



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

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Tax Bulletin

2010

Annual Meeting

The Inland Revenue Department

and

The Hong Kong Institute of Certified Public Accountants

2010
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 2010.

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

List of Discussion Items

PART A - MATTERS RAISED BY THE INSTITUTE

A1. Profits Tax Issues

- A1(a) Departmental Interpretation and Practice Notes ("DIPN") 21 (revised)
- A1(b) Taxation of financial instruments
- A1(c) Share-based payment
- A1(d) Tax treatment for reinstatement costs incurred

A2. Salaries Tax Issues

- A2(a) Long service payment
- A2(b) Income from dual capacities
- A2(c) Practice in reviewing section 81(A)(c) claims

A3. Cross-border Tax Issues

- A3(a) Finance cost on plant and machinery used outside Hong Kong under import processing arrangements
- A3(b) 100% offshore claims for taxpayers carrying out manufacturing operations in the Mainland under contract processing arrangements
- A3(c) Advance Pricing Arrangement ("APA")/ Bilateral Advance Pricing Arrangement ("BAPA")

A4. Double Taxation Agreements

- A4(a) Certificate of Hong Kong resident status for the purpose of a Double Taxation Arrangement ("DTA")
- A4(b) Foreign Tax Credit Claims ("FTC")
- A4(c) Mutual Agreement Procedure ("MAP")
- A4(d) Discussion with the State Administration of Taxation ("SAT")

A5. Departmental Policy and Administrative Matters

- A5(a) Advance ruling
- A5(b) Estimated assessment under section 59(3)
- A5(c) Acceptable accounts in support of a profits tax return of a foreign company
- A5(d) Filing process of salaries tax return
- A5(e) Electronic profits tax returns
- A5(f) Lodgment of tax returns and filing deadlines for 2009/2010

PART B - MATTERS RAISED BY THE IRD

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

B2. *Incorrect Classification of Plant and Machinery*

B3. *Date of Next Annual Meeting*

Full Minutes

The 2009/10 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department was held on 5 February 2010 at the Inland Revenue Department.

In Attendance

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

Ms Ayesha Macpherson	Chairperson, Taxation Committee
Ms Florence Chan	Deputy Chairperson, Taxation Committee
Mr Peter Yu	Member, Taxation Committee
Mr Anthony Tam	Member, Taxation Committee
Mr Alexander Mak	Member, Taxation Committee
Mr Julian Lee	Member, Taxation Committee
Mr Peter Tisman	Director, Special Practices
Ms Elena Chai	Assistant Director, Specialist Practices

Inland Revenue Department (“IRD”)

Mr Chu Yam-yuen	Commissioner of Inland Revenue
Mr Wong Kuen-fai	Deputy Commissioner of Inland Revenue (Technical)
Mrs Teresa Chu	Deputy Commissioner of Inland Revenue (Operations)
Miss Ng Yuk-chun	Assistant Commissioner of Inland Revenue
Mr Chiu Kwok-kit	Assistant Commissioner of Inland Revenue
Mrs Lai Chi Lai-ming	Assistant Commissioner of Inland Revenue
Mr Wong Kai-cheong	Senior Assessor (Research)

Mr Chu Yam-yuen ("CIR") on behalf of the IRD welcomed the representatives of the Institute to the meeting. CIR expressed that the annual meeting offered a valuable opportunity for the IRD to have a dialogue with the Institute. Items of common interest discussed at the meeting would be published in full in the minutes for information of members of the Institute. Ms Macpherson thanked the IRD for holding the annual meeting. The Institute and tax practitioners also viewed the annual meeting a valuable opportunity to clarify some practical uncertainties and to enhance the relationship between the Institute and the IRD.

PART A - MATTERS RAISED BY THE INSTITUTE

Agenda Item A1 - Profits Tax Issues

(a) Departmental Interpretation and Practice Notes ("DIPN") 21 (revised)

(i) Re-invoicing centre

In light of the IRD's view stated in paragraphs 27 and 28, the Institute would like to ask if the IRD considers that the re-invoicing exemption is no longer available.

CIR said the short answer was yes (i.e. the re-invoicing exemption was no longer available). As mentioned at the 2005 Annual Meeting, a distinction had to be drawn between service income and trading profits. It was impractical to categorise the circumstances under which a re-invoicing centre would be considered as deriving service income or trading profits. Rather, it needed to examine the nature of the operations and the types of risks involved. If a re-invoicing centre derived income from services and the services were rendered in Hong Kong, the income would be taxable. And, if a re-invoicing centre derived profits from trading transactions, the profits would be taxable if the profits were derived from trading operations carried out in Hong Kong. CIR pointed out that, in certain cases, the activities carried out by a re-invoicing centre in Hong Kong, though not substantial, were the whole profit-generating activities performed in earning the income or profits in question.

Ms Macpherson noted that, in all the examples given in DIPN 21, the profits were always taxable. She would, however, like to confirm whether the profits would be accepted as sourced outside Hong Kong and not taxable if the re-invoicing centre derived profits from trading transactions and the trading operations were carried out outside Hong Kong. CIR explained that whether the profits were chargeable to tax could not be answered without examining the peculiar facts of each case. However, if it was determined that profits from trading were really derived from outside of Hong Kong, the relevant profits would not be taxable in Hong Kong.

Mr Lee said that, given the different activities conducted by a trading business, which derived profits from the buying and selling of goods, and a service company, which merely booked the profits and without having obtained the ownership of goods, a clear dividing line must be drawn to distinguish a business of providing services from a

business of buying and selling of goods. Mr Tam shared the same view and enquired the IRD's view about the pricing for the provision of service. CIR reckoned that it all depended on facts and the price has to be the arm's length price.

(ii) Royalties

The IRD indicated in paragraph 45(g) that the source of royalties [other than those deemed chargeable under section 15(1)(a), (b) or (ba) of the Inland Revenue Ordinance ("IRO")] is determined by the place of acquisition and granting of the license or right of use. The Institute would like to seek the IRD's view on whether the place of use of the relevant intellectual properties would also be relevant in determining the source of royalties. Specifically, as suggested by the court in the *HK-TVBI* case, the location where the intellectual property is exploited is important in determining the source of royalties, particularly where the licensor has a financial interest in the subsequent exercise of the rights by the licensee.

Mr Chiu replied that the relevant paragraph in the *HK-TVBI* case read-

"The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place. Adopting this approach what emerges is that TVBI, a Hong Kong based company, carrying on business in Hong Kong, having acquired films and rights of exhibition thereof, exploited those rights by granting sub-licences to overseas customers. The relevant business of TVBI was the exploitation of film rights exercisable overseas and it was a business carried on in Hong Kong. The fact that the rights which they exploited were only exercisable overseas was irrelevant in the absence of any financial interest in the subsequent exercise of the rights by the sub-licensee. Their Lordships therefore consider that the profits accruing to TVBI on the grant of sub-licences during the relevant years of assessment arose in or derived from Hong Kong and as such were subject to profits tax under s.14."

Mr Chiu advised that their Lordships in the *HK-TVBI* case focused on the operations of TVBI which were the acquisition and granting of the licences or rights of use. They were of the opinion that the fact that such rights were only exercisable overseas was irrelevant in the absence of any financial interest in the subsequent exercise of those rights by the sub-licensee. But there is no further deliberation on the financial interest in the subsequent exercise of the rights by the sub-licensee. The IRD therefore attached primary importance, in determining the source of royalties, to the place of acquisition and granting of the license or right of use. The place of use of the intellectual properties would generally not be taken into consideration.

CIR added that the licence fee payable stipulated in the licence agreement should not constitute financial interest, nor should the source of the financial interest be determined in such manner.

Ms Chan enquired whether the licensor would have a better case to demonstrate that the royalties were derived outside Hong Kong when the licensor also took part in the overseas activities to exploit the intellectual properties in that jurisdiction and faced financial risk. CIR said that, if the licensor had an equity interest in the exercise of the

right overseas, this could be considered, but there was no definite answer. Mr Chiu said weight would be given to the licensor's overseas operations but if the overseas operations were insignificant when compared with the overall profit generating activities, the place of acquisition of intellectual properties would still be the major determinant factor.

(iii) Agency

In paragraph 59, the IRD indicated its view that the act of any person carried out overseas should not be readily attributed to a taxpayer in Hong Kong and that the comments made in *ING Baring* are only relevant to the provision of services and the earning of a commission by completing share transactions in an overseas market. In this regard, the Institute would like to seek the IRD's guidance on the circumstances where the act of an overseas person would be attributed to a Hong Kong taxpayer. Specifically, the Institute would like to seek the IRD's view on whether a sub-contractor's activities would be attributed to the Hong Kong taxpayer who is engaged in the provision of services.

Mr Chiu referred to paragraphs 17(d), (e), (j) and (l) of DIPN 21 (2009 Revised). The broad guiding principle in determining the source of profits was that one looked to see what the taxpayer had done to earn the profits in question and where he had done it, and the operations in question must be the operations of the taxpayer. Whether the acts of an overseas person should be attributed to a Hong Kong taxpayer depended on the facts and circumstances of the case. It was impractical to set out precisely the circumstances where the activities of an overseas person should be attributed to a Hong Kong taxpayer.

Mr Chiu further said that the term "sub-contractor" referred to a party who performed certain activities for earning a fee income. In performing his service, the overseas sub-contractor was often pursuing his own financial interest in the normal course of his own business. Thus, his act should not be readily attributed to the taxpayer in Hong Kong.

Mr Chiu referred to paragraph 17(j) of DIPN 21 which explained: even where a related company was in fact acting on behalf of a Hong Kong taxpayer, the related company's activities had to be considered to see if appropriate weight should be accorded thereto. The same approach would apply to the case where an overseas sub-contractor is involved.

Mr Lee said usually in a tax treaty, the tax treatment for the case of a dependent agent was differentiated from the case of an independent agent. He asked if the IRD would accept the same differentiation under the Inland Revenue Ordinance. Mr Chiu explained that their Lordships in *ING Baring* did not make such a distinction and therefore it was not appropriate to expand their Lordships' view. Mr Chiu advised that even if an overseas agent's act was to be attributed to the taxpayer, the question remained: the weight that should be put on the agent's act which took place overseas. CIR added that the distinction between dependent agent and independent agent under a tax treaty was only for double taxation agreement purpose.

Ms Macpherson pointed out that, in section 2 of the IRO, "profits arising in or derived from

Hong Kong” was defined to include all profits from business transacted in Hong Kong, whether directly or through an agent. She therefore considered that it would be equitable for the reverse situation to also apply, i.e., the activities of an overseas agent needed to be attributed to the taxpayer in Hong Kong. Mr Chiu explained that the definition should refer to an agent inside Hong Kong rather than an agent outside Hong Kong and though an agent’s activity was relevant, it had to be weighed. Mr Chiu further advised that the activities carried out by an overseas subcontractor outside Hong Kong might not necessarily be attributed to the taxpayer in Hong Kong. It might well be possible that the subcontractor was simply working on its own behalf and was earning its own profit.

Ms Macpherson commented that it would be helpful if more examples on offshore claims could be added to DIPN 21 such that a more balanced view could be given. CIR considered that this may be possible.

(iv) Apportionment of profits

Two examples (Example 4 and Example 5) are quoted to explain situations where an apportionment of profits is not applicable. The Institute would like to ask the IRD to quote an example where apportionment of profits would be allowed (other than circumstances involving contract processing arrangement).

Mr Wong Kuen-fai (“Mr Wong”) referred to paragraph 17(h) of DIPN 21 (2009 revised). The basic principle was that where gross profits from an individual transaction arose in different places, they could be apportioned as arising partly in and partly outside Hong Kong.

Mr Wong added that paragraph 46 of DIPN 21 set out the example on service fee income where the services were performed partly in and partly outside Hong Kong. In appropriate circumstances, the IRD accepted an apportionment of the service income.

(v) Manufacturing profits

In Example 2, where a Hong Kong company manufactures goods in Hong Kong and sells them to overseas customers through its sales staff based overseas, the IRD is of the view that this is not a case for apportionment and that the whole of the profits are liable to profits tax. Along this line, a Hong Kong company who manufactures goods overseas and sells them to Hong Kong customers through its sales staff based in Hong Kong should be wholly offshore and not subject to profits tax. The Institute would like the IRD to confirm this view.

Mr Wong explained that Example 2 should be read with Example 3, which were short examples for illustrating cases where apportionment of manufacturing profits should or should not apply. As illustrated by the examples, whether the manufacturing profits in a particular case should be apportioned and chargeable to profits tax was determined by the extent of the operations carried out by the taxpayer in and outside Hong Kong. If the sales activities in Hong Kong were so substantial as to constitute a retailing

business, the profits attributable to the retailing activities were fully taxable.

In reply to Mr Mak, Mr Wong added that if the Hong Kong company in the examples were a wholesaler and the customers were located outside Hong Kong (and assuming the sales contract were effected outside Hong Kong), the profits derived thereof would not be subject to profits tax.

(b) Taxation of financial instruments

The Institute would like to clarify the following matters in respect of the taxation of financial instruments:

(i) Hybrid instruments

Hybrid instruments are required to be split into debt and equity components for accounting purposes. However, based on DIPN 42 (Part A), the IRD has stated that a hybrid instrument is a single instrument in legal form, and that the IRD will look to the legal form of the financial instrument rather than the accounting treatment to ascertain its nature and the appropriate tax treatment which should be applied.

Where a hybrid instrument takes the legal form of debt, the Institute would like the IRD to confirm the tax treatment with respect to any “notional” amounts of interest which are recognised in the profit and loss statement in accordance with HKAS 39 in light of the following example:

- Company A subscribes for a 1-year convertible loan issued by Company B for an amount of HK\$10,000 and Company A has the option of converting the convertible loan into a fixed number of shares in Company B;
- The convertible loan carries an annual interest of 8%;
- Company A records the convertible loan as an asset of HK\$9,000 and a derivative (an equity conversion option) of HK\$1,000 in its balance sheet at inception; and
- Company A records interest on the convertible loan of HK\$1,800 in its income statement, consisting of cash interest in accordance with the terms of the loan agreement of HK\$800 and non-cash interest of HK\$1,000 which arises from the accretion of the asset of HK\$9,000 to HK\$10,000 over the term of the convertible bond.

In this case, the interest income of HK\$800 represents cash interest paid by Company B in accordance with the terms of the loan agreement and should be taxable interest income to Company A to the extent that it is Hong Kong sourced.

On the other hand, Company B has no legal obligation to pay the “interest” of HK\$1,000 to Company A under the terms of the loan agreement, as the non-cash interest of HK\$1,000 is only a “notional” accounting entry, and based on the IRD approach of adhering to the legal form, the non-cash interest should not be taxable for Company A.

On a similar basis, Company B should only be eligible for a tax deduction in respect of HK\$800 cash interest paid to the extent that it fulfils the criteria under sections 16(1) and 16(2) of the IRO. No tax deduction should be available in respect of the "notional" amount of interest booked in Company B's profit and loss statement.

The Institute would like the IRD to share their views on the above analysis.

Miss Ng replied that the Institute's analysis in relation to the cash interest was agreeable. However, in the case where the option of converting was exercised, the tax treatment of the non-cash portion of \$1,000 would depend on the nature of the convertible bonds, i.e. whether it is a trading or capital asset. It appeared that in the example the convertible bond was treated as an available for sale financial asset by Company A. The accounting treatment was not a conclusive indicator of the nature of the asset. The nature was to be determined by a consideration of all the relevant facts and circumstances, including the accounting classification.

(ii) FAQ

In agenda item A1(a) of the 2009 minutes, it was stated that the FAQ on DIPN 42 would be expanded to include the IRD's practice on reclassification of financial assets under HKAS39. The Institute would like to know the expected timing for the issuance of the FAQ.

Miss Ng said that the FAQ would be uploaded shortly after the meeting.

[Post-meeting note: the FAQ has been uploaded to the IRD's website.]

(c) Share-based payment

FAQ9 on share-based payment transactions on IRD website read as follows:

Q9 When a share-based compensation in form of stock option or share award is granted by a parent company, the entity concerned will debit the profit and loss account and credit the "equity - reserve" account. Upon recharging, the entity will debit the "equity - reserve" account and credit the "payable to parent" account. Is the recharge deductible for tax purpose?

A9 A recharge is deductible as long as the conditions, including the "incurred" test, under sections 16 and 17 of the IRO are satisfied and the entity has become unconditionally liable to pay the recharge. Any provision for recharge claimed by the entity for deduction in the basis period in which the parent company has not issued the shares should be disallowed. The amount of recharge settled by an entity under a cost-recharge arrangement with its parent or fellow subsidiary would generally satisfy the "incurred" test under section 16.

With reference to the answer to FAQ9, the Institute would like to know the IRD's view on the profits tax consequences where the amount of recharge paid to the parent or fellow

subsidiary was more (or less) than the amount charged to the entity's profit and loss account in any period (because part of the recharge was charged directly to an equity account), provided that the entity had become unconditionally liable to pay such recharge. The Institute would like to ask, if an entity were allowed a deduction for an amount which was not reflected in its profit and loss account in any period, whether this would be consistent with the IRD's interpretation of the *Secan* case.

Mr Wong advised that, in deciding whether a recharge was deductible under section 16 of the IRO, it was necessary that the expenditure had been "incurred" and satisfied other normal rules of sections 16 and 17. The Court of Final Appeal in the *Secan* case made it clear that assessable profits or losses must be ascertained in accordance with the prevailing generally accepted accounting principles as modified to conform with the IRO.

Mr Wong said when an entity fulfilled its stock option granted to its employees by issuing new shares, the expense recognised for accounting purposes in an equity-settled share-based payment transaction was not an outgoing or expense incurred for the purpose of section 16 of the IRO because no actual expenditure had been incurred. The term "recharge" connoted a "reimbursement of actual expenditure" and shares issued to employees were not actual expenditure. That was why the term "cost-recharge" was used in the answer to FAQ9.

Mr Wong explained that if the parent issued new shares to the employees of its subsidiary and recharged the subsidiary for the fair value of the shares issued, no deduction would be allowed to the subsidiary for the recharge as well. On the other hand, recharge paid to the parent representing the genuine costs of shares acquired by the parent from the market was allowable.

Furthermore, the IRD considered that the recharge might be a capital expenditure, representing money paid by the subsidiary to the parent for the issue of shares or an agreement to issue shares and was thus not allowable.

Mr Wong explained that if the amount of recharge expenditure reflected in the profit and loss account of the entity were different from that paid to the parent or fellow subsidiary and the entity wished to claim the difference as allowable deduction, it had to demonstrate to the satisfaction of the assessor why the difference was not charged to the profit and loss account and such amount satisfied the provisions of sections 16 and 17 of the IRO.

Mr Wong said the third sentence in the answer to FAQ9 was an example whereby the IRD would accept that the recharge expenditure had been incurred. It should not be interpreted to mean that recharge paid but not recognised in the profit and loss account would also be deductible.

Ms Macpherson indicated that the Institute found it difficult to accept the IRD's view that even a subsidiary company, which was recharged by and had actually made payment to its parent company in respect of the cost for the issue of shares by the parent company, the IRD did not regard the recharge as having been incurred. The parent company and the subsidiary company were two different entities and the latter had incurred a legal liability to pay and had actually paid to the parent company. CIR said that the IRD would look behind the legal entity and to ascertain whether the parent company had

incurred any cost for the issue of shares. Mr Wong added that the share option scheme and recharge arrangement should be regarded as one single transaction.

Ms Chan said the Institute was unable to understand the legal basis behind the position taken by the IRD to look behind the transactions of both the parent and subsidiary companies. Both she and Mr Yu were of the view that there was no tax avoidance motive in the implementation of such share-based payment arrangements. Many of these types of transaction were carried out by multi-nationals and they were not driven by tax but by global remuneration policies. Reference could always be made to section 61A if there were doubts about the objective in a particular case. Neither could the share-based payments be regarded as capital expenditure since they were in substance remuneration to employees and were recurring in nature.

CIR considered that this was a very important but complicated topic and the annual meeting was not an appropriate forum to discuss all the issues involved. He suggested that a small group be formed with representatives from both sides to discuss the issues further. Ms Macpherson welcomed this proposal.

The following example illustrates at the company level, how the subsidiary accounts for the share-based payment expenses recognised during the vesting period and the recharge amount that is ultimately required to be paid to the holding company.

Example:

Holding company ("Holdco") grants its stock options to the staff of its wholly owned subsidiary ("Subco") and there is an agreement in place for Holdco to recharge Subco when the options are exercised and new shares are issued by Holdco to the staff of Subco. The following assumptions apply to the example:

- 100 stock options have been granted with a vesting period of 3 years
- Estimate of the fair value of the stock option at the grant date is HK\$15 per option
- Exercise price is HK\$30 per share
- Par value of the share is HK\$1 per share
- Fair value of the share at time of exercise is HK\$50 per share
- Recharge amount equals to the difference between the fair value of the share at time of exercise and the exercise price i.e. $HK\$(50 - 30) = HK\20 per option
- Assuming the estimated and actual forfeiture rate during the 3-year vesting period is 0% for simplicity reason

The relevant accounting entries for the example are:

Holdco's entries

During each year of the 3-year vesting period

Dr. Investment in Subco (Fair value of options at grant date recognised proportionately over the vesting period)	500	
Cr. Equity – Stock options reserves		500

At exercise and shares issued by Holdco

Dr. Cash (exercise price paid by the staff of Subco)	3,000	
Dr. Equity – Stock options reserves (reverse amount previously recognised)	1,500	
Cr. Share capital (par value of shares issued)		100
Cr. Share premium (balancing figure)		4,400

Recharging by Holdco following exercise

Dr. Receivable from Subco (costs charged by Holdco)	2,000	
Cr. Investment in Subco (up to the amount previously debited)		1,500
Cr. Dividends received from subsidiary (balancing figure representing difference between the actual market value of the share at exercise date and the estimated market value of the share at grant date)		500

Subco's entries

During each year of the 3-year vesting period

Dr. Profit & loss (Fair value of options at grant date recognised proportionately over the vesting period)	500	
Cr. Equity – Capital contribution from Holdco		500

At exercise and shares issued by Holdco

No accounting entry.

Recharging by Holdco following exercise

Dr. Equity - capital contribution from Holdco (up to the amount previously credited)	1,500	
Dr. Dividends paid to Holdco (balancing figure, if any)	500	
Cr. Payable to Holdco (costs charged by Holdco)		2,000

The Institute would like the IRD to confirm:

- (i) the Subco can get a tax deduction at the time the employees exercise the share options, and

Discussion withheld (see Agenda Item A1(c) above).

- (ii) the amount of tax deduction allowed to the Subco would be the amount based on the contractual agreement between the Holdco and Subco (i.e., HK\$2,000 in the above example), assuming the expense is wholly incurred in the production of Subco's profits chargeable to tax in Hong Kong.

Discussion withheld (see Agenda Item A1(c) above).

(d) Tax treatment for reinstatement costs incurred

The Institute would like to follow up on agenda item A1(i) of the 2009 minutes in respect of the tax treatment for reinstatement costs on premises that is provided according to HKAS 37.

- (i) In response to the Institute's questions, the IRD advised that an "estimate" or "provision" for reinstatement costs did not qualify for commercial building allowance. However, assuming the lease term is over one year, and so the lease is a capital asset, the IRD has indicated that the reinstatement costs, when incurred, would be part of the capital cost of acquiring the lease and as capital expenditure, they would also be precluded from deduction under section 17(1)(c) of the IRO.

In the light of the above, as reinstatement costs are usually incurred before the end of the lease term (i.e. within the lease term), the Institute would like to clarify whether, once they are incurred, reinstatement costs would qualify for commercial building allowance given that the costs are regarded as capital expenditure.

Miss Ng said that according to HKAS 37, if an entity leased office premises where the lease required it to reinstate the premises at the end of the lease, a provision was to be recognised for the best estimate of the eventual costs that related to the restoration of the alterations made to the premises. These costs were included as part of the cost of the alterations at the beginning of the lease. As previously advised by the IRD in the Annual Meeting 2009, since the estimated costs of reinstatement were a provision and no actual expenditure had been incurred, the estimate or provision did not qualify for commercial building allowance.

Miss Ng advised that even if the entity had incurred costs of reinstatement before the end of the lease term (i.e. within the lease term), the actual reinstatement costs still did not qualify for commercial building allowance. The actual expenditure so incurred was for the purpose of restoring the alterations made to the premises when the lease came to an end. It was not incurred on the construction of a commercial building or structure or incurred to acquire a relevant interest in that building or structure.

Further, Miss Ng said the premises were to be surrendered to the lessor after reinstatement. It therefore failed to satisfy the test under section 18F of the IRO which provides for the allowances under Part VI to be deducted from assessable profits to the extent to which the relevant assets were used in the production of such profits. As the reinstated premises were not used by the entity in the production of assessable profits, the actual reinstatement costs did not qualify for commercial building allowance.

- (ii) The Institute would also like to know when the IRD expect to issue an FAQ on this matter.

Miss Ng informed the Institute that FAQ would be uploaded to the IRD's website as soon as possible after the meeting.

[Post-meeting note: the FAQ has been uploaded to the IRD's website.]

Agenda Item A2 - Salaries Tax Issues

(a) Long service payment

It was indicated in agenda item A2(c) of the 2009 minutes that more guidance on taxation of long service payment would be provided. The Institute would like to enquire as to when such guidance would be available.

Mr Chiu said that the guidance after revision would soon be uploaded to the IRD's website after the meeting.

[Post-meeting note: the guidance has been uploaded to the IRD's website.]

(b) Income from dual capacities

The IRD, in practice, assumes that a person's gain on stock option is derived from his office rather than employment and treats the gain as fully taxable for salaries tax purposes, including under the following circumstances:

- (i) the person assumes dual capacities in a Hong Kong entity (i.e. acting as a statutory director and an employee);
- (ii) the gain on stock options is treated by the employer as being derived in the capacity of the person's employment, and;
- (iii) the person visits Hong Kong for less than 60 days during the vesting period of each year of assessment concerned.

However, even though the person and/or his employer may be able to provide documentary evidence to substantiate that the gain is derived from the person's employment, the IRD will generally not accept the claim. The Institute would like to ask the IRD to advise as to the conditions that need to be satisfied for a stock option gain to be treated as employment income.

Mr Chiu explained that under section 8(1), an office and an employment were regarded as sources of income chargeable to salaries tax. Attribution of income to a source was a matter that depended on the facts and circumstances of each case. The mere fact that an income was claimed to have been derived from an employment instead of an office should not be conclusive.

Mr Chiu added that to decide whether an income was derived from an office or an employment, the IRD would *inter alia* examine the duties and responsibilities attached to the office and of the employment; compare the remuneration package of similar office and employment; study the remuneration package of preceding and succeeding office holder or person employed; and examine the basis for allocating the income and benefits-in-kind (including the stock options) to the office and to the employment.

To decide whether there were two sources of salaries income, the IRD would *inter alia* check whether the documentation truly reflects the existence of two different capacities (i.e. one office and one employment); whether the roles or capacities were capable of independent existence; whether duties and responsibilities of the employment were merely incidental to those of the office or vice versa; whether there were separate payrolls and whether there were separate lines of reporting and management.

To decide whether there was a transaction to obtain tax benefit, the IRD would further consider the dual capacity arrangement in the context of underlying commerciality, i.e. whether the split of capacity without commercial underpinning was artificial or tax motivated.

In reply to Ms Macpherson, Mr Chiu said that the IRD would not automatically attribute a person's gain on stock option to his office when he held dual capacities.

(c) Practice in reviewing section 8(1A)(c) claims

The Institute understands there are different practices within the IRD in reviewing time-apportionment claims. Some assessors would agree to apportion income based on business days if this creates a more desirable result, but others insist to apportion income based on the total number of days in/ out of Hong Kong.

The Institute would like to know if the IRD has a standard departmental practice for reviewing section 8(1A)(c) claims.

Mr Chiu said the IRD's practice was to adopt the day-in day-out basis for the purpose of computing income derived from services rendered in a territory outside Hong Kong under section 8(1A)(c). If apportionment were to be made on the basis of services, each year there would have to be an inquiry into the nature and responsibilities not only of overseas duties but also of Hong Kong. The relief under section 8(1A)(c) would be wholly uncertain and would depend on an *ex post facto* value judgment.

Mr Chiu explained that as a rule of law, apportionment of income should be based on the total number of days in the year, i.e. 365 or 366 days as appropriate. In *Varnam v Deeble* [1985] STC 308, Browne-Wilkinson LJ observed: in the absence of express contract

allocation, income accrued day to day; and income and leave pay should be apportioned on a time-in time-out basis under Apportionment Act 1870. In *Platten v Brown* [1986] STC 514, Hoffmann J ruled: annual salary accrued day by day over a year of 365 days; and time apportionment basis should employ unit of days rather than hours. See also *Leonard v. Blanchard* [1993] STC 259.

CIR added that apportionment on a day-in day-out basis was the standard practice adopted by the IRD and he would remind assessors in this regard.

Agenda Item A3 - Cross-border Tax Issues

(a) Finance cost on plant and machinery used outside Hong Kong under import processing arrangements

The Institute would like to clarify whether the interest costs for financing the acquisition of the plant and machinery used outside Hong Kong under import processing arrangements would qualify for tax deduction. The Institute considers that this should be the case as long as it can be demonstrated that the relevant assets are used to generate profits chargeable to tax in Hong Kong (assuming the conditions specified in section 16(2) of the IRO are satisfied). The Institute would like the IRD to confirm its position on the above matter.

Mr Wong said the Institute's view was premised on the presumption that "as long as it can be demonstrated that the relevant assets are used to generate profits chargeable to tax in Hong Kong" and that the relevant conditions specified in section 16(2) of the IRO were satisfied.

The IRD considered that the answer to the Institute's question was fact-sensitive. Insofar as interest expense was concerned, in order to qualify for deduction, section 16 provided that the interest expense had to be incurred in the production of chargeable profits and satisfied the conditions of section 16(2). If the plant and machinery were used by a party outside Hong Kong under an import processing arrangement, no depreciation allowance would be made by virtue of section 39E. As such, the interest expense would fail to satisfy section 16(2)(e)(i) of the IRO which specifically required that the capital expenditure on the acquisition of the plant and machinery qualified for depreciation allowance.

In addition, Mr Wong advised that if the requisite connection between the expenditure incurred and the production of the taxpayer's chargeable profits were not established, no deduction could be made: see *D61/08* 24 IRBRD 184 (paragraphs 43-45). If the interest were incurred to finance the acquisition of plant and machinery which were injected as equity contribution, the interest expense is of capital nature and not deductible.

In reply to Mr Lee, CIR said there was no distinction between physical use and economic use of the plant or machinery by the taxpayer because the consideration was whether or not the plant or machinery was used outside Hong Kong.

(b) 100% offshore claims for taxpayers carrying out manufacturing operations in the Mainland under contract processing arrangements

In agenda item A13 of the 2001 minutes, it was stated that "Only in very exceptional cases where taxpayers could prove otherwise would the IRD consider a basis departing from the norm." In light of the *Ngai Lik* case, the Institute would like to follow up on the apportionment basis.

In the *Ngai Lik* case, Justice Ribeiro also agreed with the decision of the Board of Review in the case that the profits of the companies carrying out manufacturing operations for the group in the Mainland under contract processing arrangements were 100% offshore for Hong Kong tax purposes. This is so despite the fact that the companies concerned sourced some of the raw materials through a group company as their agents in Hong Kong.

The Institute would like to ask whether the IRD would accept that companies carrying out manufacturing operations in the Mainland under contract processing arrangements may claim their profits as 100% offshore, if their Hong Kong activities are likewise restricted to sourcing of raw materials as in the case of *Ngai Lik* (instead of the current practice of a general 50:50 apportionment).

Miss Ng advised that the *Ngai Lik* case was decided on its own peculiar facts, in which the Court of Final Appeal endorsed the application of section 61A of the IRO in charging profits tax on Ngai Lik.

Miss Ng said the Board of Review in its decision broadly ruled that the relevant BVI companies carried on business outside Hong Kong and, hence, did not fall within the ambit of section 14 of the IRO. In arriving at the conclusion, the Board of Review did not explicitly analyze the operations of the BVI companies.

Miss Ng further commented that the Court of Final Appeal similarly did not make reference to the BVI companies' operations in remarking that the relevant profits were offshore profits. Further, Justice Ribeiro's remarks on the BVI companies were merely obita statements made in the context of *Ngai Lik* not having any manufacturing profits and that the BVI companies' profits should not be taken into account in the proper application of section 61A to *Ngai Lik*.

The IRD did not consider the *Ngai Lik* case amounted to a legal authority for the proposition that "companies carrying out manufacturing operations in the Mainland under contract processing arrangements may claim their profits as 100% offshore, if their Hong Kong activities are likewise restricted to sourcing of raw materials".

Mr Mak asked, from the transfer pricing perspective, whether the IRD would accept an apportionment basis otherwise than on 50:50. CIR replied that the 50:50 apportionment basis was not a golden rule, but was very useful in the determination of profits subject to Hong Kong profits tax in the generality of cases, while an apportionment on other basis should not be ruled out. Mr Chiu added that the 50:50 apportionment basis concerned about the locality of profits. It might be more beneficial to a Hong Kong enterprise engaged under a contract processing arrangement whereby its involvement in the Mainland factory became diminishing and minimal.

Ms Chan asked, since the 50:50 apportionment basis was an arbitrary basis of apportionment, would the IRD consider to follow the OECD Model in arriving at a more precise basis of apportionment. Mr Chiu replied that it would involve a source issue as well as a transfer pricing issue. The apportionment on a 50:50 basis in respect of contract processing cases was a source issue under which one single entity (i.e. the Hong Kong enterprise) was involved. However, in import processing cases, since it involved an FIE in the Mainland, transfer pricing could be an issue.

Mr Wong advised that it was always up to the taxpayer to establish that there was a permanent establishment ("PE") in the Mainland and to argue that all the profits derived by it were attributed to that PE. Ms Chan remarked that since the Mainland tax authority usually did not tax Hong Kong taxpayers under contract processing arrangements in the Mainland, whether or not there was a PE in the Mainland did not seem to be relevant in the issue; what was relevant was how much profit could be attributed to the taxpayer's activities in the Mainland for Hong Kong tax purposes. CIR advised that whether or not there were any profits attributed to the PE in the Mainland was always a question of fact and perhaps the issue of exchange of information might later come into play. Taxpayers could, however, always raise arguments for apportionment of profits if circumstances warranted.

Mr Tam asked whether in the circumstances where a taxpayer treated an import processing arrangement as a contract processing arrangement for accounting purposes, such that the books of accounts of the Hong Kong company would include those of the FIE, the IRD would accept the portion of the profits attributable to the FIE as not subject to Hong Kong Profits Tax. Mr Wong said that the facts could hardly justify the claim and such kind of cases had not been accepted by the Board of Review or the Court, and the taxpayer would need to ensure that its accounts were correct.

(c) Advance Pricing Arrangement ("APA")/ Bilateral Advance Pricing Arrangement ("BAPA")

There has been an increasing attention on transfer pricing issues from both the IRD and its treaty partners, especially the Mainland tax authority. As many Hong Kong companies are transacting with their subsidiaries (or associated companies) in the Mainland, transfer pricing between these related entities will inevitably arise. While DIPN 45 and DIPN 46 do provide certain practical guidelines on transfer pricing issues, there is an increasing demand for APAs by businesses operating across the border, especially BAPA, in order to minimise uncertainty in their tax liabilities.

The Institute would like to ask whether the IRD will consider:

- (i) establishing a formal procedure/ channel for Hong Kong businesses to initiate APA discussions with the IRD, and BAPA discussions with both the IRD and the competent authorities of the jurisdictions with which Hong Kong has concluded treaties.

CIR said that there was no current plan for the IRD to establish any formal procedures for Hong Kong taxpayers to apply for APA. It was considered that the advance ruling procedures were sufficient for such purposes.

CIR advised that the Mutual Agreement Procedure Article in the DTAs of Hong Kong could be used to facilitate agreement between the IRD and the competent authorities of our treaty partners on transfer pricing issues, where appropriate.

- (ii) as an alternative to (i), applications for advance ruling in relation to a transfer pricing issue or a pricing arrangement.

CIR said the advance ruling service provided by the IRD would cover transfer pricing related issues. Whether or not an advance ruling would be given in a particular case would of course be subject to the qualifications set out in paragraphs 5 to 9 of DIPN 31 on Advance Rulings. Up till now, there were three applications for advance ruling on transfer pricing issue. An adverse ruling was given to one of the applications while the IRD declined to give a ruling to another because similar arrangements were under tax audit. The third application was still being processed.

In response to the questions on whether taxpayers could negotiate with the IRD in the issue of a ruling e.g., agree a specific pricing formula, CIR replied that the IRD would normally raise queries and/or exchange views, which could include discussing a formula, before making a ruling. CIR further added that a ruling would normally cover a number of years, provided that the methodology was acceptable to the IRD and that taxpayers were to notify the IRD about any changes.

Agenda Items A4 - Double Taxation Agreements

(a) Certificate of Hong Kong resident status for the purpose of a Double Taxation Agreement ("DTA")

The Institute would like to clarify the following in respect of the certificate of Hong Kong resident status:

- (i) Article 4 of each of the five DTAs entered into by Hong Kong set out the conditions under which a corporation will be regarded as a resident of Hong Kong for the purposes of the DTAs. Specifically, a non-Hong Kong incorporated company would be considered as a resident of Hong Kong if it is “normally managed or controlled” or “centrally managed and controlled” (applicable to the DTA with Belgium) in Hong Kong.

In the DIPN 44, the IRD stated the following views:

- “Management” refers to management of daily business operations, or implementation of the decisions made by top management, etc.
- “Control” refers to control of the whole business at the top level, including formulating the central policy of the business, making strategic policies of the company, choosing business financing, evaluating business performance, etc. The IRD’s view is that the board of directors usually exercises “control” of the company.

In this regard, the Institute would like to seek the IRD’s guidance on the factors which the IRD would consider in determining the locality of an investment holding company’s

management and control. Specifically, as the IRD may appreciate, an investment holding company which does not have any active business would not have any daily business operations and would not formulate policy as frequently as those companies which have active businesses. Under this circumstance, would the IRD consider that the place where the board of directors generally meets would determine where the company is managed and/ or controlled?

CIR explained that “management” and “control” would have to be determined separately. For “control”, where the company’s top level business decisions were exercised by the board of directors, and the place where the board generally met would determine the place of control. For “management”, the IRD would look at a number of factors, including the nature of business, business activity in Hong Kong, location of the headquarters and main branches, management and other staff residing in Hong Kong, etc. Each company would have its own way of operation; hence, each case had to be decided on its own merits. The IRD would not normally use the place where the board met to determine both “management and control” or “management or control” and these two had to be decided separately.

Ms Macpherson said the guidance on “control” was clear since it normally looked at the place where the board generally met. However, she would like to know the factors in the determination of “management”. CIR explained that “management” mainly referred to decisions relating to the day-to-day operations of the business. Mr Lee asked whether e.g., a branch of a foreign bank incorporated offshore with a branch manager and full functions in Hong Kong would be regarded as managed in Hong Kong. CIR confirmed that it would.

- (ii) As Hong Kong enters into more DTAs, it is likely that there would be more applications for certificates of Hong Kong resident status. The Institute would like to ask if the IRD would consider setting a standard response time for processing such applications in its performance pledge.

CIR said currently, the standard response time of processing application for Certificate of resident status for the purpose of the DTA between the Mainland and Hong Kong was 21 working days as specified in the DIPN 44. The IRD would observe the same standard for other DTAs.

- (iii) For a company that wishes to seek benefits under the DTA between Hong Kong and Mainland (HK-Mainland DTA), the Chinese tax authorities have recently clarified, once granted, approval will usually be valid for three years under the current practice. However, currently a company that applies for a Hong Kong tax resident certificate is required to specify a particular calendar year of claim in the related application form (form 1313A), and the certificate would only cover that particular calendar year. The Institute would like to ask whether the IRD sees any potential difficulties with this difference in approach and whether it would consider the possibility of issuing a tax resident certificate covering three years so as to avoid taxpayers having to make multiple applications.

CIR said Hong Kong had adopted the policy of issuing certificate of residence with reference to a calendar year when the IRD first commenced to implement the limited arrangement between the Mainland and Hong Kong in 1998. The certificate mainly catered for those companies not incorporated in Hong Kong but were managed and controlled (managed or controlled under CDTA since 2007) in Hong Kong. Hence, the IRD had to indicate the year as the place of management and control may change over time and the IRD worked on a tax year basis. It was also the IRD's policy not to issue a certificate for future years. The IRD had not changed this policy since then.

Mr Tam noted that, under Circular No. 124, the Mainland authorities' approval was valid for three years and subject to random checks. As far as the IRD understood and according to information provided by the applicants, some Mainland local tax authorities would accept for their domestic purpose a certificate issued by the IRD for a particular calendar year to be valid for three years. It seems that multiple applications were not necessary for such purpose. The IRD had no problem with their practice in this regard. There was no need for Hong Kong to change the existing practice.

(b) Foreign Tax Credit Claims ("FTC")

Relief for juridical double taxation is provided by means of FTC. There are two provisions in the IRO dealing with FTC claims. Section 50(9) deals with the situation where no FTC has been claimed previously (i.e. a "fresh" claim) whereas section 50(10) deals with adjusting the amount of FTC previously granted due to a subsequent adjustment to the amount of tax payable in Hong Kong or elsewhere. (Refer to paragraphs 137 and 138 of DIPN 44).

Subsequent adjustment made by a DTA state

There is a possibility that an FTC claim could fall outside the time limit given under section 50(9), resulting in a double taxation, if no FTC claim has been made previously and a profits reallocation (PR) adjustment on a previous assessment is made subsequently by the tax authority of another DTA state.

For example, suppose a Hong Kong company was subject to profits tax in Hong Kong in a given year of assessment and, originally, no profit was subject to tax in the other DTA state for that year. Subsequently, a PR adjustment is made in the other DTA state two years after that year of assessment, and the Hong Kong company seeks to claim an FTC on the tax paid in the other DTA state.

Although a PR adjustment has been made, it would appear that a claim under section 50(10) could not be made as this provision states: *"the amount of a credit given ...rendered insufficient by reason of any adjustment"*. In this case, no claim for FTC was made previously. It would instead seem that a "fresh" claim for FTC would need to be made under section 50(9). Claiming an FTC in such situation could be technically "time-barred" as section 50(9) provides *"Any claim for an allowance by way of credit shall be made not later than 2 years after the end of the year of assessment, and in the event of any dispute as to the amount allowable the claim shall be subject to objection and appeal in like manner as an assessment"*.

The Institute would like the IRD to clarify its position in the above situation:

- (i) Would the IRD consider that, for example, there was an “error or omission” in the tax return previously submitted?

Mrs Chu said that at the time when the tax return was filed, tax credit was not due. Accordingly, it could not be said that there was “error or omission” in the tax return previously submitted.

- (ii) If yes, how would section 50(9) interact with section 70A in terms of the time limit of lodging a subsequent FTC claim?

In view of the answer in (i) above, Mrs Chu said that the Institute’s concern would not arise.

- (iii) If no, what double tax relief would be available for the taxpayer?

Mrs Chu advised that according to the OECD 2008 Commentary on “Timing mismatch” (paragraph 32.8 at page 268), the OECD Model text on methods for elimination of double taxation required that relief be granted where an item of income **may be taxed** by the State of source in accordance with the provisions of the CDTA. It followed that such relief must be provided regardless of when the tax was levied by the State of source. Where States linked the relief of double taxation that they gave under the CDTA to what was provided under their domestic laws (as was the case of Hong Kong), OECD considered that these States would be expected to seek other ways (the mutual agreement procedure, for example) to relieve the double taxation which might otherwise arise in cases where the State of source levied tax in an earlier or later year. Therefore, the taxpayer may bring up the matter to the IRD, in case relief was not available under section 50(9), for consideration of MAP or other appropriate relief measures.

CIR added that the IRD agreed with the spirit of the OECD that double tax relief should always be given whenever possible. However, he would further add that so long as the taxpayer was aware of the likelihood of adjustments being made by other states, he should lodge the application to the IRD as soon as possible.

Failure to lodge a FTC before the time limit specified in section 50(9)

In cases where a taxpayer’s profits have been subject to tax both in Hong Kong and in another DTA state in a given year of assessment (i.e. there is no subsequent PR adjustment) but the taxpayer fails to lodge an FTC claim in that year within the time limit specified under section 50(9), the Institute would like the IRD to clarify its position in the above situation:

- (iv) Would this be considered as an omission under section 70A? In such cases, is there any means by which a taxpayer could still make a claim for an FTC, e.g., lodge a section 70A claim to reopen the assessment concerned and then submit an FTC claim two years after the end of that year of assessment?

Mrs Chu advised that section 70A did not apply to any claim for tax credit which had been specifically dealt with under sections 50(9) and (10). Further, under section 70A, an assessor could only correct the "assessment" but not the amount of "tax" payable. Therefore the assessor was unable to give effect to a tax credit by invoking section 70A.

(v) If no, is there any alternative way for the taxpayer to obtain relief for double taxation?

Mrs Chu advised that same answer as per (iii) above applied here. In addition, the taxpayer would be required to explain why it had failed to lodge the FTC claim in time.

(c) Mutual Agreement Procedure ("MAP")

Article 23 of the DTA between Hong Kong and Mainland ("HK-Mainland DTA"), as well as other DTAs that Hong Kong has concluded, provides the MAP for taxpayers to try to resolve situations where taxpayers are not treated in accordance with the provisions of the DTA.

The Institute would like to understand the circumstances under which the IRD will consider a case of MAP initiated by a taxpayer as justifiable and would like the IRD to advise the proper procedure/ channel for taxpayers to request for MAP when necessary. Given that DIPN 45 has set out in paragraph 64 a list of actions that the Commissioner is unlikely to consider as sufficient to justify initiating a MAP, could the IRD:

(i) provide examples where MAP would be justified, and

Mr Wong provided the following examples of cases where it was possible to request MAP:

- a. cases in which a Hong Kong company has been subjected to or will be subject to (must be reasonable based on facts) transfer pricing and profits reallocation adjustments in a treaty partner state regarding transactions between the Hong Kong company and its foreign related person;
- b. (other than transfer pricing and profits reallocation adjustment cases) dual-resident cases to determine the jurisdiction of which an individual is deemed to be a resident;
- c. cases where an individual, who has right of abode in Hong Kong but is a resident of a treaty state, is subjected in that state to taxation treatment which is discriminatory under the provisions of the Article on non-discrimination.

Mr Wong advised that the procedures and channel for MAP would be worked out and announced in due course.

(ii) share its views on whether the initiation of MAP would be justifiable in the following examples where a Hong Kong taxpayer is not treated in accordance with the provisions of the HK-Mainland DTA:

- A “12-month holding period” requirement is imposed unilaterally by the Mainland for Hong Kong tax residents wishing to enjoy the reduced treaty rate on dividends under the DTA.
- A permanent establishment (“PE”) of the taxpayer in the Mainland is subject to the Mainland corporate income tax based on a deemed profit rate in accordance with the Chinese domestic law whereas the IRD only excludes the actual profits attributable to the PE that is considered offshore, resulting from a double taxation.
- Bonus received by a Hong Kong resident individual who exercises his Hong Kong employment partly in Hong Kong and partly in the Mainland is subject to the Mainland individual income tax in full but only a partial FTC can be claimed for Hong Kong salaries tax purpose.

Mr Wong said as advised in paragraphs 64 and 65 of DIPN 45, the issue relating to an interpretation of the tax laws of the Mainland tax authority or raised by a ruling or policy of the Mainland was of general application and was not related to any particular taxpayer. A taxpayer should not base on any such ruling or policy to request the MAP.

Ms Macpherson noted and asked that if a taxpayer under any one of the above situations could initiate MAP. CIR replied that given the situations concerned involved the interpretation of the Mainland domestic law or the anti-avoidance law, they were not the issues for MAP.

- (iii) In the event that the IRD do not consider some or any of the above situations to warrant initiating a MAP, would the IRD indicate what other action could be taken to resolve the problems identified.

Whilst the answer to (ii) above explained why a request for MAP would not be appropriate in the captioned situations, a taxpayer, as a person affected by the application of the Mainland tax law against it, could consider pursuing remedies available under the applicable law.

(d) Discussion with the State Administration of Taxation (“SAT”)

The Institute would like to request the IRD's views on the following issues and request the IRD to raise the issues for discussion with SAT to improve clarity for taxpayers seeking benefits under the HK-Mainland DTA:

(i) Update of discussion with SAT

The Institute would also like to ask the IRD to provide an update of its discussion with the SAT on various cross border issues between the Mainland and Hong Kong, including matters relating to the DTA.

CIR advised that the following issues were discussed with SAT:

- a. Certificate of resident status – It had been clarified with SAT that the existing administrative procedures adopted between the Mainland and Hong Kong would continue to apply even after the issue of Guoshuifa [2009] No.124 (“Circular No. 124”), which was clearly stated in Article 44 of Circular No. 124. The SAT agreed to reinforce the dissemination of the current administrative procedures to local tax authorities. Nevertheless, Circular No.124 also included other procedures not covered by the current administrative procedures, such as prior approval for treaty benefits and prior registration requirements etc., and these procedures would then be applicable to the DTA between the Mainland and Hong Kong. One point to note regarding the completion of the forms for record or for approval of “Non-resident’s claim for treatment under Double Taxation Agreement” (i.e. Annex 1 & 2 to Circular No. 124): SAT had agreed to accept a resident certificate in lieu of the chop or stamp by the IRD on the forms.

It was also noted that some companies incorporated in Hong Kong were requested by the Mainland local tax authorities to provide the Certificate of Resident Status even after submission of their Certification of Incorporation. The SAT advised that local tax authorities would only make the request in case of doubt.

Hong Kong raised the point that sometimes local tax authorities did not provide Referral Letters to the taxpayers despite repeated requests. Hong Kong would therefore consider to issue the resident certificates in the absence of Referral Letters in exceptional justifiable cases.

- b. Beneficial ownership – In October 2009, the SAT issued Guoshuihan [2009] No. 601 (“Circular No. 601”) on the interpretation of beneficial ownership in the implementation of DTA provisions. The circular applied not only to the Hong Kong DTA but to other DTAs as well. The SAT might, in the light of experience on the implementation of the Circular, consider to amend and fine-tune the Circular at a later stage.
- c. Anti-avoidance rules – The recent tax cases on capital gains happened in Chongqing and Xinjiang were discussed. The SAT understood Hong Kong’s concern and confirmed that currently local tax authorities had to seek approval before applying the anti-avoidance rules under Article 47 of the Corporate Income Tax (“CIT”) Law. The approval procedures had been centralised under the scrutiny of the SAT.
- d. Treaty withholding rate on dividends – According to Article 3 of Guoshuihan [2009] No. 81 (“Circular No. 81”), a non-resident investor had to hold the shares of a Mainland company for a continuous period of 12 months before the outbound dividends could be eligible for treaty benefits. This requirement, however, was not stipulated in the DTA between the Mainland and Hong Kong. The SAT said that as the circular applied to all treaty partners, it would not be appropriate to change it for the time being. The SAT might consider the IRD’s request for exemption of the 12-month look back period some time later.

Other issues discussed:

- e. Joint seminar on transfer pricing – the IRD and the SAT would jointly host a seminar in the first half of 2010 on the issue of transfer pricing and reference would also be made to Guoshuifa [2009] No. 2 on transfer pricing guidelines.
- f. 183 days rule regarding employment income – The SAT considered that the 183 days rule was an international standard and there was no strong impending reason for any amendment.
- g. Source of rental income – According to Article 7 of the Implementation Regulations of the CIT Law, the source of any rental income was located at the place where the payer was situated. The SAT confirmed that the provisions on source of rental income provided in Article 6 of the DTA overrode the domestic law.
- h. Business Tax – Under the current Business Tax regulation, a non-resident service provider providing services to a Mainland company had to pay Business Tax in the Mainland. The SAT confirmed that the exemption provisions stated in Articles 3 and 4 of Caishui [2009] No. 111 were applicable to Hong Kong residents.

(ii) Different taxation basis for individual income tax

In practice, the Mainland and Hong Kong authorities have a different view on the appropriate basis of taxation in some cases. This discrepancy is not consistent with the purpose of the DTA and cannot prevent a person/enterprise from suffering double taxation in the Mainland and Hong Kong.

The discrepancy can be summarised as follows:

- In Hong Kong, it is the IRD's practice to scale down a taxpayer's personal income by reference to his number of days in and outside Hong Kong for salaries tax purpose. On the other hand, in the Mainland the taxpayer's individual income tax ("IIT") is computed based on his gross income (thereby attracting the higher marginal tax rates) and then time apportioned to arrive at the tax payable.
- For Hong Kong salaries tax purpose, the IRD excludes part of a taxpayer's bonus by reference to his corresponding number of days in the Mainland during the period which his services are rendered. On the other hand, for IIT purpose, the taxpayer's bonus is fully subject to tax without any time apportionment in the Mainland.

Mr Wong said the DTA between the Mainland and Hong Kong had clearly defined the taxing rights of the two contracting parties. As a result, for a Hong Kong employee who was required to work in the Mainland, his chance of being double taxed in the Mainland had been greatly reduced. The example of double taxation mentioned above was mainly caused by the Mainland domestic tax law and its own way of tax computation. In this respect, the IRD wished to point out that each contracting party under a CDTA reserved the right to apply and enforce its own domestic tax laws and the other party would fully respect such course of action. In certain circumstances such as the first

discrepancy mentioned above, it might be advisable and more beneficial for that Hong Kong employee to apply section 8(1A)(c) exemption under the IRO.

(iii) Application of "substance over form" for eligibility of treaty benefits

The SAT issued another circular Guoshuifa [2009] No. 124 ("Circular No. 124") on 24 August 2009, setting out certain administrative measures on non-residents taking advantage of benefits of tax treaties that the Mainland has entered into with other jurisdictions (covering HK-Mainland DTA). Circular No. 124 specifies detailed requirements and procedures when determining whether a non-resident is eligible for treaty benefits. Taxpayers are now required to disclose more information than previously, in particular the disclosure requirements on a non-resident enterprise's operations in other contracting countries and other shareholders' residency status. It appears that the SAT is now placing more emphasis on "substance over form" in the assessment of whether a person is eligible for the relevant tax treaty benefits.

For a company that is incorporated but has no or very limited business operations in Hong Kong, though it qualifies as a Hong Kong resident under the provision of HK-Mainland DTA, it may have difficulties in meeting the stringent requirements specified in Circular No. 124.

The Institute would like to know the impact of circular 124 on Hong Kong resident companies in general and in particular on those who qualify by virtue of being incorporated in Hong Kong but which have no or only minimal activities in Hong Kong, for example, a Hong Kong incorporated company that is effectively centrally controlled and managed in another jurisdiction that has its own DTA with the Mainland:

- In this situation, would the IRD share its views as to which treaty should apply, i.e., the HK-Mainland DTA or the DTA between the Mainland and the jurisdiction where the Hong Kong incorporated company is effectively centrally managed and controlled (or is a resident)?

Mr Wong said the IRD would deal with certification based on the provisions of the HK-Mainland DTA. In other words, a company that was incorporated in HK would be issued with a Certificate of Hong Kong Resident Status.

Mr Wong advised, however, that it was understood that many countries were concerned about "treaty shopping" whereby a person not intended to be eligible for the benefits of a DTA enjoyed the relevant benefits by taking specific transactions or arrangements. Accordingly, those countries may implement rules to counteract the abusive use of tax treaties. The OECD considered that these rules did not conflict with the provisions of tax treaties. Yet, the OECD reminded member countries to carefully observe the specific obligations enshrined in tax treaties to relieve double taxation as long as there was no clear evidence that the treaties were being abused.

Mr Wong commented that Circular No. 124 applied to all DTAs concluded by the Mainland of China. Though the non-resident was required to disclose more information on its operation in its home country/territory, Circular No. 124 had not specified that substance would preside over form in determining whether the non-resident was eligible for the benefits under the relevant DTA. Where a HK resident company, being a

HK-registered company but centrally managed and controlled elsewhere, had been denied the benefits under the HK-Mainland DTA and was of the view that there was no abusive use of the HK-Mainland DTA through being a HK resident, it may raise the matter with the Mainland Tax Authorities.

- If the jurisdiction where the Hong Kong incorporated company is effectively managed or controlled does not have a tax treaty with the Mainland, in the IRD's view can the Hong Kong incorporated company make use of the HK-Mainland DTA?

Mr Wong said given the views expressed in the commentaries of the OECD Model Tax Convention, the denial of DTA benefits to the resident of a DTA partner based on the "substance over form" principle did not conflict with the provisions of a DTA. Therefore, if a HK-resident company was denied the benefits under the HK-Mainland DTA (for the aforesaid reasons) and there was no DTA between Mainland and its "home" country, there was simply no applicable DTA for that company. Anyway, if a person who held a Certificate of HK Resident Status was not accorded with the benefits under the HK-Mainland DTA in the Mainland, it could clarify with the Mainland Tax Authorities the basis of such decision.

(iv) Interpretation of "beneficial owners" for articles on dividend, interest and royalties

In another circular, Guoshuihan [2009] No. 601 ("Circular No. 601"), the SAT has set out guidelines on the interpretation of "beneficial owners" for the purposes of the dividend, interest and royalties articles of the Mainland's DTAs (including HK-Mainland DTA).

The Institute would like the IRD to share its views on the impact of the requirements specified in Circular No. 601 on Hong Kong resident companies, in particular on their receipt of dividends from the Mainland companies under the HK-Mainland DTA. Would the IRD revise DIPN 44 to reflect the views and position of the IRD in relation to the impact of the aforesaid tax circulars issued by the SAT on the HK-Mainland DTA?

Mr Wong said that Circular No. 601 applied to all the DTAs concluded by the Mainland. As mentioned earlier, the IRD had already discussed the issue with the SAT. The SAT might, in the light of experience on the implementation of the Circular, considered to amend and fine-tune the Circular at a later stage. DIPNs only reflected the IRD's views and the IRD did not consider it appropriate for DIPNs to include any comments on circulars issued by the SAT.

Agenda Items A5 - Departmental Policy and Administrative Matters

(a) Advance ruling

The Institute is aware that, in some cases, taxpayers' advance ruling applications are rejected by the IRD without prior notice or explanation. In this regard, the Institute would

like to seek the IRD's clarification on the circumstances in which the IRD will decline to make a ruling.

Mr Chiu advised that the IRD may decline to make a ruling in the circumstances set out in section 2 of Part I of Schedule 10 to the IRO. The circumstances included:

- a. CIR is required to determine or establish any question of fact;
- b. CIR considers that the correctness of the ruling would depend on the making of assumptions;
- c. the matter on which a ruling is sought is subject to an objection or appeal; or
- d. the matter is the subject of a return due to be lodged.

Mr Chiu said despite not specifically stipulated in the provisions in Part I of Schedule 10, the IRD would generally decline to make a ruling in the following circumstances [see paragraph 9 of DIPN 31]:

- a. the matter is the same in character as a completed transaction entered into by the applicant in an earlier year and the tax effect of that earlier transaction is the subject of discussion with the applicant or is subject to an objection or appeal, whether in relation to the applicant or any other person;
- b. the central issue concerns a matter that is before a board, a tribunal or the courts or, if a judgment has been issued, an appeal is under consideration;
- c. the request contains alternative courses of action on the part of the applicant;
- d. the matter is primarily one of fact and the circumstances are such that all the pertinent facts cannot be established at the time of the request for the ruling;
- e. the ruling requires an opinion as to generally accepted accounting principles or commercial practices; or
- f. the issue involves the interpretation of a foreign law.

In addition, the CIR shall not make a ruling pursuant to section 3 of Part I of Schedule 10 if:

- a. he considers that the arrangement is not seriously contemplated;
- b. the application is frivolous or vexatious;
- c. he is undertaking an audit on how any provision of the IRO applies to the applicant, or to an arrangement similar to the arrangement which is the subject of the application;
- d. he considers that the applicant has not provided sufficient information; or
- e. he considers that it would be unreasonable to make a ruling in view of the resources available.

Further, the Institute would like to know the basis for declining to rule in these cases and to ask if the IRD would consider providing applicants whose applications are declined with the reason(s) for this.

Mr Chiu explained that advance rulings were primarily provided as a service to taxpayers and the IRD would be accommodating to the requests for advance ruling unless they fell within the circumstances outlined above.

Mr Chiu further advised that when the IRD rejected advance ruling applications, it would always give the reasons although not legally obliged to do so. Prior notice of rejection, on the other hand, would generally not be given.

Ms Macpherson noted that, in some cases, the IRD would raise enquiries to ask for supplementary information which taxpayers might have overlooked. CIR said in the generality of cases, the IRD would be accommodating to the requests of taxpayers and would ask for supplementary information.

Ms Macpherson mentioned that some applications were rejected on the ground that they were not seriously contemplated. She was of the view that taxpayers preferred certainty or else they would not apply for a ruling. They could be deciding whether to bring business to Hong Kong and or want to know how best to structure the business to achieve tax efficiency. CIR indicated that the taxpayer should show that some practical steps had already been taken. Mr Wong said that the IRD had come across cases in which the applicants were simply testing the IRD's bottom line and revised their applications to achieve a favourable ruling.

(b) Estimated assessments under section 59(3)

The Institute understands there are cases where assessments have been issued under section 59(3) without issuing a tax return and the argument put forward for such practice is that neither section 59(1) nor section 59(3) requires an issuance of a tax return before an assessor can raise an estimated assessment.

Section 59(1) states that "Every person who is in the opinion of an assessor chargeable with tax under this Ordinance shall be assessed by him as soon as may be after the expiration of the time limited by the notice requiring him to furnish a return under section 51(1)" whereas the proviso in section 59(1) states that "Provided that the assessor may assess any person at any time if he is of opinion that such person is ..., or that for any other reason it is expedient to do so".

Section 59(3) states that "Where a person has not furnished a return and the assessor is of the opinion that such person is chargeable with tax, he may estimate the sum in respect of which such person is chargeable to tax and make an assessment accordingly ...".

The arguments put forward by the IRD are that (1) the proviso in section 59(1) itself does not include any conditions requiring a return to be issued in the first place and (2) the condition mentioned in section 59(3), i.e. "where a person has not furnished a return", is not confined to the situation where a return is issued but not furnished by the taxpayer. As such, section 59(3) is also applicable to a situation where a return is not issued at all.

The Institute would like to clarify the position of the IRD on such practice, in particular, the IRD's view on:

- (i) whether the proviso of section 59(1) should be read in conjunction with the main body of the section, which includes the conditions that a notice requiring a person to furnish a return be issued in the first place and the time limited by such notice to furnish the return has expired; and

Mrs Chu advised that the IRD's view was that had the legislature intended to make the issue of a return a specific requirement for the use of the proviso, it would have said so expressly in the proviso. The true meaning of the proviso was to empower the assessor to issue an assessment at any time, even though no return had been issued or, where a return had been issued, at any time before the due date of the return, provided that one of the conditions in the proviso was satisfied. CIR added that an affirmative advice from the Department of Justice in this regard had been sought.

Mr Lee asked whether a return would normally be issued with an estimated assessment. Mrs Chu said that a return might not automatically be issued, for example in the case of a visiting artist, but if the taxpayer wished to object to the assessment, a return could be issued. Mr Lee remarked that a valid objection by the taxpayer could not be lodged under section 64 against an estimated assessment under section 59(3) if the taxpayer did not have a return to submit in support of the objection. Since it was understood that a taxpayer did not have the right to ask for the issue of a tax return, if a section 59(3) assessment could be issued without a return, in theory, a taxpayer might be unable to object to that assessment. The legislature might have made a drafting error if a tax return was not required to be issued in estimated assessment cases. CIR replied that the IRD would issue a tax return should the taxpayer object to an estimated assessment.

- (ii) whether the phrase "where a person has not furnished a return" in section 59(3) implies that a return has to be issued in the first place as practically, a person cannot furnish a return if no such return is issued by the IRD to that person.

Mrs Chu advised that under section 51(2), a person has the obligation to inform the IRD of his chargeability within 4 months after the end of the basis period. If the person deliberately chose not to inform chargeability and section 59(3) was construed to restrict to situations whereby a return had been issued to the taxpayer, it would defeat the assessment and collection mechanism and would lead to a loss of tax revenue.

(c) Acceptable accounts in support of a profits tax return of a foreign company

With reference to A4(b) of the 2006 minutes, the Institute would like the IRD to clarify whether the position remains the same, that branch accounts prepared according to the accepted accounting standards of another jurisdiction are acceptable as the basis for the branch's Hong Kong profits tax return.

Miss Ng advised that the position of the IRD as set out in paragraph 19 of DIPN 40 remained the same. Strictly speaking, financial statements should be prepared in accordance with the standards prescribed by the Institute. However, it was recognised that the accounts of foreign companies (and the branches of such companies) which were carrying on business in Hong Kong might be prepared on the basis of standards which varied from those in Hong Kong. In such a case, the IRD would generally accept accounting treatment which was:

- a. in accordance with the relevant accounting standard of the home jurisdiction or IAS/IFRS;
- b. consistent with the true facts or otherwise apt to determine the true profits or losses of the business; and
- c. consistent with the relevant provisions of the IRO.

CIR said the essence was that the different accounting treatment adopted would enable the true profits or losses of the business to be determined. Where the account of a Hong Kong branch of a foreign company did not disclose its true profits, its tax liability would be computed in accordance with Rule 5(2)(b) to (d) of the Inland Revenue Rules.

Ms Macpherson suggested that point (c) was unclear, as even IFRS might not always be consistent with the provisions of the IRO, such as in relation to the treatment of depreciation. After further discussion, it was agreed that item (c) was not required and would be deleted from the above list.

[Post-meeting note: The IRD wishes to point out that although the accounting treatment of a foreign jurisdiction might be accepted under the above-mentioned circumstances, the accounting profits or losses would have to be adjusted in accordance with the provisions of the IRO and the established taxation principles. A note will therefore be added to the DIPN for the sake of completeness.]

(d) Filing process of salaries tax return

Practitioners suggest that there is often a delay for the IRD to issue the first salaries tax return after the employer has filed the first employer's return for its employee. The Institute would like to ask if the IRD would accept the completion of a "generic" salaries tax return (not the original issued by the IRD) as a valid return, or if the IRD has any other suggestion to accelerate the filing process.

Mr Chiu explained that if the employee had already had a file in the IRD and was chargeable to salaries tax, he would continue to receive a return in May of the year.

Mr Chiu further said that employer's returns issued in April should be submitted by employers within one month. The IRD would process them from May to July. Notification of chargeability to salaries tax should also be given by an employee to the IRD within 4 months after the end of the year, i.e. end of July, as required under section 51(2). A return would then be issued to the employee if he was found to be chargeable to salaries tax.

If an employer had followed the requirement in section 52(4) to give notification (IR 56E) to the IRD within 3 months of commencement of an employee, the IRD would also consider the issue of a provisional tax return to the employee after receipt of the notice and the raising of a provisional salaries tax assessment on the employee. If a file had been opened upon issue of the provisional return, the employee would receive his return in May the year after.

As a matter of practice, the IRD's responses to the notifications of employees or employer included: the issue of a return for provisional or final tax to the employee if he was liable to salaries tax; the issue of a reply to the employee advising that a return would be issued to him in the next annual bulk issue if the date of notification was close to the bulk issue date; or the issue of a reply to the employee advising that a tax return would not be issued to him as he was not liable to tax.

If it was a non-taxable case, a reply would be made by the IRD within 21 days after receiving notifications from employees. If it was a taxable case and the notification was received during April to November, a tax return would be issued within 3 months. If it was a taxable case and the notification was received during December to March, a tax return would be issued within 5 months. Other than the bulk issue of tax returns, the IRD arranged about 7 mini bulk issues of tax returns throughout a year of assessment.

Under section 51AA, a return for the purpose of section 51(1) must be a printed form specified by the Board of Inland Revenue or an electronic record that fulfilled certain conditions. A "generic" return would not satisfy the statutory requirement.

CIR added that an IR 56E should be filed by an employer as early as possible.

(e) Electronic profits tax returns

The Institute would like to enquire about the status of electronic profits tax returns.

Miss Ng advised that the IRD would implement the electronic filing [e-filing] of profits tax returns by corporations and partnerships on 1 April 2010.

The Board of Inland Revenue had, under section 51AA(2) of IRO, approved the tax return to be furnished in the form of an electronic record. The notice under section 51AA(5) and (6) of the IRO specifying profits tax returns that could be electronically filed and the manner of e-filing was expected to be gazetted in mid February 2010.

Miss Ng said that in the process of designing the e-filing system, three accountancy bodies including the Institute had been consulted in August 2009 and their views had been taken on board as far as possible. Publicity of this new electronic service would commence in March 2010 and two training seminars for tax practitioners would be held on 23 March 2010.

Taking this opportunity, the IRD would be much obliged if members of the Institute could encourage their eligible clients to make use of this new means of submission of returns. Miss Ng believed that this new service should be beneficial to both taxpayers and the IRD.

Ms Macpherson took the opportunity to ask the requirements for submission of financial statements and the measures adopted in the preservation of privacy under the e-filing of profits tax returns. Mr Wong advised that under the first phase of the e-filing project, corporations or partnerships with gross income of less than two millions which satisfied certain criteria could file their profits tax returns electronically, and there was no requirement for the submission of financial statements. One of the criteria was that the corporation or the partnership should not have made royalty payments because, if it had made such payments, it would have to file separate schedules showing particulars of the recipients. Mr Wong further explained that tax representatives could prepare the tax returns for their clients but, the returns had to be filed by the company's officers through their personal eTAX account. Taxpayers could open an eTAX account using a PIN and password and an e-certificate was not required. If tax representatives' email address were provided in the electronic returns, they would be notified by way of an email when their client had filed the returns. As a security measure, tax returns could only be retrieved for viewing by the sender within one month after filing.

(f) Lodgment of tax returns and filing deadlines for 2009/2010

The Institute would be interested to know the latest statistics on the filing of tax returns and the filing deadlines for 2009/2010.

Miss Ng advised that, as shown in Table 1 of Appendix A, the IRD issued more returns in the 2008/09 bulk issue exercise than the previous years. Table 2 showed the filing position for the files under different accounting codes. Table 3 showed the progressive filing results. The overall lodgment rate for the “M” code returns by the deadline improved but that for the “D” code returns was 3% lower than that of last year. Miss Ng urged tax representatives to further improve their performance. Table 4 was a comparative analysis of compliance with the block extension scheme.

Bulk Issue of 2009/10 Profits Tax Returns

The bulk issue of 2009/10 Profits Tax Returns for “active” files would be made on 1 April 2010. The extended due dates for filing 2009/10 Profits Tax Returns would be:

<u>Accounting Date Code</u>	<u>Extended Due Date</u>
“N” code	3 May 2010 (no extension)
“D” code	16 August 2010 (no change)
“M” code	15 November 2010 (no change)
“M” code – current year loss cases	31 January 2011 (no change)

The Department would launch the service for e-filing of profits tax returns in April 2010. To promote the service, an additional extension of 2 weeks would be granted upon application on the ground that the return would be sent through the Internet. The extended due dates for filing the returns under the bulk issue would be:

<u>Accounting Date Code</u>	<u>Further Extended Due Date if opting for e-filing</u>
“N” code	17 May 2010
“D” code	30 August 2010
“M” code	29 November 2010
“M” code – current year loss cases	31 January 2011 (same as paper returns)

PART B - MATTERS RAISED BY THE IRD

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

Mrs Lai 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 2009. Comparative figures for the years 2007 and 2008 were included.

Mrs Lai pointed out that the Field Audit teams uncovered discrepancies in 229 corporation cases, of which 189 carried clean auditors' reports. Amount of discrepancies detected in the clean report cases account for 94% (90% for 2008) of the total discrepancies detected in corporation cases completed during the year and total tax of \$398 million was recovered from these cases. Average understatement per clean report case is \$13.5 million (2008: \$16.7 million) while tax undercharged per clean report case is \$2.1 million (2008: \$2.6 million).

Mrs Lai advised that discrepancies resulted mainly from understatement of gross profits and over-claim of expenses. In the majority of cases, the discrepancies were detected after examining the business ledgers and source documents.

Agenda Item B2 – Incorrect Classification of Plant and Machinery

CIR said the IRD noticed that in a number of cases plant and machinery which had been injected into the foreign investment enterprises in the Mainland as equity contribution were recorded in the balance sheets of the Hong Kong companies as assets owned by them instead of investment in subsidiaries. Furthermore, depreciation allowances were claimed. The amounts of capital expenditure were quite substantial. CIR wished to remind the auditors and tax representatives that such classification was not acceptable and penal actions in appropriate cases would be instituted.

Agenda Item B3 – Date of Next Annual Meeting

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

Lodgement of Corporations and Partnerships Profits Tax Returns

Table 1**Lodgement Comparison from 2006/07 to 2008/09**

	<u>Y/A</u> <u>2006/07</u>	<u>Y/A</u> <u>2007/08</u>	<u>Y/A</u> <u>2008/09</u>	Comparison 2007/08 and <u>2008/09</u>
1. Bulk issue (on 1 April)	149,000	155,000	158,000	2%
2. Cases with a failure to file by due date:-				
'N' Code	1,700	1,900	1,600	-16%
'D' Code	5,200	4,600	4,900	7%
'M' Code	<u>10,000</u>	<u>10,600</u>	<u>8,300</u>	-22%
	16,900	17,100	14,800	-13%
3. Compound offers issued	6,700	7,200	5,400	-25%
4. Estimated assessments issued	6,800	6,550	5,800	-11%

Table 2**2008/09 Detailed Profits Tax Returns Statistics**

	<u>'N'</u>	<u>'D'</u>	<u>'M'</u>	<u>Total</u>
Total returns issued	17,000	47,000	94,000	158,000
Failure to file on time	1,600	4,900	8,300	14,800
Compound offers issued	600	2,000	2,800	5,400
Estimated assessments issued	600	2,000	3,200	5,800

Table 3
Represented Profits Tax Returns - Lodgement Patterns

<u>Code</u>	<u>Lodgement Standard</u>	<u>Actual Performance</u>	
		<u>2008/09 PTRs</u>	<u>2007/08 PTRs</u>
D - 15 August	100%	82% ⁽¹⁾	85%
M - 31 August	25%	12%	10%
M - 30 September	55%	18%	15%
M - 31 October	80%	36%	30%
M - 16 November	100%	83% ⁽²⁾	75%

(1) 34% lodged within a few days around 15 August 2009 (17% lodged within a few days around 25 August 2008 for 2007/08 PTRs)

(2) 32% lodged within a few days around 16 November 2009 (20% lodged within a few days around 15 November 2008 for 2007/08 PTRs)

Table 4
Tax Representatives with Lodgement Rate of less than 83% of 'M' code Returns as at 16.11.2009

1,560 T/Rs have 'M' Code clients. Of these, 723 firms were below the average performance rate of 83%. An analysis of the firms, based on size, is:-

	<u>Current Year Performance</u>					<u>Last Year Performance</u>			
	<u>No. of clients per firm</u>	<u>Total No. of firms</u>	<u>No. of firms below the average of 83%</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 75%</u>	<u>No. of non-compliance cases</u>	<u>% of total non-compliance cases</u>
Small size firms	100 or less	1,422	669	4,637	71%	1,437	689	6,697	69%
Medium size firms	101 - 300	126	52	1,798	27%	129	65	2,862	30%
Large size firms	over 300	12	2	143	2%	12	1	102	1%
		<u>1,560</u>	<u>723</u>	<u>6,578</u>	<u>100%</u>	<u>1,578</u>	<u>755</u>	<u>9,661</u>	<u>100%</u>

Analysis of Completed FA Corporation Cases for the years ended 31 December 2007, 2008 and 2009

Auditor's Report = Unqualified	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Sales omitted	22	40	37	18,704,524	75,797,914	26,238,198	3,068,088	10,863,854	4,491,152
Purchases overstated	12	17	12	22,921,812	11,047,506	12,596,287	4,052,183	1,631,212	2,272,691
Closing stock understated	3	1	1	461,730	214,598	(6,470,216)	74,531	37,555	0
Gross profit understated	31	25	31	100,563,642	147,112,439	108,782,698	16,630,189	27,248,129	17,872,130
Expenses over-claimed	69	64	51	56,692,872	94,006,902	66,310,819	7,731,967	15,940,550	10,744,485
Technical adjustments	56	56	53	51,475,474	55,908,670	23,543,334	7,445,844	7,726,461	3,792,798
Other	69	65	76	221,464,746	273,089,387	301,702,922	38,251,710	41,771,901	49,258,521
TOTAL	262*	268*	261*	\$472,284,800	\$657,177,416	\$532,704,042	\$77,254,512	\$105,219,662	\$88,431,777
TOTAL NUMBER OF CASES	191*	211*	189*						
AVERAGE AMOUNT PER CASE				\$2,472,695	\$3,114,585	\$2,818,540	\$404,474	\$498,671	\$467,893
	* in one case there may be more than one type of discrepancy								
				Total Discrepancy for All Years			Total Tax Undercharged for All Years		
				2007	2008	2009	2007	2008	2009
Other statistics for the above cases: TOTAL AMOUNT				\$1,879,586,776	\$3,539,825,437	\$2,551,595,640	\$300,156,626	\$568,792,154	\$398,570,394
AVERAGE AMOUNT PER CASE				\$9,840,768	\$16,776,424	\$13,500,506	\$1,571,501	\$2,695,697	\$2,108,838

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Auditor's Report = Qualified	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Sales omitted	5	12	10	7,146,452	18,884,194	14,273,262	626,835	2,908,348	2,479,177
Purchases overstated	1	2	0	80,000	1,930,409	0	14,000	337,822	0
Closing stock understated	1	1	1	180,569	765,579	139,932	0	74,512	24,488
Gross profit understated	12	11	8	29,580,017	23,037,758	5,290,375	5,170,139	2,924,905	653,385
Expenses over-claimed	13	15	8	28,263,941	20,131,037	3,214,532	3,865,639	2,972,730	582,712
Technical adjustments	10	13	19	6,765,869	8,805,578	9,633,270	1,119,247	666,972	1,591,641
Other	15	14	13	26,844,036	26,529,348	2,299,723	3,511,863	4,206,258	294,497
TOTAL	57*	68*	59*	\$98,860,884	\$100,083,903	\$34,851,094	\$14,307,723	\$14,091,547	\$5,625,900
TOTAL NUMBER OF CASES	41*	47*	40*						
AVERAGE AMOUNT PER CASE				\$2,411,241	\$2,129,445	\$871,277	\$348,969	\$299,820	\$140,648
	* in one case there may be more than one type of discrepancy								
				Total Discrepancy for All Years			Total Tax Undercharged for All Years		
				2007	2008	2009	2007	2008	2009
Other statistics for the above cases: TOTAL AMOUNT				\$475,624,462	\$375,857,787	\$157,641,033	\$62,333,000	\$56,382,636	\$25,628,675
AVERAGE AMOUNT PER CASE				\$11,600,597	\$7,996,974	\$3,941,026	\$1,520,317	\$1,199,631	\$640,717

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TOTAL NUMBER OF CASES 232 258 229

	Total Discrepancy for All Years			Total Tax Undercharged for All Years		
	2007	2008	2009	2007	2008	2009
Other statistics for the above cases: TOTAL AMOUNT	\$2,355,211,238	\$3,915,683,224	\$2,709,236,673	\$362,489,626	\$625,174,790	\$424,199,069
AVERAGE AMOUNT PER CASE	\$10,151,773	\$15,177,067	\$11,830,728	\$1,562,455	\$2,423,158	\$1,852,398