Hong Kong Institute of
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香港會計師公會

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Annual Meeting

The Inland Revenue Department

and

The Hong Kong Institute of Certified Public Accountants

2018
ANNUAL MEETING BETWEEN
THE INLAND REVENUE DEPARTMENT AND
THE HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Full Minutes

The 2017/18 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department was held on 18 May 2018 at the Inland Revenue Department.

In Attendance

Hong Kong Institute of Certified Public Accountants (the Institute)

Mr KK So	Chair, Taxation Faculty Executive Committee
Mr Edward Lean	Member, Taxation Faculty Executive Committee
Ms Agnes Cheung	Member, Taxation Faculty Executive Committee
Ms Sarah Chan	Member, Taxation Faculty Executive Committee
Ms Jo An Yee	Member, Budget Sub-committee
Ms Alice Leung	Member, the Institute
Mr Peter Tisman	Director, Advocacy and Practice Development
Mr Eric Chiang	Deputy Director, Advocacy and Practice Development
Mr Wallace Wong	Associate Director, Advocacy and Practice Development
Ms Winnie Chan	Associate Director, Standard Setting

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)
Mr Yim Kwok-cheong	Assistant Commissioner of Inland Revenue
Ms Fong Wai-hang	Assistant Commissioner of Inland Revenue
Ms Connie Chan	Assistant Commissioner of Inland Revenue
Mrs Wong Yu Sui-ying	Chief Assessor (Tax Treaty)
Ms Peggy Leung	Senior Assessor (Tax Treaty)
Ms Hui Chiu-po	Senior Assessor (Research)

Mr Wong Kuen-fai (CIR) welcomed the representatives of the Institute to the meeting and expressed that the annual meeting was a platform for the IRD and the Institute to exchange views on areas of common interest. Mr So on behalf of the Institute thanked CIR for arranging the annual meeting. He said that the Institute viewed the annual meeting a valuable opportunity to clarify issues which were useful and important to its members. He considered that the issues discussed during the meeting should focus on issues of common interest rather than specific cases or rulings. He remarked that with the Institute's conscious effort, the questions posed this year were more precise and concise than those in the previous meetings. He hoped that the meeting would be convened effectively and efficiently. As some representatives of the Institute joined the meeting for the first time, Mr So asked the representatives to introduce themselves in turn. CIR, after thanking the Institute's representatives for joining the meeting, introduced the IRD's officers in attendance. The meeting then proceeded to discussion of the agenda items raised by both sides.

PART A - MATTERS RAISED BY THE INSTITUTE

Agenda item A1 - Profits Tax Issues

(a) Tax treatments for transitional adjustments arising from adoption of Hong Kong Financial Reporting Standard (HKFRS) 15

HKFRS 15 *Revenue from Contracts with Customers* is effective for annual reporting periods beginning on or after 1 January 2018. Entities will be required to apply HKFRS 15 retrospectively using either a "full retrospective" approach or a "modified retrospective" approach.

Entities that elect the "full retrospective" approach will have to apply HKFRS 15 as if it had been in effect since the inception of all contracts presented in the financial statements. The comparative period will be adjusted and will show the HKFRS 15 numbers.

Alternatively, entities that elect the "modified retrospective" approach will apply HKFRS 15 to the most current period presented in the financial statements. Entities will continue to present comparative periods in accordance with existing revenue standards (e.g. Hong Kong Accounting Standard (HKAS) 18 *Revenue* and HKAS 11 *Construction Contracts*) and recognize a retrospective adjustment to the opening balance of retained earnings at the date of initial application (1 January 2018 for December year-end).

Some stakeholders are concerned that applying the new revenue standard retrospectively may result in double taxation of profits or drop out of profits as these retrospective adjustments will be reflected in retained earnings, not in the profit and loss account.

Although the IRD had commented on the tax treatment for retrospective adjustments in our previous meetings (i.e. item A4 of the 2004 Annual Meeting, item A2(a)(iv) of the 2005 Annual Meeting, item A1(e) of the 2008 Annual Meeting), those meetings were long before the introduction of the new standard.

Given that the impacts of HKFRS 15 are pervasive, the Institute would like to seek the IRD's confirmation whether its position on the tax treatment for retrospective adjustments remains unchanged (i.e. the retrospective adjustment would be taxable or deductible in the year of assessment in which the adjustment is recognized in the retained earnings).

CIR reiterated the IRD's views expressed at previous annual meetings:

- For profits tax purposes, an increase or decrease in retained earnings which satisfied the taxability and deductibility conditions under the Inland Revenue Ordinance (IRO) would be assessable or deductible in the year of assessment in which the prior period adjustment was recognised (2005 Annual Meeting, agenda item A2(a)(iv)).
- The presumption was that there should not be any drop out of profits, double taxation of profits or double deduction of expenses. Back year assessments would not be reopened under section 70A because the back year returns did not contain any error or omission (2008 Annual Meeting, agenda item A1(e)).

CIR explained that with the adoption of HKFRS 15, the accounting profits as determined in accordance with the standard would continue to be accepted as the assessable profits in most cases for profits tax purposes, except where specific tax treatment had been established through case law or provided under the IRO, or where the accounting treatment deviated from tax principles. CIR remarked that regardless of whether an entity adopted the "full retrospective" approach or the "modified retrospective" approach, any upward transitional adjustment that was revenue in nature would be subject to tax and any downward transitional adjustment that was revenue in nature would be deducted from the profits or allowed as a deduction, as the case might be, in the year of assessment relating to the basis period in which HKFRS 15 was adopted for the first time.

(b) Taxability of variable considerations recognized under HKFRS 15

In the *Nice Cheer Investment Limited* case (FACV 23/2012), the Court of Final Appeal found that unrealized profits are not chargeable to tax, notwithstanding that, in accordance with accounting standards, they have been recognized in the taxpayer's financial statements. The Court of Final Appeal further explains that there are two cardinal principles of tax law:

(1) Profits can only be taxed when earned or realized; and
(2) Neither profits nor losses may be anticipated.

The court decision leads to a question of whether the estimated amount of variable considerations included in the measurement of revenue under HKFRS 15 would be considered as “anticipated profits” in the eyes of the IRD.

The transaction price of a contract might include an element of consideration that is variable. Examples of such variables are price discounts, rebates, incentives and performance bonuses. When a contract includes variable consideration, HKFRS 15 requires the entity to estimate, at contract inception, the amount of variable consideration to which the entity will be entitled. The estimation will then be updated by the entity throughout the term of the contract to depict conditions that exist at each reporting date. The entity should recognize variable considerations as revenue only when performance obligations are satisfied and it is “highly probable” (defined in HKFRS as "significantly more likely than probable") that a change in the estimate of the variable consideration would not result in a significant reversal of the cumulative revenue recognized.

Under HKAS 18, preparers often defer measurement of variable consideration until revenue is reliably measureable, which could be when the uncertainty is removed or when payment is received. As a result, some entities may recognize revenue sooner under the new standard.

The Institute would like to seek the view of the IRD on:

(i) whether the estimated amount of variable considerations, which are recognized as revenue under HKFRS 15, is taxable under profits tax. If not, a taxpayer may need to exclude the amounts of variable considerations from the taxable profits when preparing tax computations until the uncertainty associated with the variable consideration is subsequently resolved; and

> CIR referred to *Nice Cheer* in which Lord Millett NPJ stated (in paragraph 51):
>
> “In my judgment the taxpayer’s financial statements, prepared in accordance with mandatory international accounting standards, record both profits which the taxpayer has realised during the accounting period and which are assessable to tax and increases in the value of its trading stock during the period which represent unrealised profits and are not assessable to tax. In preparing its tax computations the taxpayer was entitled to remove the amounts of its unrealised profits as not chargeable to tax.”
>
> CIR explained that realised profits were the profits earned from business transactions carried out by the company, whereas unrealised profits referred to the “accounting profits” created by writing up the value of trading stock in

accordance with the accounting standards.

CIR pointed out that the main features of HKFRS 15, which set out the principle on an entity's recognition of revenue, were explained in paragraph IN7:

> "The core principle of HKFRS 15 is that an entity recognises revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. An entity recognises revenue in accordance with that core principle by applying the following steps:
>
> (a) Step 1: Identify the contract(s) with a customer—a contract is an agreement between two or more parties that creates enforceable rights and obligations. …
>
> (b) Step 2: Identify the performance obligations in the contract—a contract includes promises to transfer goods or services to a customer. …
>
> (c) Step 3: Determine the transaction price—the transaction price is the amount of consideration in a contract to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The transaction price can be a fixed amount of customer consideration, but it may sometimes include variable consideration or consideration in a form other than cash. … If the consideration is variable, an entity estimates the amount of consideration to which it will be entitled in exchange for the promised goods or services. The estimated amount of variable consideration will be included in the transaction price only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.
>
> (d) Step 4: Allocate the transaction price to the performance obligations in the contract …
>
> (e) Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation—an entity recognises revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service)."

CIR referred to the 2016 Annual Meeting, agenda item A1(h)(i), in which it was explained that, on the application of HKFRS 15, the treatments set out in HKFRS 15 for the recognition of revenue from contracts with customers, subject to the provisions of the IRO, would generally be accepted by the IRD.

CIR held the view that, under HKFRS 15, an entity only recognised revenue (both fixed and variable consideration) under Step 5 when it satisfied a performance obligation by transferring a promised good or service to a customer. The revenue so recognised, subject to provisions of the IRO or case law, gave rise to taxable realised profits. That the recognised variable consideration was an estimated amount would not turn realised profits into unrealised profits.

Mr Lean expressed concerns on the taxability of variable consideration and mentioned that there were cases where the quantum of the variable consideration was fixed at the inception of the contract. Mr Lean gave the following illustration:

- a company had a long term contract with a customer; if the company could complete the contract ahead of the schedule, the customer would pay an early completion bonus to the company;
- the company would need to evaluate the probability that they could complete the project ahead of the schedule and would include the variable consideration in the contract price at the inception date;
- the variable consideration would be recognised as revenue over the life of the contract; and
- part of the completion bonus would be recognised as income for accounting purposes before the company was legally entitled to it.

Ms Winnie Chan, referring to the example, supplemented that HKFRS 15 introduced a rather high hurdle for variable consideration to be recognized as revenue. Ms Winnie Chan explained that, to include variable consideration in the transaction price, the entity had to conclude that it was highly probable that a significant reversal in the amount of cumulative revenue recognised would not occur in the future periods. Furthermore, the estimate of variable consideration, including the amounts subject to constraint, should be updated at each reporting period. Mr Lean pointed out that, while the variable consideration recognised in the prior period would be taxed, it would be written back in the current year if the project schedule in the current period fell behind the original projection. Mr So expressed that he had similar concerns and commented that taxing variable consideration in the interim could lead to hardship to taxpayers because the contract might eventually be completed at a loss. Mr So took the view that, given the absence of loss carry-back provisions in Hong Kong, there would be situations in which such loss would not be able to be recouped. Mr So summarised two key issues as follows:

- If profits derived from the variable elements were recognised in the financial statements, should those profits be treated as realised profits?
- If yes, should taxpayers be allowed to revise the back year assessments if those realised profits turned out to be not realisable in a subsequent year?

In response, Mr Chiu said that the IRD had taken note of the Institute's concerns and advised that the crux of the issues was the gap between the accounting standards and tax rules. Mr Chiu indicated that some industries were skeptical about HKFRS 15 because different services and products would have different variable elements, meaning that different methodologies might be adopted to recognize the revenue. Mr Chiu held the view that it would be ideal if one set of rules could be used because it would help avoid uncertainties and administrative difficulties. Mr Chiu, however, pointed out that some industries would want to maintain their prevailing tax treatments, and stressed that profits could only be taxed when realised, subject to case law or the provisions of the IRO.

Mr Lean and Mr So asked whether the Government would consider codifying the current practice into the IRO so as to bridge the gap between the accounting standards and tax rules. Mr Chiu replied that the IRD was working on a bill to adopt fair value accounting for financial instruments for tax reporting. Mr Chiu disclosed that taxpayers would be given an option to elect for fair value accounting for tax reporting purposes.

(ii) whether any FAQs or the Departmental Interpretation and Practice Notes (DIPN) would be issued on this subject.

CIR responded that the IRD's position had been clearly explained. CIR welcomed members of the Institute to pass on their questions, if any, and the IRD would consider if FAQs or DIPN were needed.

(c) DIPN 53 Tax treatment of Regulatory Capital Securities (RCSs)

A specified connected person (SCP) is defined in section 17D(5) of the IRO to mean a connected person (CP) of the issuer who is not excepted within the meaning of section 17D(6).

Section 17D(6) provides that a CP of the issuer of an RCS is excepted if the CP is chargeable to profits tax in Hong Kong in respect of a sum payable in respect of the RCS.

Based on the above, it is the Institute's understanding that an associated corporation of an issuer of RCSs would not be an SCP of the issuer where the associated corporation is chargeable to profits tax in Hong Kong in respect of distributions received on the RCSs.

In Example 6 of DIPN 53, given that Company-HK is chargeable to tax in Hong Kong in respect of any sums received from the RCSs, it appears that Company-HK is not an SCP of Bank-HK. As such, the tax treatment of any fair value gains or losses in respect of the RCSs held by Company-HK should be governed by the general rules (i.e. whether the RCSs are held on capital or revenue account by Company-HK) and should not be disregarded under section 17D(2).

The Institute would like to seek the IRD's comment on this view.

CIR replied that the legislative intent should be clear (i.e. fair value accounting was not applicable to RCS issued by an issuer and RCS held by a connected person of the issuer subject to certain exceptions). He indicated that the IRD had taken note of the observation made by the Institute and would seek legal advice from DOJ before deciding whether any legislative amendment should be made to remove the ambiguity.

(d) DIPN 54 Taxation of aircraft leasing management activities

To qualify for the concessionary tax regime, in addition to being a qualifying aircraft lessor or leasing manager as defined, such a lessor or manager must satisfy one of the specified conditions that the activities which produce its qualifying profits have to be either: (1) carried out in Hong Kong by the lessor or manager themselves; or (2) arranged by the lessor or manager to be carried out in Hong Kong (i.e. “the substantial activity requirement”).

Hong Kong as yet may not have established a critical mass of aircraft leasing management expertise in certain overseas aircraft leasing markets. As such, an aircraft lessor set up as a special purpose vehicle (SPV) in Hong Kong may need to appoint related or unrelated overseas aircraft leasing managers to solicit lessees, negotiate lease terms and provide other lease management services including aircraft acquisition and disposal matters etc, whilst the ultimate investment and leasing decisions are evaluated and made by the SPV in Hong Kong.

Assuming “the central management and control requirement” and “no attribution to a foreign permanent establishment requirement” having been satisfied, the Institute would like to ask whether the IRD would accept that “the substantial activity requirement” is satisfied in the following scenarios.

(i) An aircraft lessor set up as an SPV in Hong Kong appointed related or unrelated overseas aircraft leasing managers to solicit lessees, negotiate lease terms and provide other lease management services including those relating to aircraft acquisition and disposal matters etc, while the ultimate investment and leasing decisions are evaluated and made by the SPV in Hong Kong.

Mr Chiu responded that under section 14H(4)(a)(ii)(B), the activities that produced the qualifying profits of a qualifying aircraft lessor could be arranged by the lessor to be carried out in Hong Kong. He said that a qualifying aircraft

lessor could appoint an aircraft leasing manager to solicit lessees, negotiate lease terms and provide other lease management services including those relating to aircraft acquisition and disposal matters, etc. He, however, pointed out that the qualifying aircraft lessor had to ensure that the business solicitation, negotiation of lease terms and other profit-generating activities were carried out by the aircraft leasing manager in Hong Kong so as to be eligible for the profits tax concessions. He further said that section 26AB, proposed under the Inland Revenue (Amendment) (No. 6) Bill 2017, provided that profits tax concession under section 14H was available only if the threshold requirement, in terms of full time employee and operating expenditure, was met and CIR was empowered to prescribe the threshold requirement by a notice published in the Gazette. The IRD and the Transport and Housing Bureau would be engaging the industry regarding the threshold requirement.

[Post-meeting note: The Inland Revenue (Amendment) (No. 6) Bill 2017 was passed by the Legislative Council on 4 July 2018 and gazetted as the Inland Revenue (Amendment) (No. 6) Ordinance 2018 on 13 July 2018.]

(ii) An aircraft leasing manager in Hong Kong subcontracted part of its aircraft leasing management services to an overseas aircraft leasing manager.

Mr Chiu stated that under s.14J(5)(a)(ii)(B), the activities that produced the qualifying profits of a qualifying aircraft leasing manager could be arranged by the manager to be carried out in Hong Kong. He said that a qualifying aircraft leasing manager could subcontract part of its qualifying aircraft leasing management activities to another person. He, however, pointed out that to be eligible for the profits tax concessions, the qualifying aircraft leasing manager had to ensure that such activities were carried out by the subcontractor in Hong Kong. He further said that section 26AB, proposed under the Inland Revenue (Amendment) (No. 6) Bill 2017, provided that profits tax concession under section 14J was available only if the threshold requirement (see item (i) above) was met and CIR was empowered to prescribe the threshold requirement by a notice published in the Gazette.

[Post-meeting note: The Inland Revenue (Amendment) (No. 6) Bill 2017 was passed by the Legislative Council on 4 July 2018 and gazetted as the Inland Revenue (Amendment) (No. 6) Ordinance 2018 on 13 July 2018.]

(e) Transactions in virtual currencies and digital tokens

Virtual currencies or digital tokens (cryptocurrencies) are new ways of financing which have gained considerable popularity in recent years. Initial coin offerings (ICO) are a new way that companies, start-ups and even governments are using to raise funds. The Securities and Futures Commission (SFC) issued a statement on 5 September

2017 to explain that, depending on the facts and circumstances of an ICO, digital tokens that are offered or sold may be “securities” as defined under the Securities and Futures Ordinance and thus subject to the securities laws of Hong Kong (https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=17PR117).

Under Part 1 of Schedule 16 to the IRO, there are six specified categories of transactions as of today:

1. a transaction in securities;
2. a transaction in future contracts;
3. a transaction in foreign exchange contracts;
4. a transaction consisting in the making of a deposit other than by way of a money-lending business;
5. a transaction in foreign currencies; and
6. a transaction in exchange-traded commodities

The Institute would like to seek the IRD’s views on whether a transaction in cryptocurrencies falls into any of these specified transactions. If yes, please clarify under which categories of transactions that a cryptocurrency transaction belongs to.

Further, it would be to the benefits to the taxpayers if the IRD clarifies how the source of profits derived by a trader of cryptocurrencies in Hong Kong from trading in cryptocurrencies should be determined.

Mr Chiu gave the following response:

- In general, a transaction in cryptocurrencies would not be a specified transaction falling within section 20AC(1)(a).
- Cryptocurrencies were not “foreign currencies” because they did not constitute legal tender in foreign jurisdictions.
- Cryptocurrencies offered in typical ICOs were usually characterized as virtual commodities in Hong Kong, and a virtual commodity itself was not “securities” as defined in section 1 of Part 2 of Schedule 16 to the IRO.

Mr Chiu referred to a statement issued by SFC on 5 September 2017 for the protection of investors. In the statement, it was clarified that depending on the facts and circumstances of an ICO, digital tokens offered or sold might be subject to the securities law of Hong Kong. Mr Chiu explained that, depending how ICOs were structured, certain digital tokens might be regarded as “securities” in the following circumstances:

- If digital tokens offered in an ICO represent equity or ownership interests in a corporation, these tokens might be regarded as "shares". For example, token holders might be given shareholders' rights, such as the right to receive dividends and the right to participate in the distribution of the corporation's surplus assets upon winding up.

- If digital tokens were used to create or to acknowledge a debt or liability owed by the issuer, they might be considered as a "debenture". For example, an issuer might repay token holders the principal of their investment on a fixed date or upon redemption, with interest paid to token holders.
- If token proceeds were managed collectively by the ICO scheme operator to invest in projects with an aim to enable token holders to participate in a share of the returns provided by the project, the digital tokens might be regarded as an interest in a "collective investment scheme".

Mr Chiu indicated that "shares", “debentures" and “interests in a collective investment scheme" were "securities" as defined in Schedule 16. Mr Chiu expressed his view that a transaction in cryptocurrencies with such features and under such circumstances might be regarded as a specified transaction.

On the source of profits, Mr Chiu advised that:

- Since cryptocurrencies were generally regarded as virtual commodities, any profits from the sale of cryptocurrencies should be chargeable to profits tax under section 14 of the IRO.
- The source of profits derived from electronic transactions in cryptocurrencies, like traditional transactions, was a hard matter of fact.
- The broad guiding principle similarly applied - what the taxpayer had done to earn the profit in question and where he had done it. It was necessary to ascertain what were the operations which produced the relevant profits and where those operations took place. The relevant operations did not comprise the whole of the taxpayer’s activities carried out in the course of his business but only those which produced the profit in question.

Mr Lean held the view that an analogy should be drawn between transactions in virtual commodities and traditional transactions in securities or commodities. Mr Lean said: the source of profits from trading in traditional securities or commodities depended on whether the sale and purchase were effected on an exchange or OTC; for exchange traded securities or commodities, the source of the profit would be where the exchange was located; for OTC traded securities or commodities, it was where the contracts for sale and purchase were effected; and this should apply equally to trading of tokens/cryptocurrencies/virtual commodities. Mr Lean expressed concerns that it might not be appropriate to apply the operations test. Mr Lean also referred to DIPN 39 dealing with the treatment of electronic commerce, a core tenet of which was neutrality of treatment such that electronic transactions should be treated similarly to their real-world counterparts. Therefore, the principles and policies for determining the source of profits from trading virtual commodities should be similar to those for trading tangible commodities. CIR understood Mr Lean’s concerns and gave an example in which the Stock Exchange in Germany was going to launch a new trading platform for cryptocurrencies. CIR explained that the source of profits from the purchase and sale of listed securities was generally determined by the location of the stock exchange where the securities were traded and the same approach equally applied to the trading of cryptocurrencies at a stock exchange.

CIR, however, stressed that the source of profits was a question of fact and it might not be appropriate to regard the place of listing as a general rule for determining the source of profits derived from all sorts of listed securities or virtual commodities.

Mr So suggested that a more proper approach should focus on the place where the contracts of purchase and sale were effected, as indicated in DIPN 21. He said that there was a line of cases from Hang Seng Bank to ING Baring Securities which looked at where the transactions took place. While, in the Hang Seng Bank case, the bank had staff conducting research, etc, in Hong Kong, the court concluded that the broker effected the transactions on an overseas exchange and that was key. Mr Chiu responded that in the generality of cases, the IRD would apply the operation test to see whether profit-generating activities were carried out in Hong Kong to produce the profits in question. Mr Chiu explained that, while Lord Bridge said in *Hang Seng Bank* that profits from buying and reselling of commodities were derived from the place where "the contracts of purchase and sale were effected", the IRD did not merely look at the place of signing the contracts of purchase and sale to determine the source of profits but would contemplate all the relevant operations carried out to earn the profits.

Ms Cheung took the view that the broad guiding principle emerged from *Hang Seng Bank* applied to businesses in the traditional economy and it was more difficult to apply the operation test to businesses in a digital world, where a taxpayer made a virtual contract with a service provider and every operation or step was virtual. Ms Cheung asked if the IRD would consider providing tax guidance. In response, Mr Chiu drew attendees' attention to a report titled "Tax Challenges Arising from Digitalisation – Interim Report 2018" issued by the Organisation for Economic Cooperation and Development (OECD) in March 2018. Mr Chiu said that the IRD was keeping a close watch on the development and would consider issuing a tax guidance in future.

(f) Royalties paid by branch

Under a scenario where a bank's overseas head office charges royalties to its Hong Kong branch for use of certain intellectual property (IP), which relates to the branch's business in Hong Kong, for generating taxable profits.

Would the royalties be subject to tax in Hong Kong? If yes, should the effective tax rate of 4.95% (i.e. 30% $\times$ 16.5% = 4.95%) or the relevant tax treaty rates be applied?

Mr Yim responded that:

- If the Hong Kong branch was treated as a distinct and separate enterprise, royalties could be charged by the head office on the Hong Kong branch for the use of IP in Hong Kong. The royalties, if not otherwise chargeable to tax, should be deemed to be trading receipts chargeable to tax under section 15(1)(a) or (b) of the IRO.

- If the assessable profits in respect of the royalties were ascertained under section 21A(1)(b) (i.e. 30% of the royalties as assessable profits), the effective tax rate of 4.95% or the treaty rate, whichever was the lower, would be applied.

- If the assessable profits in respect of the royalties were ascertained under section 21A(1)(a) (i.e. 100% of the royalties as assessable profits), the effective tax rate of 16.5%, but not the treaty rate, would be applied. For the purpose of section 21A(1)(a), the head office would be regarded as an associate of the Hong Kong branch.

Mr Yim pointed out that, for tax treaty purposes, section 21A(1)(a) was a domestic measure concerning tax avoidance. Mr Yim said that tax treaties generally provided that the terms of the tax treaties should not prejudice the right of Hong Kong, as a contracting party, to apply its domestic laws and measures concerning tax avoidance.

Agenda item A2 - Salaries Tax Issues

(a) Investment gain in respect of the Employer's voluntary contributions

Based on the DIPN No. 23 (Revised) (DIPN 23) issued in September 2006, it appears that the IRD's view is that the accrued benefit only includes the amount of employer's voluntary contributions to a MPF Scheme and the associated investment return is not included as part of the accrued benefits. Reference is made to the following paragraph of the DIPN 23:

> *Paragraph 19 states that, "In general, only benefits attributable to the employer's voluntary contributions attract tax liability. The withdrawal of accrued benefits attributable to the employee's contributions and investment income from the trust funds is not chargeable to salaries tax.".*

This appears to be at odds with the current Notes and Instructions for Forms BIR56A and IR56B (http://www.ird.gov.hk/eng/pdf/bir56a_notes_e.pdf), which states that, for a MPF Scheme, the accrued benefit is equal to the employer's voluntary contributions and the investment return attributable to the employer's voluntary contributions. (Previous versions of the Notes and Instructions stated that the accrued benefit equals the aggregate employer's voluntary contributions made.)

If it is the IRD's current view that the accrued benefit should include the employer's voluntary contributions and investment returns/losses, the Institute would like to clarify whether investment losses should also be included for the purposes of the accrued benefit.

Ms Fong referred to the 2016 and 2017 annual meetings in which the IRD clarified, among other things, that for the purpose of calculating the proportionate benefits, the accrued benefits under an MPF scheme were equal to the vested balance of investment attributable to employer's voluntary contributions, and such investment included the employer's voluntary contributions and investment returns (i.e. gains or losses) arising therefrom. She stressed that the IRD maintained the view that the accrued benefits should include the employer's voluntary contributions and investment returns (i.e. gains or losses). She therefore concluded that the investment losses arising from investment of employer's voluntary contributions under an MPF scheme should also be included for the purposes of the accrued benefits.

Apart from the Notes and Instructions for Forms BIR56A and IR56B, Ms Fong told the meeting participants that the following documents had been updated to reflect the IRD's current view on "accrued benefits":

- the FAQ No. 12 under the topic of "Mandatory Provident Fund – Proportionate Benefit" (http://www.ird.gov.hk/eng/faq/mpf.htm#q12); and
- the Pamphlet on "Employer's Tax Obligation under MPF Schemes and recognized Occupational Retirement Schemes" (http://www.ird.gov.hk/eng/pdf/esem_er_mpfe.pdf#page+6).

Ms Fong said that the updated version of DIPN 23 would be issued to further clarify the issue.

Agenda item A3 - Double Tax Agreements

(a) Mechanism for reviewing refusal of a Certificate of Resident Status (CoR) application

The Institute understands that the IRD is obliged to act in good faith in accordance to the terms of a comprehensive double taxation agreement (CDTA) and if the IRD considers the applicant is clearly not entitled to the tax relief under a CDTA, it would refuse to issue a CoR to the applicant.

It was explained in the 2016 Annual Meeting that the applicant cannot pursue his claim through a judicial process under the IRO on the IRD's refusals to issue CoR. Is there any avenue for the applicant to seek a higher level second review within the IRD on the initial decision made by the case officer?

Mr Tam responded that the IRD had all along been committed to providing Hong Kong residents with assistance in claiming the tax benefits to which they were entitled under a CDTA. He emphasised that when processing a CoR application, the IRD officers would thoroughly examine the relevant facts of the application and exercise professional judgment accordingly.

Mr Tam appealed to the Institute's understanding of the importance of upholding the purpose of a CDTA and the necessity to refuse issuing a CoR where it was clear that the applicant would not be entitled to benefits under the CDTA.

Mr Tam advised:

- In the case that a CoR application had to be declined, the IRD would give the reasons for the decision.
- If new and material information and documents were subsequently available (e.g. information of the significant controllers of a company formed and registered under the Companies Ordinance which was previously not available), the applicant could furnish such information and documents to the Assessor for reconsidering the application.
- Where the previous application was based on incomplete or incorrect information, the applicant might apply afresh with complete and correct information.

Mr Tam pointed out that the IRD took the view that the above arrangement had been working well and a separate formal review mechanism might not be warranted.

Ms Yee expressed the concern that in handling CoR applications, different case officers might arrive at different decisions based on the same facts. She was of the view that the applicant should be given the right to request his case to be reviewed by a second officer if he was aggrieved by the refusal of CoR application. Mr Lean, Mr So and Ms Alice Leung also voiced out that they had similar concern. In the absence of any appeal channel concerning CoR applications, the Institute's representatives appealed to the IRD to put in place a separate formal review mechanism for reviewing refusal of CoR applications.

In response, Mr Chiu explained that concerns had been raised about treaty abuse by Hong Kong's CDTA partners and the IRD had to act in good faith to fulfil Hong Kong's obligations under CDTAs. He stressed that the IRD had to apply caution in deciding whether a CoR could be issued. Having duly considered the Institute's concern, Mr Chiu advised that if an applicant was aggrieved by the refusal of a CoR application, the applicant could take the following steps to pursue the case:

- The applicant should first contact the case officer to see whether further information and documents could be submitted to support the issue of a CoR.
- If the case officer maintained the decision of not accepting the CoR application, the applicant could request the case to be referred to the Chief Assessor of Tax Treaty Section for further review.

(b) Period of applicability of CoR

Practitioners observed situations where the Mainland tax authority and the IRD hold different views in respect of the period of applicability of a CoR.

For example, it was contemplated that Company A would receive dividend from its subsidiary in the Mainland in January 2017 and Company A was requested by the Mainland tax authority to submit the CoR issued in 2016 or 2017 pursuant to Gonggao [2015] No. 60 issued by the State Administration of Taxation (SAT) in order to enjoy the tax treaty benefits. In order to complete the remittance of dividend in January 2017, Company A submitted an application to the IRD in 2016 requesting for a CoR for the calendar year 2016. The IRD rejected the application on the basis that Company A has been issued with a CoR for the calendar year 2014 and such CoR should be valid from 2014 to 2016 according to the administrative agreement under the notes exchanged between the Mainland and Hong Kong on 16 March and 15 April 2016.

While the Institute has raised this issue with the SAT and the SAT replied that it would provide more guidance to the local tax bureaus on the application of the administrative agreement. In order to avoid putting taxpayers in difficult situations, would the IRD consider processing the CoR applications when the taxpayers are specifically requested for the CoR for particular years by the Mainland tax authorities?

Mrs Wong explained that according to the administrative arrangement agreed in the notes exchanged between the Mainland and Hong Kong on 16 March 2016 and 15 April 2016, a CoR issued by the IRD to an applicant for a particular calendar year generally served as a proof of the Hong Kong resident status of the applicant for that calendar year and the two succeeding calendar years. It would not be necessary for the applicant to apply for CoR for the latter two calendar years. She advised that such streamlined administrative arrangement was publicised via not only the IRD's website but also Gonggao [2016] No. 35 issued by the SAT. She further explained that in the Interpretation Note that accompanied Gonggao [2016] No. 35, the SAT clearly illustrated that a Hong Kong resident with a CoR issued by the IRD for, say, Year 1 could use that CoR to support tax benefits claims under the Mainland-HK CDTA for Year 1, Year 2 and Year 3.

Mrs Wong pointed out that in the case mentioned in the question, the CoR issued to the Hong Kong resident company for the calendar year 2014 should suffice for the purpose and it would not be necessary for the company to apply for a CoR for the calendar year 2016. She advised that under normal circumstances, the IRD would not entertain an applicant's request for a CoR for Year 3 if a CoR for Year 1 had been issued. If the Hong Kong resident company encountered real difficulties in claiming treaty benefits and was specifically requested to submit a CoR for Year 3 by the Mainland tax authority, it could elaborate in its CoR application the reasons and circumstances for requiring a CoR for Year 3 despite that it had been issued a CoR for Year 1. The IRD would consider the facts and circumstances of each individual case to see if the application should be entertained.

Mrs Wong went on to say that the SAT issued Gonggao [2017] No. 37 which took effect from 1 December 2017. She pointed out that under Gonggao [2017] No. 37, the timing of withholding tax obligation on dividends derived by a non-resident company was changed from the date of resolution of payment to the date of actual payment. Accordingly, where a Hong Kong resident company expected in December of Year 3 to receive dividends from its Mainland subsidiary in January of Year 4, the relevant calendar year of claim was Year 4. The IRD reckoned that a CoR issued for Year 1 under the Mainland-HK CDTA could not serve to prove the resident status for Year 4. She advised that if the Hong Kong resident company seeking tax benefits on dividends under the Mainland-HK CDTA for Year 4 wished to obtain a CoR for Year 3 to prove its resident status covering Year 4, the company could also elaborate in its CoR application the reasons and circumstances for requiring a CoR for Year 3. The IRD would also consider the facts and circumstances of the case to see if the application should be entertained.

Mr Chiang commented that it was always difficult for taxpayers to provide written evidence from the Mainland tax authority in support of their CoR applications to the IRD. Mr So echoed this point and suggested that the IRD should accommodate requests to issue a CoR for a particular year, if required by the Mainland tax authority to avoid undue hardship to the taxpayers. Mr So took the view that from the taxpayers' perspective, without the requests from the Mainland tax authority, Hong Kong taxpayers would not ask the IRD to issue a CoR for a particular year. CIR responded that the IRD would adopt a more flexible approach in dealing with such cases without requiring excessive elaboration from taxpayers. CIR added that the IRD would consider raising the issue with the Mainland tax authority.

(c) Application for CoR

We understand that when the IRD reviews an application for CoR, it will assess the beneficial ownership status of the recipient company based on certain factors. Would the IRD consider different set of factors for different kind of income, e.g. capital gain versus dividend? What are the key factors that the IRD would consider in handling these applications?

Mr Tam advised that a CoR served to prove the Hong Kong resident status of a Hong Kong resident for the purposes of claiming tax benefits under CDTAs. He remarked that to prevent treaty abuse and to protect Hong Kong's reputation as a responsible treaty partner, in deciding whether a CoR can be issued, the IRD would consider, among other things, whether the applicant was the beneficial owner of the income concerned and hence whether the applicant was entitled to the tax benefits.

Mr Tam elaborated:

- Hong Kong followed the interpretation of the term "beneficial owner" given under the Commentary to the OECD Model Tax Convention, which had received wide acceptance internationally.
- As explained at paragraphs 12 to 12.6 of the OECD Commentary on Article 10 (2017 version) at pages 233 to 235, the term "beneficial owner" was not used in a narrow technical sense. Rather, the term should be understood in light of the object and purpose of CDTAs, including avoiding double taxation and the prevention of fiscal evasion and avoidance.
- A person simply acting as a "conduit" for another person, who in fact received the benefit of the income concerned, was not the beneficial owner.
- A person whose right to use and enjoy the income concerned was constrained by a contractual or legal obligation to pass on the payment received to another person was not the beneficial owner.

Mr Tam indicated that given the above interpretation, whether a company was the beneficial owner of a particular kind of income was a question of fact, depending on the circumstances of each case. There was no exhaustive list of the factors to be considered. He advised that the factors that the IRD might take into consideration include:

- the legal owner of the relevant asset;
- the economic substance of the company;
- whether the company had any obligation to pass on the income received to another person;
- the extent of the company's power to decide on the use of the relevant asset; and
- the income derived therefrom, whether the company assumed the risk and control of the income, etc.

On the interpretation of the term "beneficial owner", Ms Sarah Chan asked whether the IRD would make reference to the Circular of the SAT on Matters Concerning

"Beneficial Owners" in Tax Treaties (SAT Circular 2018 No. 9). Mr Chiu responded that the IRD was studying the recent re-interpretation by the SAT Circular 2018 No. 9 which clarified how the beneficial ownership test should be applied to tax treaty benefits claims. He took the view that there was a need to revise the existing CoR application forms to address the changes introduced by the SAT Circular 2018 No. 9. He told the meeting participants that the IRD was in the process of revising the CoR application forms and would consult with stakeholders including the Institute.

(d) Time gap between tax payment and foreign tax credit claim

By virtue of Section 20B(3) of the IRO, taxpayers are required to deduct tax from certain sums paid or credited. However, the amount deducted (i.e. tax being withheld) will only be paid to the IRD on behalf of the non-resident recipients after the IRD issue notices of assessment to the taxpayers. The inability to obtain tax payment receipts from the IRD in a timely manner creates unnecessary complications for the non-resident recipients when they make foreign tax credit relief applications in their home jurisdictions as proof of payment of foreign tax is a general requirement for such applications. As tax has already been withheld from payments, is it possible to make the payments and have the payment receipts issued shortly after the tax is withheld?

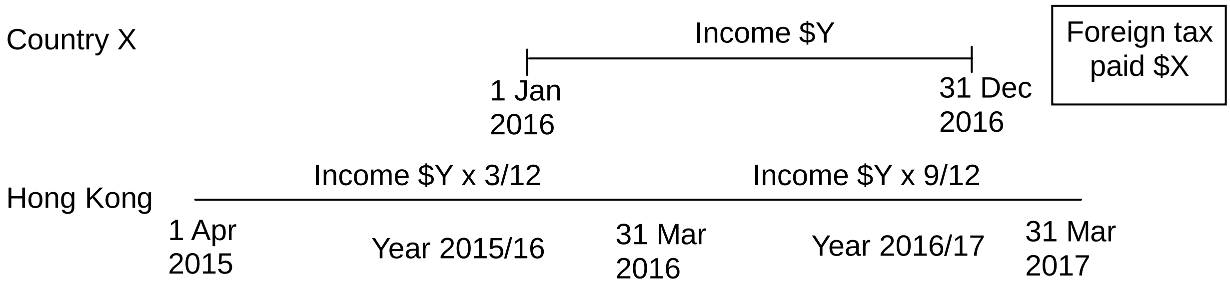
Mr Yim responded that, under section 20B(2) of the IRO, a non-resident person was chargeable to tax in the name of the person who paid sums to the non-resident person in Hong Kong. The Hong Kong payer would be issued with a tax return since tax would be charged in the name of the payer who bore the legal obligation to report such sums. Mr Yim said that the tax assessment issued to the non-resident person in the Hong Kong payer's name would show the amount of tax chargeable on the non-resident person.

Mr Yim pointed out that, to facilitate the non-resident person's application for tax credit relief in his home jurisdiction, the Hong Kong payer should file the tax return on the non-resident person's behalf on a timely basis. The IRD would endeavour to issue the tax assessment as soon as practicable. Mr Yim indicated that, while it might not be administratively practical to issue a tax assessment or a tax receipt for each sum paid to a non-resident person by the Hong Kong payer, the IRD would consider offering the non-resident person the appropriate administrative assistance if necessary.

Mr Lean raised concerns about the time gap between the tax being withheld and the tax assessment issued. Mr Lean said that it would be much appreciated if the IRD would issue tax payment receipts shortly after the tax was withheld. Ms Alice Leung suggested that reference be made to the mechanism for raising assessments on consignment sales made by non-residents. In response, CIR said that there were no statutory provisions in the IRO to impose an obligation on the Hong Kong payer to instantly pay the amount withheld from the non-resident person to the IRD. CIR took note of the Institute's concerns and indicated that the IRD would consider exploring some arrangements to assist non-resident persons on applications for tax credit relief in their home jurisdictions.

(e) Timing of foreign tax credit claim

A Hong Kong taxpayer has an accounting year end date of 31 March. It derived income $Y during the 12-month ended 31 December 2016 in Country X. Country X raised a tax assessment of $X for the income derived during the year ended 31 December 2016. The foreign tax was paid in February 2017. The same income $Y was also subject to tax in Hong Kong under two years of assessment (i.e. 2015/16 and 2016/17).



Assuming the relevant tax treaty is applicable, which of the following basis should the taxpayer adopt in claiming tax credit in Hong Kong? Please also advise the Institute if the IRD would accept bases other than the two methods stated.

(a) Claim foreign tax credit in two years of assessment (i.e. $X*3/12 in 2015/16 and $X*9/12 in the 2016/17) – based on the timing of income derived

(b) Claim foreign tax credit of $X in 2016/17- based on the timing of foreign tax paid

Mr Tam referred to section 50(1) of the IRO which provided that, under arrangements for relief from double taxation having effect under section 49, tax payable in respect of any income in the territory with the government of which the arrangements were made was to be allowed as a credit against tax payable in respect of that income in Hong Kong.

Mr Tam said that, under the IRO, tax was chargeable on income accrued in a year of assessment. Foreign taxes payable in the example in respect of income accrued in years of assessment 2015/16 and 2016/17 would be allowed as tax credits for these two years of assessment (i.e. Method (a) was followed). Method (b), which allowed tax credit by reference to the timing of payment of foreign tax, was not followed.

(f) CoR application for individuals

An individual who fulfills the 180/300 day physical presence test can apply for a CoR as a temporary resident. While an individual who is ordinarily residing in Hong Kong can apply for a CoR as a permanent resident. As the physical presence test is objective, one can hardly argue that the temporary resident should not be issued with the CoR if he/she passed the physical presence test. As a result, individuals who failed to pass the physical presence test would apply the CoR under the permanent resident route.

The CoR issued by the IRD would indicate whether the application was made as a temporary resident or a permanent resident as defined under Article 4 of the Mainland-Hong Kong Comprehensive Avoidance of Double Taxation Arrangement (the Mainland-HK CDTA). However, we note that the IRD may reject CoR applications under the permanent route when the individuals failed to pass the physical presence test even though they hold strong Hong Kong ties (e.g. employment in Hong Kong, family moved to Hong Kong to live with taxpayer, maintains a permanent place of residence in Hong Kong, centre of vital interests lie towards Hong Kong, etc). If the IRD is taking such stance, the physical presence test seems to apply to applications made under both temporary and permanent resident routes.

We came across a case where the individual applied for a CoR and asked that the CoR indicating that the application was made under the permanent resident route. Yet, the IRD still issued a CoR indicating the application was made under the temporary resident route as the applicant passed the physical presence test. Upon further checking, the case officer confirmed that documents indicating the Hong Kong ties had not been reviewed in this particular case.

According to Clause 3(3) of Guoshuihan [2007] No. 403 (Circular 403) issued by the SAT, if an individual is a Hong Kong temporary resident and a permanent resident of another jurisdiction, the tax treaty between the Mainland and the other jurisdiction (rather than the Mainland-HK CDTA) should apply. If there is not a tax treaty between the Mainland and the other jurisdiction, the Mainland domestic tax law should apply. As such, the Mainland tax authority may reject the tax treaty benefit claim if the Hong Kong CoR is issued under the temporary resident test.

Whilst the IRD had reminded taxpayers of the above rejection risk in the 2015 Annual Meeting with the Institute, the IRD advised the taxpayer that if a letter of rejection under Circular 403 is issued by the Mainland tax authority, the taxpayer can request the IRD to reconsider the CoR application under permanent resident test with the rejection letter as a supporting document to the request.

In view of the above, the Institute would like to clarify with the IRD on its current practices and stance on CoR applications.

Mrs Wong referred to Article 4 of the Mainland-HK CDTA which provided the meaning of resident of Hong Kong. She elaborated:

- Under paragraph 1(2)(i) of Article 4, an individual who ordinarily resided in Hong Kong was a resident of Hong Kong.
- It had been established by decided cases that "ordinary residence" connoted residence in a place with some degree of continuity and "ordinary resident" meant residing in a place in the ordinary course of everyday life, apart from temporary or occasional absences.
- It was a question of fact and degree depending on objective evidence rather than on state of mind. The emphasis did not lie on intention or expectation for the future, which was implicit in the idea of permanence, but on immediately past events.
- All the relevant facts had to be considered before a decision was made based on the merits on each case. No single factor was decisive.

Mrs Wong further elaborated that physical presence in Hong Kong was one of the objective facts to be taken into account in determining whether a person ordinarily resided in Hong Kong. She referred to paragraph 22 in DIPN 44 stated as follows:

> "It is generally considered that an individual 'ordinarily resides' in Hong Kong if he has a permanent home in Hong Kong where he or his family lives. **Other relevant factors include the duration of his stay in Hong Kong**, whether he has a permanent place of residence in Hong Kong, whether he owns any property overseas for residential purposes, and whether he is **primarily resident in Hong Kong** or overseas." (emphasis added)

Mrs Wong explained that in practice, if an individual clearly indicated in his application that he would apply a CoR under the permanent resident route, the IRD officers would also consider, apart from the period of his physical presence in Hong Kong, all the facts and circumstances of the particular case (e.g. whether the individual habitually and normally resided in Hong Kong with some degree of continuity, the nature, duration and reasons of his absence from Hong Kong, where his family members habitually lived, whether he had any social and economic ties with Hong Kong etc) to determine whether he could be regarded as an ordinary resident of Hong Kong during the relevant year of assessment.

Mrs Wong advised that in the past, the IRD had issued CoRs to applicants who ordinarily resided in Hong Kong under paragraph 1(2)(i) of Article 4 in the Mainland-HK CDTA. The IRD had no record of any actual case as that mentioned in the third paragraph of the question. She further advised that if an individual was issued with a CoR under the temporary resident route (i.e. per paragraph 1(2)(ii) of Article 4 in the Mainland-HK CDTA) and he considered that he was an ordinary resident of Hong Kong, he might contact the IRD officer to see whether further information and documents could be submitted to support the issue of a CoR under the permanent resident route.

Agenda item A4 – Automatic Exchange of Financial Account Information (AEOI)

(a) Obtaining self-certification forms on verbal / recorded onboarding as indicated during the Institute meeting

In the case where an account is opened by telephone or internet, the self-certification must be positively affirmed. The IRD commented that if a self-certification is provided electronically, the reporting financial institution (FI) has to have systems in place to ensure that the information provided was that of the account holder, and it has to be able to provide a hard copy of all such self-certifications to the IRD on request. The IRD also suggested that for verbal self-certifications, FIs should also collect an electronic or a paper self-certification in order to have a hard copy on file.

In view of the above, are FIs now required to ask for self-certification forms from all account holders whose account was opened with verbal self-certifications / recording in the past and in the future?

Ms Peggy Leung responded:

- A self-certification might be provided in any manner and in any form. The approach taken by the FI in obtaining the self-certification was expected to be in a manner consistent with the procedures followed by the FI for the opening of the account. If an account was opened via telephone or internet, the self-certification could also be provided verbally or electronically.
- The FI had to have a system in place to ensure that the self-certification contained all the required information and the self-certification was positively affirmed by the account holder. The FI would need to maintain a record of this process for audit purposes. The documentation that was stored electronically had to be made available by the FI in hard copy form.
- Upon request by the IRD, the FI should be able to extract the relevant information from the system for the purpose of producing a printed copy of the self-certification which contained the information provided by the account holder upon account opening.
- As long as the FI could produce the self-certification containing such information, it was not required to ask for submission of self-certification in paper form from all account holders whose accounts were opened with verbal self-certifications or recording.

(b) Reporting by liquidated entities

The OECD FAQ 11 states as follows:

"Reporting Obligations of the Reporting Financial Institution that is in the process of being liquidated - How should a Reporting Financial Institution that is in the process of being liquidated or wound up discharge its due diligence and reporting obligations under the CRS?"

As a general rule, a Financial Account is treated as a Reportable Account as of the date it is identified as such pursuant to the due diligence procedures (Section II(A)). The Reportable Account remains reportable until the date it ceases to be a Reportable Account (e.g. due to the closure of the account). If a Reportable Account is closed due to the liquidation or winding up of the Reporting FI, information with respect to such account remains annually reportable until the date of closure of the Financial Account (Commentary to Section II(A)) by the Reporting FI in the framework of the liquidation or the winding-up. **In this respect, jurisdictions may provide further guidance to their Reporting FIs on how to fulfil their due diligence and reporting obligation during the liquidation or winding up process, taking into account relevant domestic legal provisions, in particular in the areas of corporate and insolvency law**. In this respect, an option could be to allow reliance on a third-party service provider to ensure that all due diligence and reporting obligations of the Reporting FI are adequately carried out (Section II(D)).

Based on the words underlined above, when can the FIs expect the IRD to issue guidance for reporting by liquidated entities?

Ms Peggy Leung explained:

- The above OECD FAQ clarified that reportable accounts held by reporting FIs that were in liquidation or winding-up process remained reportable by the reporting FIs until the date of closure of the financial accounts. The IRD took the same position as the OECD.
- A liquidator of a reporting FI which was in the process of winding-up had to ensure that the reporting FI continued to satisfy all its due diligence and reporting obligations under the IRO. In particular, but without limitation, this included the obligation to file returns in respect of reportable accounts maintained by the reporting FI (up to the date of closure of the relevant accounts).
- The liquidator could file the returns by himself or engage a service provider under section 50H of the IRO to perform the obligations. The liquidator who wished to operate the AEOI Account of the reporting FI had to possess an e-Cert (Organisational) with AEOI Functions for authentication purposes. If a service provider was engaged instead to operate the AEOI Account, it was not necessary for the liquidator to apply for an e-Cert (Organisational) with AEOI Functions. A Notification of Details of Person Authorized to Register/Operate an AEOI Account (Form IR1459) had to be furnished to the IRD for notifying the details of the service provider.

Ms Peggy Leung told the meeting participants that the above explanation would be uploaded to the IRD's website.

Mr Tisman mentioned that the Financial Institutions (Resolution) Ordinance established a resolution regime for FIs in Hong Kong and suggested that the IRD should also consider whether the establishment of such resolution mechanism would have any implications on the implementation of AEOI. CIR noted the concern and advised that the IRD would duly look into this issue.

(c) Discretionary Portfolio Management

We would like to obtain the IRD's views on scenarios where entities open Discretionary Portfolio Mandate accounts with FIs (typically Private Banks) and in particular:

(i) Should opening of these accounts make the entity an Investment Entity - FI (given that the entity is investing in financial assets and **managed** by another FI, the Bank in this case)?

Mr Chiu explained:

- The definition of "investment entity" included an entity whose gross income was primarily (at least 50% of its gross income) attributable to investing, reinvesting, or trading in financial assets over the specified period; and it was managed by another FI (i.e. a professionally managed investment entity).
- Whether an entity was an investment entity (an FI included an investment entity) depended on the facts and circumstances;
- Other than meeting the requirement of "managed by an FI", the "primarily" test had to be satisfied before an entity was to be considered as a professionally managed investment entity;
- Despite the above, the definition of "investment entity" did not include an entity that was an active NFE solely because it fell within any of the descriptions in paragraphs (d), (e), (f) and (g) of the definition of active NFE (i.e. holding companies that were members of a non-financial group; start-up entities; entities that were liquidating or emerging from bankruptcy; or treasury centres that were members of a non-financial group).
- In addition, the definition of passive NFE included a professionally managed investment entity that was not a participating jurisdiction FI, meaning that the requirement of looking through a passive NFE to identify and report its controlling persons also applied to such professionally managed investment entity.

(ii) Where the entity selects an NFE classification in the self-certification form submitted to the Bank at the time of account opening, should the FI ignore such self-certification form and consider the entity as an FI?

Mr Chiu referred to section 2, Part 7, Schedule 17D to the IRO, which provided that a reporting FI might not rely on a self-certification or documentary evidence if it knew or had reason to know that the self-certification or documentary evidence was incorrect or unreliable. He went on to explain:

- A reporting FI had reason to know that a self-certification or documentary evidence was unreliable or incorrect if its knowledge of relevant facts or statements contained in the self-certification or other documentation, including the knowledge of the relevant relationship managers, if any, was such that a reasonably prudent person in the position of the reporting FI would question the claim being made.

- A reporting FI also had reason to know that a self-certification or documentary evidence was unreliable or incorrect if there was information in the documentation or in the reporting FI's account files that conflicted with the person's claim regarding its status.
- The mere fact that an entity opened a Discretionary Portfolio Mandate account with a reporting FI (i.e. the FI had discretionary authority to manage the entity's assets) appeared not sufficient for the FI to arrive a reasonable conclusion that the entity was an FI.
- Other information and documentation obtained in connection with the opening of the account had to be taken into account to see whether there was any information that conflicted with the entity's claim regarding its status.

[Post-meeting note: Further clarification was sought from the OECD. The OECD advised:

- In case the information on file with the FIs included details on the activities of the entity, such as financial statements and/or articles of incorporation, such information should be used in order to confirm the reasonableness of the classification of the entity in its self-certification. In case there was a particular reason to assume that the entity might either be classified as a passive NFE or an investment entity, such as the discretionary management, it would be reasonable to expect that the FI ensured that the relevant information, in particular recent financial statements, were obtained as part of the account opening process to confirm the validity of the self-certification.

- In any event, and in particular when relevant additional information (such as financial statements) was obtained subsequent to account opening, new information that cast doubts as to the validity of the self-certification of an entity account holder with respect to its status as a passive NFE or investment entity, would constitute a reason to know that the self-certification was incorrect or unreliable. In such instances, therefore, the FI would be required to obtain a new, valid self-certification to confirm the status of the entity account holder.]

Agenda item A5 – Departmental Policy and Administrative Matters

(a) Lodgment of tax returns and filing deadlines for 2017/18

Would the IRD please share with the Institute the latest statistics on tax return filing and information on the 2017/18 tax filing deadlines?

Mr Yim referred to the tables at Appendix A:

- Table 1 showed that the IRD issued 4,000 less returns in the 2016/17 bulk issue exercise and some 20,400 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. Though there were slight improvements in the lodgment rate for "D" code returns (from 77% to 79%) and "M" code returns (from 78% to 79%) by the deadline, the overall performance was still far from satisfactory and the progressive lodgments remained significantly below the lodgment standards. Mr Yim through the Institute urged tax representatives to improve the return filing performance in the coming years.
- Table 4 was a comparative analysis of compliance with the block extension scheme.

Bulk Issue of 2017/18 Profits Tax Returns

Mr Yim pointed out that the 2017/18 Profits Tax Returns for "active" files were bulk-issued on 3 April 2018. The extended due dates for filing 2017/18 Profits Tax Returns would be:

Accounting Date Code	Extended Due Date	Further Extended Due Date if opting for e-filing
"N" code	3 May 2018 (no extension)	17 May 2018
"D" code	15 August 2018	29 August 2018
"M" code	15 November 2018	29 November 2018
"M" code – current year loss cases	31 January 2019	31 January 2019 (same as paper returns)

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 2017 with comparative figures for the years 2015 and 2016 included. She reported:

- Field Audit teams uncovered discrepancies in 367 corporation cases, of which 301 carried clean auditors' reports.
- The amount of discrepancies detected in the clean report cases accounted for 92% (2016: 88%) of the total discrepancies detected in the year 2017 and total tax of $773 million was recovered from these cases.
- Average understatement per clean report case was $16.37 million (2016: $15.07 million) while tax undercharged per clean report case was $2.6 million (2016: $2.4 million).

Ms Connie Chan further said that discrepancies in 2017 resulted mainly from incorrect claims of offshore profits, understatement of gross profits and over-claiming of expenses. She pointed out that the discrepancies in the majority of cases were detected after examining the business ledgers and source documents.

Ms Sarah Chan referred to Table 1 of Appendix B and asked whether the Field Audit and Investigation Unit (the FAI Unit) had stepped up audit actions on reviewing offshore claims since there was a twofold increase in both the amounts of discrepancies detected and tax undercharged under the category of offshore income/profits disallowed. Ms Yee also enquired whether large cases were targeted at. In response, Ms Connie Chan advised that the FAI Unit adopted a risk-based approach to select cases for tax audit. In the generality of cases, larger amount of revenue at stake entailed higher risk. In reviewing offshore claim, apart from examination of source documents, tax auditors would meet the operational staff or key personnel of the taxpayer's business, in order to obtain or confirm information concerning its operations. In the process, new facts might be discovered pointing towards the offshore claim being untenable and demanding audit adjustment. Regarding cases involving losses, Ms Cheung asked whether there should be timeframe for assessing losses, as it was difficult for taxpayers to substantiate losses that might go back for 10 years. CIR replied that there was no time limit under the law and it could be seen as unusual if a company had suffered losses for that length of time but remained in operation.

Agenda Item B2 – Date of Next Annual Meeting

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

Appendix A

Lodgement of Corporations and Partnerships Profits Tax Returns

Table 1

Lodgement Comparison from 2014/15 to 2016/17

		Y/A 2014/15	Y/A 2015/16	Y/A 2016/17	Comparison 2015/16 and 2016/17
1.	Bulk issue (on 1 April)	185,000	188,000	184,000	-2%
2.	Cases with a failure to file by due date:-				
	'N' Code	2,100	2,200	2,200	0%
	'D' Code	5,900	6,600	7,200	9%
	'M' Code	10,400	10,500	11,000	5%
		18,400	19,300	20,400	6%
3.	Compound offers issued	7,500	6,600	6,300	-5%
4.	Estimated assessments issued	7,400	8,300	9,000	8%

Table 2

2016/17 Detailed Profits Tax Returns Statistics

	'N'	'D'	'M'	Total
Total returns issued	19,000	64,000	101,000	184,000
Failure to file on time	2,200	7,200	11,000	20,400
Compound offers issued	700	2,600	3,000	6,300
Estimated assessments issued	1,000	3,000	5,000	9,000

Table 3
Represented Profits Tax Returns - Lodgement Patterns

Code	Lodgement Standard	Actual Performance 2016/17 PTRs	2015/16 PTRs
D - 15 August	100%	79% (1)	77%
M - 31 August	25%	11%	11%
M - 30 September	55%	17%	16%
M - 31 October	80%	32%	32%
M - 15 November	100%	79% (2)	78%

(1) 34% lodged within a few days around 15 August 2017 (35% lodged within a few days around 15 August 2016 for 2015/16 PTRs)

(2) 30% lodged within a few days around 15 November 2017 (30% lodged within a few days around 15 November 2016 for 2015/16 PTRs)

Table 4
Tax Representatives with Lodgement Rate of less than 79% of 'M' code Returns as at 15 November 2017

1,489 T/Rs have 'M' Code clients. Of these, 687 (46%) firms were below the average performance rate of 79%. An analysis of the firms, based on size, is shown below:-

		Current Year Performance				Last Year Performance			
	No. of clients per firm	Total No. of firms	No. of firms below the average of 79%	No. of non-compliance cases	% of total non-compliance cases	Total No. of firms	No. of firms below the average of 78%	No. of non-compliance cases	% of total non-compliance cases
Small size firms	100 or less	1,384	641	5,461	71%	1,363	638	5,630	72%
Medium size firms	101 - 300	97	44	2,072	27%	114	45	2,121	27%
Large size firms	over 300	8	2	115	2%	7	1	94	1%
		1,489	687	7,648	100%	1,484	684	7,845	100%

<u>Table 1</u> *Appendix B*

Analysis of Completed FA Corporation Cases for the years ended 31 December 2015, 2016 and 2017

	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
Auditor's Report = Unqualified	**2015**	**2016**	**2017**	**2015**	**2016**	**2017**	**2015**	**2016**	**2017**
Sales omitted	79	48	44	186,476,379	59,316,705	39,050,545	27,749,925	6,755,119	5,563,507
Purchases overstated	7	12	15	28,635,845	15,088,982	55,609,437	4,846,068	2,626,954	8,347,423
Gross profit understated	29	34	28	106,013,231	89,373,014	121,821,702	17,144,539	14,476,529	18,478,838
Expenses over-claimed	103	79	107	83,095,914	42,027,622	88,978,759	9,500,900	3,512,642	13,247,219
Technical adjustments	105	79	87	40,567,413	215,971,015	34,250,130	5,146,476	34,989,593	4,806,637
Offshore income / profits disallowed	16	18	18	89,444,192	164,997,882	348,858,847	13,683,477	25,488,041	59,294,913
Other	137	78	115	202,142,448	99,918,370	167,765,187	33,250,462	14,327,836	25,620,662
TOTAL	476*	348*	414*	$736,375,422	$686,693,590	$856,334,607	$111,321,847	$102,176,714	$135,359,199
TOTAL NUMBER OF CASES	363*	265*	301*						
AVERAGE AMOUNT PER CASE				$2,028,582	$2,591,297	$2,844,965	$306,672	$385,573	$449,698

FOR AUDIT YEAR ONLY

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

		Total Discrepancy for All Years			Total Tax Undercharged for All Years		
		2015	**2016**	**2017**	**2015**	**2016**	**2017**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$3,554,239,498**	**$3,992,788,229**	**$4,927,912,899**	**$544,448,403**	**$625,741,686**	**$772,514,422**
	AVERAGE AMOUNT PER CASE	**$9,791,293**	**$15,067,125**	**$16,371,804**	**$1,499,858**	**$2,361,289**	**$2,566,493**

	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
Auditor's Report = Qualified	**2015**	**2016**	**2017**	**2015**	**2016**	**2017**	**2015**	**2016**	**2017**
Sales omitted	7	14	17	1,331,662	11,728,283	31,353,279	47,873	1,927,593	3,550,667
Purchases overstated	1	2	1	255,450	4,138,600	1,993,535	1,788	682,869	328,933
Gross profit understated	9	16	6	13,189,578	26,435,919	15,709,868	1,913,550	4,551,295	2,704,564
Expenses over-claimed	13	16	23	4,121,877	4,759,273	18,289,960	90,598	584,626	2,227,625
Technical adjustments	13	18	10	4,594,305	11,781,676	3,967,230	543,626	1,156,035	657,413
Offshore income / profits disallowed	1	4	1	512,307	3,499,202	(1,087,772)	84,531	514,143	(361,648)
Other	24	26	33	10,382,983	69,399,172	21,577,332	1,498,085	4,745,171	3,216,549
TOTAL	68*	96*	91*	$34,388,162	$131,742,125	$91,803,432	$4,180,051	$14,161,732	$12,324,103
TOTAL NUMBER OF CASES	48*	70*	66*						
AVERAGE AMOUNT PER CASE				$716,420	$1,882,030	$1,390,961	$87,084	$202,310	$186,729

FOR AUDIT YEAR ONLY

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

		Total Discrepancy for All Years			Total Tax Undercharged for All Years		
		2015	**2016**	**2017**	**2015**	**2016**	**2017**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$224,762,950**	**$535,242,825**	**$454,288,187**	**$31,476,587**	**$74,488,239**	**$63,645,638**
	AVERAGE AMOUNT PER CASE	**$4,682,561**	**$7,646,326**	**$6,883,154**	**$655,762**	**$1,064,118**	**$964,328**

	2015	2016	2017
TOTAL NUMBER OF CASES	411	335	367

		Total Discrepancy for All Years			Total Tax Undercharged for All Years		
		<u>2015</u>	**<u>2016</u>**	**<u>2017</u>**	**<u>2015</u>**	**<u>2016</u>**	**<u>2017</u>**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$3,779,002,448**	**$4,528,031,054**	**$5,382,201,086**	**$575,924,990**	**$700,229,925**	**$836,160,060**
	AVERAGE AMOUNT PER CASE	**$9,194,653**	**$13,516,511**	**$14,665,398**	**$1,401,277**	**$2,090,239**	**$2,278,365**

Extracts of Analysis in Appendix B

		2016	2017
(a)	No. of corporation cases with discrepancies uncovered	335	367
(b)	No. of corporation cases in item (a) carried clean auditor's reports	265	301
(c)	Total discrepancies detected in all cases	$4,528m	$5,382m
(d)	Total discrepancies detected in clean auditor's report cases	$3,993m	$4,928m
(e)	Percentage of (d) over (c)	88%	92%
(f)	Total tax uncovered in clean auditor's report cases	$626m	$773m
(g)	Average understatement per clean auditor's report case	$15.07m	$16.37m
(h)	Tax undercharged per clean auditor's report case	$2.4m	$2.6m