption to a great variety of locally generated interest income (such as deposit interest derived from authorized institutions).

Mrs Chu explained that given the quantum of interest income and interest expenses and their significance to businesses, the tax treatment of interest expenses and interest income were material aspects of the IRO. There was no special provision in relation to shipping and aircraft operators under section 16(2). On the other hand, section 23E specifically provided that the total shipping profits or total aircraft profits for apportionment might be adjusted so as to correspond as nearly as might be to the sum that would have been arrived at had they been computed in accordance with the provisions of the IRO. It was clear from the above that section 16(2) should apply in ascertaining the total shipping/aircraft profits.

Mrs Chu said that, accordingly, the IRD could not see any justification to disregard the anti-avoidance measures so as to favour shipping or aircraft businesses. Neither did the IRD consider that it was more onerous to apply section 16(2) on shipping and aircraft companies than other businesses. The international nature of shipping and aircraft operations had already been duly recognised in the IRO. Specific rules and exemptions were provided in sections 23B, 23C and 23D. Besides, many non-resident shipping and aircraft businesses were exempted from Profits Tax by virtue of tax exemption arrangements and double taxation agreements.

Ms Macpherson pointed out that shipping and air carriage were international in nature. The businesses were normally managed and controlled outside of Hong Kong and surplus funds were located outside of Hong Kong. Section 16(2) related to general financing. In her view, shipping and air carriage businesses did not breach the spirit of the anti-avoidance provisions. She noted that in relation to claiming depreciation allowances, some shipping and aircraft businesses had agreed to

claim only accounting depreciation and the IRD had shown flexibility in this regard. Mrs Chu said interest and depreciation were different and depreciation involved only a difference in timing. She believed that it was fair to apply the law as it stood.

Ms Florence Chan said that the section 16(2) conditions were anti-avoidance provisions in the context of the territorial concept of taxation. She suggested that, as taxable Hong Kong shipping or aircraft income under section 23E was ascertained by calculating the “worldwide” income first, so, under a “global” concept, if the relevant companies were subject to tax in a particular jurisdiction in respect of interest received, it could be argued that this was equivalent to interest received by a local company chargeable to Hong Kong tax. Therefore, the section 16(2) conditions should be regarded as being satisfied for the purpose of computing the “worldwide” profits of an “international” shipping or aircraft business. Mr Chiu explained that as Profits Tax was only charged on the “Hong Kong” profits ascertained under section 23E rather than the “worldwide” profits, the rationale suggested by Ms Florence Chan did not justify the non-application of the section 16(2) conditions to a shipping or aircraft business.

CIR said she did not recall any concerns of a similar nature being raised when the law was changed.

A1(c) Tax treatment of financial guarantees

The Institute would like to know the IRD’s position on the taxability of income recognised in respect of a financial guarantee under the revised Hong Kong Accounting Standard (“HKAS”) 39, which took effect as from 1 January 2006.

Under the revised HKAS 39, where a financial guarantee was provided, the income therefrom would be recognised in the grantor’s profit and loss account over the period of the guarantee. Applying the principle referred to in the *Secan* case, it seemed reasonable to suggest that the timing of when such income should be subject to tax should follow the accounting treatment, i.e. the amortised amount should be taxed when it was recognised in the grantor’s profit and loss account, and not when the full amount of guarantee fee income was received by the grantor.

In the situation where a financial guarantee was provided without any fee income (e.g. for a guarantee provided by a parent company to its subsidiary company), on initial recognition, the grantor was required to recognise a liability at fair value in relation to the guarantee. Over the period of the guarantee, assuming that there was no default by the grantee, the liability would be amortised on a straight-line basis in the profit and loss account as income. As an illustration, the relevant accounting entries for a

parent company providing a financial guarantee to its subsidiary company without any fee were shown below:

On initial recognition

Dr Investment in subsidiary (B/S) x (being fair value of the guarantee)
Cr Liability under financial guarantee (B/S) x

Over the period of the guarantee

Dr Liability under financial guarantee (B/S) y (being x divided by the period of the guarantee)
Cr Income from financial guarantee (P/L) y

The Institute would like to seek the IRD's view on whether the notional income recognised in respect of a financial guarantee under revised HKAS 39 (for which no fee income was actually received by the grantor) was assessable.

For interest-free loans, the IRD had expressed its view in the "FAQ" section of the IRD website that the imputed interest income was not assessable on the basis that the lender did not have any right (legal or contractual) to receive interest and the interest income so recorded in the profit and loss account was merely a book entry for which there was no actual receipt or payment. It was therefore considered that the same principle should apply to the income recognised in respect of a financial guarantee that contractually did not provide for any fee to be earned by the grantor.

Mrs Chu advised that the *Secan* case had established the principle that the tax treatment should follow the accounting treatment, except as otherwise provided for in the IRO. For normal financial guarantee, HKAS 39 required income from the guarantee to be recognised in the grantor's profit and loss account over the period of the guarantee. This treatment was not inconsistent with the provisions of the IRO. With respect to the timing of assessment on the income from normal financial guarantee, IRD would follow the accounting treatment.

Mrs Chu further explained that accounting treatments could not alter the nature of a financial instrument, which had to be ascertained by examining its legal rights and obligations. In situations where the financial guarantee was provided without any fee income, the notional income recognised in the accounts of the grantor in respect of financial guarantee under the revised HKAS 39 would not be assessable. This was because the grantor did not have any legal or contractual right to receive

such notional income. It followed that any payment made or loss suffered by the grantor under such financial guarantee would not be deductible as it was not an expense incurred in the production of chargeable profits.

CIR noted that, historically, Hong Kong law had been quite principles-based but, in some areas, practitioners were pushing for a more rules-based approach. Dr Cho believed that because of the complexity of transactions, there might be a need for more rules to ensure a balance between certainty and flexibility. CIR explained that this was one of the reasons why DIPNs were being updated. Mr Southwood said that the work done by the IRD on DIPNs was appreciated. He felt that practitioners also wanted certainty and clarity in the legislation.

A1(d) Profits tax deduction for share-based payment recognised under HKFRS 2

In the minutes of the 2006 Annual Meeting, under item A1(d), the Deputy Commissioner, Mr. Tam, stated that “[t]he IRD had done some study on the subject and was at present researching on the practices adopted in other countries. Upon finalisation of the research, the IRD would consider to issue a DIPN”. Recently, the IRD has listed some FAQs on share-based payment transactions on its website covering some of the issues concerned. However, one important common situation was not covered, namely the situation whereby a Hong Kong subsidiary was under an agreement to pay a fee/charge to its Hong Kong or overseas parent or associated company for the latter’s share-based schemes to cover the employees of the former as well. The actual inter-company recharges in this situation could possibly be different from the profit and loss account charges of the Hong Kong subsidiary under HKFRS 2 in terms of both amount and the timing of incurring the liabilities.

Since this situation was quite common, the Institute hoped that the IRD could state its view on this matter in general. The Institute would also like to clarify whether the charge was a deductible expense for the Hong Kong subsidiary.

Further, in the FAQs, the Institute noted that the IRD had taken the position that expenses recognised under a cash-settled, share-based payment transaction were deductible only when the counter-party’s rights had vested and become unconditional. However, it appeared to practitioners that this requirement might not be in line with the relevant established case-law principle, that an accrual for a sufficiently matured liability, which could be ascertained with substantial accuracy, was tax deductible, albeit that there might not be a strict legal liability to make the payment at the time the accrual was made, or that the liability might eventually not materialise (*CIR v Lo & Lo*).

Given that the tax deduction was more a matter of timing, and in view of the general trend towards convergence of tax and accounting treatments, provided this was not inconsistent with any specific provision of the IRO, it also appeared to the Institute that it would be expedient for both taxpayers and the IRD to adopt the same in relation to liabilities accrued for cash-settled, share-based payment transactions (without reference to the vesting conditions based on the rights concerned).

The Institute requested the IRD's further consideration and comment in this regard.

Mr Chu explained that the deductibility of a recharge had to be considered under sections 16 and 17 of the IRO, and by reference to the terms of the agreement between the group company and the Hong Kong subsidiary. In general, an expense on recharge would satisfy the "incurred" test under section 16 when the Hong Kong subsidiary had an accrued liability to pay it.

Mr Chu advised that *Lo & Lo* merely confirmed that an expense incurred was not confined to a disbursement and would include an accrued liability which was undischarged. In *Lo & Lo*, the right of the employee to receive his retirement benefit was a vested right which was defeasible only in an unlikely event. In the case of a cash-settled share-based payment transaction where the counter-party's rights had not been vested, the "accounting expenses" charged to the profit and loss account under HKFRS 2 in respect of the unvested liability would appear to be in the nature of a contingent liability and would not satisfy the "incurred" test under section 16.

Ms Macpherson noted that once the scheme had been extended to the subsidiary there was a legal agreement and the subsidiary had to pay. Ms Florence Chan said that, as a result of the *Secan* case, the IRD generally took the view that income was taxable when it was recognized in the profit and loss account. However, when it came to expenses, such as stock option costs, these might not be allowed as a deduction at the time they were accrued in the profit and loss account. She considered that consistency in tax treatment was required.

CIR explained that reference should be made to the statutory provisions. There was no inconsistency if the approach adopted followed the law. Salaries tax was imposed on gains on exercise of stock options under the specific provisions of section 9 of the IRO. She added that it was difficult to respond to specific examples in isolation. CIR noted that a sub-committee under the Joint Liaison Committee on Taxation was looking at this particular area and the Institute might want to consider giving its feedback.

A1(e) Commercial and industrial building allowance

Ranking cost of buildings was commonly calculated based on half or one third of the purchase price for the purposes of commercial building allowance ("CBA") and industrial building allowance ("IBA"). In light of HKAS 17 on "*Leases*" which required companies to separately account for the cost of leasehold land and building components based on their relative fair values at the inception of each lease, some practitioners had found that in some surveyors' reports, the land costs were zero (i.e. the purchase price was equal to the building cost) while in other cases, the land costs were more than 2/3 of the purchase price, especially in high value areas (i.e. the building cost was less than 1/3 of the purchase price). If the CBA or IBA were claimed on the basis of half the purchase price, the Institute would like to clarify whether the IRD would retrospectively adjust the CBA and IBA for past years if they learned that the restated building cost for accounting purposes was less than half the purchase price (i.e. in practice the taxpayer "overclaimed") or was more than half the purchase price (i.e. in practice the taxpayer "underclaimed"). If there had been any underclaim, would the taxpayer be able to claim back the understated balance under section 70A of the IRO?

Going forward, what basis should be used to claim the CBA and IBA (i.e. half, or other proportion of the purchase price, or the fair value of building at the inception of a lease in the surveyor's report)?

Mr So explained that, for CBA and IBA, cost of construction meant the actual cost incurred on the construction of the building. This was the historical cost. On the other hand, HKAS 17 required a measurement of the fair value of the land and building portions of the property. This was not historical cost. In any event, the fair value of the building portion covered a lot more than just the cost of construction of the building. Therefore, the IRD did not consider that the implementation of HKAS 17 would affect the computation of CBA and IBA. In other words, no adjustment was required.

Mr So advised that the existing practice of calculating CBA and IBA should continue. Under the existing practice, if no exact figure of cost of construction was available, 1/2 of the first assignment price of the building generally would be adopted. There had been very few disputes on this basis of calculating CBA and IBA. Mr Chu explained that section 70A generally did not come into play on the calculation of CBA and IBA unless it could be demonstrated that the related assessment was wrong due to an error or omission in any return or statement submitted. CIR said that occasionally taxpayers made a claim on the basis of a reassignment price, in which case the assessment might be reopened as the basis adopted was incorrect.

A1(f) Tax treatment of swap gains/losses relating to non-deductible revenue items

The Institute would like to know the IRD's view on the appropriate tax treatment of gains or losses arising from hedging instruments, which were entered into to hedge against a non-deductible revenue item.

According to the Departmental Interpretation and Practice Notes No. 42 ("DIPN 42"), where gains or losses were recognised on hedging arrangements, the hedged item and hedging instrument should be considered as a whole, as the hedging instrument was an attempt to mitigate the economic risks associated with the hedged item. In particular, the IRD considered that the locality of the hedging instrument should follow that of the hedged item, and the nature of the gain or loss, being capital or revenue, arising from the hedging instrument depended on the nature of the hedged item. However, it appeared that DIPN 42 did not expressly state whether the specific tax treatment of a swap gain or loss would follow that of the hedged item.

For instance, where a taxpayer had entered into a swap contract to hedge against the interest rate risks associated with its borrowings, the interest expenses arising from these borrowings were non-deductible for the taxpayer, since they did not satisfy the conditions laid down in section 16(2) of the IRO and/or they were not incurred to produce the taxpayer's assessable profits. In this situation, the Institute would like to seek the IRD's view as to whether any gains arising from the swap contract should follow the specific tax treatment adopted for the interest expenses (i.e. be non-taxable). Similarly, any loss arising from the swap contract should be treated in the same way as the interest expenses (i.e. be non-deductible).

Mr Chiu advised that a hedging instrument was meant to compensate for fluctuations in the value of a hedged item. The IRD would examine the hedging relationship as well as the effectiveness of a hedge by reference to the facts and circumstances of each case. If the hedging relationship qualified for hedge accounting under HKAS 39 and was accounted for as such, the IRD took the view that the hedging instrument derived its character from the hedged item. Both the hedged item and the hedging instrument would be regarded as having the same nature and locality. The IRD also accepted that in general, the tax treatment of a designated and effective hedging instrument depended on that of the hedged item.

Mr Chiu explained that in situations where a swap contract was entered into as a hedge against the interest rate risks associated with borrowings, the tax treatment of gains or losses arising from the contract would depend on whether the interest expenses were deductible. However, if the swap contract did not qualify for hedge accounting in accordance with HKAS 39, the tax treatment for the swap contract and the hedged item would in general be considered separately.

Ms Macpherson said that the source of a hedged item might not necessarily follow that of the hedging item. She referred to an example where a hedging instrument arranged with a local bank would give rise to Hong Kong-sourced income whereas the hedging instrument was used to hedge against offshore trading profits.

Mr Chiu explained that the relevant transaction would be viewed as a composite transaction, and the current approach was that the nature of the hedging item should follow that of the hedged item.

A1(g) DIPN 43 - Application of offshore funds tax exemption under paragraphs 37 and 56

The Institute would like the IRD to clarify the following in relation to DIPN 43:

- (i) Investment funds are often invested in debt securities and they derived interest income from these securities. In paragraph 37, the IRD seemed to take the view that receipt of interest income could be only an “incidental transaction” when it stated: “Typical incidental transactions include custody of securities, and receipt of interest or dividend on securities acquired through the specified transactions”.

The Institute would like to clarify with the IRD the rationale for treating such net interest income as merely incidental to a specified transaction, and not profits from specified transactions.

Mr Yim explained that the tax treatment of interest or dividend on securities set out in paragraph 37 of DIPN 43 was in accordance with the provisions under section 20AC of the IRO. Section 20AC allowed exemption in respect of assessable profits derived from specified transactions, which meant “a transaction in” securities, futures contracts, etc. Interest or dividend on securities was derived from holding the securities rather than from “a transaction in” those securities. The interest or dividend therefore could only be considered as derived from incidental transactions and not specified transactions. For interest derived from a deposit (within the meaning of Schedule 16.4), the interest

was profit from a specified transaction. Dividends, offshore profits and other interest income already exempt from tax under other sections of the IRO would retain their tax-exempt status without relying on section 20AC. Ms Florence Chan pointed out that bonds were often purchased primarily for the interest income. Nevertheless, it was noted that, in practice, most bonds were issued outside Hong Kong and, therefore, the interest income arising from them would be offshore and already tax-exempt without having to rely on section 20AC.

Mr Chu said that the scope of exemption already covered the common types of transactions carried out by a typical offshore fund.

- (ii) In paragraph 56, it was stated that section 20AE should not apply if a resident person was a partner in the offshore fund.

The Institute would like the IRD to clarify what other conditions were required for this practice to apply? What happened if the resident also exercised a degree of control over the offshore fund? Would the IRD specify the degree of control required for the practice to apply?

Mr Yim explained that paragraph 56 had been misread. The paragraph only stated that the mere fact that a resident person was a partner in an offshore fund would not render the offshore fund an “associate” of the resident person for the purposes of section 20AE. This did not amount to saying that section 20AE did not apply to the resident person. The practice was adopted to avoid invoking section 20AE on a resident person in the generality of cases where the resident person was a partner in an offshore fund but only entitled to less than 30% of the profits of the offshore fund.

Mr Yim further explained that section 20AE still applied to the resident person if he was entitled to 30% or more of the profits of the offshore fund, or any percentage if the offshore fund was an “associate” of the resident person by reasons other than that the resident person was a partner in the offshore fund.

A1(h) Definition of certificate of deposits

The Institute sought clarification from the IRD as to the definition of a Certificate of Deposit (“CD”) for the purposes of the IRO.

It appeared that there were differing views on the definition of a CD. Some might consider that debt securities, irrespective of whether they were issued by Financial Institutions (“FIs”) or non-Financial Institutions (“NFIs”), fell under the definition of CD in section 2 of the IRO, and thus the interest income derived therefrom should follow the prescribed tax treatment in DIPN 21 (i.e. be fully taxable in the hands of the FIs which acquired them). However, others were of the view that only debt securities issued by FIs were classified as CDs for Profits Tax purposes.

Since NFIs should not have the authority to take deposits under the Banking Ordinance, it should be reasonable to hold the view that, even if debt securities in principle fall within the definition of CD, only debt securities issued by FIs should be regarded as CDs for Profits Tax purposes. Debt securities issued by NFIs, on the other hand, should be regarded as loans and the interest income derived therefrom should be determined by reference to paragraph 28, point 1 under DIPN 21.

The Institute would like the IRD to advise as to its position on this issue.

Mr So advised that the position of the IRD was that a CD might be issued by a NFI. The definition of CD in section 2 of the IRO did not require that a CD must be issued by a FI. The IRD considered that the meaning of the word “deposited” in the section 2 definition of CD should not be restricted by the term “deposit” as defined in section 2 of the IRO, which term was only introduced into the IRO after the enactment of sections 15(1)(j) and (k) and the definition of CD. Therefore, IRD’s position was that a CD was not confined to a loan of money to a FI. The Banking Ordinance was not relevant to the issue. CIR added that, in principle, the same term could be defined differently in different ordinances. There was no need to look to other ordinances unless a definition was unclear or an undefined generic term was used.

Ms Macpherson noted that, under the IRD’s definition, a simple loan would fall into the definition of a CD. Mr So replied that it was necessary to look at the document itself and section 2 of the IRO. There were conditions in section 2. A loan to an NFI might be, but was not necessarily, a CD.

A1(i) DIPN 21 - Locality of profits

The Institute requested an update on the progress with regard to revising DIPN 21 on the locality of profits.

CIR advised that the work on revising DIPN 21 was in progress. IRD would seek the Institute's comments when the draft was finalised.

Agenda Item A2 - Salaries Tax Issues

A2(a) DIPN 10 - time apportionment

(i) Follow up on 2006 Annual Meeting and revised DIPN 10

The Institute firstly requested an update on the revisions to DIPN 10.

At the 2006 Annual Meeting, in response to the Institute's request for clarification on the practice in allowing time apportionment (minutes of the 2006 Annual Meeting, item A3(a) referred), the CIR replied that the drafting of the revised DIPN was near completion. Given the revised DIPN had yet to be issued, the Institute would like the IRD to follow up on the issue raised in the 2006 meeting. At that meeting, the Institute reported practitioners' observation that, in some instances, assessors disallowed claims of non-Hong Kong employment on the basis of minor facts, rather than looking at the substance of the employment arrangement. We would be grateful for the IRD's response to this and clarification of its current position on non-Hong Kong employment.

Mrs Jennifer Chan advised that the revised DIPN 10 in draft was sent to the Institute for comments in early April 2006. In August 2006, the Institute had sent its comments to IRD.

Mrs Jennifer Chan explained that the original DIPN 10 was prepared in 1987, almost some 20 years ago. Since 1987, there had been numerous decisions at the Board of Review and also another Court decision [*Lee Hung Kwong v. C.I.R.*, 6 HKTC 543] on the source of employment. It was necessary to update this Practice Note with some of these decisions. The revised draft was intended to bring more clarity, especially in respect of the three factors mentioned in the original DIPN. The IRD was working on the revised draft and in the process would try to incorporate all

relevant comments from the Institute, the Joint Liaison Committee on Taxation (“JLCT”) and other professional bodies. It was IRD’s plan to issue the revised DIPN as soon as it was ready.

Mrs Jennifer Chan advised that, regarding the Institute’s question about assessors disallowing claims of non-Hong Kong employment on the basis of minor facts rather than looking at the substance of the employment arrangement, it was never intended to concentrate on minor facts and to disregard the substance of the employment arrangement. However, as decided in the *Geopfert* decision, all relevant facts have to be taken into account.

(ii) Determination of non-Hong Kong employment in cases of no employment contract

According to a member firm, in handling a time apportionment case, the IRD had sent various letters requesting information including a copy of the employment contract. However, some commercial businesses did not issue employment contracts. It seemed there was no clear practical guidance on this issue in DIPN 10, which made it very difficult to substantiate non-Hong Kong employment in some circumstances, regardless of the merits of the case. We should also be grateful for the IRD’s response to this particular point.

Mrs Jennifer Chan explained that in the present day and age, employers and employees normally would like to set out their respective rights and obligations in writing in an employment contract, especially with high-pay employees who were recruited to fill important positions. The IRD would consider the absence of a written contract rather unusual. There were occasions in the past where taxpayers and their advisors told the assessors there was no written contract. However, when the assessors approached the Immigration Department, the assessors could sometimes obtain the written contracts. If taxpayers or advisors should adopt the approach of refusing to supply available documents, the IRD would take a serious view of such uncooperative attitude, which could also amount to the supply of false information depending on the circumstances.

Mrs Jennifer Chan advised that if indeed there was no written contract, the IRD would consider the factual situation of who had control over the employee, the capacity that employee represented to third parties, the organisation set-up of which that employee was part, etc. Based on the facts, the assessor would come to the view of whether the person had a non-Hong Kong employment.

(iii) Apportionment of ex-gratia termination payments

The question was whether a non-contractual or ex-gratia termination payment, which was calculated by reference to an employee's total length of service and made to the employee when he was based in Hong Kong, could be apportioned to exclude that part attributable to his previous non-Hong Kong service, as being non-Hong Kong-sourced employment income.

For example, an employee was employed by a US company in 1991 and was posted to work in Hong Kong only at the end of 2000. He started paying Salaries Tax in 2001 on time-apportionment basis, under section 8 (1A) of the IRO, but his employment was terminated at the end of 2005 while he was still under the Hong Kong assignment. His employer, on account of his past 15 years of total service, agreed to give him an ex-gratia termination payment of \$1,500,000 (i.e. \$100,000 for each year of service).

The Institute would like to know whether in these circumstances the IRD would be prepared to exclude two-third of \$1,500,000 as non-taxable in Hong Kong, as the amount was related to the previous non-Hong Kong service of the employee. The taxable portion of \$500,000 would then be subject to the normal time-apportionment assessment for 2005 (or relate back for a three-year period, under section 11D(b)(i), if the employee so elected).

Further, what would be the position of the employee in the example if he were under a Hong Kong employment contract and qualified for the income exclusion under section 8(1B) of the IRO (i.e. no services rendered in Hong Kong) during the years from 1991 to 2000. Would he similarly be able to exclude two thirds of the ex-gratia termination payment from the charge of Salaries Tax in 2005?

Mrs Jennifer Chan advised that in the example given by the Institute, the IRD would first consider (a) whether the employee had an entitlement to part of the sum of \$1,500,000 since 1991, similar to arrears of pay, but had not received payment until 2005, or (b) whether the employee had no right to claim until the end of 2005 when his employment was terminated. If it was (a), section 11D(a) was applicable and if it was (b), section 11D(b) was applicable.

Depending on the applicable subsections of section 11D, the income would be included in the relevant years of assessment and assessed according to the time basis factor for the particular year concerned if time basis apportionment was relevant to the case, i.e., non-Hong Kong employment

situations. If it was a Hong Kong employment, the sum would be included in the relevant years of assessment and assessed according to section 8(1)(a), read together with sections 8(1A)(b)(ii) and 8(1B).

A2(b) Tax credits - situations where double taxation cannot be relieved by way of the tax credit provisions

The Institute understood that, under the relevant Mainland China tax laws, a bonus received by a Hong Kong resident exercising his Hong Kong employment partly in the Mainland was taxed in full in the Mainland without the usual days-in-days-out apportionment.

However, it appeared that the current practice of the IRD was not to allow a tax credit in Hong Kong on the full Mainland tax paid on such bonuses, even in the case where the Hong Kong resident chose to claim a tax credit instead of the section 8(1A)(c) exclusion. Rather, the Mainland tax paid on the bonus was required to be scaled down for tax credit in Hong Kong by reference to the days-in-days-out formula.

The practice was apparently based on the assumption that part of the Mainland tax paid on the bonus was not attributable to the Mainland services and was not paid in respect of income derived from the Mainland (but paid in respect of income derived from the Hong Kong services). The full Mainland tax paid was therefore not creditable under the previous limited tax agreement between Hong Kong and the Mainland. If this was the case, part of the bonus received by the Hong Kong resident would be subject to double taxation in the Mainland and Hong Kong.

The Institute would like the IRD to clarify this issue and advise whether the situation will be different after the comprehensive Arrangement between Hong Kong and the Mainland (“the Arrangement”) signed in August 2006 came into effect (e.g. whether the IRD would, upon request, invoke the mutual agreement procedure under Clause 2 of Article 23 of the Arrangement to resolve the issue, if necessary).

Mr Chu advised that paragraph 2 of Article 4 of the previous limited agreement between Hong Kong and the Mainland (“the Limited Arrangement”) provided that a tax credit against the Hong Kong tax imposed could only be allowed in respect of the income which was derived from the Mainland, which meant income derived from the exercise of employment there. As the bonus received by a Hong

Kong resident was attributable to services rendered by the taxpayer partly in Hong Kong and partly on the Mainland, only a portion of the bonus could be regarded as having been derived from the Mainland from the exercise of his employment there. It was thus only this portion of the bonus that would fall within the scope of double taxation relief as provided under the Limited Arrangement. Notwithstanding the fact that Mainland tax had been paid in respect of the remaining part of the bonus that was derived from Hong Kong, no tax credit could be allowed.

It should be noted that the above method of elimination of double taxation remained unchanged under the Comprehensive Arrangement signed between Hong Kong and the Mainland on 21 August 2006 (see paragraph 2 of Article 21 of the Comprehensive Arrangement). In the circumstances, the IRD considered it both proper and correct to maintain the existing assessing practice after implementation of the Comprehensive Arrangement.

Mr Chu explained that where a person was aggrieved by an assessment raised by either side, he might raise objection with the relevant authority in accordance with the domestic law; or if he considered that the actions of one side or both sides resulted or would result in taxation on him not in accordance with the provisions of the Comprehensive Arrangement, he might, in accordance with Article 23, present his case to the competent authority of the side of which he was a resident to invoke the mutual agreement procedure. In reply to a question from Ms Law, Mr Chu confirmed that an amount of tax credit given to a taxpayer could be the subject of an objection.

The IRD had just issued DIPN 44 on the Comprehensive Arrangement in January 2007. Reference could be made thereto for clarification on how the IRD interpreted the provisions under the Comprehensive Arrangement.

Dr Cho said that, as there was no days-in-days-out apportionment in the Mainland, double taxation on the bonus actually arose. She asked if tax credit could also be allowed in respect of the person's number of days in Hong Kong. CIR reiterated that no such tax credit could be allowed as Hong Kong had to tax that part of the bonus derived from Hong Kong. Mr Tisman asked whether the matter could be raised with the Mainland, given that there might, in practice, be cases of double taxation. CIR said that if the IRD was provided with sufficient data on actual cases, they could consider raising the issue in their annual meeting with the Mainland side.

A2(c) Tax treatment for restrictive share award schemes

DIPN 38, last revised in March 2005, dealt only with stock option schemes, but the IRD had committed to issue a separate practice note to cover the tax treatment of other share award schemes, especially those with a vesting period or other restrictions.

The Institute would like to enquire about the timeframe for issuing the proposed practice note.

CIR advised that tax treatment of share awards received by employees from schemes operated by their employers would depend very much on details of the terms in the relevant schemes. IRD was waiting for comments from the JLCT, which had formed a sub-committee to study the topic. In any case, if no further comments were received in the coming few months, IRD might include some general guidelines in a revised DIPN 38.

Agenda Item A3 - Cross-border Tax Issues

A3(a) Operation of sections 15(1)(a), 15(1)(b) and 15(1)(ba) of the IRO

The Institute would like to seek IRD's clarification on the operation of sections 15(1)(a), 15(1)(b) and 15(1)(ba) of the IRO, as follows:

- (i) What was IRD's view on the relative scope of sections 15(1)(a) and 15(1)(b)? Did the IRD consider that they were mutually exclusive and that section 15(ba), which closely followed the wording of section 15(1)(b), related only to that subsection?

CIR advised that the two provisions were differently worded and were introduced with different objectives. Section 15(1)(a) related to income arising from "the exhibition or use" of certain *media items* in Hong Kong whereas section 15(1)(b) brought into charge the income received or accrued from "the use of or right to use" the specified *intellectual properties* in Hong Kong.

There might be some overlapping in that the items that generated profits chargeable under section 15(1)(a), i.e. cinematograph or television film or tape, sound recording etc., might also be "copyright material" for purposes of 15(1)(b).

The IRD did not think the 2 subsections were mutually exclusive. However, where the charges overlapped, tax would only be imposed on either one of the provisions.

CIR explained that the wording of section 15(1)(ba) mirrored that of section 15(1)(b). It expanded the latter to include the income for the use of or the right to use the specified intellectual properties outside Hong Kong where the sum was deductible in ascertaining the assessable profits of another taxpayer in Hong Kong.

- (ii) The IRD's comments on Agenda Item A4(c) - Operation of section 15(1)(ba) of the IRO - in the 2006 Annual Meeting was based on the assumption that the "royalties" were for the use of a trade mark. Would the IRD's view be different if the "royalties" were for the use of a patented manufacturing technology even if the finished goods were to be transported back to Hong Kong for sale in Hong Kong or for re-export?

CIR advised that, under section 73(a) and (c) of the Patents Ordinance (Cap. 514), a patent conferred on its proprietor the right to prevent all third parties not having his consent from making, putting on the market, using or importing or stocking in Hong Kong the product which was the subject-matter of the patent, or the product obtained directly by means of a patented process. It followed that if the goods were transported back to Hong Kong for domestic sales or for export, the "patent" on the relevant manufacturing technology was used in Hong Kong. Thus section 15(1)(b) should apply and the full amount of royalty paid on the patent should be taxed. The same applied to goods transited through Hong Kong.

A3(b) Plant and machinery used in import processing

In the minutes of the 2006 Annual Meeting (Agenda Item A4(a)), the CIR said, in situations where the plant and machinery were owned by the Hong Kong entity and they were used in the production of chargeable profits, the matter could be considered further:

" CIR pointed out that, in import processing cases, the Hong Kong entity was a trader not taking part in any manufacturing processes. Rather, the products were manufactured by a separate entity on the other side of the border, i.e. on the Mainland. Evidence showed that the legal title of the plant and machinery was generally no longer held by the Hong Kong entity. The issue was to be resolved by considering two factors – whether the plant and machinery were

owned by the Hong Kong entity and whether they were used in the production of its profits chargeable to tax under the IRO (if not otherwise excluded under section 39E(1)(b)(i)). Ms Macpherson pointed out that import processors incurred substantial costs on plant and machinery and the Mainland enterprise was in effect the manufacturer's agent producing goods for the Hong Kong entity. *CIR said if, in a particular case, the two factors applied, then the matter could be considered further.*" (emphasis added.)

The Institute would like the IRD to clarify, how the matter was treated, in practice, if the two factors were satisfied.

It was not uncommon for a Hong Kong company to be responsible for moulds that were loaned to the Mainland supplier or manufacturer. Such moulds were usually used solely for the production of products that belonged to the Hong Kong company. If there was no depreciation allowance allowed, this appeared to be in violation of the basic principle of allowing taxpayers to get relief for costs incurred in generating revenue. Alternatively, one can argue there was an imputed rental income for the use of the moulds outside Hong Kong included in the profits of the Hong Kong entity and such rental income should be excluded from the assessable profits of the Hong Kong entity since the moulds were used outside Hong Kong.

The Institute would like the IRD to advise its position on this issue.

Mrs Chu pointed out that, for import processing cases, information available to the IRD indicated that in most cases the Hong Kong entities were not legal owners of the P&M involved. Rather, the FIE on the Mainland generally attained legal ownership of the P&M through injection of the P&M as equity by the Hong Kong entity into the FIE or purchasing of the P&M by the FIE itself. Even if the Hong Kong entity continued to own the P&M provided to the FIE, it would be difficult for the IRD to ascertain that the P&M was not subsequently sold or transferred to other parties, that depreciation allowances on the same P&M were not claimed by other entities, and that the P&M was not used to produce goods sold otherwise than to the Hong Kong entity. The IRD would look at the actual arrangement and not merely rely on audited accounts as sufficient proof of ownership of the P&M imported into the Mainland.

Ms Law asked whether there were circumstances in which the Hong Kong company did not own the factory on the Mainland that could be acceptable as apportionment cases? She added that the

situation in the Mainland had changed, as previously, in order to obtain a subcontracting contract, it was necessary for the Hong Kong company to own a factory. This was no longer the case. Mr Chiu replied that the IRD looked at the actual operations and considered whether the Hong Kong company was really carrying out operations in the Mainland. A right of domestic sales, for example, meant that the P&M was not exclusively being used in relation to Hong Kong.

The IRD, however, would explore the matter further and welcomed the Institute's input on possible safeguards against abuses should the concession be extended. For obvious reasons, the IRD would review the current practice of granting concession to contract processing cases in like circumstances and consider if the same set of restrictive criteria should be applied.

A3(c) Apportionment of profits in import processing

In the past, the IRD had granted 50:50 apportionment for some arrangements that would now be regarded as import processing. In some cases, the Institute understood that the apportionment was agreed after queries had been raised while in other cases no queries were raised in relation to the original claim. Since the 50:50 apportionment had been strictly applied and restricted to specific forms of arrangements only, the IRD had raised queries on the back years tax returns of some taxpayers with import processing arrangements, even though it appeared that the IRD had previously allowed the apportionment in some of those cases.

The Institute would like the IRD to clarify whether all apportionments previously granted in respect of import processing arrangements were now liable to be queried and disallowed. In what circumstances would past years' tax returns be re-opened in respect of the 50:50 apportionment and in what situations would IRD seek to impose penalties where the apportionment was subsequently disallowed? If a penalty was imposed, what level of penalty is applied?

Mrs Chu advised that, where appropriate, the IRD would raise queries and withdraw the concession of 50:50 apportionment wrongly granted to import processing cases in the past.

The power of the Assessor to raise additional assessment under section 60 had been confirmed in the decision by the Court of Final Appeal in June 2006 (*Lam Soon Trademark Ltd*, FACV No. 29 of 2005). Where the information available showed that the arrangement under query was clearly import processing and 50:50 apportionment was not applicable, additional assessment would be

raised under section 60 to withdraw the 50:50 apportionment.

Mrs Chu pointed out that the issue on reopening of prior years' assessments had been raised and answered in the 2003 and 2004 Annual Meetings (Agenda Items A3(b) and A2(b) of the minutes respectively). The IRD's policy had remained the same. Reopening a back year assessment due to a change of *opinion* would require the approval of an Assistant Commissioner. For other cases, the Assessor had the power to raise additional assessment where additional information was available showing that a person had been assessed "at less than the proper amount".

IRD would impose penalty where the 50:50 apportionment was previously accepted based on omissions of information or incorrect information/misrepresentations supplied by taxpayers and/or their representatives without reasonable excuse. The level of penalty would depend on individual facts of each case. Basically, the IRD's published penalty policy would be followed.

Agenda Item A4 - Policy and Administrative Matters

A4(a) Determination of statutory due date after implementation of five-day week

The Institute would like to seek the IRD's view as to how a statutory due date under the IRO should be determined after the implementation of the five-day week scheme by the Government.

Pursuant to section 71 of the Interpretation and General Clauses Ordinance (Cap 1), "*where any act or proceeding is directed or allowed to be done or taken on a certain day, then if that day is a public holiday or a gale warning day or black rainstorm warning day, the act or proceeding shall be considered as done or taken in due time if it is done or taken on the next following day, not being a public holiday or a gale warning day or black rainstorm warning day.*" Further, "public holiday" was defined under the General Holidays Ordinance (Cap 149) to include every Sunday, but generally not include Saturday. However, as far as the Institute was aware, these provisions had not been changed since the implementation of the five-day week scheme by the Government. Where, under the IRO, a statutory due date (e.g. objection against a notice of assessment under section 64 or a holdover application under section 63J) falls on a Saturday, the Institute would like to seek the IRD's view as to whether the due date will, in practice, be considered as falling on the following Monday.

Mr So pointed out that the implementation of the five-day week scheme did not involve any change of law. Therefore, the statutory provisions cited in the question still applied to the IRO. In other words, if the due date for filing a notice of objection fell on a Saturday, the taxpayer should submit his objection on that day, unless it was a public holiday as defined, a gale warning day or a black rainstorm warning day. The taxpayer was not required to submit his notice of objection in person. He could do that by post or fax. In response to a question from Mr Southwood, CIR confirmed that submissions by mail stamped with the deadline date would be accepted.

Mr So added that, on the other hand, if a taxpayer wanted to deliver the notice by hand, he might put it into the IRD's drop-in box, which was located near the main entrance on the ground floor of the Revenue Tower. It would not be possible for taxpayers to obtain an acknowledgement stamp if they chose to submit their documents to the IRD by hand on Saturdays. For payment of tax, the post offices were open on Saturdays. Taxpayers were also encouraged to use e-payments. In general, when the IRD set the due dates for tax payments, the IRD would avoid Saturdays.

A4(b) M-code loss case companies

Under the block extension scheme, the usual filing deadline for M-code companies (with accounting date of March 31) was November 15. In respect of a company which had an allowable loss (so called "loss case company"), the IRD would generally grant an extension to January 31 in the following year.

- (i) Some practitioners understood that the reason for this concession was to enable practitioners and the IRD to focus their attention on companies with assessable profits, which generated tax revenue to the Government. As such, the Institute would suggest that consideration be given to extending the concession to companies that had no assessable profits (e.g. companies that had only non-taxable dividend income), even though they might not also have an allowable loss for the year.

Mrs Chu advised that the IRD had considered the proposal carefully but concluded that it would not be appropriate to change the current practice, i.e. the filing deadline was to remain 15 November.

Mrs Chu explained that there were several reasons why a company might declare no assessable profit or an allowable loss. For example, a company might lodge a return on the basis that it had

only received non-taxable dividend income, or only derived offshore income. Companies falling into the latter category might eventually turn out to be taxable cases if their offshore claims failed. As such, the IRD considered it would not be appropriate to allow a further extension of time to all companies declaring 'nil' assessable profits. Nor would a restricted expansion of the concession to certain companies only (e.g. companies receiving non-taxable dividend income), be warranted; the benefits to practitioners and the IRD would be limited in view of the small number of such cases involved and the complexities caused to the Block Extension Scheme. Besides, a company receiving only dividend income might be a listed company which would usually compile its consolidated accounts well before the current extended due date. In such a case, there should generally be no difficulty in complying with the current filing obligation.

- (ii) Some practitioners had indicated that most of their M-code clients were now making profits and only around 1/6 of them were still suffering losses. As a result, the number of taxpayers/practitioners making use of this concession had reduced correspondingly. Some practitioners requested the IRD to consider extending the filing deadline for Groups 22 and 23 companies that had assessable profits to a date between November 15 and January 31, so that these companies, which would not automatically have been issued a return in April, could have more time to prepare their returns. The Institute would be grateful for the IRD's response to this suggestion.

Mrs Chu advised that files bearing a prefix number of "22" were review files. When these files were due for review in a year of assessment, a majority had tax returns (about 90%) issued in April. There were also "odd-issues" of review returns when, for example, there was information showing that a company was about to liquidate or it had a potential tax liability. However, the odd-issues after the month of July were usually not significant in number.

On the other hand, M-code companies were obliged under section 51(2) of IRO to notify the Commissioner in writing about their chargeability not later than 31 July if a return had not yet been issued to them. Therefore, if a return was issued after July, the accounts of the company concerned should have already been prepared. A lengthy extension for filing such returns would therefore not be appropriate.

Mrs Chu pointed out that, regarding those newly incorporated companies bearing a prefix number of “23”, this subject had been discussed previously – see the minutes of the 2002 Annual Meeting (Agenda Item A2(c)). Tax representatives should urge their clients to comply with the Companies Ordinance (sections 111(1) and 122(1)); granting a further extension would send a wrong message of encouraging non-compliance with the Companies Ordinance.

A4(c) Lodgement of tax returns

The Institute invited the IRD to discuss the latest lodgement figures.

CIR advised that **Table A** in **Appendix A** showed that the IRD had issued more returns in the 2005/06 bulk issue than the previous year. The IRD had further extended the normal due dates for “D” code cases by 2 weeks and that for “M” code cases by 1 week. However, failures of filing returns in time (on or before the extended due dates) remained high. Nearly 10% of the returns issued had not yet been filed or had been filed late.

Table C in **Appendix A** analysed the progressive patterns of returns lodgement. The lodgement standards were not met in all cases. The overall lodgement performance had continued to deteriorate. Tax representatives were urged to improve their performance in the coming years.

The IRD would also like to remind practitioners of the following omissions spotted in the 2005/06 lodgement:

(a) Declaration of due representation in the application for extension in filing returns

Starting from 2006, when applying for block extension, tax representatives were required to make a declaration in their applications confirming that they had obtained written authorisation from their clients appointing them as the tax representative (see the previous year’s Agenda Item B1(a)). Applications without such a declaration had to be rejected and the tax representative would be asked to confirm whether written authorization from their clients had been obtained. Over 5,000 rejection letters had been issued in processing extension requests received in 2006. This created additional workload for both the tax representatives and the IRD. Tax representatives were reminded to obtain written authorization from their clients and make declaration in their applications for block extension in future. Same declaration was still

required even in the application for extension for the case of a single client. Besides, the authorisation from the clients must be in writing and bear the client's signature. Authorisation by way of emails was not acceptable. A declaration was valid for all future years in respect of the same clients.

(b) No section 16G deduction for plant and machinery used by Mainland manufacturing entities

DIPN 15 (Revised) issued in January 2006 had made it clear that P&M provided by a Hong Kong entity for use by a Mainland manufacturing entity rent-free under a contract processing arrangement that entitled the taxpayer to the 50/50 concession was under a lease for the purpose of the IRO. They were therefore "excluded fixed assets" within the meaning of section 16G(6). Capital expenditures incurred in acquisition of such P&Ms did not qualify for deduction under section 16G. However, the publication of DIPN 15 (Revised) might have escaped the attention of some practitioners. The IRD noted that many continued to claim a deduction under section 16G for such P&Ms in the 2005/06 computations. Practitioners were reminded to follow DIPN 15 (Revised) in preparing the 2006/07 returns. Similar deduction claims under section 16G would be denied and adjustments would be made when processing the returns for the year of assessment 2006/07 onwards.

CIR advised that, as the stance of IRD on section 16G had been made clear only upon the issuing of DIPN 15 (Revised) in January 2006, the IRD would not disturb the section 16G claims made and allowed for years of assessment up to and including 2005/06.

Bulk issue of 2006/07 Profits Tax returns

CIR advised that bulk issue of 2006/07 Profits Tax returns for “active” files would be made on 2 April 2007. The extended due dates for filing 2006/07 Profits Tax Returns would be:

| <u>Accounting Date Code</u> | <u>Extended Due Date</u> |
|------------------------------------|---------------------------|
| “N” code | 2 May 2007 (no extension) |
| “D” code | 15 August 2007 |
| “M” code | 15 November 2007 |
| “M” code – current year loss cases | 31 January 2008 |

PART B - MATTERS RAISED BY IRD

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

Mr Chiu advised that **Table 1** in **Appendix B** was compiled to illustrate the specific problem areas detected in corporations with tax audits completed during the year ended 31 December 2006. Comparative figures for the years 2004 and 2005 were included. **Table 2** related to a specific case with apparent irregularities which should have been detected during the statutory audit.

Table 1 showed that Field Audit teams uncovered discrepancies in 254 corporation cases, 184 of which carried clean auditors’ reports. Amount of discrepancies detected in the clean report cases accounted for 68% (80% for 2005) of the total discrepancies detected in corporation cases completed during the year and a total of \$218m tax was recovered from these cases. Average understatement per clean report case slightly reduced to \$8.1m from \$8.7m (figure for 2005) while tax undercharged per clean report case reduced to \$1.2m from \$1.3m (figure for 2005).

Discrepancies resulted mainly from overstatement of purchases, omission of sales and overclaim of expenses. In the majority of cases, the discrepancies were detected after examining the business ledgers and source documents. Unsubstantiated purchases were uncovered which, in IRD's view, could have been detected during statutory audit by vouching the payments for the purchases.

Table 2 involved a company that wrongly charged in its accounts handling fees and transportation expenses even though the sums were never paid. The sums were found to have been deposited into the personal bank account of the director. An unqualified audit report was given.

CIR said that specific cases were referred to just to give an impression of some of the issues. She hoped that the Institute would remind members to exercise due care in their work for clients.

Agenda Item B2 - Date of Next Annual Meeting

CIR proposed that the 2008 meeting might be held on the Friday of 18 or 25 January 2008. The final date would be agreed between the Institute and the IRD in due course.

Lodgement of Corporations and Partnerships Profits Tax Returns

A. Lodgement Comparison from 2003/04 to 2005/06

| | <u>Y/A</u> <u>2003/04</u> | <u>Y/A</u> <u>2004/05</u> | <u>Y/A</u> <u>2005/06</u> | Comparison 2004/05 and <u>2005/06</u> |
|--|------------------------------|------------------------------|------------------------------|--|
| 1. Bulk issue (on 3 April) | 149,000 | 143,000 | 146,000 | 2% |
| 2. Cases with a failure to file by due date:- | | | | |
| 'N' Code | 1,600 | 1,600 | 1,600 | 0% |
| 'D' Code | 4,500 | 4,000 | 4,000 | 0% |
| 'M' Code | <u>8,300</u> | <u>7,900</u> | <u>8,500</u> | 8% |
| | 14,400 | 13,500 | 14,100 | 4% |
| 3. Compound offers issued | 6,800 | 5,700 | 5,500 | -4% |
| 4. Estimated assessments issued | 4,100 | 4,300 | 5,200 | 21% |

B. 2005/06 Detailed Profits Tax Returns Statistics

| | <u>'N'</u> | <u>'D'</u> | <u>'M'</u> | <u>Total</u> |
|------------------------------|------------|------------|------------|--------------|
| Total returns issued | 16,000 | 40,000 | 90,000 | 146,000 |
| Failure to file on time | 1,600 | 4,000 | 8,500 | 14,100 |
| Compound offers issued | 600 | 1,700 | 3,200 | 5,500 |
| Estimated assessments issued | 600 | 1,500 | 3,100 | 5,200 |

C. Represented Profits Tax Returns - Lodgement Patterns

| <u>Code</u> | <u>Lodgement Standard</u> | <u>Actual Performance</u> | |
|------------------|---------------------------|---------------------------|---------------------|
| | | <u>2005/06 PTRs</u> | <u>2004/05 PTRs</u> |
| D - 29 August | 100% | 80% ⁽¹⁾ | 80% |
| M - 31 August | 25% | 11% | 12% |
| M - 30 September | 55% | 15% | 18% |
| M - 31 October | 80% | 29% | 33% |
| M - 22 November | 100% | 81% ⁽²⁾ | 82% |

(1) 31% lodged within a few days around 29 August 2006 (35% lodged within a few days around 15 August 2005 for 2004/05 PTRs)

(2) 31% lodged within a few days around 22 November 2006 (30% lodged within a few days around 15 November 2005 for 2004/05 PTRs)

D. Tax Representatives with Lodgement Rate of less than 81% of 'M' code Returns as at 22.11.2006

1,622 T/Rs have 'M' Code clients. Of these, 714 firms were below the average performance rate of 81%. An analysis of the firms, based on size, is:-

| | <u>Current Year Performance</u> | | | | | <u>Last Year Performance</u> | | | |
|-------------------|---------------------------------|---------------------------|--|------------------------------------|--|------------------------------|--|------------------------------------|--|
| | <u>No. of clients per firm</u> | <u>Total No. of firms</u> | <u>No. of firms below the average of 81%</u> | <u>No. of non-compliance cases</u> | <u>% of total non-compliance cases</u> | <u>Total No. of firms</u> | <u>No. of firms below the average of 82%</u> | <u>No. of non-compliance cases</u> | <u>% of total non-compliance cases</u> |
| Small size firms | 100 or less | 1,487 | 671 | 4,921 | 74% | 1,515 | 704 | 5,040 | 77% |
| Medium size firms | 101 - 300 | 124 | 42 | 1,646 | 25% | 119 | 38 | 1,435 | 22% |
| Large size firms | over 300 | 11 | 1 | 67 | 1% | 11 | 1 | 59 | 1% |
| | | <u>1,622</u> | <u>714</u> | <u>6,634</u> | <u>100%</u> | <u>1,645</u> | <u>743</u> | <u>6,534</u> | <u>100%</u> |

Table 1

Appendix B

Analysis of Completed FA Corporation Cases for the years ended 31 December 2004, 2005 and 2006

| Auditor's Report = Unqualified | Number | | | Discrepancy Amount by Nature | | | Tax Undercharged by Nature | | |
|---|-------------|-------------|-------------|--|------------------------|------------------------|---|----------------------|----------------------|
| | 2004 | 2005 | 2006 | 2004 | 2005 | 2006 | 2004 | 2005 | 2006 |
| Sales omitted | 21 | 21 | 40 | 29,188,511 | 20,591,422 | 43,147,687 | 4,520,540 | 2,897,294 | 7,411,410 |
| Purchases overstated | 10 | 4 | 7 | 33,730,413 | 1,728,123 | 14,841,154 | 5,449,859 | 350,862 | 1,366,542 |
| Closing stock understated | 3 | 4 | 1 | 4,107,878 | 1,598,848 | 36,712 | 657,261 | 169,850 | 5,874 |
| Gross profit understated | 27 | 31 | 17 | 53,783,583 | 63,387,464 | 50,669,617 | 8,552,421 | 9,968,242 | 8,878,418 |
| Expenses over-claimed | 32 | 37 | 57 | 14,253,326 | 10,131,095 | 60,645,475 | 2,303,064 | 1,145,114 | 10,133,289 |
| Technical adjustments | 40 | 47 | 45 | 23,741,968 | 10,082,151 | 26,384,452 | 3,329,950 | 2,420,874 | 4,305,811 |
| Other | 50 | 52 | 69 | 26,015,167 | 98,296,255 | 57,736,904 | 4,059,847 | 15,110,038 | 7,401,341 |
| TOTAL | 183* | 196* | 236* | \$184,820,846 | \$205,815,358 | \$253,462,001 | \$28,872,942 | \$32,062,274 | \$39,502,685 |
| TOTAL NUMBER OF CASES | 115* | 139* | 184* | | | | | | |
| AVERAGE AMOUNT PER CASE | | | | \$1,607,138 | \$1,480,686 | \$1,377,511 | \$251,069 | \$230,664 | \$214,689 |
| | | | | * in one case there may be more than one type of discrepancy | | | | | |
| | | | | Total Discrepancy for All Years | | | Total Tax Undercharged for All Years | | |
| | | | | 2004 | 2005 | 2006 | 2004 | 2005 | 2006 |
| Other statistics for the above cases: TOTAL AMOUNT | | | | \$956,004,128 | \$1,207,777,452 | \$1,496,676,285 | \$128,527,858 | \$184,399,144 | \$217,670,512 |
| AVERAGE AMOUNT PER CASE | | | | \$8,313,079 | \$8,689,046 | \$8,134,110 | \$1,117,634 | \$1,326,613 | \$1,182,992 |

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| Auditor's Report = Qualified | Number | | | Discrepancy Amount by Nature | | | Tax Undercharged by Nature | | |
|---|------------|------------|-------------|--|----------------------|----------------------|---|---------------------|----------------------|
| | 2004 | 2005 | 2006 | 2004 | 2005 | 2006 | 2004 | 2005 | 2006 |
| Sales omitted | 11 | 9 | 13 | 8,479,097 | 15,606,685 | 44,480,884 | 1,017,664 | 2,414,546 | 6,143,817 |
| Purchases overstated | 5 | 6 | 3 | 15,543,940 | 14,497,553 | 5,075,467 | 2,587,502 | 2,425,785 | 726,015 |
| Closing stock understated | 1 | 1 | 2 | 3,485,370 | 691,601 | 854,497 | 557,659 | 110,656 | 149,537 |
| Gross profit understated | 13 | 9 | 17 | 29,320,487 | 21,857,935 | 28,196,238 | 4,232,930 | 3,159,332 | 5,196,801 |
| Expenses over-claimed | 20 | 11 | 28 | 11,993,085 | 1,981,307 | 18,308,425 | 1,774,074 | 313,644 | 2,948,996 |
| Technical adjustments | 11 | 11 | 19 | 13,490,940 | 1,859,998 | 17,236,897 | 2,226,380 | 234,992 | 2,825,123 |
| Other | 14 | 8 | 24 | 2,903,870 | 9,966,248 | 16,361,033 | 459,775 | 688,498 | 2,482,117 |
| TOTAL | 75* | 55* | 106* | \$85,216,789 | \$66,461,327 | \$130,513,441 | \$12,855,984 | \$9,347,453 | \$20,472,406 |
| TOTAL NUMBER OF CASES | 45* | 41* | 70* | | | | | | |
| AVERAGE AMOUNT PER CASE | | | | \$1,893,706 | \$1,621,008 | \$1,864,478 | \$285,689 | \$227,987 | \$292,463 |
| | | | | * in one case there may be more than one type of discrepancy | | | | | |
| | | | | Total Discrepancy for All Years | | | Total Tax Undercharged for All Years | | |
| | | | | 2004 | 2005 | 2006 | 2004 | 2005 | 2006 |
| Other statistics for the above cases: TOTAL AMOUNT | | | | \$330,797,269 | \$307,994,676 | \$691,644,789 | \$47,298,081 | \$47,805,251 | \$104,635,184 |
| AVERAGE AMOUNT PER CASE | | | | \$7,351,050 | \$7,512,065 | \$9,880,640 | \$1,051,068 | \$1,165,982 | \$1,494,788 |

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TOTAL NUMBER OF CASES 160 180 254

| | Total Discrepancy for All Years | | | Total Tax Undercharged for All Years | | |
|---|--|------------------------|------------------------|---|----------------------|----------------------|
| | 2004 | 2005 | 2006 | 2004 | 2005 | 2006 |
| Other statistics for the above cases: TOTAL AMOUNT | \$1,286,801,397 | \$1,515,772,128 | \$2,188,321,074 | \$175,825,939 | \$232,204,395 | \$322,305,696 |
| AVERAGE AMOUNT PER CASE | \$8,042,509 | \$8,420,956 | \$8,615,437 | \$1,098,912 | \$1,290,024 | \$1,268,920 |

Table 2

**Field Audit case with discrepancy considered detectable through statutory audit
For the period from 1.1.2006 to 31.12.2006**

| Item that should be detected by Auditor | Amount of item for audited year that should be detected | Reasons why the item should be detected | Auditor's Report | Discrepancy amount for audited year | Tax undercharged for audited year | Total discrepancy amount | Total tax undercharged |
|---|---|--|--------------------|-------------------------------------|-----------------------------------|--------------------------|------------------------|
| Handling fees and transportation charges over claimed | \$7,393,792 | The taxpayer is a company providing freight forwarding services. The company charged to its accounts handling fees to overseas agencies and transportation charges. IRD's field auditor found that the payments for handling fees were not made to the overseas agencies but deposited in the director's personal bank account. For the transportation charges, the fixed sum charged to accounts at each month end was deposited in the director's personal bank account. | Unqualified report | \$7,393,792 | \$1,201,136 | \$21,406,626 | \$3,496,355 |