



Hong Kong Institute of
Certified Public Accountants
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

2013
ANNUAL MEETING BETWEEN
THE INLAND REVENUE DEPARTMENT AND
THE HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Preamble

As part of the Institute's regular dialogue with the government to facilitate tax compliance, improve procedural arrangements and to clarify areas of interpretation, representatives of the Institute met the Commissioner of Inland Revenue ("CIR") and members of his staff in February 2013.

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

List of Discussion Items

PART A - MATTERS RAISED BY THE INSTITUTE

A1. *Profits Tax Issues*

- A(1a) Waiver of debt
- A1(b) Deduction of capital expenditure on developing a computer system
- A1(c) Losses on disposal or redemption of financial instruments mentioned in section 26A
- A1(d) Source of stock brokerage commission income for transactions executed electronically
- A1(e) Share-based payment transactions
- A1(f) Whether a discount on an original issue discount note is "interest" or "discount"
- A1(g) Interest income for insurance companies
- A1(h) Pension funds - investment income of recognised schemes

- A1(i) Li & Fung case
- A1(j) DIPN 21
- A1(k) Research and development ("R&D") expenditures under section 16B
- A1(l) DIPN 49
- A1(m) Tax rate to be applied where a partner of a partnership is itself a partnership with corporate partners

A2. *Salaries Tax Issues*

- A2(a) Proportionate benefit – computation of month of service for the purpose of section 8(5)
- A2(b) Taxation of share awards – changes in employment during vesting period
- A2(c) Taxation of payments in lieu of notice ("PILON")

A3. *Cross-border Tax Issues*

- A3(a) Application of tax treaty in situations where a Hong Kong company is also considered as a Mainland tax resident enterprise
- A3(b) Issue of Hong Kong tax resident certificate
- A3(c) Employee from Mainland providing service in Hong Kong

A4. *Double Tax Agreements*

- A4(a) Application for treaty benefits under a CDTA with Hong Kong in respect of Hong Kong sourced profits derived through a foreign partnership
- A4(b) Administrative procedures for Hong Kong payers to apply a lower rate of withholding on royalties under DTAs
- A4(c) Indonesia-Hong Kong double tax treaty
- A4(d) Tax residency

- A4(e) Profits attributable to permanent establishment ("PE")
- A4(f) Progress of legislative amendments for tax information exchange agreements ("TIEAs")

A5. *Stamp Duty*

- A5(a) Whether a Hong Kong general or limited partnership is a transparent entity for the purposes of section 45 stamp duty relief
- A5(b) Transactions that do not constitute a "sale or purchase" of the relevant shares

A6. *Departmental Policy and Administrative Matters*

- A6(a) Advance pricing arrangement ("APA")
- A6(b) Filing of non-resident profits tax return
- A6(c) Design of the paper profits tax return (form BIR 51)
- A6(d) Block extension of salaries tax return of individuals employed by the same entity
- A6(e) Record of electronic transactions
- A6(f) Interest on tax reserve certificate ("TRC") vs. judgment interest
- A6(g) Objections to CIR
- A6(h) Progress with the development of e-filing
- A6(i) Lodgment of tax returns and filing deadlines for 2012/2013

PART B - MATTERS RAISED BY THE IRD

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

B2. *Certificate of Resident Status*

B3. *Residence of the Hong Kong Branch of an Overseas Bank*

B4. *Applications for Advance Ruling*

B5. *Date of Next Annual Meeting*

Full Minutes

The 2012/13 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department was held on 1 February 2013 at the Inland Revenue Department.

In Attendance

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

Ms Florence Chan	Chairperson, Taxation Faculty Executive Committee
Mr Anthony Tam	Deputy Chairman, Taxation Faculty Executive Committee
Mr Curtis Ng	Member, Taxation Faculty Executive Committee
Mr K K So	Member, Taxation Faculty Executive Committee
Mr Peter Tisman	Director, Specialist Practices
Ms Elena Chai	Associate Director, Specialist Practices

Inland Revenue Department (“IRD”)

Mr Chu Yam-yuen	Commissioner of Inland Revenue
Mr Chiu Kwok-kit	Deputy Commissioner of Inland Revenue (Technical)
Mr Wong Kuen-fai	Deputy Commissioner of Inland Revenue (Operations)
Ms Doris Lee	Assistant Commissioner of Inland Revenue
Mr Chiu Sai-ming	Ag. Assistant Commissioner of Inland Revenue
Mr Tam Tai-pang	Assistant Commissioner of Inland Revenue
Ms Mei Yin	Ag. Chief Assessor (Tax Treaty)
Mr Wong Kai-cheong	Senior Assessor (Research)

Mr Chu Yam-yuen (CIR) welcomed the representatives from the Institute to the meeting. Ms Chan thanked the IRD for arranging this annual platform for exchange of views and clarification of various tax rulings and administrative policies of the IRD. In particular, Ms Chan thanked the support given by the IRD in launching of the Taxation Faculty last year and she looked forward to continuing the cooperation between the Institute and the IRD in future.

PART A - MATTERS RAISED BY THE INSTITUTE

Agenda item A1 - Profits tax issues

(a) Waiver of debt

Section 15(1)(c) of the Inland Revenue Ordinance ("IRO") deems "sums **received by or accrued to** a person by way of grant, subsidy or similar financial assistance in connection with the carrying on of a trade, profession or business in Hong Kong" chargeable to profits tax.

As money is neither received by nor accrued to a company in the waiver of a loan, is it the case that section 15(1)(c) is not applicable to waiver of loan?

CIR explained the IRD's view that section 15(1)(c) applied to a waiver of loan. When the lender waived the loan, a financial assistance became available to the borrower company. At that point, the sum waived by the lender "accrued" to the company by way of a "grant, subsidy or financial assistance".

Moreover, where a deduction for the interest on "loan" or "debt" had previously been claimed and allowed as a trading expense, the amount waived would be treated as a trading receipt under section 15(2) of the IRO at the time of waiver.

Ms Chan gave an example of a company in deficit where the waiver of loan was for the sole purpose of facilitating it to become solvent and undergo members' voluntary liquidation. She asked whether it would be possible that the waiver was not *in connection with* the carrying on a trade, profession or business in Hong Kong such that section 15(1)(c) was not applicable. Ms Lee responded that, for liquidation cases involving severe losses incurred, it would not normally be an issue of concern after the set-off of the losses by the waiver of loan. In reply to a question of Mr Anthony Tam regarding the waiver of loan which might have happened well after the cessation of business by a company, Mr Chiu Kwok-kit ("Mr Chiu") explained that since the loan at the very beginning was incurred in connection with a trade, it would be right to look backwards so as to decide whether the subsequent waiver was in connection with the carrying on of a trade. He added that the statutory wording "*in connection with* the trade, ..." would imply a wider meaning than merely "*for the purpose of* the trade, ...".

CIR said that IRD would take a further look at the issue in the light of additional information provided by the Institute.

(b) Deduction of capital expenditure on developing a computer system

In section 16G, IRO, prescribed fixed asset is defined as “..... (a) such of the machinery or plant specified in items 16, 20, 24, 26, 28, 29, 31, 33 and 35 of the First Part of the Table annexed to rule 2 of the Inland Revenue Rules (Cap 112 sub. leg. A) *as is used specifically and directly* for any manufacturing process; (b) computer hardware, other than that which is an integral part of any machinery or plant; and (c) computer software and computer systems,....”

While it is clear that in (a), the machinery and plant is required to be in use before claiming deduction under section 16G, there is no similar requirement for computer software and systems in (b) and (c). Is it the case that a deduction under section 16G can be claimed on the capital expenditure incurred in a year of assessment while the development of a computer system is in progress, provided the system is used for the production of chargeable profits upon completion of development in a subsequent year of assessment?

CIR advised that there was no requirement that the asset had to be in use in the basis period, but the deduction was subject to the asset being eventually used in the production of chargeable profits. A taxpayer should notify the IRD if the asset concerned was eventually used outside Hong Kong or not used at all. The IRD would consider penal actions if the taxpayer failed to do so.

(c) Losses on disposal or redemption of financial instruments mentioned in section 26A

Section 26A, IRO, excludes from the profits tax, any profit on sale or disposal or redemption or presentment of certain financial instruments (such as Government bonds, Exchange Funds debt instruments or multilateral agency debt instruments).

Although it is uncommon that losses would result from the sale or disposal or redemption of such instruments, there is no specific provision in the IRO that deals with such losses (Note: in the offshore fund exemption regime, there is a specific provision, section 20AD, which deals with loss from transactions the gains from which would be excluded under section 20AC(1)).

Is it the case that losses incurred from redemption or disposal of debt instruments mentioned in section 26A are allowable, provided the transaction is trading in nature and is onshore?

Mr Chiu advised that in general, where profits from certain transactions were not chargeable to tax, setting off against taxable profits would NOT be allowed for losses suffered from such transactions. Where profits were excluded from tax under section 26A, losses incurred from the sale or other disposal or on the redemption of such instruments, as a symmetry, were not allowable. This treatment was similar to that for offshore losses and capital losses.

Mr Chiu further explained that since losses and chargeable profits were required to be “computed in like manner”, such losses could also be excluded by application of section 19D.

(d) Source of stock brokerage commission income for transactions executed electronically

The landmark decision in *ING Baring Securities (Hong Kong) Limited v CIR* [FACV 19 of 2006] establishes that, amongst other things, the general source rule for stock brokerage commission is the location where the execution of trades in securities takes place. Generally, for trades in securities transacted through an exchange floor, the place of execution is regarded as the place where the stock exchange is located.

It is noted that most brokers have established an electronic link with the electronic execution system of the Hong Kong Stock Exchange. Customers of the brokers can, through the electronic link of the brokers with the Hong Kong Stock Exchange, input their orders to buy or sell securities listed on the Stock Exchange. The electronic execution system of the Stock Exchange will then automatically match the customers’ orders with counterparty orders without any human intervention in Hong Kong.

Consider the situation where a Hong Kong broker has established an overseas branch to solicit customers. Most, if not all, business functions including sales and settlement in respect of orders from the overseas customers are performed by the overseas branch. These overseas customers would be able, through the broker’s electronic link with the system of the Hong Kong Stock Exchange, to input their orders to buy or sell securities listed on the Stock Exchange electronically from outside Hong Kong. These orders from the overseas customers would be executed electronically without any human intervention, provided that the customer’s orders inputted electronically to the system were within the pre-determined terms agreed beforehand between the broker and the customer.

The Institute would like to know how the IRD would, in practice, determine the source of the commission earned by the broker in respect of trades in securities listed on the Hong Kong Stock Exchange executed electronically for overseas customers, without any human intervention in Hong Kong.

Mr Chiu advised that pursuant to the CFA judgment in *ING Baring*, the place of execution of share transactions was an important factor to take into account in determining the source of the respective brokerage commission. In the example given, the share transactions could be regarded as completed when the broker inputted the order data into the computer system. Execution of the transactions only took place when there was a successful matching of the buy / sell orders. As the matching was done at the Hong Kong Stock Exchange, the place where the shares were listed, it followed that the place of execution of the transactions and hence the source of the respective brokerage commission was in Hong Kong. This was consistent with Mr Justice Chan's statement in paragraph 9 of the judgment in *ING Baring* that the share "transactions were not completed until after they had been executed; and execution took place at the stock exchange where the securities were traded".

(e) Share-based payment transactions

The Institute welcomes the IRD's clarification and new stance on allowing deductions for share-based payments in group-recharge situations announced on its website on 6 March 2012, and would like to raise the following questions:

- (i) The FAQ on Share-based Payments as published in the IRD's website which states that: "the amount of deduction claimed must not be excessive [for example, it should not be more than the open market value of the shares acquired at the date when the stock option/ share awards is exercised/ vested less the amount or value of consideration given by the grantee/ awardee for the grant and/ or exercise of the option/ award, as the case may be]."

In respect of the announcement, the Institute would like the IRD to further clarify the amount that Company B in the example below can claim as a tax deduction in Year 4.

Example

Under a group employee share-based incentive scheme, Company A, as parent, grants some employees of its subsidiary, Company B, share awards at a nominal consideration. The employees of Company B will receive the share awards at the end of their third year of employment, provided the employees have remained with Company B for the three-year period.

To discharge its obligations under the group scheme, Company A acquires its own shares from the market (as treasury stock) in Year 1, incurring actual costs of HK\$2 million. Furthermore, from the outset of the group scheme, pursuant to a recharge agreement, Company B agrees to pay Company A the fair value of the share awards involved at the end of each year of the 3-year vesting period, when

the relevant expenses are charged to Company B's income statement in accordance with Hong Kong Financial Reporting Standard 2. The shares involved on date of grant are valued at HK\$1.8 million. Therefore, under the recharge agreement, Company B is liable to pay Company A HK\$600,000 at the end of each of the three years concerned, assuming, for the sake of simplicity, the costs are evenly recharged over the three years.

Assume now that the employees of Company B obtain, in Year 4, all the share awards previously granted to them and that the market value of the shares involved on the date of vesting is HK\$2.5 million.

The table below summarises the relevant figures:

	HK\$
Actual costs incurred by Company A for acquiring its own shares from the market in Year 1	2.0 million
Total amount recharged by Company A to Company B (i.e., a recharge of \$600,000 payable for each year at the end of Year 1, Year 2 and Year 3)	1.8 million
Market value of shares involved on the date of the vesting to the employees in Year 4	2.5 million

The relevant questions are:

- (a) Provided that there is no additional recharge from Company A for the difference on the market value of shares, what is the amount that Company B can claim for a tax deduction in Year 4 – HK\$2 million or HK\$1.8 million or HK\$2.5 million?
- (b) Would the tax position be different if Company A incurred only HK\$1.5 million to acquire the shares involved from the market, i.e., would the tax deduction claimable by Company B be restricted to the costs actually incurred by Company A of HK\$1.5 million, even though the total amount agreed to be recharged to Company B and incurred by Company B would be HK\$1.8 million?
- (c) Would the tax position be different if the market value of shares on the date of vesting to the employees dropped to HK\$1.5 million, assuming that the actual costs incurred by Company A remained as HK\$2.0 million and the total amount of the recharge to Company B remained as HK\$1.8 million?
- (d) Is it the case that, as Company A has incurred the costs to obtain the shares in Year 1 and recharged Company B in Year 1, Year 2 and Year 3, Company B can claim deductions in Year 1, Year 2 and Year 3, as it has incurred the costs in Year 1, Year 2 and Year 3, when it settled the recharge to Company A for the costs of shares?

(e) Could IRD clarify the legal basis for the view published on its website?

Ms Lee advised that the IRD revisited the issues concerning deduction of share-based payments and published in March 2012 a revised position for recharge arrangement.

The employing entity and the group entity offering share benefits to employees of the employing entity were separate legal entities. In general, the costs, if any, incurred by the group entity in acquiring the shares concerned might not be relevant. Under the revised position, the IRD accepted that in a recharge arrangement the employing entity would incur an expense when the shares were vested or the share options were exercised. The deductible amount would be the amount of recharge incurred by the employing entity provided that the amount was not excessive. The deduction was basically governed by the general deduction rules (i.e. sections 16 and 17 of the IRO). Where abuse was found, the general anti-avoidance provisions would be invoked. Ms Lee responded to the detailed questions as follows:

- (a) In the Example, the amount of deduction allowable to Company B in year 4 would be HK\$1.8 million, i.e. the actual amount of recharge incurred by it under the recharge agreement.
- (b) The amount of deduction allowable to Company B remained at HK\$1.8 million (assuming there was no indication that the recharge of HK\$1.8 million was grossly excessive).
- (c) In the scenario described, Company B could have acquired the shares from the open market at a cheaper cost of HK\$1.5 million in discharging its obligations towards the employees. To safeguard Company B's interests, it was expected that the terms of a commercial realistic recharge agreement would allow for an adjustment of the amount of recharge having regard to the market circumstances. The payment of the recharge of HK\$1.8 million by Company B without regard to market circumstances might indicate an excessive deduction claim.
- (d) Company B would be allowed deduction of the recharge in Year 4, i.e. after the lapse of the 3-year vesting period. It was the IRD's stance that the employing entity would be liable or had a definite liability for the expenses in connection with the share benefits upon vesting of the shares or exercise of the share options.
- (e) The IRD still considered the authority of *Lowry v Consolidated African Selection Trust Ltd [1940] 23 TC 259* applicable (deduction of expenses recognised for accounting purposes in an equity-settled share-based payment transaction should be denied for new issue of shares). The published revised position served as a practical way to resolve protracted disputes for group recharge arrangement.

Ms Lee added that, based on the above principles, the IRD had already resolved a substantial number of objections.

- (ii) The Institute would like to seek the IRD's view on the chargeability of the recharge received where the stock option obligation is discharged by a recharge arrangement between group companies under various scenarios.

For example, under a group employee share-based incentive scheme, the holding company would discharge the stock option obligations of the subsidiary by issuing new shares or acquiring the shares from the market, and then recharge the subsidiary.

On the assumption that the holding company carries on a business in Hong Kong and is listed on the Hong Kong Stock Exchange, will the holding company be subject to tax for the recharge received from the subsidiary? Will the case be different for issuing new shares and acquiring shares from the market?

Ms Lee advised that where the holding company discharged the stock option obligations of the subsidiary by issuing new shares, the recharge payment received was normally considered a capital receipt and not taxable. Whereas if the holding company discharged the obligations by acquiring the shares from the market, the taxability of the recharge payment would depend on whether the holding company was trading in the shares concerned. This would in turn depend on the particular facts and circumstances of the case.

In reply to a question of Mr Anthony Tam, Ms Lee clarified that the IRD would not **normally** regard the acquisition of shares from market by the holding company in satisfaction of its obligation under a stock option scheme as trading in shares, unless the facts of the case concluded otherwise. Mr Wong Kuen-fai ("Mr Wong") added that should the shares be acquired otherwise than for the satisfaction of stock options, it might amount to trading in shares. With regard to certainty on tax treatment as advanced by Ms Chan, Ms Lee advised that the company concerned might consider applying for an advance ruling.

Mr Chiu remarked that, it might be necessary to examine whether the recharge would include some kind of service fee corresponding to intra-group services provided by the holding company. Such fee should be chargeable to profits tax.

CIR added that if the holding company was in itself carrying on a share dealing business, the acquisition of its own shares, depending on facts of the case, would also be regarded as part and parcel of its share dealing business and profits derived thereof would be chargeable to profits tax. The crux of the matter would still be rested on the purposes for which the shares were acquired by such holding company: whether the shares were acquired to form its own trading shares portfolio or solely for discharging its obligations under the stock option scheme.

- (iii) We would also like to clarify with the IRD on how the deduction on the recharged amount should be claimed in the situation where the employee has been transferred from one subsidiary to another subsidiary as illustrated in the following example:

Company A and Company B are within the same group and both are subsidiaries of Parent Company. Mr X was an employee of Company A in Year 1. A certain number of share options of Parent Company were granted to Mr X by Company A in Year 1 when he was an employee of Company A. The stock options had a vesting period of three years. According to the employee stock option plan, Mr X would be entitled to exercise the stock options granted to him by Company A as long as he remained an employee of a company within the group at the end of Year 3. At the beginning of Year 3, Mr X was transferred from Company A to Company B (i.e., Mr X ceased to be an employee of Company A and became an employee of Company B). He then exercised his stock options at the end of Year 3 when he was employee of Company B. Upon exercise of the stock options by Mr X, Parent Company recharged the difference between the fair value of the shares acquired at the exercise date and the consideration paid by Mr X to Company A and Company B in proportion to the year(s) of services during the vesting period (i.e. 2/3 of the amount was recharged to Company A and 1/3 of the amount was recharged to Company B).

Based on the above, the Institute would like to ask whether the IRD would allow Company A and Company B to claim a profits tax deduction for the amounts recharged by Parent Company to them respectively in Year 3 (provided the other conditions for deduction specified by the IRD were met)?

Ms Lee advised that the tax treatment would depend on the terms and conditions of the recharge agreement. If the recharge agreement clearly provided that each of Company A and Company B would be liable to pay the portion of recharge relating to the employee's respective period of employments, both companies would be allowed the corresponding deductions in Year 3, provided that the other conditions as specified in the published revised position were met.

- (iv) The Institute noted that tax implications of share-based payments have been the subject of discussion in the previous meetings as well as in the meeting this year. The Institute would like to ask whether the IRD would consider consolidating all its practices by issuing a Departmental Interpretation and Practice Notes (DIPN) on this subject. For example, in respect of question A1(e)(i) above, it would be helpful to provide in a DIPN, details of the amount and timing of tax deductions by way of examples for different group recharge situations for both share option and award schemes.

Ms Lee advised that the IRD had published its general view on the deduction of share-based payments in the IRD's website (see "FAQ for Share-based Payment

Transactions” and the published revised position under the Tax Representatives’ Corner). The IRD’s views on the subject expressed during various annual meetings between the Institute and IRD (2005 meeting – item A2(a)(ii), 2006 and 2007 meetings – item A1(d), 2008 meeting – item A1(a) and 2010 meeting – item A1(c)) had also been uploaded to the Institute’s website. Actual recharge arrangements and their terms varied from case to case and also with the passage of time. It might not be practicable to give examples which fitted into all situations. The IRD had no plan to issue a DIPN on the subject but would continue to update the IRD’s website. Taxpayers might consider applying for advance rulings for individual cases if warranted, or they might wish to discuss their own cases with their assessors.

(f) Whether a discount on an original issue discount note is “interest” or “discount”

“Interest” is not defined in the IRO but there are a number of case law precedents shedding light on the issue. The leading common law case on interest is *Re Euro Hotel Belgravia Ltd* (51 TC 293). The principles established in that case are that for a payment to amount to interest, in general, two requirements have to be satisfied: (a) there has to be a sum of money due, by reference to which the payment said to be interest is to be ascertained, and (b) that sum of money has to be due to the person entitled to the interest. In the case of an original issue discount (“OID”) note, the discount (i.e., the difference between the face value of the note and the issue price) is not ascertained by reference to the sum of money due (i.e., the amount payable under the OID note), but is actually a component of the sum of money due. On this basis, many practitioners take the view that a discount on an OID note, albeit being compensation for the time use of money, and therefore revenue in nature, is not interest.

In terms of overseas tax practice, the UK Revenue clearly state that they will not apply interest withholding tax to a discount on an OID note, as they take the view that the discount is not interest (even though it is compensation for use of the money). (HMRC manual refers: <http://www.hmrc.gov.uk/manuals/intmanual/INTM505060.htm>.)

The Institute would like to seek the IRD’s view on the tax treatment of a discount on an OID in the context of sections 16(1) and 16(2) of the IRO.

Mr Chiu advised that in general terms, “interest” was the return or consideration or compensation for the use or retention by one person of a sum of money belonging to, in a colloquial sense, or owed to another person [see *FCT v Broken Hill Pty Co Ltd (2000) 45 ATR 507*]. The Shorter Oxford Dictionary defined “interest” as “money charged for the use of money lent or for not having to repay a debt, according to a specified ratio”.

Mr Chiu further said that what constituted interest was a question of legal substance, not terminology. In *Westminster Bank Ltd v Riches 28 TC 159*, it was held that the

essential quality of interest depended on substance not on the mere name. The substantive test was reaffirmed in *Re Euro Hotel (Belgravia) Ltd.*

Where the lending did not carry a reasonable commercial rate of interest and was either issued at a discount or repayable at a premium, it might normally be assumed that the discount or premium was in the nature of interest.

Mr Chiu explained that paying interest was only one way in which a borrower rewarded a lender. Arms' length loans that required less than adequate interest payments bore an OID. Such discount was therefore an alternative form of interest on a debt instrument paid by the issuer for the use of money. It was in the nature of compensation for deprivation of the use of money.

In the present question, there was a debt, the note. The issue price was the sum of money by reference to which the payment, be it called interest or not, was to be ascertained. And the sum was due to the person who is entitled to receive the face value on maturity.

The IRD therefore took the view that the amount of such discount was deductible as interest. This amount would be prorated or amortized over the life of the OID note, recognizing a portion of the discount annually as interest. In addition to the requirements under section 16(1), specific conditions set out in section 16(2) and the restrictions in subsections (2A) to (2C) had also to be satisfied before deduction could be allowed.

Mr Chiu advised that the UK practice mentioned in the question referred to the need to withhold tax only. It treated discounts as interest for corporation tax purpose.

In reply to a question of Ms Chan regarding the situation when a discount would not be regarded as interest, Mr Chiu said no straight-forward answer could be given since it involved an overall comparison of the quality of debt, market rate, etc. Mr Anthony Tam contrasted the situation in the UK and said that if, according to the case law, all discounts were to be treated as interest, then it would not have been necessary to deem discount as interest by a specific provision. Mr Chiu noted the observation but reiterated that it was still a question of legal substance, not terminology, and it would require the IRD to look at full facts of the case.

Mr Ng, on the other hand, raised the question that subsections (2A) to (2C) could create a practical issue on taxpayers to discharge the onus in proving the identities of recipients of interest so as to qualify for the deduction of interest expenses. In particular, Mr Ng was concerned that section 16(2)(f) had been amended: from an instrument which was "marketable" in Hong Kong to an instrument which was "marketed" in Hong Kong. In his view, what constituted marketing activities in Hong Kong could create uncertainty. It could be that there was only a couple of institutional holders of the instruments, so the sale of the instruments would not require significant marketing efforts. However, the Departmental Interpretation and Practice Notes No. 13A required that, e.g., a road show be held or the fulfilment of other tests. Even though the initial issue came within the framework, if the instruments were subsequently transferable, there could be a problem. Mr Chiu, however, considered that it could not be problematic to taxpayers since the provisions, which were anti-

avoidance in nature, were targeted at those round-robin schemes. It would not be a problem if the financial instrument itself was a marketable instrument. Mr Chiu added that the problem as claimed might require a relaxation to section 16(2)(f).

(g) Interest income for insurance companies

The Institute has noticed that for insurance companies, the IRD appears to take the position that the test for the source of interest income from bonds listed overseas is the operations test and not the provision for credit test. This is notwithstanding that:

- Insurance companies are not financial institutions
- The interest is from a simple loan of funds (i.e. not a complex financing arrangement)
- The insurance companies are not actively trading the bonds

This seems to be inconsistent with DIPN 13. Given the above, would the IRD please clarify the rationale behind applying the operations test in the case of an insurance company. Would the IRD explain, under what circumstances the provision of credit test could still be used, instead of the operations test, in similar situations?

Ms Lee advised that the business of an insurance company included not only insurance but also the investment of its funds. It was an integral part of the business of an insurance company to invest its funds held in reserve and to turn over those funds to maximize its profits or meet its liabilities when they arose. Bond investment was a common means of investment of funds. The return from such bond investment, whether interest or profit on sale, formed a part of the profits of the insurance business. These investments were considered as current assets of the insurance company even though some of them might be held for long term and not of speculative nature [*CIR v Sincere Insurance and Investment Company, Limited* [1973] 1 HKTC 602].

Ms Lee further explained that in determining the source of interest income from bonds, the place where credit was provided was an important factor but by no means a conclusive test. In particular, the “provision of credit test” was not applicable where the loans were not simple loans of money. An insurance company’s bond investment activities clearly went beyond making simple loans of money. Given that any profits, including the interest income, from buying and/or selling these bonds would form an integral part of the insurance company’s profits, the place where the profit generating activities were carried out would be relevant to the determination of the source of interest income.

The IRD did not consider that the application of “operations test” was inconsistent with DIPN 13. It had been clearly mentioned in paragraph 4 there that the “provision of credit test” was not applicable where the loans were not simple loans of money. The IRD, in the 2008 annual meeting with the Institute [agenda Item A1(c) –

determination of source of interest income from bonds purchased from the secondary market], further clarified that where a taxpayer carried on a business of buying and selling securities, the place where the profit generating activities took place needed to be taken into consideration and the “operations test” was applicable.

(h) Pension funds - investment income of recognised schemes

DIPN 23 (Revised), paragraph 61 states that, “ROR schemes are established under statutory control to receive, hold and manage funds earmarked for the provision of employee benefits rather than to provide employers with “profits” per se. In holding and managing funds, the trustees of retirement schemes will from time to time, and perhaps occasionally with a degree of frequency, acquire and dispose of investments. That notwithstanding, as retirement schemes are operated for the common advantage of their constituent members (i.e. the employees), the trustees’ fiduciary duties are to maintain the investment funds in a healthy financial state to meet long-term commitments. Taken overall, recognised retirement schemes and their trustees are not considered to be subject to profits tax on their investment income.”

Does the IRD hold the view that recognised retirement schemes and their trustees are not considered to be subject to profits tax on their investment income on the basis that they are not carrying on a business, as per paragraph 61 of DIPN 23?

If so, would the IRD accept that the same treatment should apply to overseas pension funds?

Ms Lee advised that ROR schemes stated in paragraph 61 of DIPN 23 (Revised) referred to the approved retirement schemes approved by CIR, schemes registered under the Occupational Retirement Schemes Ordinance, Cap. 426 (“ORSO”) or exempted from registration under the ORSO [see paragraph 9 of DIPN 23 (Revised)].

Whether the operation of an overseas pension fund amounted to the carrying on of a business was a question of fact. As stated in paragraph 60 of DIPN 23 (Revised), in deciding the issue, the most important determinant was the purpose for which the fund was established.

In reply to a question of Ms Chan regarding whether or not an overseas pension fund, which was established solely for providing retirement benefits to employees and was properly regulated by an overseas jurisdiction, would be accorded the same tax treatment as that of an ORSO scheme, CIR replied that there was no automatic assumption that the same tax treatment would apply. The IRD would still look at the primary purpose of the pension fund to ascertain whether it was established for providing retirement benefits. In any event, an overseas pension fund would nonetheless be entitled to offshore funds exemption if it qualified as an offshore fund.

(i) Li & Fung case

It is noted that in the article published in the Institute's journal "A Plus" in July 2012, the IRD said the decision of the Board of Review and the judgements of the courts in the case of Li & Fung are far from satisfactory. In the light of that article, the Institute would like to request the IRD to explain further its view on what is meant by a supply chain structure/ model/ management ("the approach") and how this affects the broad guiding principle for determining the source of profits?

Mr Chiu advised that supply chain management was about the integration of business processes that included planning and management of sourcing, procurement, manufacturing and logistics management. Therefore, one of the major roles should be on the efficient coordination and integration of suppliers, factories, warehouses and stores so that the goods were produced and distributed in the right quality and quantities, to the right locations and at the right time.

Mr Chiu further explained that regarding the taxation of supply chain management business, one of the concerns was whether the correct amount of profits had been allocated to the Hong Kong company. For this purpose, the total income or profits had to be split among the entities within the supply chain on an arm's length basis, taking into account the functions performed, assets used and risk assumed by each entity involved.

Mr Chiu then said the next question was the source issue. As mentioned in the A Plus article, the *Li & Fung* case did not represent a change of law or had it overturned any judicial precedents. The IRD would continue to apply consistently the broad guiding principle, focus on the effective causes and ignore antecedent or ancillary matters in determining the source of profits. If the profits of supply chain management business were derived from the activities undertaken in Hong Kong, the profits should be chargeable to tax.

In reply to a question of Mr Anthony Tam, Mr Chiu explained that supply chain is a generic term, with different scenarios, for example, the Hong Kong company could operate as a chain taking up the risks, the title in goods, etc, or could simply be an agent by providing co-ordination services. All these depended on the structure, function, risk and the terms of the arrangement. CIR left the meeting after the discussion of items A1(a) to A1(h) and A5. Mr Wong then took over the chair.

(j) DIPN 21

Example 2 in paragraph 31 of DIPN 21 (July 2012) reads as follows:

"Company B manufactures goods in Hong Kong and sells them to overseas customers. The fact that Company B has sales staff based overseas does not give a part of the profits an overseas source.

This is not a case for apportionment. The whole of the profits are liable to profits tax."

The Institute would like to ask if the approach referred to in agenda item A1(i) above were applicable, would this mean that the tax consequence would be the same as indicated in paragraph 31 and, if not, what would be the tax consequence?

Mr Wong advised that paragraph 31 of DIPN 21 was on manufacturing profits whereas agenda item A1(i) above was not. As explained above, in determining the source of profits derived from the supply chain management business, the basis of attribution of profits was a relevant issue to such business with a regional or global structure.

Mr Wong further explained that on the other hand, in Example 2 of DIPN 21, which was an example on manufacturing profits, the IRD considered that Company B derived profits from the manufacturing operations carried out in Hong Kong and hence the profits were fully taxable in Hong Kong.

Mr Wong summarised that it could be seen that for these two different kinds of businesses, the source of profits was decided on their own facts, the nature of transactions and the actual operations of the taxpayers. However the tax principle remained the same.

With regard to the following scenario, please clarify whether the profits would be derived from a source in Jurisdiction A or Jurisdiction B or both (both Jurisdiction A and B are exclusive to each other and could be anywhere):

Company C manufactures goods in Jurisdiction A and sells them to customers in Jurisdiction B. Company C has sales staff based in Jurisdiction B, who handle the sales.

Mr Wong advised that source of profits was a question of fact. The crux of the issue in this case was whether Company C derived profits from both the manufacturing operations in Jurisdiction A and the services performed by the sales staff in Jurisdiction B. If the services performed by the sales staff in Jurisdiction B were antecedent or ancillary matters, Company C's profits were derived from a source in Jurisdiction A. In the scenario where the activities of the sales staff were substantial, like Example 3 of the DIPN, it was necessary to apportion the profits derived by Company C between Jurisdiction A and Jurisdiction B for reason that its profits were derived from the activities undertaken in both jurisdictions.

(k) Research and development ("R&D") expenditures under section 16B

Section 16B provides that R&D expenditures incurred in relation to trade, profession or business are deductible.

- (i) Section 16B(1)(b) states that "..., in ascertaining the profits from any trade, profession or business in respect of which a person is chargeable to tax under this Part for any year of assessment there shall, subject to subsection (2), be deducted the following payments made, and expenditure incurred, by such person during the basis period for that year of assessment ... (b) expenditure on research and development related to that trade, profession or business, including capital expenditure except"

According to the discussion in the 2011 annual meeting (item A1(e)(i)), the IRD took the position that the expenditures have to be incurred by the taxpayer in respect of R&D activities being "undertaken by the person himself". The IRD further agreed to give some guidelines on what amounted to "activities undertaken by the person himself."

The Institute would like to follow up on the guidelines to be given as to what amounted to "activities undertaken by the person himself." In particular, what is the IRD's view on the following scenarios?

- (a) A Hong Kong company sets up a subsidiary in China to house some of the R&D staff hired locally in order to make use of the cheaper operating costs in China. The Mainland subsidiary would solely carry out the activities instructed by the Hong Kong company. The R&D project is managed by the Hong Kong company's employees who provide step-by-step instructions to the R&D staff employed by the Mainland subsidiary to carry out certain R&D activities. It also sends employees to supervise the day-to-day R&D activities carried out by the Mainland subsidiary. The Hong Kong company would reimburse the operating expenses of the Mainland subsidiary, including the wages of the R&D staff. Would the activities of the R&D staff of the Mainland subsidiary be viewed as activities undertaken by the Hong Kong company? Is the Hong Kong company entitled to claim deduction of the R&D expense paid to the Mainland subsidiary?

Ms Lee advised that as pointed out by CIR in the 2011 annual meeting, whether R&D activities would be regarded as "undertaken by the person himself" was a matter of fact and degree. Each case had to be decided on its own merits. Given that the Hong Kong company and the Mainland subsidiary were two separate legal entities, R&D activities undertaken and expenditure incurred by the Mainland subsidiary could not be regarded as undertaken or incurred by the Hong Kong company itself. The Hong Kong company was not entitled to claim deduction under section 16B(1)(b) of the R&D expenses charged by and paid to the Mainland subsidiary.

- (b) Under a group cost-sharing arrangement, a Hong Kong company sends its own employees to the group's R&D centre to conduct R&D activities together with other employees of the group. The cost of the group's R&D centre would

be allocated to the Hong Kong company. For example, the allocated cost to the Hong Kong company is HK\$1 million while the actual staff cost of the employees sent to the R&D centre is HK\$300K. How much deduction can the Hong Kong company claim?

Ms Lee advised that according to paragraph 8.23 in Chapter VIII of the OECD Transfer Pricing Guidelines (July 2010), the deductibility for contributions to a cost contribution arrangement depended on whether the criteria in the domestic tax legislation were met.

Ms Lee further explained that the Hong Kong company itself had incurred actual staff cost of HK\$300,000 for its R&D activities. Therefore it could only claim deduction of that amount under section 16B(1)(b). Expenses incurred by other members of the group and recharged to the Hong Kong company could not be regarded as incurred by the company itself and claimed for deduction.

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

The law is written in a way that two conditions must be fulfilled for an apportionment of expense applies:

- (a) The R&D expenditure is made or incurred outside Hong Kong; and
- (b) The business in relation to which is carried on partly in and partly out of Hong Kong

According to the discussion in the 2011 annual meeting (item A1(e)(ii)), the IRD advised that the phrase "incurred outside Hong Kong" in sub-section (2) referred to the expenditure on R&D activities which were carried out by the taxpayer outside Hong Kong. In addition, it is advised that the IRD's practice is to seek apportionment of R&D expenditures only where a person's profits are partly chargeable to tax in Hong Kong. If a person's profits are fully chargeable to tax in Hong Kong, the full amount of R&D expenditure, where other conditions in section 16B are satisfied, will be allowable for deduction. It appears that the IRD focuses on whether the profits are chargeable to tax in Hong Kong in determining whether apportionment of R&D expenditure is required, instead of considering the above two conditions under section 16B(2).

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

- (a) If all the R&D activities are carried out in Hong Kong; and
- (b) the business in relation to which the R&D is undertaken is carried on partly in and partly outside Hong Kong

will apportionment of the R&D expenses be applied, assuming that the profits are partly taxable and other conditions in section 16B are satisfied?

Ms Lee advised that section 16(1)(ga) provided that payments and expenditure specified in, among others, section 16B would be deducted to the extent to which they were incurred in the production of chargeable profits. When section 16B, read in conjunction with section 16(1)(ga), in deciding to what extent R&D expenditure incurred by a person was deductible, regard had to be had to whether its profits were wholly or partly chargeable to tax. Given that the profits of the person who carried out the R&D activities in the example were only partly taxable, the R&D expenditure incurred had to be apportioned even though the R&D activities were all carried out in Hong Kong.

Mr Anthony Tam followed up the discussion in the 2011 annual meeting that, to what extent the R&D activities undertaken by a separate entity rather than by the taxpayer itself would still be regarded as deductible under section 16B(1). Ms Lee advised that it all depended on facts and degree of each case. Further, the determination on the extent of R&D activities undertaken by the taxpayer or the relevant factors to be looked at could be varied from industry to industry and no hard and fast rule could therefore be given. Where in doubt, taxpayers could always apply for an advance ruling with regard to such deductibility. Mr Wong added that, the IRD's interpretation on section 16B(1) had had regard to the legislative history as well as the legal advice having been sought. It required that the R&D activities had to be carried out by the taxpayer itself.

As regards the IRD's interpretation in section 16B(2), Mr Anthony Tam suggested that since it was a specific provision, it should be regarded as a separate regime by its own and could not be read into other provisions like section 16(1). He also noted that it did not seem to require that the profits of the taxpayer be partly taxable, but only that the business had to be carried out partly in and partly out of Hong Kong. Mr Wong, on the other hand, considered that section 16B was not in itself a self-contained provision, and had to be construed in conjunction with other provisions of the IRO, like section 16(1)(ga). Ms Lee reiterated that it did not seem proper to allow full deduction of R&D expenditure when the taxpayer's profits were not fully subject to tax.

(I) DIPN 49

Based on the DIPN 49 regarding taxation of royalties derived from licensing of intellectual property rights ("IPR"), if a taxpayer has purchased the "proprietary interest" of an IPR and licenses that IPR to another party for use outside Hong Kong, the

royalties so derived will generally be regarded as non-Hong Kong sourced income and will not be subject to Hong Kong tax. On the other hand, if a taxpayer only obtains a licence to use an IPR from its owner (i.e. the taxpayer has not obtained the proprietary interest of the IPR) and then sub-licenses the IPR to another party for use outside Hong Kong, the IRD will take the place of acquiring and granting the licence as the source of income.

The Institute would like the IRD to clarify the rationale behind the above views on the source of income derived from different types of licensing arrangement (i.e. whether the taxpayer has acquired the proprietary interest of the IPR or not).

Mr Wong advised that the question of source in determining whether royalties derived from the licensing of IPRs would be chargeable to tax in Hong Kong would very much turn on the facts of individual cases. This point had been particularly stressed in paragraph 72 of DIPN 49 and it was important to note that "no single test is decisive". Thus, there was no single fact (e.g. the place of use of IPRs, the place of contractual arrangement effected or the place where IPRs are created or developed) which was decisive. The purpose of the examples mentioned in paragraphs 73-75 of DIPN 49 was to help illustrate the IRD's general views only. In determining the source of profits in a particular case, the IRD had to reserve its rights to ascertain the full facts of the case and take into account the actual operations of the taxpayer that generated the profits in question.

Furthermore, in paragraph 73 of DIPN 49, it was stated that,

"If an IPR is created or developed by a taxpayer carrying on business in Hong Kong and is licensed by the taxpayer to another party for use outside Hong Kong, the royalties so derived will generally be regarded as Hong Kong sourced income and hence will be subject to Hong Kong tax."

In respect of the above quoted statement, the Institute would like the IRD to state its views on the following situations:

- (i) Where an IPR is created or developed by a taxpayer in Hong Kong but all the contractual arrangements in respect of the licensing of the IPR to another party for use outside Hong Kong are effected outside Hong Kong, would the royalty income be subject to an apportionment as being partly onshore and partly offshore?

Mr Wong advised that for an IPR created or developed by a taxpayer, the source of royalties derived from such IPR would generally be the place where the taxpayer had used his wits and labour to create or develop the IPR. If the IPR was created or developed in Hong Kong, the fact that all contractual arrangements in respect of the licensing of the IPR to another party for use outside Hong Kong were effected outside Hong Kong would not change the locality of the royalty income. Therefore the IRD considered that an

apportionment of royalties as being partly onshore and partly offshore was unwarranted in such circumstances.

In reply to a question of Ms Chan regarding whether or not the apportionment of royalty income could be warranted in cases where substantial effort had been undertaken outside Hong Kong in deriving such income, Mr Wong said that the IRD interpretation was based on a South African authority, *Millin v CIR*, 1928 AD 207, that the source of royalties was accrued as a result of the taxpayer's wits, labour and intellect. Ms Chan considered that if the OECD Transfer Pricing Model was adopted, it would have been possible to attribute profits according to some functions of the business, e.g. sales, etc. On the other hand, if the source principle was to be applied, it would create uncertainty regarding what profit-generating activities of the taxpayer were to be looked at. Mr Chiu commented that in tax treaties where the OECD Model was applied, it could be more complicated since double taxation might also arise in the place where the permanent establishment was established. He said that the IRD would give a tax credit in such cases where the whole of the royalty was taxed in Hong Kong.

In response, Ms Chan said it would be more appropriate to focus on non-tax treaty cases. She considered that only the source principle should be applied in those cases and it should not preclude that apportionment of profits could always be possible depending on facts and circumstances of each case. To conclude, Mr Wong maintained the position that apportionment of royalty income would not normally be warranted.

Mr So said that there were some practical cases of double taxation with major trading partners, such as the United States and Australia, where no tax treaty existed. Mr Chiu suggested that it would be better for the institute to provide some specific examples on an anonymised basis.

- (ii) (a) An IPR was created or developed by a foreign company outside Hong Kong (at the relevant time no business was carried on in Hong Kong) and subsequently the foreign company has established a business presence in Hong Kong. While carrying on business in Hong Kong, the foreign company effects in Hong Kong all the contractual arrangements in respect of the licensing of the IPR to another person for use outside Hong Kong. Would the relevant royalty income be accepted as wholly non-taxable offshore income or subject to an apportionment?
- (b) Same facts as stated in (a) above, except that the licensing is now in respect of the use of the IPR in Hong Kong, would any part of the royalty income be chargeable to tax in Hong Kong under section 14 of the IRO (assuming that section 15 (1) has no application as the foreign company is now carrying on business in Hong Kong and therefore only chargeable to tax under section 14 of the IRO)?

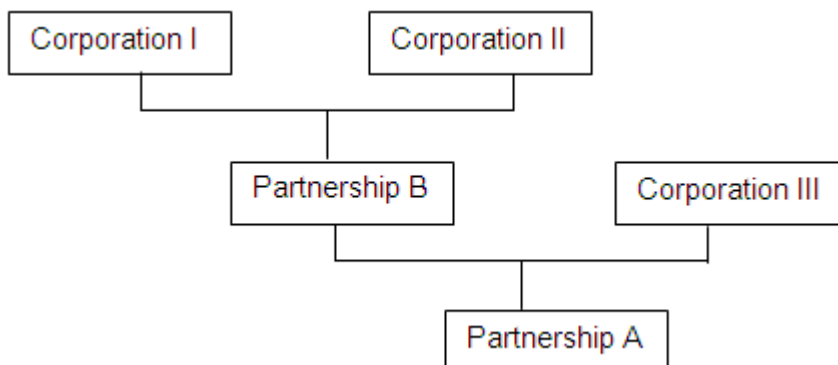
Mr Wong advised that the example in (ii)(a) was just the reversed scenario of (i). The IRD accepted that the royalties would generally be regarded as non-Hong

Kong sourced income not subject to Hong Kong profits tax.

Mr Wong further explained that if it was concluded that the royalty income was offshore in nature not subject to tax under section 14 of the IRO, the royalty would still be chargeable under the deeming provision of section 15(1) if the IPR concerned was used in Hong Kong. This was notwithstanding that the recipient was chargeable to tax under section 14 in respect of its other income. The two sections were not mutually exclusive. Section 15(1) served to enlarge the scope of section 14 and brought into charge receipts which were not otherwise taxable.

(m) Tax rate to be applied where a partner of a partnership is itself a partnership with corporate partners

The diagram below illustrates the situation:



The issue in this example is the tax rate applicable to Partnership B's share of the profits of Partnership A when the relevant profits are assessed in the name of Partnership A. It appears that since Partnership B is not a corporation, its share of Partnership A's profits should be taxed at the standard rate of 15%, even though all the partners of Partnership B are corporations. The Institute would welcome IRD's comments on this observation.

Mr Wong advised that section 14(2)(b) provided that where a corporation to which a share of assessable profits of a partnership was apportioned under section 22A and charged under section 22, profits tax would be charged on those profits at the corporate rate. As such, in computing the tax liability of a partnership, it was necessary to ascertain the tax liability of each partner. And where a partner was itself a partnership, the same was necessary for each partner of that partnership. In the example quoted, profits tax charged on the share of profits of Partnership B in Partnership A should also be computed at corporate rate.

Agenda item A2 - Salaries tax issues

(a) Proportionate benefit – computation of month of service for the purpose of section 8(5)

Paragraph 27 of DIPN 23 states: “Where there has been a transfer of benefits from a scheme operated by a previous employer to the current employer’s scheme, the service with the previous employer that has been recognised by the present scheme as qualifying service with the current employer can be taken into account in calculating the completed months of service.”

Against this background, the Institute would like to clarify with the IRD the following issues:

- (i) An individual was in the United States for 10 years before he is seconded to Hong Kong. He has been employed by the same employer and is in the United States retirement plan (401(k) plan) prior to and during his Hong Kong assignment. His employer obtained an exemption status for the 401(k) plan in Hong Kong (hence it qualifies as a Recognised Retirement Scheme (“RRS”) in Hong Kong). If he terminates his employment after one year in Hong Kong and cashes out his RRS, should he be taxed on 9/10 of the distribution under the proportionate benefit (“PB”) rule, or be fully tax exempt as he has been in the plan and under the same employer for 11 (10+1) years?

Mr Chiu Sai-ming (“Mr Vincent Chiu”) advised that since the individual remained an employee of the employer in the United States (the “US Employer”) during his assignment to Hong Kong, he was employed by the same employer throughout the 11 years. When he cashed out his RRS upon termination of service, sections 8(2)(cc)(i) and 9(1)(ab)(ii) as read with sections 8(4), (5) and (6) of the IRO were applicable.

Mr Vincent Chiu further explained that the number of completed months of service of that individual with the employer was 132. By virtue of section 8(5) of the IRO, the amount of proportionate benefit should be 132/120 times his accrued benefit. As the amount received by the individual that was attributable to his employer’s contributions was less than the proportionate benefit, no amount should be assessable under section 9(1)(ab)(ii) of the IRO. In other words, no part of the payment under the RRS was taxable. Paragraph 27 of DIPN 23 was not relevant to this situation.

- (ii) Same facts as (i) above, except that the individual switches to Hong Kong employment and is under the MPF scheme of his Hong Kong employer. There is an employer's voluntary contribution to the MPF scheme and his Hong Kong employer recognises his previous 10 years of services in the United States under the MPF scheme. If his employment is terminated after one year, what is the tax implication of the distribution related to the voluntary contribution he received from

MPF scheme? Is 9/10 of the amount subject to salaries tax or is the sum fully tax exempt?

Mr Vincent Chiu advised that under case (ii), the individual had an employment with the US Employer for 10 years when he was covered by a 401(k) plan. Subsequently, he was employed by the Employer in Hong Kong ("HK Employer") for 1 year when he was covered by a MPF scheme. Upon termination of service with the HK Employer, sections 8(2)(cc)(ii) and 9(1)(ae) as read with sections 8(4), (5) and (6) of the IRO were applicable. The amount of proportionate benefit would be 1/10 of the accrued benefit. The amount received by the individual which was attributable to the voluntary contribution paid by the HK Employer that exceeded the proportionate benefit was taxable.

Mr Vincent Chiu further explained that paragraph 27 of DIPN 23 would only be applied to the situation in which the accrued benefit (i.e. the accumulated contributions and investment returns) from the scheme operated by the previous employer was transferred to the current employer's scheme. Since the amount received by the individual was attributable to the employer's contribution rather than the transfer of accrued benefit from the previous employer's scheme, the treatment as prescribed in paragraph 27 of DIPN 23 was not applicable.

(b) Taxation of share awards – changes in employment during vesting period

In recent years, increasing number of expatriates having non-Hong Kong employment ("non-HK employment") and seconded to work in Hong Kong have switched from a non-HK to HK employment during their secondment. It is also common that they have been granted share awards for which the vesting period spans over the two employments. In the 2011 annual meeting, the IRD (see agenda item A2(a)) stated that in case of change of employment, the share awards should be split into two portions, one attributable to HK employment and one attributable to non-HK employment.

The Institute would like to clarify with the IRD as to the practical treatments of the share awards (which are not articulated in DIPN 38) using the following two examples.

Example 1

An employee with a non-HK employment had been seconded to work in HK since 1 January 2008. His employment is localised and changed to a HK employment on 1 October 2011. He was granted restricted share awards on 1 January 2009 with a three-year vesting period (i.e., they vested on 31 December 2011).

(i) Taxation upon vesting

There are three possible treatments.

- (a) Pro-rating the whole amount between the "non-HK employment" portion and "HK employment" portion, based on the vesting period, and only the "non-HK employment" portion is eligible for time-apportionment.
- (b) The whole amount is eligible for time-apportionment, because the share awards were granted during the non-HK employment period. If this approach applies, which year's ratio should be adopted for time-apportionment purpose?
- (c) The whole amount is not eligible for time-apportionment, because the share awards vested and were accrued during the HK employment period.

According to the spirit in the clarification given by the IRD in 2011 meeting, the treatment in (a) should be apply. However, the Institute has seen different assessors using different approaches. In cases where the treatment in (a) is applied, there are still sometimes inconsistencies in the basis adopted for time-apportionment purpose. We invite the IRD's views on this observation and would welcome assurances that possible inconsistencies in approach will be reviewed.

Mr Vincent Chiu advised that as pointed out in agenda item A2(a) of 2011 annual meeting, where an employee changed from a Hong Kong employment to a non-Hong Kong employment or vice versa, the general principle was that share awards would be split into 2 portions, one attributable to the period of Hong Kong employment and the other attributable to the period of non-Hong Kong employment.

Mr Vincent Chiu further explained that an employee was unconditionally entitled to the ownership of the shares upon fulfillment of all the vesting conditions. The shares accrued to the employee in the year when all the vesting conditions were satisfied and were taxable in that year as perquisites.

For Hong Kong employment, the full amount of the value of the vested shares was subject to tax except where the provisions of sections 8(1A)(b)(ii) and 8(1B) were satisfied. For non-Hong Kong employment, the time apportionment factor applicable to the taxable income in the year of vesting would be applied to the value of the vested shares in ascertaining the amount that was chargeable to tax – paragraph 63 of DIPN 38.

In Example 1, the value of the vested shares (\$A) was split and assessed in the year of assessment 2011/12 as follows:

Vesting period	No. of days		Taxable share awards
01.01.2009-30.09.2011	1,003	Non-HK employment	\$A x 1,003 / 1,095 x F
01.10.2011-31.12.2011	92	HK employment	\$A x 92 / 1,095

where F = time apportionment factor in the year of assessment 2011/12 (for the period from 01.04.2011 to 30.09.2011)

(ii) Reporting by employer in form 56B

There are three possible treatments:

- (a) Pro-rating the whole amount into "non-HK employment" and "HK employment" portions based on the vesting period, with the "non-HK employment" portion being reported in additional form 56F and the "HK employment" portion reported in form 56B.
- (b) Reporting the whole amount in additional form 56F for the period from 1 April to 30 September 2011, as a post-cessation income under section 11D(b)(ii) of the IRO.
- (c) Reporting the whole amount in form 56B for the period from 1 October 2011 to 31 March 2012.

We invite IRD's views on the correct approach to be applied.

Mr Vincent Chiu said the correct approach was (a).

Example 2

The facts are the same as in example 1, except that the employee started his Hong Kong assignment on 1 October 2010 (i.e., during the vesting period) rather than 1 January 2008. What would be the answers to (i) and (ii) above?

Mr Vincent Chiu advised that if the value of the vested shares was assumed as \$A, the split and the taxable amounts in the year of assessment 2011/12 were as follows:			
Vesting period	No. of days		Taxable share awards
01.01.2009-30.09.2010	638	Before assignment	Nil
01.10.2010-30.09.2011	365	Non-HK employment	\$A x 365 / 1,095 x F
01.10.2011-31.12.2011	92	HK employment	\$A x 92 / 1,095
where F = time apportionment factor in the year of assessment 2011/12 (for the period from 01.04.2011 to 30.09.2011)			
The reporting requirement was the same as in Example 1.			

(c) Taxation of payments in lieu of notice ("PILON")

- (i) In the 2012 annual meeting, (see item B2) IRD stated that counsel of Department of Justice advised that payments in lieu of notice under section 7 of the Employment Ordinance ("EO") are taxable because the right to receive a payment in lieu of notice under section 7 constituted an implied term of employment contract.

- (a) In this regard, the Institute would like to seek clarification with the IRD how it has been concluded that the payment under section 7 of the EO is an “implied term of employment contract”, as it could be argued that payment in lieu of notice is a payment as damages by reference to point 7 of Chapter 5 of UK HM Revenue & Customs (page 77) and/ or a payment of the abrogation of the taxpayer’s rights as described in the Fuchs case.

Mr Chiu advised that the Employment Ordinance (Cap. 57) (“EO”) was the main piece of legislation which governs the conditions of employment in Hong Kong. It outlined the rights and obligations of employer and employee, including those relating to termination of employment and entitlements upon termination. By virtue of section 70 of the EO, any agreement attempting to contract out of the provisions in EO would be void.

Mr Chiu further explained that under the EO, either the employer or employee may terminate an employment contract by giving notice within a requisite period, while either of them may at any time terminate the contract without notice by making a payment in lieu of notice in accordance with section 7 of the EO. In the situation that the employer terminated an employment contract without proper notice, the employee had a legally enforceable right to receive PILON in pursuance of section 7 of the EO even though this right had not been explicitly stated in the employment contract. Therefore, section 7 of the EO should be construed as an implied term of the employment contract.

Mr Chiu emphasized that the “Employer Further Guide to PAYE and NICs” [CWG2 (2012)] (“the Guide”) issued by the HMRC provided guidelines to employers in the UK on the reporting requirements for Pay-As-You-Earn and National Insurance contributions. Point 7 of Chapter 5 of the Guide (page 77) covered the situation where the employer did not give the employee proper notice, and there was no entitlement or option to make payment in lieu of notice. A payment in lieu then made was damages for the breach and not taxable. On the other hand, Point 1 of the same page stated that payment in lieu of notice paid under a legal entitlement (or paid automatically) or under an employer’s discretion which was within the terms and conditions of employment should be included in gross pay for PAYE purposes and was taxable.

Since section 7 of the EO provided a legal entitlement to employee to PILON, the amount so received should be taxable. PILON paid under either express or implied terms of employment was not an abrogation of rights because the employee had surrendered no right. The employee got exactly what he was entitled to get under his contract of employment. The IRD found support of such view from *EMI Group Electronics v Coldicott* [1999] STC 803, *Dale v de Soissons* (1950) 32 TC 118 and *Fuchs, Walter Alfred Heinz v CIR* [2011] 2 HKC 422.

- (b) In view of counsel's opinion, would the IRD consider severance payments under section 31B of EO to also be an "implied term of employment contract"?

Mr Chiu advised that section 31B of the EO confers on an employee who had been employed under a continuous contract for a period of not less than 24 months the right to receive severance payment when he was dismissed by his employer by reason of redundancy or when he was laid off within the meaning of section 31E. Under 31Q of the EO, an employee who had been dismissed by his employer would, unless the contrary was proved, be presumed to have been so dismissed by reason of redundancy. Redundancy had a special legal meaning. Broadly, there had to be a reduced need for employees which caused the termination of the employment.

Mr Chiu further explained that since the right to severance payments was a legal entitlement, it could also be regarded as an implied terms of employment contract. However, see the IRD's further elaboration in (ii) below.

- (ii) If the employment contract does not explicitly mention (i) a payment in lieu of notice and (ii) severance payment and the employee is laid off, why should it be the case that (i) a payment in lieu of notice is taxable but (ii) severance payment is not taxable in the hands of an employee, since there is a statutory requirement to pay both to employees under the EO?

Mr Chiu advised that while it was a legal entitlement, it had always been the practice of the IRD to accept the statutory severance payment calculated under the EO as not chargeable to salaries tax as it was not an "income from employment" (see below). Excess amount over the statutory severance payment might be chargeable to salaries tax, if such excess was in fact reward for services rendered.

Mr Chiu further explained that in considering the nature of the payment, it was relevant to refer to the legislative intent for enactment of provisions relating to severance payment in the EO. On 3 July 1974, when the Secretary for Social Services (Acting) moved the second reading of the Employment (Amendment) (No.2) Bill 1974, he explained that the bill was designed to provide for severance pay on redundancy. He said:

"Severance pay on redundancy is the means whereby an employee may be compensated for loss of employment through no fault of his own. It is simply compensation for loss and not a reward for long service or good behaviour such as a gratuity or bonus. It arises only from dismissal due to redundancy and not where there is any element of volition or fault on the part of the employee."

In *Mairs v Haughey* [1994] 1 AC 303, Lord Woolf held that redundancy payment

in its nature was not an emolument from employment but compensation to the employee for his no longer receiving emoluments from the employment. Lord Woolf explained redundancy in the following terms:

“Redundancy, whether statutory or non-statutory, involves an employee finding himself without a job through circumstances over which he has no control. A redundancy payment has therefore a real element of compensating or relieving an employee for the consequences of his not being able to continue to earn a living in his former employment. Instead of being an emolument from employment, it is a payment to compensate the employee for not being able to receive emoluments from his employment.”

Mr Chiu summarised that in the light of the legislative intent and Lord Woolf’s observation above, the IRD held the view that severance payment received by an employee under the EO should not be assessable as an “income from employment”.

In reply to a question of Mr Tisman regarding the excess portion of severance payment which might be chargeable to salaries tax, Mr Chiu explained that the IRD would look at all the circumstances under which the excessive amount was payable by the employer to ascertain whether there was any contractual terms or bargains whereby the payment was made in connection with services rendered by the employee. Mr Wong added that it would be typical for the IRD to ask why the excessive portion was paid by the employer, and to ascertain whether the payment was income from employment and be assessable.

- (iii) As stated in “Fuchs, Walter Alfred Heinz v CIR [2011]” (“Fuchs case”), if an emolument is not paid as a reward for past services or as an inducement to enter into employment and provide future services, but is paid for some other reason, then the emolument is not received “from the employment” [re: paragraph 16(c) of Fuchs case]. As in paragraph 25 of Fuchs case, it states that being given a right to substantial compensation in the event of early termination without cause was plainly an important part of the contractual consideration and self-evidently an inducement for Mr. Fuchs to sign the employment contract, the emolument is taxable. However, it is not likely that one can be induced to sign an employment contract with or without a clause of one month’s notice under section 7 of the EO. In this regard, could the IRD explain how one’s month notice (and so a requirement to make payment in lieu of said notice) under section 7 of the EO could be considered as an inducement to enter into employment?

Mr Chiu advised that section 8 of the IRO assessed income derived from employment. In *Shilton v Wilmshurst [1991] 1 AC 684, 64 TC 78*, Lord Templeman explained that an emolument “from employment” meant an emolument “from being or becoming an employee”. Thus, it was necessary to distinguish in each case between an income which was derived from being or becoming an employee and an income which was attributable to something else.

Mr Chiu further explained that in *Fuchs, Walter Alfred Heinz v CIR [2011] 2 HKC 422*, Mr Justice Ribeiro PJ said that if a payment was found to be derived from the taxpayer's employment, it was assessable. The approach in *EMI Group Electronics v Coldicott [1999] STC 803* which concerned the taxation of payment in lieu of notice should be adopted in the construction of section 8(1), i.e. a payment in lieu of notice, contractually agreed from the outset of the employment relationship, fell squarely within it.

Mr Chiu summarised that with this clarification of the relevant law, the IRD was obligated to follow the CFA's interpretation in determining the taxability of PILON. PILON was taxable because it was plainly an entitlement under the contract of employment. Whether the taxpayer had taken the right to receive PILON as an inducement to enter into employment would not alter the taxability of the payment.

- (iv) Could the IRD clarify the position regarding the taxability of a payment in lieu of notice under section 7 of EO (i.e., statutory damage clause) and under an employment contract (i.e., employment clause), because ordinary employees who receive payments in lieu of notice, which usually involve around HK\$10,000 – HK\$20,000 (and tax of around HK\$1,000 – HK\$2,000) would not be well equipped to lodge an objection with the IRD given their limited knowledge and resources, unlike the taxpayer in the Fuchs case, which involved a large amount of tax.

Mr Chiu advised that PILON was taxable no matter whether it was paid under the express term of an employment contract or under section 7 of the EO. The IRD had published information in its website to advise taxpayers of the assessing practice on PILON. Any taxpayer aggrieved by an assessment may lodge objection and appeal in accordance with the provisions in the IRO.

Agenda item A3 - Cross-border tax issues

(a) Application of tax treaty in situations where a Hong Kong company is also considered as a Mainland tax resident enterprise

A Hong Kong incorporated company can be regarded by the Mainland tax authority as a Mainland tax resident enterprise under the Mainland Corporate Income Tax Law if its place of effective management is in the Mainland. According to the tie-breaker rule in the Resident article of the Mainland China-Hong Kong double tax arrangement ("Mainland-HK DTA"), the company would be regarded as a resident of the Mainland instead of Hong Kong.

Say a company hires a group of employees who need to travel to the Mainland to perform their employment duties. The employees also spend more than 60 days but less than 183 days in Hong Kong rendering services in a given year of assessment.

Against this background, the Institute would like to clarify with the IRD on the following issues:

- (i) As the test to be used under the Hong Kong domestic law in determining the residency of an employer for salaries tax purpose is the location of the central management and control of the company (which is slightly different from the "place of effective management" test under the Mainland-HK DTA), would the IRD treat the above company as a non-Hong Kong resident in assessing whether the above employees are eligible for time-apportionment claim for salaries tax purposes?

Ms Mei advised that under the HK-Mainland DTA, Hong Kong had the right to tax the remuneration of an employee who was a resident of the Mainland if the employment was exercised in Hong Kong and any of the three conditions stipulated in paragraph 2 of the Income from Employment Article was not satisfied.

Ms Mei further explained that the "place of effective management" test was used as a tie breaker if the company was resident of both Hong Kong and the Mainland.

Ms Mei remarked that if the remuneration of an employee who was a resident of Mainland was taxable in Hong Kong under the HK-Mainland DTA, the IRD would then apply the provisions under section 8 of the IRO to assess the employee. In applying the provisions, it might be necessary for the IRD to apply the domestic law to determine the situs of the employment. The test for residence used in the Mainland would not be adopted in Hong Kong to decide the residence of the employer. The IRD would continue to apply the test of the central management and control.

- (ii) In the case where these employees are residents of Hong Kong and need to pay individual income tax on their full employment income in the Mainland because they are employed by a Mainland tax resident enterprise, if it is determined that they are not eligible for time-apportionment claim, is it correct that they can get double tax relief through either a section 8(1A)(c), IRO income exclusion claim or a foreign tax credit claim under the Mainland-HK DTA? In the case of section 8(1A)(c) claim, is it correct that only income from services rendered in China can be excluded despite the fact that the whole employment income has been subject to China individual income tax?

Ms Mei advised that the employee resident in Hong Kong could apply for exemption under section 8(1A)(c) or tax credit under section 50.

Ms Mei further explained that income was excluded from assessable income under section 8(1A)(c) if the income was derived from services rendered in the Mainland and Individual Income Tax had been paid on the income.

- (iii) In the case where these employees are residents of the Mainland, and assuming that their provision of services in Hong Kong does not create a permanent establishment of the company in Hong Kong, are they eligible for salaries tax exemption in Hong Kong under the Income from Employment article of the Mainland-HK DTA?

Ms Mei said the answer was yes provided that the employee who was a resident of the Mainland was present in Hong Kong for a period or periods not exceeding 183 days, his remuneration was not paid by an employer resident in Hong Kong, and the remuneration was not borne by a PE in Hong Kong.

- (iv) For the directors of the company, is it the case that Hong Kong does not have taxing right on the directors' fees received by the directors because the Hong Kong company is regarded as a resident of the Mainland pursuant to the tie-breaker rule in the Mainland-HK DTA?

Ms Mei advised that Hong Kong had taxing right over the directors' fee and other similar remuneration paid to a Hong Kong resident if the company was resident in Hong Kong according to Hong Kong domestic law.

Ms Mei further explained that to decide the residence of the company, the IRD would apply Hong Kong domestic law.

If the State Administration of Taxation of the Mainland ("SAT") and the IRD had different views on the taxability of directors' fees in accordance with the HK-Mainland DTA, which might involve determination of the residence of the company, both sides would resolve the difficulties or doubts by way mutual agreement.

(b) Issue of Hong Kong tax resident certificate

According to the FAQ18 on Double Taxation Relief on the IRD's website, under normal circumstances, the Mainland tax authority will accept Certificate of Incorporation and certified extract of the Business Registration particulars issued by Hong Kong as evidence in determining the resident status of a Hong Kong resident. Only when the Mainland tax authority is not able to ascertain the resident status will it issue a referral letter 《關於請香港特別行政區稅務主管當局出具居民證明的函》 to the applicant for obtaining a certificate of resident status from the IRD.

In the 2009 annual meeting (item A4(a)(ii)(b)), the IRD advised that there was no strong justification to dispense with the requirement of a referral letter. However, in practice, many tax practitioners have encountered difficulties in applying for a certificate of resident status from the IRD without a referral letter.

The Institute would like to ask the IRD the following:

- (i) Has the IRD ever issued a certificate of resident status for the Mainland-HK DTA purpose in the absence of a referral letter issued by the Mainland tax authority?

Ms Mei advised that the IRD would normally issue a rejection letter to the applicant if no referral letter was attached to the application for a certificate of resident status for HK-Mainland DTA purpose. As far as the IRD understood, the applicant would be able to obtain a referral letter from the Mainland local tax authority upon presentation of rejection letter issued by the IRD. Per IRD's records, no certificate of resident status for HK-Mainland DTA purpose had been issued in the absence of a referral letter.

Mr Wong reiterated that this matter had been referred to in each and every meeting between the IRD and SAT, and the latter had agreed to inform the local tax authority about the requirement. Ms Mei added that it was the agreed practice between the IRD and SAT that if the taxpayer was a company incorporated in Hong Kong, and the local tax authority could ascertain that it was a Hong Kong resident, then the issue of a referral letter would not be required. Only in cases where the local tax authority was not certain about the position would then a referral letter be issued.

- (ii) Based on the release of SAT Announcement [2012] No. 30, which clarifies the determination of beneficial ownership under Guoshuihan (2009) 601, in the context of qualifying for the Mainland-HK DTA benefits, subsidiaries that are wholly owned by the listed parent company, directly and/or indirectly, and are tax residents of the same DTA partner state, may also be automatically regarded as the beneficial owners of any Mainland dividends they receive. In this regard, the Institute notes that taxpayer may need to apply for certificate of resident status for all the holding companies involved under the structure. However, the Mainland tax authority would normally issue referral letter to the immediate holding company of the Mainland subsidiary only and taxpayer may have practical difficulties in

obtaining a referral letter for each of the intermediate holding companies and the listed parent company.

The Institute would like the IRD to clarify whether it would allow some flexibility in processing applications for certificate of resident status:

- (a) As Circular 30 provides safe harbour for Hong Kong listed companies (including those incorporated overseas but "normally managed or controlled" in Hong Kong) as the beneficial owner of dividends received from a Mainland company, it is anticipated that there will be more applications for certificate of resident status to the IRD. Would the IRD, therefore, consider simplifying the procedures in applying for a certificate of resident status generally and not necessarily require the applicants to submit a referral letter issued by the Mainland tax authorities?
- (b) In particular, would IRD consider accept applications in the absence of a referral letter addressed specifically to the applicant, provided that the applicant can prove that it is related to the subject company under the referral letter issued by the Mainland tax authority?

Ms Mei advised that during the annual meeting with the SAT in 2012, the issue of referral letter was discussed and agreement was reached to retain this long established requirement.

Ms Mei further explained that at the request of the IRD, the SAT agreed to issue internal guidelines to local tax authorities on the issue of referral letters. The local tax authorities should be able to issue referral letter, listing out the holding company and the relevant subsidiaries. Any company, whether holding company or subsidiaries, applying for a certificate of resident status had to complete an application form and attach the referral letter. If the companies concerned were all listed under one referral letter, they might consider lodging all the application forms in one batch. Generally, the IRD would only process application with a referral letter addressed to the applicant.

If Hong Kong resident companies encountered difficulties in obtaining referral letters from the Mainland local tax authorities, the IRD was prepared to raise the issue with the SAT. Members of the Institute were welcome to provide details of the specific cases to the IRD. Mr Anthony Tam said that the Mainland tax authorities might decline to issue a referral letter where there was a Hong Kong resident public company with a British Virgin Islands company interposed as an immediate holding company, as the safe harbour rules under Circular 30 would not apply in such circumstances. Safe harbour rules would apply only if the immediate holding company and the ultimate public company were resident of the same jurisdiction.

Mr Chiu said as long as central management and control were in Hong Kong, under the DTA an entity could be considered a Hong Kong resident. He restated

that the SAT had agreed to issue circulars to local tax authorities about the matter. It would be helpful if members of the Institute could provide real cases where the issue of a referral letter by local tax authorities had been declined.

Mr So suggested that it would be better if a more holistic approach could be adopted towards the issue of residence. Mr. Wong said that IRD could convey this request to SAT.

(c) Employee from Mainland providing service in Hong Kong

An employee of a Mainland enterprise comes to Hong Kong to perform services (for example in-house training) to its Hong Kong subsidiary as part of the group's management function. His employment income is borne by the Mainland enterprise. During his stay in Hong Kong, the Hong Kong subsidiary pays him an allowance and provides him with hotel accommodation. If the employee is in Hong Kong for more than 60 days in a year of assessment but less than 183 days in any 12-month period that is part of that year of assessment, he is not protected by Article 14 of the Mainland-HK DTA as part of his employment income is borne by the Hong Kong company (the allowance paid by the Hong Kong subsidiary). Strictly speaking only the allowance and the rental value of the accommodation provided by the Hong Kong subsidiary will be subject to salaries tax in Hong Kong, while the salaries paid and borne by the Mainland enterprise will not be. It is suggested that the fact that the Hong Kong subsidiary in the example bore the costs of the allowance and accommodation should not make the salary from the Mainland enterprise subject to salaries tax in Hong Kong.

The Institute would like to seek the IRD's view on the above observation on this fairly common scenario relating to cross-border employment service.

Mr Chiu advised that pursuant to Article 14 of the HK-Mainland DTA, remuneration derived by a Mainland resident in respect of an employment exercised in Hong Kong would be taxable only in the Mainland if:

- (a) the recipient was present in Hong Kong for a period or periods not exceeding in the aggregate 183 days in any 12-month period commencing or ending in the taxable period concerned; and
- (b) the remuneration was paid by, or on behalf of, an employer who was not a resident of Hong Kong; and
- (c) the remuneration was not borne by a PE which the employer had in Hong Kong.

In the present case, conditions (a) and (c) were satisfied and the Mainland resident would be liable to salaries tax in Hong Kong if condition (b) was not satisfied. Whether there was a Hong Kong resident employer would be the crucial factor and had to be determined on a case by case basis. If it did, remuneration (including benefits in kind) derived from rendering services in Hong Kong would be subject to Hong Kong salaries tax. Thus, the IRD would assess the employee's income according to the number of days that he spent in Hong Kong during the year of

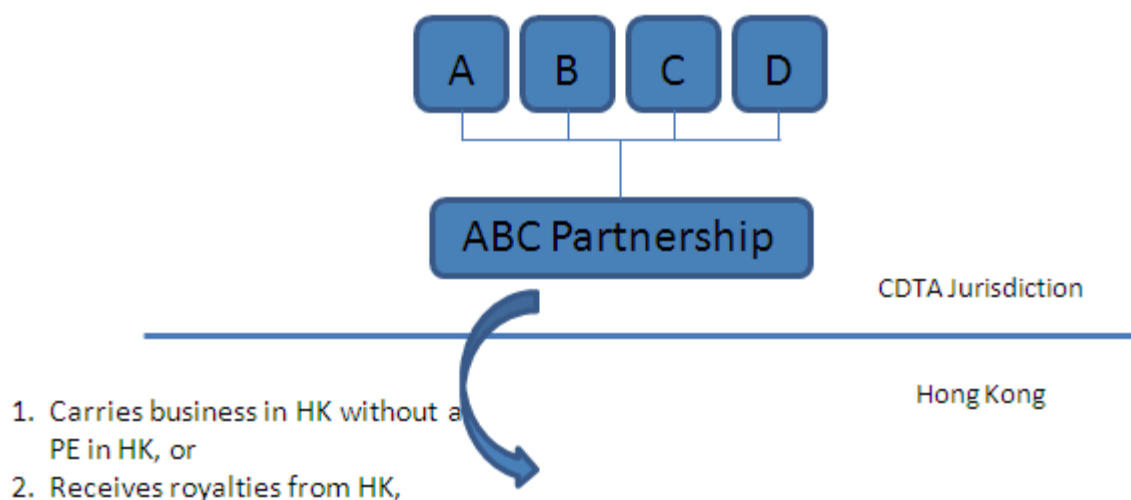
assessment concerned, i.e. time apportionment. Since the allowance paid by the Hong Kong subsidiary was specifically referable to the employee's stay in Hong Kong, it would be fully taxable and no apportionment was allowed.

Mr Chiu remarked that if the employee was resident in Hong Kong, then Hong Kong had taxing right over the remuneration of the employee. The IRD would apply the domestic law to assess the remuneration of the employee accordingly.

Agenda item A4 - Double tax agreements

(a) Application for treaty benefits under a CDTA with Hong Kong in respect of Hong Kong sourced profits derived through a foreign partnership

In some jurisdictions, a partnership is not regarded as an entity for income tax purposes (i.e. a disregarded entity) and the profits of the partnership will flow through to the partners and be taxed in the hands of the partners. The Institute would like to clarify the IRD's position on the application of a CDTA with Hong Kong in such situation. The following example illustrates the issues:



In the CDTA jurisdiction, ABC Partnership is a disregarded entity for income tax purposes. The profits of ABC Partnership are subject to tax in the CDTA jurisdiction in the names of its partners, i.e. A, B, C or D according to their profit sharing from the partnership. On the other hand, the profits derived by ABC Partnership may be subject to Hong Kong profits tax under the domestic tax law of Hong Kong either because they are (1) Hong Kong sourced trading profits from the carrying on of a business in Hong Kong, or (2) profits deemed to be sourced from Hong Kong from the carrying on of a business in Hong Kong, e.g. royalties received from a Hong Kong payer from use of intellectual property rights in Hong Kong.

These profits derived by ABC Partnership could be either exempt from Hong Kong profits tax (e.g. due to the lack of a permanent establishment in Hong Kong) or subject to profits tax at a reduced rate (e.g. for royalties from Hong Kong) under the CDTA between the CDTA jurisdiction and Hong Kong ("the relevant HK CDTA") if ABC was regarded as a tax resident of the CDTA jurisdiction. However, since ABC Partnership (being a disregarded entity) is not subject to tax in the CDTA jurisdiction, it will probably not qualify as a tax resident of that jurisdiction under the relevant CDTA. In this case, will the IRD accept the partners (instead of the foreign partnership) as the applicants for treaty benefits/protection under the relevant CDTA (assuming that the partners qualify as tax residents of the CDTA jurisdiction)?

Mr Wong advised that the OECD Commentary (2010 version) on Article 1 expressed the views of OECD on the application of CDTA to partnerships. In particular, reference was made to paragraph 6.4 at pages 46 and 47. It was stated that where income had "flowed through" a transparent partnership to the partners who were liable to tax on that income in the State of their residence then the income was appropriately viewed as "paid" to the partners since it was to them and not to the partnership that the income was allocated for purpose of determining their tax liability in their State of residence. Hence the partners, in these circumstances, satisfied the condition, imposed in several articles, that the income concerned was "paid to a resident of the other Contracting State". The conditions that the income be paid to, or derived by, a resident should be considered to be satisfied even where, as a matter of domestic law of the State of source, the partnership would not be regarded as transparent for tax purposes, provided that the partnership was not actually considered as resident of the State of source.

Mr Wong further explained that generally, the IRD would adopt the OECD approach and accepted applications for treaty benefits under the relevant CDTA, provided that (i) the formulation of the article on royalties adopted "paid to a resident of the other Contracting Party"; (ii) the ABC Partnership was not considered as a resident of Hong Kong; (iii) all partners were residents of the CDTA jurisdiction and; (iv) the CDTA jurisdiction adopted a similar approach as Hong Kong.

Mr So asked, for condition (iii), what would be the position if the partners were not residents of the same CDTA jurisdiction. Ms Lee explained that there could be cases where partners were residents of different CDTA jurisdictions, and in those cases, different treaty rates would then apply. Mr Chiu added that it would also be important to establish that the partnership concerned was considered as a taxable entity first. In reply to a question from Mr So, Mr Chiu confirmed that all four tests should be applied individually to each and every partner of different CDTA jurisdictions.

(b) Administrative procedures for Hong Kong payers to apply a lower rate of withholding on royalties under DTAs

The minutes of the 2012 annual meeting (item A4(d)) specified that, in order to withhold tax on royalties at a lower treaty rate, a Hong Kong payer has to write to the IRD, with a tax resident certificate of the non-Hong Kong resident recipient, applying for the same. Furthermore, where the non-Hong Kong resident recipient ceases to be a resident of the relevant treaty jurisdiction, the Hong Kong payer should notify the IRD of the change within 30 days and withhold payment at the normal rate as from the date of change.

As a follow-up, the Institute would like to ask the IRD how frequently the Hong Kong payer should obtain a tax resident certificate of the non-Hong Kong resident recipient. Given that royalties are often paid at short, periodic intervals, such as a monthly or

quarterly basis, it may be impractical for the Hong Kong payer to produce a tax resident certificate in respect of each payment.

As related issue, we should like to ask about the IRD's position regarding liability, if any, of the Hong Kong payer where, after the reduced withholding rate has been applied, the recipient ceases to be a resident of the relevant treaty jurisdiction without informing the Hong Kong payer of the same.

We should also like to seek the IRD's confirmation that, where the final tax for a year of a non-Hong Kong resident recipient is charged at a lower treaty rate, provisional tax for the following year would, as a matter of practice, likewise be charged at the lower treaty rate.

Mr Wong advised that generally, the Hong Kong payer would file the tax return (BIR54) on behalf of the overseas recipient. If the recipient who was entitled to treaty benefits intended to enjoy the reduced withholding tax rate, the relevant tax resident certificate should be enclosed with the tax return submitted to the IRD. The IRD would then determine whether the claim for treaty benefits should be accepted.

Mr Wong further explained that the IRD took note that royalties were often paid at short, periodic intervals such as on a monthly or quarterly basis. If the recipient's resident status was not certain, the payer should deduct the withholding tax at the normal rate as required in the IRO.

In general, where the final tax for a year was charged at the treaty rate, the provisional tax of the following year was also charged at that rate. Any necessary adjustment would be made in the assessment for the following year.

The Institute has been informed of a case where an assessor requested the taxpayer to produce the original tax resident certificate issued by the United Kingdom tax authority for claiming the reduced withholding tax rate on royalties under the Hong Kong-United Kingdom treaty, even though the taxpayer had already provided a copy of the certificate (as the original had been submitted to the tax authority of another jurisdiction for same reason). The Institute would like to clarify the IRD's practice in accepting overseas tax resident certificates, in particular whether the IRD would accept photocopies of certificates issued by overseas tax authorities?

Mr Wong advised that in order to enjoy a treaty rate, the original tax resident certificate should be produced for verification. The IRD would not accept photocopies of certificates. However, in the light of the experience that would be gained with those CDTAs coming into force shortly, the IRD agreed to review the existing practice at a later stage.

(c) Indonesia-Hong Kong double tax treaty

In respect of dividends, based on experience, the Institute understands that the tax authorities in Indonesia may not consider a recipient as the beneficial owner for tax treaty purposes, if the dividend is not subject to tax in the partner jurisdiction. As dividends are generally not taxable in Hong Kong, it is likely that a Hong Kong recipient will not be granted the lower treaty rate on dividends received from Indonesia.

How can the IRD help address this potential issue, considering that this could jeopardise Hong Kong's competitiveness in the region and deny Hong Kong residents expected benefits of the DTA?

Mr Wong advised that the IRD had sought clarification from the Indonesian competent authority on this matter and their reply was pending.

In all tax treaty negotiations, the Hong Kong delegation would explain to the treaty partners details of Hong Kong's tax system, in particular the source basis of taxation and the exemption of dividend from taxation. If the subsequent amendment to the domestic tax law of the treaty partner impact on the provisions of the DTA already agreed, clarification would be sought from the treaty partner.

(d) Tax residency

In order to obtain the benefit of the lower treaty rate on dividends, interest and royalties, many DTA countries require recipients to complete and have certified by the partner competent authority their residency status on a prescribed form.

At the 2011 annual meeting (see agenda item A4(d)(iii)), the Institute asked if, normally, the IRD would accede to such requests. At that time, CIR replied that the IRD would discuss the implementing arrangements with the DTA partners. Depending on the outcome of discussions with the DTA partners, the IRD would be in a position to stamp on any prescribed forms.

The Institute would like to know if there is any update on the implementation arrangements.

In addition, the Institute would request that details of procedural arrangements, once they are available, be posted on the IRD's website to guide taxpayers in obtaining the necessary documentation for the application of treaty benefits.

Mr Wong advised that Hong Kong had signed 27 CDTAs, 21 of which were currently in force. The IRD normally issued a certificate of resident status to a Hong Kong resident as a proof of residence under the CDTAs. One certificate for each CDTA would be issued to an eligible applicant for each calendar year of claim.

Mr Wong further explained that the IRD was currently seeking the agreement of the CDTA partners to accept the certificate of resident status and promoting its use. It was noted that the acceptance of the certificate issued by the IRD, for the purpose of claiming treaty benefits, was subject to mutual agreement with the CDTA partners. In the absence of an agreement to the contrary, the IRD would not generally sign nor stamp on any form issued by an overseas tax administration relating to treaty benefits or issues.

To date, no CDTA partners had declined to accept the certificate of resident status issued by the IRD. Nor did the IRD receive any feedback from Hong Kong residents regarding any rejection of the certificate. Nevertheless, should any CDTA partner request the IRD to stamp on its prescribed form in future, the IRD would be pleased to discuss the matter with that partner and found a mutually acceptable solution.

Mr Wong summarised that the IRD agreed with the Institute that details of procedural arrangements could be made available on the IRD's website.

[Post meeting note: Hong Kong has since further signed CDTAs with Guernsey and Qatar after the meeting which made the total number of CDTAs concluded to 29, 23 of which are currently in force.]

(e) Profits attributable to permanent establishment ("PE")

Inland Revenue Rule 5 ("IRR5") states that the assessment to profits tax for a non-resident person having a PE in Hong Kong will be computed by reference to the profits disclosed in its accounts if its accounts reflect the true profits arising in or derived from Hong Kong. In the event that such accounts are not available or that the accounts do not disclose the true profits, the tax liability of the PE will be computed by apportionment of the overall profits of the entity. Such apportionment can be done on turnover basis (i.e. Hong Kong turnover/ total turnover of the entity or a fair percentage of the turnover determined by the assessor).

In responses given at the 2011 annual meeting (see agenda item A4(b)), the IRD expressed the following views:

- (i) According to Rule 5(2)(a), where the person kept accounts for his PE in Hong Kong in such a way that his true profits arising in or derived from Hong Kong could be readily ascertained from those accounts, his assessment to profits tax would be computed by reference to the profits disclosed in those accounts;
- (ii) According to Rules 5(2)(b) and (c), where the person's accounts did not disclose the true profits arising in or derived from Hong Kong, his tax liability would be computed by reference to his total profits wherever made after necessary adjustments in accordance with the IRO;

- (iii) According to Rule 5(2)(d), where it was impracticable or inequitable to do so, the assessor would compute the profit based on a fair percentage of the turnover of the person in Hong Kong.

The IRD was of the view that, in principle, the PE in Hong Kong should make up its accounts and report the profits according to the arm's length principle endorsed by the OECD Model. Thus if the profits of the PE as shown in its accounts were derived from Hong Kong, they would be fully charged to profits tax and would not be reduced.

Nevertheless, while the profits of a branch could be disclosed pursuant to the arm's length principle as endorsed by the OECD model, the profits of the branch may be composed of income arising in or derived from Hong Kong as well as income arising in or derived from outside Hong Kong. For example, services may be performed by personnel of a branch partly in and partly outside Hong Kong, such that under proper accounting principles, as well as the arm's length principle endorsed by the OECD, such service income would be accounted for as profits of the branch.

Similarly, there may be profits not attributable to the PE or branch, yet the income may be arising in or derived from Hong Kong. For example, trading activities may be conducted by personnel of the overseas head office without Hong Kong branch's involvement, but the profits may be arising in or derived from Hong Kong. Such profits would not be accounted for in the account of the branch.

The Institute would like to ask:

- (i) In the first scenario (the service example), i.e., the accounts may disclose not only the profits arising in or derived from Hong Kong, would the IRD apply Rules 5(2)(b) and (c) to compute the Hong Kong tax liability by reference to the total profits wherever made, although this would be contrary to the arm's length principle endorsed by the OECD and noted in Article 7(2) of the OECD Model Tax Treaty?
- (ii) In the second scenario (the trading example), where the entity is a tax resident of a country which has a tax treaty with Hong Kong, if profits are not attributable to the PE (i.e., the branch) in Hong Kong, and hence not accounted for in the accounts of the branch, but they arise in or derive from Hong Kong, is it the case that such profits are not taxable because the tax treaty provides Hong Kong with the taxing right only on the profits attributable to PE?

Mr Chiu advised the following:

- (i) In the first scenario, the question remained whether the profits arising in or derived from Hong Kong could be readily ascertained from the accounts which might include onshore and offshore profits. If the answer was yes, the assessment to profits tax would be computed by reference to the profits disclosed in the accounts under Rule 5(2)(a). As a rule, after the attribution of

profits to the Hong Kong PE according to the authorized OECD approach, the source of the profits attributed needed to be considered when determining whether the profits attributed were chargeable under section 14.

- (ii) The enterprise of a CDTA partner would not be chargeable to Hong Kong profits tax unless the enterprise carried on business in Hong Kong through a PE situated herein and the profits were attributable to that PE.

In the second scenario, the facts given were: the non-resident enterprise had a PE in Hong Kong; the non-resident enterprise had certain profits arising in or derived from Hong Kong; but the onshore profits were not attributable to that PE.

Mr Chiu explained that whether a PE existed in Hong Kong, whether the profits were attributable to the PE and whether the profits were sourced in Hong Kong were questions of facts. If the profits were attributable to the head office according to the authorized OECD approach, then the profits should not be recognized in the accounts of the Hong Kong PE. If the profits were attributable to the Hong Kong PE, then the profits if sourced in Hong Kong would be assessed to profits tax even though the profits were not recognized in the accounts of the Hong Kong PE.

(f) Progress of legislative amendments for tax information exchange agreements (“TIEAs”)

In the 2012 annual meeting (see agenda item A4(i)), the CIR said that he would recommend to the legislature that legislative measures be introduced, which would enable Hong Kong to enter into TIEAs, following the Phase 1 peer review report by the Global Forum in 2011. In particular, Hong Kong was required to submit a progress report in October 2012 regarding its follow-up actions on this area. Furthermore, the Phase 2 review of Hong Kong should have already been conducted in the second half of 2012. The Institute would like to ask about the development in relation to implementing the recommendations of the Global Forum from the Phase 1 review, and the comments, if any, arising from the Phase 2 review.

Mr Chiu advised that the Financial Services and the Treasury Bureau (“FSTB”) had already presented the twelve-month follow up report to the Global Forum Secretariat on 22 October 2012 to address the points raised in the Phase 1 peer review report.

Mr Chiu remarked that the lack of a legal basis for Hong Kong to enter into TIEAs was flagged as the particular area for improvement during the Phase 1 peer review. To take forward the matter of TIEA, a two-month consultation exercise had been conducted in May and June 2012 to gauge the views of the business chambers and professional bodies as to whether Hong Kong should put in place a legal framework for entering into TIEAs with other jurisdictions. Generally, most of the stakeholders that had responded supported the provision of a legal framework for TIEAs. As for taxpayers’ rights and confidentiality of information exchanged, the stakeholders were of the view that CDTA and TIEA should have the same safeguards.

To effect the changes, the IRO and the Inland Revenue (Disclosure of Information) Rules had to be amended as appropriate. For this purpose, a legislative slot to introduce an Amendment Bill into the Legislative Council in late April 2013 had been secured and the administration would strive to secure passage of the Amendment Bill by the summer recess in order to tie in with the finalisation of Phase 2 peer review on Hong Kong.

As regards the Phase 2 peer review, Hong Kong would be required to fill in a questionnaire and the assessors of the Global Forum would conduct an on-site visit to Hong Kong in March 2013 to obtain first-hand information on exchange of information in practice through interviews with related parties. Afterwards, the Global Forum Secretariat would prepare a Phase 2 review report on Hong Kong for consideration by the Global Forum's Peer Review Group in the meeting to be held in September 2013.

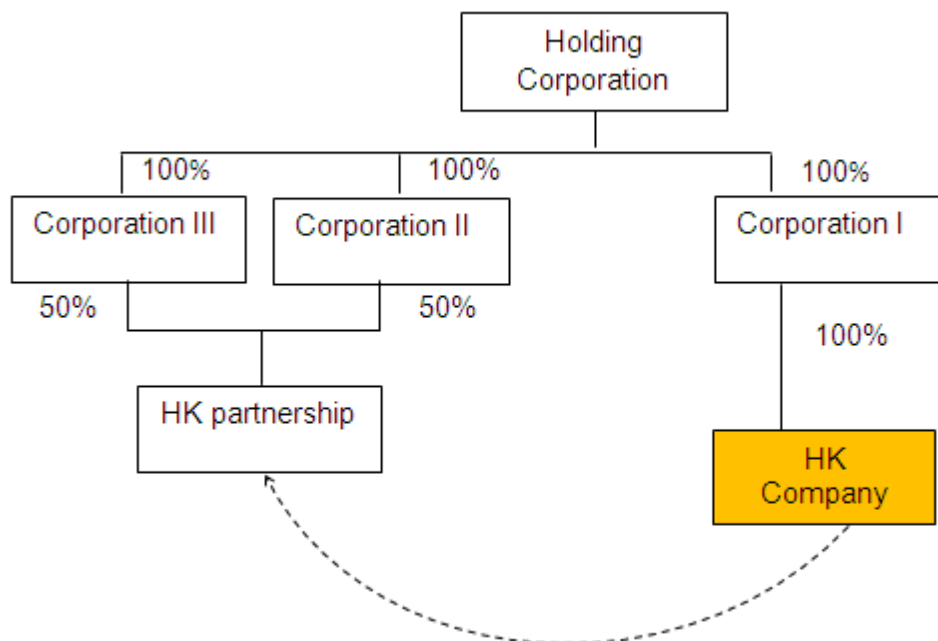
Mr Chiu summarised that the Phase 2 peer review on Hong Kong commenced on 20 December 2012 formally and Hong Kong was required to furnish the questionnaire to the Global Forum by 28 January 2013.

[Post meeting note: The Inland Revenue (Amendment) Ordinance 2013 which contained provisions to enable Hong Kong to enter into TIEAs with other jurisdictions became effective on 19 July 2013.]

Agenda item A5 – Stamp duty

(a) Whether a Hong Kong general or limited partnership is a transparent entity for the purposes of section 45 stamp duty relief

The following diagram would illustrate the issue.



Transferring shares in HK Company from Corporation I to HK partnership

Many take the view that, under the common law, the partners of a partnership have a proprietary interest in the assets held by the partnership. Hence they consider that for the purposes of section 45 relief of the Stamp Duty Ordinance (“SDO”), a Hong Kong general partnership or a limited partnership constituted under the Limited Partnership Ordinance of Hong Kong should be disregarded as a transparent entity. As such, the relevant subject Hong Kong properties or stocks should be regarded as being transferred from or to the partners of the relevant partnership concerned (i.e., disregarding the relevant partnership as being a transferor or transferee for the purposes of Section 45 stamp duty relief).

Using the example in the above diagram, the Institute would like to know whether the IRD would treat HK partnership (constituted either as a Hong Kong general partnership or a limited partnership under the Limited Partnership Ordinance of Hong Kong) as a transparent entity for the purposes of section 45 stamp duty relief. Under this transparent entity approach, is it the case that the shares in HK Company are in fact being transferred from Corporation I to Corporation II and Corporation III? As such, since Corporations I, II and III are all 100% owned by Holding Corporation, they are all associated bodies corporate within the terms of section 45 of the SDO. Therefore, the transfer of shares in HK Company would qualify for section 45 stamp duty relief under this transparent entity approach, provided that other conditions specified in section 45 of the SDO are satisfied. The Institute would welcome IRD’s comments on the above.

CIR advised that under section 45(2) of the SDO, the intra-group relief applied to, among other conditions, an instrument of which the effect was to transfer a beneficial interest in Hong Kong stock from one associated body corporate to another. In the given example, the shares in HK Company were transferred by Corporation I to HK Partnership. IRD considered that HK Partnership was the transferee of the shares and would not disregard HK Partnership for the purposes of section 45. Indeed, under section 22 of the Partnership Ordinance (Cap. 38), all property acquired on account of the firm for the purposes and in the course of partnership business constituted partnership property, and had to be held and applied as such, in accordance with the partnership agreement. The English case law also established that a partner had no specific right in any individual asset of the partnership.

Furthermore, for entities constituted under foreign laws other than a typical corporation, would the IRD consider spelling out, by way of a practice note, what characteristics and features the IRD would look to in its consideration of whether the entities in question are bodies corporate for the purposes of section 45 stamp duty relief, and how the IRD would apply the Third Schedule of the SDO, where such entities do not have issued share capital, citing examples of previously determined cases where applicable?

CIR explained the IRD's view that an entity would generally be considered as a body corporate for the purposes of section 45 of the SDO, if it had perpetual succession, a legal personality distinct from that of its members and an issued share capital. Whether or not an entity had perpetual succession and separate legal personality was a mixed question of fact and law. Since each case had its own particular facts and foreign laws were subject to change, it was not feasible to provide an exhaustive list of acceptable entities under the foreign laws. Having said that, as a matter of general law, an entity could not be regarded as having perpetual succession if it would be dissolved upon the death, bankruptcy or incapacity of its members. The entity would also not be accepted as having a separate legal personality if it was not in law a different person altogether from its members, and/or was not permitted to hold assets on its own. In reply to a question from the Institute, CIR indicated that there could be isolated cases where, under foreign laws, a limited liability partnership could be regarded as a separate legal entity. However, the three criteria would still be applied to the facts.

Section 45(2) specified the thresholds in terms of issued share capital in determining whether two bodies corporate were associated. The Third Schedule provided guidelines on how to determine the amount of share capital held by one body corporate in another through other bodies corporate. If entities did not have issued share capital, they were unlikely to be associated for the purposes of section 45 and the Third Schedule would not be applicable.

(b) Transactions that do not constitute a “sale or purchase” of the relevant shares

Head 2(1) of the First Schedule of the SDO charges to duty contract notes for the sale or purchase of any Hong Kong stock. Section 19(16) of the SDO defines the term “sale or purchase” to include “any disposal or acquisition (other than an allotment) for valuable consideration, and exchange, and any transaction in respect of which an instrument is deemed by virtue of section 30(3), (4) or (5) to be a transfer by way of sale, and any reference to “sale” or “purchase” shall be construed accordingly”.

The Institute would like to know whether in the IRD's view, it is the case that the following share transactions do not amount to a “sale or purchase” and are thus, not dutiable:

- (i) Reduction of capital sanctioned by the Court under section 60 of the Companies Ordinance (Cap 32).
- (ii) Redemption of shares.
- (iii) Repurchase of shares (applicable to companies that have the power to purchase their own shares).

Many take the view that transactions (i) and (ii) do not constitute a “sale or purchase” of the relevant shares in the conventional sense of the term. While transaction (iii) may, on the face of it, constitute a “sale or purchase”, for company law purposes, the shares repurchased are deemed to be “cancelled” when acquired by the company. As such, transaction (iii) is very similar to transaction (ii) and in this sense is also not a “sale or purchase” in the conventional sense of the term. In the event that the IRD considers any one of the above three types of transactions to be dutiable, the Institute would like to understand the legal analysis for such a charge.

CIR advised that the term “sale or purchase” was defined under section 19(16) of the SDO to include, among others, “any disposal or acquisition (other than allotment) for valuable consideration”.

For transactions (i) and (ii), the IRD accepted that they merely involved extinguishment of shares, and hence were not subject to stamp duty. The IRD however considered that transaction (iii) was subject to stamp duty because a share repurchase constituted a disposal of the shares, notwithstanding that upon completion of the sale, the sales were to be treated as cancelled. See *Strand Options and Futures Ltd v Vojak (Inspector of Taxes)* [2003] STC 331, at 342j-343a.

Agenda item A6 - Departmental policy and administrative matters

(a) Advance pricing arrangement (“APA”)

With the issuance of DIPN 48 on Advance Pricing Arrangement, the Institute notes there is increasing interest by Hong Kong taxpayers to pursue Hong Kong-Mainland China APA on inter-company transactions, in particular, Hong Kong based companies with manufacturing base in Southern China undergoing conversion from a contract processing arrangement (來料加工) to a wholly foreign owned enterprise (“WFOE”) with an import processing arrangement (進料加工). However the newly formed WFOE would be unlikely to meet the three-year profit history requirement as set by the Mainland tax authorities.

Under the Implementation Regulations for Special Tax Adjustments (Trial) (Guoshuifa (2009) 2), an APA application can be made to the Mainland tax authority as long as the conditions as specified under an APA are met. Nevertheless, the Mainland tax authority, in practice, will give priority to APA applications made by enterprises that have been investigated by the tax authorities for their transfer pricing policies. In general, the Mainland tax authorities will not accept APA applications by enterprises which do not have a three-year profit history.

Under DIPN 48, instead of both parties applying to the respective tax authorities for an APA, the IRD undertakes to approach the competent tax authority of the corresponding jurisdiction, once the APA application is accepted by the IRD. In this regard, would the IRD consider an APA application where the counter-party (i.e., the WFOE) does not meet the three-year profit history requirement?

Ms Mei advised that generally, any Hong Kong enterprise which satisfied the conditions and thresholds specified in DIPN 48 might apply for a Bilateral Advance Pricing Arrangement (“BAPA”). The IRD would consider and decide whether or not to accept the Hong Kong enterprise into the BAPA process at the pre-filing stage. If the Hong Kong enterprise was accepted into the BAPA process, it should submit to the IRD a formal application. At the same time, the associated enterprise concerned should submit another application to the competent authority of the relevant tax jurisdiction for consideration.

Ms Mei further explained that the IRD had taken notice of the requirements in different tax jurisdictions regarding APAs. Therefore, after receipt of the formal BAPA application, the IRD would seek the agreement of the competent authority of the relevant tax jurisdiction on whether it would participate in the BAPA process. The IRD would convey a clear message that Hong Kong had no objection in principle to the bilateral process. However, the IRD was not in a position to interfere with the decision of the other side. The final decision on whether the associated enterprise’s application should be entertained rested with the competent authority of the relevant jurisdiction. If that competent authority did not see fit to participate in the BAPA process, the APA application could not be proceeded further.

Mr Chiu had taken note of the advice of Mr Anthony Tam that it would be useful if the above message could be communicated to taxpayers, for example, in the DIPN.

(b) Filling of non-resident profits tax return

Box 2.1 in the current non-resident profits tax return (form BIR 54) is used for filling the assessable profits for the year. In the case of royalty income received by non-residents, the assessable profits are calculated normally as 30% of the gross amount. However for those non-residents from a treaty jurisdiction where the withholding tax rate is capped at 3%, the profits tax liability is not based on assessable profits, but is calculated at the reduced treaty rate on the gross amount.

It has been noted that the assessments raised in some cases were incorrect either because (i) the gross amount of royalties was stated as the assessable profits; or (ii) the reduced rate was not applied. In this regard, the Institute would like to ask for the form BIR 54 to be further modified to avoid any ambiguity and enhance the assessment process.

In respect of the assessment of non-residents on royalty income at reduced treaty rate, Ms Lee advised that the presentation of the profits tax computations attached to notices of assessment had already been modified. The modified computations showed clearly the amount of assessable profits as well as the respective calculations of normal tax under the IRO and the reduced tax under the CDTA.

Ms Lee further explained that the assessment process for handling cases of non-residents claiming for the reduced treaty rate under a CDTA had also been modified. Cases with box 5.6 of the form BIR54 ticked "Yes" would be personally examined by professional officers before issue of the assessments. It was expected that the omission of applying the reduced treaty rate in appropriate cases could be avoided.

(c) Design of the paper profits tax return (form BIR 51)

Many CPA firms use computer software to fill the paper profits tax return for their clients. The margin of the 2011/12 profits tax returns varies quite significantly from batch to batch. The variations have been causing difficulties in aligning the boxes when printing the paper tax returns. Oftentimes, this results in printing errors. As profits tax return are statutory documents issued by the IRD, it is necessary to ask for duplicate returns for re-printing.

The Institute would like to reflect this problem to the IRD to see what can be done to rectify the problem in future.

Ms Lee advised that for efficient and mass printing, profits tax returns were printed continuously on paper with side sprocket holes. After printing, the returns were fed into guillotines which removed the sprocket holes along both sides of the returns and the perforations between pages. The cutting areas had to be set to ensure that the content of profits tax return was not cut out in any way. Due to the cutting and feeding processes involved, slight differences in the margins of the profits tax return were inevitable. In any event, the IRD would remind the printer to improve the accuracy as far as possible.

In reply to a question of Ms Chan regarding the alternative of printing out the tax returns by the taxpayers themselves, Ms Lee said that the IRD's priority in this area would still be on the System Infrastructure Enhancement ("SIE") project.

(d) Block extension of salaries tax return of individuals employed by the same entity

Generally the IRD will only accept a one-month block extension (i.e. until beginning of July) to file salaries tax returns for tax representative cases and any further block extension will be entertained on a case-by-case basis. Some represented cases are expatriate employees of the same multinational corporation. Some of these cases are subject to time-apportionment or section 8(1A)(c) claims. The income information and their travelling itineraries come from various sources both local and overseas. Hence additional time is needed to gather information to prepare their employer's returns (for which the information may come from various sources both local and overseas).

Applying for (and considering) extensions for each individual case can be administratively cumbersome to both the practitioners and the IRD. For this reason, the Institute would ask the IRD to consider granting further block extensions to these types of employees on the employing entity basis.

Mr Vincent Chiu advised that it had been the policy of the IRD not to grant long period of extension because the IRD had a tight schedule of assessment and collection programme. For represented cases not involving sole proprietorship business accounts, a block extension would be granted to end of June or early July. For those involving sole proprietorship business accounts (irrespective of accounting date), extension would be granted to end of September or early October. Tax representatives should plan ahead to meet the deadlines.

Mr Vincent Chiu further explained that request for further extension of time beyond the normal extension date for filing the Individuals Tax Return would not be granted except in exceptional circumstances. Applications for further extension should be made on a case-by-case basis. Request for further block extension would not be acceded to. If the reasons or exceptional circumstances were the same for employees of a particular company, the request for further extension could be made by way of a list.

(e) Record of electronic transactions

More and more transactions are being put through electronically. In some circumstances, the taxpayer cannot get any physical evidence for direct proof of the transaction, e.g., paying with Octopus or online or where the recipients do not issue any receipt. Would the IRD consider issuing detailed guidance as to what indirect evidence should be kept by the taxpayer for proving such transactions?

Mr Wong Kai-cheong advised that taxpayers were responsible for keeping records on how they declared and claimed on their tax returns. The records that taxpayers needed to keep depended on circumstances and it would not be practical to provide a full list of the required indirect evidence which proved the existence of a transaction, whether electronically or otherwise. In general, records kept by taxpayers for tax purposes must:

- be complete;
- allow them to work out correctly the amount of tax they had to pay;
- allow them to file an accurate tax return;
- be easily accessible if the IRD asked to examine them during an enquiry.

(f) Interest on tax reserve certificate ("TRC") vs. judgment interest

When an assessment is under objection or appeal, the IRD may order the tax-in-dispute be held over either unconditionally or conditionally upon the purchase of a TRC.

If the payment of tax is held over unconditionally, interest is payable to the IRD on the tax held over that is found to be payable upon final determination of the objection, according to section 71, IRO. The interest rate is fixed by the Chief Justice by notice in the Gazette pursuant to section 50 of the District Court Ordinance. The current judgment interest rate is 8% per annum (with effect from 1 April 2009).

If the payment of tax was held over conditionally upon the purchase of a TRC, interest is payable to the taxpayer on the sum eventually repaid to taxpayer upon final determination of the objection. The interest rate on TRC is currently 0.0433% per annum (with effect from 4 January 2010).

There is a huge discrepancy between the rates for calculating interest payable by the IRD to the taxpayer (0.0433% p.a.) and by the taxpayer to the IRD (8% p.a.). In view of the "inequality", the Institute would like to ask whether the IRD would consider proposing to the policy bureau that the bureau look at this issue and consider a change in the law.

Mr Wong advised that it was imperative that notwithstanding objection or appeal, tax was to be paid as assessed (see s.71(1)).

Mr Wong further explained that before 1985, no interest was paid when the taxpayer's objection or appeal is allowed. Section 71(2) was introduced in 1985 such that interest was paid on tax stood over upon purchase of TRCs. The requirement to purchase TRCs were applicable to cases where there were some merits but the balance of probability, based on the facts known to exist on the date of objection, did not weigh definitely in favour of the taxpayer. This was to some extent a concessionary measure.

However, the legislative intent of section 71(2) was different from that of section 71(10). Section 71(10), which was also introduced in 1985, required that, in the event of an unsuccessful objection or appeal the taxpayer had to pay interest on the amount held over unconditionally at the rate applicable to judgment debt. The purpose was to avoid abuse of the objection mechanism. Hence a different rate was used for tax stood over unconditionally.

Mr Wong summarised that, where a taxpayer under objection did not pay the tax as assessed, he risked himself paying interest at higher rates, as a debtor would under section 50 of the District Court Ordinance. In contrast, a taxpayer was obliged to pay the tax as assessed; the purchase of TRCs was just an alternative arrangement that provided a yield to him where the principal sum was repaid in whole or in part.

(g) Objections to CIR

In respect of objections to CIR, the Institute would like to ask the following questions:

- (i) If the IRD does not agree with the taxpayer's/tax representative's submissions on technical matters, will the IRD elaborate the IRD's view on the relevant issue and the reasoning thereof?
- (ii) If the answer to (i) is "yes", at what point will during exchanges of technical arguments and supporting authorities will the IRD issue an assessment/ determine an objection?
- (iii) According to paragraph 24 of DIPN 6, a draft statement of facts will not be issued in simple cases, or cases where there have already been long delays on the part of the taxpayer or his representative or where, for other reasons, an urgent determination is considered desirable. How does the IRD determine whether a case is complex or simple, in deciding to issue a draft statement of facts for the taxpayer's/ tax representative's comments before an objection is determined?

Mr Chiu advised the following:

- (i) Yes. If the IRD did not agree with the taxpayer's/tax representative's submissions on technical matters raised under an objection, the IRD would reject the taxpayer's claim and elaborated the IRD's view on the relevant issue and the reason therefor.
- (ii) There was no hard and fast rule. It would depend on the complexity of the issue in dispute and the facts and circumstances of each case. In simple cases, when the Assessor formed an opinion that the claim could not be allowed, he would explain his views and invited the taxpayer to withdraw the objection.
- (iii) There were understandably no precise parameters for dividing cases into simple or complex cases. Simple cases generally only involved straightforward facts, and a statement of facts was not necessary as the facts were not disputed. On the other hand, complex cases might involve complicated arrangements or transactions to be supported by detailed documents or other evidence.

(h) Progress with the development of e-filing

At the 2012 annual meeting (see agenda item A5(e), IRD indicated that as the department was now fully engaged in a large-scale system infrastructure enhancement project, which would last another few years, a time table had not yet been set to proceed further with the development of e-filing at the present stage.

- (i) Has there been any further progress in terms of setting a timetable for developing the e-filing system?
- (ii) What benefits will accrue from the system enhancement project?

Mr Vincent Chiu advised the following:

- (i) At present, there was no time table yet for extending the e-filing services to tax representatives. The IRD was being actively engaged in the implementation of the SIE Project which would last for a few years. However, the IRD would continue to enhance the existing eTAX services.
- (ii) The SIE Project included 3 stages, namely "File server and workstation infrastructure upgrade", "Document Management System upgrade" and "Migration of mainframe application to midrange platform". The establishment of a more flexible and adaptable IT infrastructure would bring about various benefits, including:
 - enhanced operational efficiency and business capability;
 - better system integration;
 - enhanced system security and risk management; and
 - better use of IRD's resources

(i) **Lodgment of tax returns and filing deadlines for 2012/2013**

The Institute would be interested to know the latest statistics on the filing of tax returns and the filing deadlines for 2012/2013.

Ms Lee referred to Table 1 which showed that IRD issued some 4,000 more returns in the 2011/12 bulk issue exercise. Compared with 2010/11, some 16,400 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 was a slight improvement in the lodgment rates from 79% to 80% for both “D” and “M” code returns by the respective deadlines, the overall performance was still far from satisfactory. The progressive lodgments remained significantly below the lodgment standards. Tax representatives were urged to improve their future performance. Table 4 was a comparative analysis of compliance with the block extension scheme.

Bulk Issue of 2012/13 Profits Tax Returns

Ms Lee advised that the bulk issue of 2012/13 Profits Tax Returns for “active” files would be made on 2 April 2013. The extended due dates for filing 2012/13 Profits Tax Returns would be:

<u>Accounting Date Code</u>	<u>Extended Due Date</u>	<u>Further Extended Due Date if opting for e-filing</u>
“N” code	2 May 2013 (no extension)	16 May 2013
“D” code	15 August 2013	29 August 2013
“M” code	15 November 2013	29 November 2013
“M” code – current year loss cases	4 February 2014	4 February 2014 (same as paper returns)

PART B – MATTERS RAISED BY THE IRD

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

Mr Tam Tai-pang (“Mr Tam”) advised that Appendix B was compiled to illustrate the specific problem areas detected in corporations with tax audits completed during the year ended 31 December 2012. Comparative figures for the years 2010 and 2011 were included.

Mr Tam further explained that the Field Audit teams uncovered discrepancies in 337 corporation cases, of which 285 carried clean auditors’ reports. Amount of discrepancies detected in the clean report cases account for 87% (2011: 84%) of the total discrepancies detected in the year 2012 and total tax of \$1,049 million was recovered from these cases. Average understatement per clean report case was \$23.05 million (2011: \$13.03 million) while tax undercharged per clean report case was \$3.7 million (2011: \$2.1 million).

In 2012, discrepancies resulted mainly from offshore claims, omission of sales and understatement of gross profits. In the majority of cases, the discrepancies were detected after examining the business ledgers and source documents.

Agenda Item B2 – Certificate of Resident Status

Ms Mei advised that at present, an applicant was required to provide general and basic information in Form IR1313A. From past experience, the IRD might request the applicant to provide further and better particulars to support the application. In particular, for applicants incorporated / constituted outside Hong Kong, the IRD would often need to make further enquiry regarding the applicant’s place of management or control.

Ms Mei remarked that two new application forms for certificate of resident status would be introduced for HK-Mainland DTA purpose: one for applicant incorporated / constituted in Hong Kong; and the other for applicant incorporated / constituted outside Hong Kong. The new form for use of applicants incorporated / constituted in Hong Kong would be similar to the existing IR1313A. The new form for use of applicants incorporated / constituted outside Hong Kong, in addition to the basic information, full details of the establishment and business activities required to be provided in the Appendix to the form. With the additional information provided, it was expected that follow up enquiry could be reduced or eliminated.

The certificate of resident status would also be revised. The heading of the certificate of resident status would after revision indicate whether the applicant was incorporated / constituted in or outside Hong Kong.

The new application forms and the revised certificates of resident status would be put in use as from 1 April 2013.

Agenda Item B3 – Residence of the Hong Kong Branch of an Overseas Bank

Mr Chiu advised that after several rounds of negotiations since 2006, the IRD and SAT had reached a consensus on the interpretation of the residence of an overseas bank with a branch in Hong Kong. In deciding whether an overseas bank was “normally managed or controlled in Hong Kong”, it had been agreed that the management or control of the bank as a whole should be considered. The IRD would cease to issue certificate of resident status to a bank incorporated overseas with a branch in Hong Kong if the management or control was outside Hong Kong. The relevant paragraph of the Departmental Interpretation and Practice Notes No. 44(Revised) would be updated accordingly.

Agenda Item B4 – Applications for Advance Ruling

Ms Lee advised the following:

- (a) The ruling system was designed to clarify the tax treatment of arrangements under serious contemplation but not those which were hypothetical or speculative.
- (b) In processing an application for advance ruling, the IRD in general would rely on the information supplied in the application. In some recent applications, it had come to the IRD’s attention that certain statements made in the applications were not up-to-date, not reflecting the full picture, or otherwise incomplete or incorrect. Members of the Institute were encouraged to make endeavors to ensure the completeness and correctness of the information supplied in the application so that resources could be efficiently utilized.
- (c) Before making an application for an advance ruling, the applicant should ensure that they were in possession of all relevant information. The applicant should provide all the relevant information in the application and made ready and timely clarifications if the assessor requested.

Agenda Item B5 – Date of Next Annual Meeting

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

Lodgement of Corporations and Partnerships Profits Tax Returns

Table 1**Lodgement Comparison from 2009/10 to 2011/12**

	<u>Y/A</u> <u>2009/10</u>	<u>Y/A</u> <u>2010/11</u>	<u>Y/A</u> <u>2011/12</u>	Comparison 2010/11 and <u>2011/12</u>
1. Bulk issue (on 1 / 2 April)	164,000	168,000	172,000	2%
2. Cases with a failure to file by due date:-				
'N' Code	1,800	1,900	2,100	11%
'D' Code	4,100	4,600	5,100	11%
'M' Code	<u>8,300</u>	<u>8,900</u>	<u>9,200</u>	3%
	14,200	15,400	16,400	6%
3. Compound offers issued	5,100	5,600	6,600	18%
4. Estimated assessments issued	5,200	6,000	6,100	2%

Table 2**2011/12 Detailed Profits Tax Returns Statistics**

	<u>'N'</u>	<u>'D'</u>	<u>'M'</u>	<u>Total</u>
Total returns issued	18,000	55,000	99,000	172,000
Failure to file on time	2,100	5,100	9,200	16,400
Compound offers issued	1,600	2,000	3,000	6,600
Estimated assessments issued	0	2,100	4,000	6,100

Table 3
Represented Profits Tax Returns - Lodgement Patterns

<u>Code</u>	<u>Lodgement Standard</u>	<u>Actual Performance</u>	
		<u>2011/12 PTRs</u>	<u>2010/11 PTRs</u>
D - 15 August	100%	80% ⁽¹⁾	79%
M - 31 August	25%	11%	11%
M - 30 September	55%	17%	16%
M - 31 October	80%	34%	33%
M - 15 November	100%	80% ⁽²⁾	79%

(1) 34% lodged within a few days around 15 August 2012 (36% lodged within a few days around 15 August 2011 for 2010/11 PTRs)

(2) 30% lodged within a few days around 15 November 2012 (32% lodged within a few days around 15 November 2011 for 2010/11 PTRs)

Table 4
Tax Representatives with Lodgement Rate of less than 80% of 'M' code Returns as at 15 November 2012

1,524 T/Rs have 'M' Code clients. Of these, 698 firms were below the average performance rate of 80%. An analysis of the firms, based on size, is:-

	<u>No. of clients per firm</u>	<u>Current Year Performance</u>				<u>Last Year Performance</u>			
		<u>Total No. of firms</u>	<u>No. of firms below the average of 80%</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 79%</u>	<u>No. of non-compliance cases</u>	<u>% of total non-compliance cases</u>
Small size firms	100 or less	1,398	646	5,448	69%	1,401	633	5,445	69%
Medium size firms	101 - 300	115	49	2,133	27%	120	49	2,153	27%
Large size firms	over 300	11	3	336	4%	11	3	319	4%
		<u>1,524</u>	<u>698</u>	<u>7,917</u>	<u>100%</u>	<u>1,532</u>	<u>685</u>	<u>7,917</u>	<u>100%</u>

Table 1 [Appendix B]

Analysis of Completed FA Corporation Cases for the years ended 31 December 2010, 2011 and 2012

Auditor's Report = Unqualified	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Sales omitted	35	42	69	39,231,439	53,386,046	132,533,189	5,314,753	5,984,227	20,031,579
Purchases overstated	9	13	22	16,137,588	30,184,316	31,379,475	2,681,964	4,878,078	4,253,167
Gross profit understated	35	29	35	108,899,917	84,801,142	99,805,280	19,245,306	10,808,430	16,616,245
Expenses over-claimed	55	78	82	33,263,505	85,763,465	88,219,800	5,297,220	10,782,119	13,848,632
Technical adjustments	70	80	88	103,312,165	61,121,856	85,014,811	16,062,359	8,908,455	11,362,598
Offshore income / profits disallowed	15	13	20	687,681,260	121,529,355	679,584,028	113,737,761	20,244,418	109,191,220
Other	92	78	94	115,850,683	148,985,403	74,324,527	16,108,434	21,910,249	11,386,574
TOTAL	311*	333*	410*	\$1,104,376,557	\$585,771,583	\$1,190,861,110	\$178,447,797	\$83,515,976	\$186,690,015
TOTAL NUMBER OF CASES	235*	240*	285*						
AVERAGE AMOUNT PER CASE				\$4,699,475	\$2,440,715	\$4,178,460	\$759,352	\$347,983	\$655,053
* in one case there may be more than one type of discrepancy									
				Total Discrepancy for All Years			Total Tax Undercharged for All Years		
				2010	2011	2012	2010	2011	2012
Other statistics for the above cases: TOTAL AMOUNT				\$6,040,296,560	\$3,128,304,734	\$6,568,698,928	\$980,325,950	\$502,706,126	\$1,048,880,535
AVERAGE AMOUNT PER CASE				\$25,703,390	\$13,034,603	\$23,048,066	\$4,171,600	\$2,094,609	\$3,680,283

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Auditor's Report = Qualified	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Sales omitted	5	9	16	1,954,675	5,524,645	16,542,085	365,202	684,626	2,696,337
Purchases overstated	1	1	1	1,497,436	619,277	39,652,682	0	109,805	6,530,489
Gross profit understated	9	12	14	18,236,737	25,211,810	48,809,945	2,915,120	3,966,081	8,049,671
Expenses over-claimed	11	7	16	15,310,258	4,820,821	19,262,247	2,422,734	221,930	3,147,040
Technical adjustments	6	14	15	4,497,427	9,825,491	30,638,891	465,541	1,666,856	4,775,282
Offshore income / profits disallowed	2	5	4	7,314,612	47,638,540	12,908,977	705,035	8,307,655	2,078,838
Other	10	14	17	17,646,090	15,559,517	8,731,869	2,820,659	2,567,318	1,100,449
TOTAL	44*	62*	83*	\$66,457,235	\$109,200,101	\$176,546,696	\$9,694,291	\$17,524,271	\$28,378,106
TOTAL NUMBER OF CASES	37*	47*	52*						
AVERAGE AMOUNT PER CASE				\$1,796,141	\$2,323,406	\$3,395,129	\$262,008	\$372,857	\$545,733
* in one case there may be more than one type of discrepancy									
				Total Discrepancy for All Years			Total Tax Undercharged for All Years		
				2010	2011	2012	2010	2011	2012
Other statistics for the above cases: TOTAL AMOUNT				\$421,381,642	\$604,348,303	\$995,934,619	\$64,295,339	\$98,746,514	\$156,530,715
AVERAGE AMOUNT PER CASE				\$11,388,693	\$12,858,475	\$19,152,589	\$1,737,712	\$2,100,990	\$3,010,206

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TOTAL NUMBER OF CASES 272 287 337

				Total Discrepancy for All Years			Total Tax Undercharged for All Years		
				2010	2011	2012	2010	2011	2012
Other statistics for the above cases: TOTAL AMOUNT				\$6,461,678,202	\$3,732,653,037	\$7,564,633,547	\$1,044,621,289	\$601,452,640	\$1,205,411,250
AVERAGE AMOUNT PER CASE				\$23,756,170	\$13,005,760	\$22,446,984	\$3,840,519	\$2,095,654	\$3,576,888

Extracts of Analysis at Appendix B

	<u>2011</u>	<u>2012</u>
(a) No. of corporation cases with discrepancies uncovered	287	337
(b) No. of corporation cases in item (a) carried clean auditor's reports	240	285
(c) Total discrepancies detected in all cases	\$3,733m	\$7,565m
(d) Total discrepancies detected in clean auditor's report cases	\$3,128m	\$6,569m
(e) Percentage of (d) over (c)	84%	87%
(f) Total tax uncovered in clean auditor's report cases	\$503m	\$1,049m
(g) Average understatement per clean auditor's report case	\$13.03m	\$23.05m
(h) Tax undercharged per clean auditor's report case	\$2.1m	\$3.7m