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

TaxB 18 November 2008

Tax Bulletin

2008

Annual Meeting

The Inland Revenue Department

and

The Hong Kong Institute of Certified Public Accountants

2008

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

Preamble

As part of the Institute's regular dialogue with the government to facilitate tax compliance, improve procedural arrangements and to clarify areas of interpretation, representatives of the Institute met the Commissioner of Inland Revenue ("CIR") and members of her staff in January 2008.

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

List of Discussion Items

PART A - MATTERS RAISED BY THE INSTITUTE

A1. Profits Tax Issues

A(1a) Share-based payment

A1(b) Operation of section 15(1)(h) of the IRO

A1(c) Determination of source of interest income from bonds purchased from the secondary market

A1(d) Interest income arising from equity-linked notes

A1(e) Impact of changing to a different GAAP

A1(f) Sale and leaseback arrangement and application of section 39E

A1(g) Industrial and commercial building allowance

A1(h) Section 51(2) of IRO

A1(i) DIPN 21 – Locality of Profits

(i) CFA judgment in the *ING Baring* case

(ii) Other queries

A2. Salaries Tax Issues

A(2a) Taxability of per diems

A3. Cross-border Tax Issues

A3(a) Apportionment of Profits

(i) Policy pending outcome of appeal in BOR case *D43/06*

(ii) Impact of *ING Baring* case

(iii) Re-opening of 50:50 apportionment cases (to follow up with the 2007 annual meeting)

A3(b) Plant and machinery (“P&M”) used in import processing

A3(c) Offshore funds tax exemption

(i) Specified transaction

(ii) Exemption status of a non-resident fund

A3(d) Offshore claims

A3(e) Cross-border service income

A4. Double Taxation Agreements

A4(a) Dual residence of a corporation under the arrangement between Hong Kong and Mainland China

A4(b) Exchange of information clause

A4(c) Update on DTAs

A5. Departmental Policy and Administrative Matters

A5(a) Signing of profits tax returns and supporting documents

A5(b) Issuance of practice notes and guidelines

(i) DIPN update

(ii) DIPN on the taxation of stock awards

(iii) Application of section 61A and transfer pricing legislation

A5(c) Field audit

A5(d) Lodgment of tax returns and filing deadlines for 2007/08

PART B - MATTERS RAISED BY IRD

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

B2. Date of Next Annual Meeting

Full Minutes

The 2007/08 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department was held on 25 January 2008 at the Inland Revenue Department.

In Attendance

Hong Kong Institute of Certified Public Accountants (the Institute)

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

Inland Revenue Department (IRD)

Mrs Alice Lau	Commissioner of Inland Revenue
Mr Chu Yam-yuen	Deputy Commissioner of Inland Revenue (Technical)
Mrs Teresa Chu	Deputy Commissioner of Inland Revenue (Operations)
Mr Chiu Kwok-kit	Assistant Commissioner of Inland Revenue
Mrs Jennifer Chan	Assistant Commissioner of Inland Revenue
Mrs Lai Chi Lai-ming	Assistant Commissioner of Inland Revenue
Mr Yim Kwok-cheong	Senior Assessor (Research)

Mrs Alice Lau (CIR) on behalf of the IRD welcomed the delegation from the Taxation Committee to the meeting. CIR expressed that the annual meeting offered a valuable opportunity for the Institute and the IRD to discuss and resolve issues of common interest. CIR said that the Institute and the IRD had been in close cooperation as reflected in the events held by the Institute's Taxation Interest Group. Communication between the Institute and the IRD should be maintained throughout the year and not be restricted to the annual meeting. Ms Law thanked CIR for holding the annual meeting with her and other members of the Taxation Committee. She said that the Institute and the IRD always had good communication. The Institute appreciated the IRD's practice of uploading comprehensive tax information to the IRD website, which kept accountancy bodies, including the Institute, updated on the current developments in Hong Kong taxation.

PART A - MATTERS RAISED BY THE INSTITUTE

Agenda Item A1 - Profits Tax Issues

A1(a) Share-based payment

When a share-based compensation was granted by a parent company, the subsidiary company would debit the "P&L" account and credit the "equity-reserve" account. Upon recharging, the subsidiary company would debit the "equity-reserve" account and credit the "payable to parent" account.

Though the amount had to go through the "equity-reserve" account, the deductibility of the share-based compensation should not be affected as long as the conditions, including the "incurred" test, under sections 16 and 17 of the Inland Revenue Ordinance ("IRO") were satisfied.

The Institute would like to know IRD's views on share-based payment transactions.

CIR said that IRD held the view that a recharge was deductible if the entity had 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 or fellow subsidiary 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.

Tax treatment of share based payment transactions has been published on IRD's website in the FAQ Section http://www.ird.gov.hk/eng/faq/sbpt.htm. The above answer would also be uploaded.

[Post-meeting note – The above answer has been uploaded to IRD's website.]

A1(b) Operation of section 15(1)(h) of the IRO

Contributions to a retirement scheme were made for the benefit of the employees and for funding the scheme. Upon winding up, distributions from the retirement scheme to the employer could be regarded to comprise contributions previously made by the employer to the scheme and investment gains from the scheme assets.

The Institute would like to know the way a distribution from a scheme on winding up was assessed under section 15(1)(h), in particular whether the distribution would first be taken as a refund of contributions previously made by the employer, with the excess or shortfall treated as investment gains or losses arising from the scheme assets.

Mr Chiu advised that section 15(1)(h) deemed sums received by or accrued to a person as an employer, by way of refunds of contributions made to a recognized occupational retirement scheme or of voluntary contributions paid to a mandatory provident fund scheme, to the extent deduction had been allowed in ascertaining his assessable profits, to be taxable. To invoke section 15(1)(h), any refund was to be allocated in order of priority as a refund of the following components –

(a) the amount of contributions made (net of any previous refund of such contributions) that had *not* been allowed for deduction, or, after the adoption of HKAS 19, the amount of contributions made (also net of any previous refund) but *not* covered by the “net total” allowed for deduction;

(b) the amount of contributions made (net of any previous refund) that had been allowed for deduction, or, after the adoption of HKAS 19, the amount of contributions made (also net of any previous refund) and covered by the “net total” allowed for deduction; and

(c) any excess of the cash refund over the aggregate amount of items (a) and (b) above.

Only item (b) was taxable under section 15(1)(h). “Net total” would normally include current service cost, interest cost, expected return and actuarial gains and losses.

CIR pointed out the broad principle that a refund would not be taxable if the corresponding contributions were not allowed for deduction. This basis of allocation represented a reasonable approach.

Dr Cho said that the “net total” might include realized investment gains which were capital in nature. Mr Chiu explained that, in such a case, the realized investment gains normally would come under item (c).

A1(c) Determination of source of interest income from bonds purchased from the secondary market

The source of interest income from bonds was determined by the place where the initial funds were received by the issuer and any subsequent transactions in the bonds would not alter the source of the interest that had been fixed by the initial offering. IRD seemed to have expressed this view in an article "*The Taxation of Interest*" published in "*The Hong Kong Accountant*" (January/ February, 1998).

The Institute would like to know whether the source of interest income from second-hand bonds should not be the place where the bonds were purchased.

> Mr Chiu explained that the source of profit was a question of fact depending on the nature of the transaction. Interest was generally taken to mean remuneration on money lent and was earned from the place where the money was lent. Subsequent transactions in the bonds would not normally alter the source of the interest income.
>
> Mr Chiu further explained that, if the taxpayer carried on the business of buying and selling bonds (i.e. trading in securities), the place where the profit generating activities took place needed to be taken into consideration and the operations test was applicable. As interest income would form part of the profits from the bond trading business, the place of acquisition of the bonds would also be taken into consideration in determining the source of such profits.
>
> Ms Chan asked, where a person was not trading in bonds, whether the source of the interest income would still be determined by applying the provision of credit test by reference to the place where the bonds were first issued. Mr Chiu confirmed that the test would continue to be applied.

A1(d) Interest income arising from equity-linked notes

Equity-linked notes were often regarded as "deposits" placed with the issuer for a fixed period of time with the return linked to the performance of a stock market index or a basket of equity securities over a pre-determined period of time. Given the broad definition of "certificate of deposit" provided in section 2 of the IRO, it seemed that equity-linked notes should be regarded as certificates of deposit for the purposes of the IRO.

The Institute would like to know how the nature of a financial instrument was determined and, if the IRD did not regard an equity-linked note as a certificate of deposit, whether the "provision of credit" test should be applied in determining the source of the interest income derived by non-financial institutions from that equity-linked note.

Mr Chiu advised that IRD's position was to decide the nature of a financial instrument according to its legal form, i.e. regard was had to the legal rights and obligations under the instrument, rather than any "label" it might bear. If the purported legal form was not consistent with the rights and obligations, it was necessary to look beyond the label. For tax purposes, the nature and locality of profit or loss of a hybrid instrument were determined on the basis that it was one single instrument. Equity-linked notes would normally be regarded as "certificates of deposits" unless there were features that suggested otherwise.

Regarding the source of the interest, the answer to item A1(c) equally applied.

Ms Macpherson asked, where equity-linked notes were regarded as "certificates of deposit", whether the related interest received by a non-financial institution would be covered by the Exemption From Profits Tax (Interest Income) Order (Cap. 112T). Mr Chiu agreed that equity-linked notes would likely constitute "certificates of deposit". He explained that it was necessary to examine the nature of the return and the terms of issue to determine whether the return was wholly made up of interest. If the return was composed wholly of interest, then Cap. 112T should apply.

Mr Wong asked whether the interest would be taxable where the recipient was trading certificates of deposit and the operations test applied. CIR replied that interest and trading profits sourced in Hong Kong from certificates of deposit would in principle be taxable under sections 14 and 15 of the IRO subject to the exemption provisions of Cap. 112T.

A1(e) Impact of changing to a different GAAP

A company might apply an accounting standard that was different from that applied in the previous year and, in so doing, move from "fair value" to "historical cost" basis of accounting. For example, where a company qualified as a Small and Medium-sized Entity ("SME") it might switch to the Small and Medium-sized Entity Financial Reporting Standard ("SME-FRS") from the HKFRS, resulting in either an increase or a decrease in retained earnings brought forward.

The Institute would like to know the tax treatment of such adjustments.

Mrs Chu advised that IRD would examine the nature of each of the adjustments to the retained earnings before making a decision. It was very difficult, if not impossible, to lay down a simple rule. The presumption was that there should not be any drop out of profits, double taxation of profits or double deduction of expenses.

A similar question was answered at the 2005 annual meeting. The answer remained correct and relevant. See paragraph A2(a)(iv) of the 2005 minutes. Generally and subject to the specific provisions of the IRO, the tax treatment was:

(a) Profits recognized in the back years upon derecognition would not be allowed for deduction as expenses in the current year because they were not expenses. If such derecognized profit had been assessed in the back years, they would not be assessed again in future when they were recognized again.

(b) Profits arising from changes in valuation method of trading stock would be assessed to profits tax in the current year following the decision in *Pearce v Woodall-Duckham Ltd* 51 TC 271.

(c) Expense items would be deductible if they satisfied the conditions in section 16 (e.g. the "incurred" test) and were not disallowable under section 17 or other statutory provisions.

(d) Back year assessments would not be reopened under section 70A because the back year returns did not contain any error or omission.

CIR explained that the above answers and those to other agenda items aimed to set out general principles rather than execution details. Whilst there could be exceptional cases, the general principles were clear and if they were properly applied, it should not be difficult to reach a consensus on implementation.

<u>A1(f) Sale and leaseback arrangement and application of section 39E</u>

A sale and leaseback agreement (the finance company paid a price not more than the price the end-user paid to the supplier) provided for the lease of the asset to the end-user who would be the sales agent for the asset at the end of the lease. 99% of the sale proceeds of the asset would be retained by the end-user as his sale commission while the finance company would only receive a nominal sum. The end-user had signed a section 39E(3) disclaimer in respect of the statutory depreciation allowances.

From an accounting point of view, as all the risks and rewards of the ownership would pass to the end-user, the asset should be classified as a financial lease asset of the end-user with the corresponding finance lease payments recognised as liabilities in the balance sheet.

Some members were of the view that the sale and leaseback agreement was a hire-purchase agreement under section 2, and the section 39E disclaimer might not be applicable. The end-user should be entitled to claim depreciation allowances whether or not the taxpayer had signed a section 39E disclaimer and whether or not the finance company might also claim depreciation allowances.

The Institute would like to know IRD's view, in particular, on the person who was entitled to claim depreciation allowances and the deductibility of the finance lease payments of the end-user.

Mr Chu advised that IRD would examine the terms of the lease, the nature of the asset, the duration of the lease, the realisable value of the asset at the end of the lease, the contractual intent, the commercial practice and the surrounding circumstances before deciding whether an arrangement fell within the meaning of the term "lease" under section 2.

Mr Chu explained that section 39E(1)(a) was a specific anti-avoidance provision. It operated to deny depreciation allowances to the owner or lessor under a sale and lease back arrangement. It did not operate to allow depreciation allowances to more than one person. Section 39E(2) provided an exception to the general rule that no initial or annual allowances would be granted to the lessor under a sale and leaseback arrangement.

Mr Chu further explained that, in the example given, it was prima facie a lease and not a hire purchase agreement because: the finance company retained the legal ownership to the asset (after acquisition from the end-user); the finance company had the right to obtain possession of the asset upon default by the end-user; and the contractual intent to transfer the ownership was absent. If the sale and leaseback arrangement satisfied the conditions in sections 39E(2) and (3), the finance company as owner would be allowed to claim depreciation allowances. Under the lease, the end-user would be entitled to claim deduction of the rental payments but not depreciation allowances.

Mr Chu said that, under the circumstances, the taxpayer could not go back on the disclaimer which had been accepted and acted upon by the IRD.

Ms Chan asked, as 99% of the sale proceeds of the asset would be retained by the end-user under the sale and leaseback agreement, whether the agreement would be accepted as a hire-purchase agreement by reference to its substance. Mr Chu replied that the conclusion would be based on facts. In the highlighted case, the agreement most probably was a lease. Mr Chiu said that in practice a person could readily enter into a straightforward hire-purchase agreement if he so wished to.

A1(g) Industrial and commercial building allowance

(i) If an industrial or commercial building more than 25 years old was acquired, no industrial or commercial building allowances under sections 33A(2) and 34(2)(b) might be claimed. For example, in the year 2007/08, a used industrial building was acquired for qualifying purposes and the year of first use was 1981/82. The residue of expenditure was to be spread over the years from the year of acquisition to the 25th year after the year of first use i.e. from 2007/08 to 2006/07, which was not a positive figure.

The Institute would like to know whether, in the above situation, IRD would grant any tax relief in respect of the purchase price paid for the used building.

> Mr Chu advised that the combined effect of sections 33A to 36 was to grant relief in respect of the capital expenditure incurred on construction within a period of not more than 25 years. If the building was scrapped before the end of this period, a balancing adjustment would be given. If the building was used for a longer life than 25 years, there was no provision for granting allowances beyond the 25 years. IRD did not have the power to grant relief not provided under the IRO.

(ii) If details of construction were not available, it is understood, per agenda item A1(e) of the 2007 annual meeting, IRD would consider taking 1/2 of the first assignment price of the building as the cost of construction. To compute the balancing allowance or charge and the allowance under sections 33A(2) and 34(2)(b), it was necessary to determine the selling price of the building (excluding the land price). The Institute would like to know whether the selling price should be:

(a) (1/2 of first assignment / purchase price) x sale moneys; or
(b) valuation by a surveyor using the amortised replacement cost.

If the figure in (b) was taken as the selling price, how would the successor (i.e. the purchaser) account for the construction cost?

> Mr Chu advised that details of the current purchase and sale should be readily available. Computing the balancing adjustments should not be difficult. IRD would not rule out the adoption of the formula in (a) above if the estimate was reasonably accurate.
>
> Mr Chu explained that, to compute the allowance under sections 33A(2) and 34(2)(b), it was necessary to compute the residue of expenditure. The residue of expenditure was a function of the capital expenditure incurred on construction or cost of construction. In the absence of details, IRD would continue to take 1/2 of the first assignment price of the building as the cost of construction which was a historical figure. The formula in (b) above would not be accepted because it did not reflect the actual cost of construction.

A1(h) Section 51(2) of IRO

Section 51(2) required every person chargeable to tax for any year of assessment to inform the Commissioner in writing that he was so chargeable not later than 4 months after the end of the basis period for that year of assessment unless he had already been required to furnish a return.

The Institute would like to know whether the accounts needed to be submitted upon informing chargeability.

Mrs Chan advised that a taxpayer was not required to submit the accounts for a year of assessment when informing chargeability to tax under section 51(2) for that year of assessment. Subsequently, when the return was filed, the accounts had to be attached to the completed tax return if the total gross income of the taxpayer exceeded the current threshold of $500,000.

Ms Macpherson said that she was aware of cases where a return was not issued until the accounts had been submitted. CIR said that the assessor had to examine the accounts to ensure that the current year profits did exceed the losses brought forward in a review case (i.e. the review case was a profit case). However, if it concerned a newly-incorporated company, a return would be issued upon request.

A1(i) DIPN 21 – Locality of Profits

(i) CFA judgment in the *ING Baring* case

(a) *When could activities of others be attributed to a taxpayer in Hong Kong?*

In the judgment, Lord Millet NPJ said that:

"In considering the source of profits, however, it is not necessary for the taxpayer to establish that the transaction which produced the profits was carried out by him or his agent in the full legal sense. It is sufficient that it was carried out on his behalf and for his account by a person acting on his instructions …"

The Institute would like to know IRD's view on the above observation.

Mr Chiu explained whether one was acting for another or on his behalf and for his account was a factual matter. At paragraphs 138 and 139, Millet NPJ was referring to "stockbrokers". Millet NPJ did not lay down any new principle of law. The words "on his behalf and for his account" should refer to an "act" done by a stockbroker for his client. At paragraph 147, Millet NPJ neatly summarised the position:

> "147. In summary (i) the place where the taxpayer's profits arise is not necessarily the place where he carries on business; (ii) where the taxpayer earns a *commission* for rendering a *service* to a *client*, his profit is earned in the place where the service is rendered not where the contract for *commission* is entered into; (iii) the transactions must be looked at separately and the profits of each transaction considered on their own; *and* (iv) where the taxpayer employs others to *act for* him in carrying out a transaction for a *client*, his profit is earned in the place where they carry out his instructions whether they do so as agents or principals."

Mr Chiu advised what Millet NPJ said was in relation to brokerage income derived from service provided overseas in respect of an overseas stock purchase or sale transaction. Paragraphs 138 and 139 did not relate to goods purchased from another person. Provision of service was inherently different from the sale of goods and goods were not services. The dictum of Millet NPJ was not considered to have any relevance to the issue of source in respect of the sale of goods.

Mr Chiu pointed out that Millet NPJ firmly rejected the proposition that in the case of a group of companies, "commercial reality" dictated that the source of the profits of one member of the group could be ascribed to the activities of another. At paragraphs 132 and 133, he said:

> "132. Before us the Taxpayer has repeated the submission made before Barma J that, while it was ordinarily sufficient to look at what the taxpayer had done to earn the profit, that was not so where it traded as a member of a group. In such a case, it was said, the "effective causes" which generate the profit may lie in the activities of other members of the group, and focusing exclusively on the operations of the taxpayer to the exclusion of the operations of its associated companies could lead to a conclusion at variance with commercial reality.
>
> 133. Barma J rightly rejected this submission. He observed that the authorities directed the court to a consideration, not of the operations which produced the profits in question (as Atkin LJ's formulation with its omission of any reference to the taxpayer might suggest), but more narrowly of the operations *of the taxpayer* which produced them. As Barma J observed, Lord Bridge, no less than Lord Jauncey, referred to 'what *the taxpayer* has done to earn the profit in question'."

(b) *Securities underwriting commission*

At the Board of Review, there were queries whether the placement income actually represented (i) execution commission for Baring Securities ("BSHK")'s purchase of new securities issued or to be listed outside Hong Kong on behalf of clients (therefore arguably offshore), or (ii) sub-underwriting commission received from underwriters in respect of sub-underwriting agreements performed by BSHK in Hong Kong (therefore arguably onshore).

Lord Millet noted these queries but said they were irrelevant. He viewed the source of the placement income in both cases to be offshore, which was earned in the place where the shares were subscribed for, namely overseas and not in Hong Kong (paragraphs 173 and 174 of the judgment).

The Institute would like to know whether the source of securities underwriting commission was the place where the securities were subscribed for, regardless of where the underwriting agreement was executed and performed.

Mr Chiu advised that source was a question of fact and there was no single, simple, legal test. In *ING Baring*, the fact-finding process was critically examined. Chan PJ neatly summarized the problem faced by the CFA and said at paragraph 7 of the judgment, "The principal difficulty facing the courts is whether, in the absence of specific findings of the relevant facts, there was sufficient evidence to conclude that the incomes in dispute were earned offshore and thus not taxable under s.14 (1) of the Ordinance."

Mr Chiu advised that, in the absence of a finding of the actual operation that generated the commission income, the CFA had to decide whether on the available facts, though limited in scope, there was sufficient evidence to draw a conclusion. Ribeiro PJ thus agreed at paragraph 87 with what Barma J said at the CFI, "If one is to identify a single transaction or set of transactions that in substance gives rise to the profits or 'commission' income with which we are concerned, it seems to me that the obvious candidate is the actual execution of the trades in the relevant securities, on the relevant foreign stock exchange."

Mr Chiu explained that *ING Baring* did not represent a change of law: the law remained that "one looks to see what the taxpayer has done to earn the profits in question and where he has done it". See paragraphs 34 to 36 and 124 to 134 of the judgment. *ING Baring* represented a particular way of looking at the facts in a stockbroker case. The judgment could be regarded as being entirely dependent on an analysis of the facts found or available.

Mr Chiu further explained that in *ING Baring*, the CFA confirmed as correct the judgments of *CIR v Wardley Investment Services (Hong Kong) Ltd.*, 3 HKTC 703 and *Kim Eng Securities (Hong Kong) Ltd. v CIR*, [2007] 2 HKLRD 117. In view of the above, the rule propounded by the Institute that the source of securities underwriting commission was the place where the securities were subscribed for regardless of where the underwriting agreement was executed and performed could not have general application. It could be sensibly said that the decision applied only to the particular facts of *ING Baring* itself.

Mr Southwood said that the Institute was of the view that *ING Baring* had a wider application. CIR did not agree with the view of the Institute.

[Post-meeting note - After the meeting, IRD sent two comprehensive replies, dated 2 May 2008 and 3 July 2008, to letters from the Institute, to explain the legal basis for IRD's own views. Please click for the relevant correspondence.]

(c) *Introductory commission*

Lord Millet said:

"An introductory fee is earned where the introduction is made, i.e. where the party to whom the introduction is made is located, since an introduction is valueless (and indeed is not effected) until it is received."

The Institute would like to know whether this was a general source rule for other types of introductory commission as well. For example, a Hong Kong sourcing agent referred a Hong Kong or overseas customer to a Mainland China factory enterprise that had no business presence in Hong Kong. After the introduction, the Hong Kong sourcing agent would not be involved in any subsequent transactions between the Mainland China enterprise and the Hong Kong/overseas customer.

For the introduction of business, the Hong Kong sourcing agent would receive as commission from the Mainland China enterprise a certain percentage of the amount of any subsequent purchases that the Hong Kong/ overseas customer made from the Mainland China enterprise.

Based on Lord Millet's judgment, quoted above, it would, therefore, appear to the Institute that the introductory commission in the above circumstances should be regarded as offshore in nature, regardless of whether the customer introduced was a Hong Kong or an overseas customer. What was the IRD's view on this?

Mr Chiu advised that IRD did not agree that there was any general source rule regarding all sorts of commission income. In *ING Baring*, the Board of Review did not find the operations that had generated the commission income. See the answer to agenda item A(1)(i)(b) above. IRD would continue to apply the operations test to ascertain the source of the commission income. If operations were undertaken in Hong Kong to generate the commission, these operations or activities would remain relevant.

Mr Chiu said that, in the example given, if the Hong Kong company undertook operations in Hong Kong to secure a customer, then these operations or activities would be relevant and the source of the commission income would be of Hong Kong source.

(d) *Section 70A claim to re-open prior year assessments*

The Institute's view was that the CFA judgment established that the general rule for determining the source of brokerage commission earned by a broker was to look at the "place of execution of trades".

In this regard, were taxpayers eligible to lodge section 70A claims to reopen tax assessments in respect of brokerage commission income not originally claimed as offshore in the returns on a mistaken view of the applicable source rule (there being apparently no applicable prevailing assessing practice on stock brokerage commission at the time)?

Mr Chu advised that the judgment in *ING Baring* had not overturned any judicial precedents and had not laid down any new source rules. The judgments in *CIR v Wardley Investment Services (Hong Kong) Ltd.*, 3 HKTC 703 and *Kim Eng Securities (Hong Kong) Ltd. v CIR*, [2007] 2 HKLRD 117 were confirmed as correct in *ING Baring* and would continue to be followed by IRD.

Mr Chu said that, unless there were errors or omissions in a return, an assessment could not be reopened under section 70A. A mere change of opinion would not constitute an error or omission within the meaning of section 70A per the judgment in *Extramoney Ltd v CIR*, 4 HKTC 394.

(ii) <u>Other queries</u>

(a) *Listed Hong Kong shares subsequently delisted from the Hong Kong Stock Exchange and relisted on an overseas stock exchange*

Paragraph 20 of DIPN 21 (Revised) said that the locality of profits from the purchase and sale of listed shares was the location of the stock exchange where the shares in question were traded.

The Institute would like to know the tax treatment in cases where shares were listed on the Hong Kong Stock Exchange when acquired, but subsequently delisted in Hong Kong and relisted on an overseas stock exchange by the time of disposal (or vice versa).

Mr Chiu advised that the place of listing was a simple test to decide the source of profits from share transactions. Since source of profit was a question of fact, it was not appropriate to apply the rule indiscriminately if the actual operations which generated the profits had a different locality.

Mr Chiu explained that, where either the contract of purchase or contract of sale was effected in Hong Kong, the initial presumption would be that the profits are fully taxable (see paragraph 8(c) of DIPN 21). CIR added that the place of listing was nonetheless a factor that the IRD would take into account.

(b) *Listed securities other than shares*

There appeared to be a "place of listing" source rule which should apply not only to listed shares but also to other types of listed securities. The *Hang Seng Bank* case, which established this general source rule, was concerned with listed securities such as bills of exchange and certificates of deposit but not shares.

The Institute would like to know whether the "place of listing" was a general rule for determining the source of profits and applied to other types of listed securities, such as listed bonds.

Mr Chu explained that, given that the term "certificate of deposit" in section 2 of the IRO covered bonds, notes and various debt instruments and that the provisions in section 15(1)(l) had extended the general charging section, it might not be appropriate to regard the place of listing as a general rule for determining the source of profits from all sorts of securities transactions (including listed bonds). IRD would continue to apply the operations test to see whether profit-generating activities were carried out in Hong Kong to produce the profits in question.

Ms Chan asked about the determination of the source of profits derived from over-the-counter transactions on listed securities. Mr Chu advised that, in such cases, the general source rule would similarly be applied by looking at the place where the transactions were carried out.

Agenda Item A2 - Salaries Tax Issues

A2(a) Taxability of per diems

The Institute would like the IRD to clarify if the expense allowances from employers, referred to in paragraph 12 of DIPN 9 (Revised), included per diems (i.e. daily subsistence allowances paid by an employer to its employees working temporarily away from their normal place of work). Per diems were generally paid to cover meals and other minor expenses incurred by employees when working away from their normal place of work or residence. Clarification was requested as paragraph 12 of DIPN 9 was amended in the 2006 revision to remove the reference to "subsistence", which now referred to "travelling, accommodation and related expenses".

Mrs Chan advised that paragraph 12 of DIPN 9 (Revised) stated:

> "12. Allowances which are reasonable in amount and do no more than covering the employee's travelling, accommodation and related expenses incurred when he is working away from his usual base or place of residence as required by his employer would not be brought into charge as assessable income. However, any claim for expenses in excess of the employer's reimbursement would be expected to fail the test of "necessarily" incurred and would not be allowed. Moreover, a reimbursement from an employer for disallowable expenses incurred by an employee would be assessable."

Mrs Chan explained that the emphasis was on "reasonable in amount" and "incurred when working away from his usual base or place of residence as required by his employer". Whilst "subsistence" had been replaced by "travelling, accommodation and related expenses", there was no change in practice.

Ms Macpherson said that a "per diem" could be a fixed amount paid on a day basis to cover accommodation and related expenses and asked about the related tax treatment. CIR explained that, whilst different terms might be used for similar payments, the existing practice would continue to apply by reference to the nature of the payment and whether the amount was reasonable.

Agenda Item A3 - Cross-border Tax Issues

<u>A3(a) Apportionment of Profits</u>

<u>(i) Policy pending outcome of appeal in BOR case *D43/06*</u>

The BOR decided in *D43/06* to apportion the profits. The Institute noted that CIR had appealed against the decision and would like to enquire IRD's assessing practice in dealing with similar cases pending outcome of the appeal.

CIR advised that IRD would continue to raise assessments according to existing practice, i.e. no apportionment of chargeable profits in import processing cases. It had to be emphasised there were a number of decisions of the Board of Review and the court that lent support to IRD's practice.

CIR said that members of the Institute might wish to refer to the following cases: *Consco Trading Co. Ltd. v CIR* [2004] HKLRD 818, *D111/03* 19 IRBRD 51, *D56/04* 19 IRBRD 456, *D24/06* 21 IRBRD 461, *D36/06* 21 IRBRD 694.

<u>(ii) Impact of *ING Baring* case</u>

With reference to the *ING Baring* case (see agenda item A1(i)), the Institute would like to know whether the manufacturing activities of a Mainland China wholly-owned subsidiary or joint-venture company could be attributed to a Hong Kong taxpayer where the former manufactures goods with raw materials supplied by the latter according to the latter's instructions or specifications, with the related risks and benefits assumed by the latter. If so, the Institute also wished to know whether IRD was prepared to extend the 50:50 apportionment, as stated in paragraph 16 of DIPN 21, to this sort of arrangement.

CIR pointed out that *ING Baring* concerned the service of a stockbroker and the source of commission income. The case did not concern the source of profit from trading transactions or operations.

CIR advised that, in a trading case, including an import processing arrangement, the relevant buying and selling activities in Hong Kong were always relevant. In the example given, IRD regarded it as a trading case and did not agree that an apportionment of profit was appropriate.

Mr Southwood said that, while *ING Baring* was not a trading case, the Institute considered that it made some general points. Ribeiro PJ pointed out that the Board of Review had erred because it had not focused on the transactions that directly produced the profits but had emphasized other factors, which, while being “commercially essential” were “legally irrelevant”.

CIR noted that the Institute held a different view regarding *ING Baring* and indicated that the IRD would write to the Institute to set out the basis for IRD’s views.

[Post-meeting note – The IRD subsequently issued two letters responding to various points raised by the Institute. See the post-meeting note to Agenda Item A1(i) above.]

<u>(iii) Re-opening of 50: 50 apportionment cases (to follow up with the 2007 annual meeting)</u>

In the 2007 minutes, it was recorded in agenda item A3(c):

> *“Mrs Chu advised that, where appropriate, the IRD would raise queries and withdraw the concession of 50:50 apportionment wrongly granted to import processing cases in the past … Reopening a back year assessment due to a change of opinion would require approval of an Assistant Commissioner … IRD would impose penalty where the 50:50 apportionment was previously accepted based on omissions of information or incorrect information/misrepresentations supplied by taxpayers and/or their representatives without reasonable excuse.”*

While the concept was familiar to taxpayers nowadays, it was not necessarily so in the past. In the past, assessors might not have asked for detailed information. Could a failure or omission to provide certain information in the absence of a specific request from the assessor constitute “reasonable excuse” in relation to the submission of incorrect return/information?

Mrs Lai said that the taxation treatment of import processing cases was repeatedly raised in the past annual meetings. As early as in the 2000 meeting held on 3 March 2000, IRD drew to HKICPA members’ attention that upon a change of mode of operation to import processing, 50:50 apportionment was not applicable. IRD “asked tax representatives, in apportionment cases, to verify annually that the apportionment of profits remained appropriate” [paragraph B6 of the 2000 minutes]. Subsequent Board of Review and Court cases on import processing confirmed the IRD’s view that the trading profit was 100% assessable [see agenda item A3(a)(i) above].

Mrs Lai advised that taxpayers were responsible for their own tax affairs. They should file correct returns and documents and provide complete and accurate information relating to the computation of assessable profits even if they were not asked by the IRD. It was necessary for the taxpayer to make a full and frank disclosure of all material facts in the first instance.

Mrs Lai explained that, where incorrect returns were made without reasonable excuse, penal action would be considered. IRD's penalty policy was transparent. What constituted a reasonable excuse was determined by the facts of the individual cases. CIR or her deputies would consider the representations before imposing a penalty under section 82A. Omission of information or provision of incorrect/misleading information due to no specific request from the assessor could hardly mitigate the wrongdoings.

A3(b) Plant and machinery ("P&M") used in import processing

The Institute would like to follow up with agenda item A4(a) of the 2006 annual meeting and agenda item A3(b) of the 2007 annual meeting. It appeared that, for import processing cases, the IRD had identified the following possible administrative and technical issues:

(i) the P&M might be subsequently sold or transferred to other parties;
(ii) depreciation allowances on the same P&M might be claimed by other entities; or
(iii) the P&M might be used to manufacture goods sold other than to the Hong Kong entity.

For contract processing cases, the IRD allowed, as a concession, 50% of the depreciation allowances for P&M on the condition that the profits from manufacturing activities of the Hong Kong company were assessed on a 50:50 basis. It seemed that taxpayers in import processing cases, whose profits were fully taxable, should, as a concession, be allowed 100% of the depreciation allowances.

Audited accounts should be a sufficient proof of ownership of P&M irrespective of whether they were located in Hong Kong or in the Mainland (or elsewhere). If in a particular case, the IRD considered that the booking of P&M in audited accounts alone was not sufficient evidence, the Institute suggested that the IRD could request a management representation as to the ownership and usage of the P&M as evidence.

CIR advised that the provisions in section 39E(1)(b)(i) were clear and unambiguous. No depreciation allowances should be given to the owner if the plant and machinery were used wholly or principally outside Hong Kong by a person other than the taxpayer.

CIR said that the suggestions of the Institute could not resolve all the administrative and technical issues above-mentioned. Besides, there might be other administrative and technical issues that were yet to be identified. In any event, the suggestions did not give strong justifications for extending the concession. Taking all considerations into account, IRD was not prepared to extend the concession to import processing cases. It should be noted that even where a concession had been granted in contract processing cases, it was subject to review and might be withdrawn at any time.

A3(c) Offshore funds tax exemption

(i) Specified transaction

Pursuant to Schedule 16 of the IRO, a transaction in “listed equities” fell within the definition of “specified transaction” under section 20AC of the IRO.

The Institute would like to know whether a transaction in the shares of a company would qualify as a “specified transaction” if the shares were acquired when the company was unlisted, but were sold when the company had become a listed company (or vice versa).

Mr Yim advised that IRD was of the view that such a “single-sided” transaction was covered by “specified transaction” under section 20AC of the IRO.

(ii) Exemption status of a non-resident fund

The Institute would like to know when a non-resident fund would be regarded as carrying on a business in Hong Kong involving any transaction other than a specified transaction (and transactions incidental thereto) under section 20AC(3) of the IRO. An example would be where a non-resident fund, whose day-to-day business was carried on in Hong Kong, dealt in Hong Kong listed securities and overseas immovable properties.

The issue was whether the exemption status of the non-resident fund in respect of the Hong Kong listed securities (i.e. onshore, specified transactions) would be tainted by its involvement in the transactions in the overseas immovable properties (i.e. offshore, non-specified transactions) under section 20AC(3) of the IRO.

Mr Yim advised that the exemption status of a non-resident fund under section 20AC would depend on whether it carried on another business in Hong Kong, which was a question of fact. In the example, if the non-resident fund’s involvement in the transactions in the overseas immovable properties amounted to carrying on a business in Hong Kong, tax exemption for the non-resident fund under section 20AC would be denied. The position would not be altered by the fact that the profits from the transactions in the overseas immovable properties were offshore profits and not chargeable to profits tax.

A3(d) Offshore claims

In determining the source of service income, some members were of the view that whether tax was payable in an overseas jurisdiction or not (which depended on the local law of that jurisdiction) should not be relevant. The Institute would like to know IRD's view on this matter.

Mrs Chan advised that whether tax had been paid overseas was not determinative of the source of the service income under IRO. However, if tax had been paid overseas, it was more likely (at least on an evidential basis) that the income was derived offshore.

A3(e) Cross-border service income

A Hong Kong company provided consultancy services to a Mainland China company in Hong Kong and the Mainland. According to Guoshuifa [2000] No. 82, issued by the State Administration of Taxation ("SAT"), the portion of service fee allocated to services rendered in the Mainland could not be less than 60%. Under the circumstances, 10% of the service fee would be subject to double taxation, as IRD generally applied a 50:50 onshore/offshore split, unless IRD allowed the Hong Kong company a foreign tax credit in respect of the 10% service fee income.

The Institute noted that IRD had indicated that it would consider a split other than 50:50 in specific situations and would like to know IRD's view regarding SAT's administrative practice.

Mrs Chan explained that, as stated in DIPN 21, paragraph 22, where apportionment was appropriate, it would be on a 50:50 basis in the vast majority of cases. However, the basis to be adopted for apportioning service income could vary according to facts of each case. A taxpayer could explain to IRD his apportionment basis and if the basis was justified, IRD was quite prepared to consider it. If a Hong Kong taxpayer did not agree with the apportionment basis in an assessment raised under the IRO or if he did not agree with the amount of tax credit allowed, he had a right to object.

Mrs Chan advised that IRD was not in a position to comment on Guoshuifa [2000] No. 82. In cross-border service cases, reference should also be made to Article 7 of the comprehensive double taxation arrangement with Mainland China.

Dr Cho asked if a tax credit in respect of the 10% service income in the example above could be allowed. Mr Chu advised that Hong Kong only taxed the appropriate share of the service income derived in Hong Kong (i.e. 50% in the majority of cases) and hence no tax credit should be allowed.

Mr Yu asked whether the IRD would consider entering into advance pricing agreements with the Mainland. CIR replied that there was no current plan to do so and that the advance ruling procedures were considered sufficient for such purposes.

Agenda Item A4 – Double Taxation Agreements

A4(a) Dual residence of a corporation under the arrangement between Hong Kong and Mainland China

A Hong Kong incorporated company was by definition a Hong Kong resident under the comprehensive double taxation arrangement with Mainland China ("the Arrangement"). The Hong Kong company could also be a resident of another jurisdiction under the management and control test.

For example, a Taiwan group might use a Hong Kong incorporated company to hold its investments in the Mainland. However, the management and control of the Hong Kong incorporated company was exercised by the Taiwan group in Taiwan where all the management personnel were based. The Institute would like to know whether a Hong Kong incorporated company of this kind, which was managed and controlled overseas, was eligible to benefit from the Arrangement.

This question was raised because in the context of an individual that was a temporary resident of Hong Kong and also a permanent resident of a third country, DIPN 44 stated that such an individual, despite being a Hong Kong resident by definition, was not eligible to enjoy the benefits of the Arrangement. Some members were concerned that a similar interpretation might apply and so deny a dual-resident corporation (i.e. a resident of Hong Kong as well as Taiwan in the example) from enjoying the benefits of the Arrangement.

Mr Chu advised that, under paragraph 1(2)(iii) of Article 4 of the Arrangement, a company incorporated in the Hong Kong SAR should be a resident of Hong Kong. The place where its management and control was exercised would not affect such status.

Ms Law asked about companies incorporated outside of Hong Kong. CIR said that companies incorporated in Hong Kong would not need a certificate of residence, whilst those managed and controlled in Hong Kong, but incorporated elsewhere, could apply for a certificate of residence from the IRD if they had obtained a referral letter from the Mainland authorities. IRD had received only a few applications from non-Hong Kong incorporated companies so far.

A4(b) Exchange of information clause

The Institute would like to know if the IRD had received any information requests from other countries pursuant to the "exchange of information" clause in the double taxation agreements ("DTAs") signed with those countries. If applicable, the Institute also would like to know:

(a) the type of information requested in general; and

(b) if there was any requirement or practice to inform a taxpayer when a DTA partner requested information about that taxpayer.

CIR advised that Hong Kong had so far received three requests for information from its treaty partners. These were all specific requests and were in compliance with the conditions as laid down in the relevant articles. IRD would not publish the types of information requested.

IRD would comply with the provisions in the information exchange article laid down in the DTAs upon an exchange of information. Like all other tax jurisdictions with a tax treaty network, Hong Kong was not required under any legal obligation to inform the taxpayer if information relating to him was passed to a treaty partner.

Dr Cho asked whether Hong Kong had issued any requests for exchange of information to its treaty partners. CIR advised that so far there was none.

A4(c) Update on DTAs

The Institute would like to request an update on the status of DTA negotiations with other countries, including the one with Macau.

During the year of 2007, Hong Kong held DTA negotiations with 4 countries/regions. Second round of negotiations with Macao was completed on 9 February. First round of talks with Kuwait was held in Hong Kong from 14 to 17 May. Hong Kong concluded the DTA with Luxembourg during the negotiation held in August which was then formally signed on 2 November 2007. The first round of negotiations with Pakistan was held in Hong Kong in September 2007. The status of the DTA negotiations with other countries could be found at IRD's website www.ird.gov.hk. IRD held a meeting with the SAT in Beijing in September 2007 on the post-implementation details of the Arrangement. To record the consensus reached by both parties, a letter of exchange was signed and a Second Protocol to the Arrangement was initialed after the meeting. Details would be announced after the formal signing of the Second Protocol which was scheduled on 30 January 2008.

[Post-meeting note – The Secretary for Financial Services and the Treasury, Professor K C Chan, signed the Second Protocol with the Deputy Commissioner of the SAT, Mr Wang Li, in Beijing on 30 January 2008. The order made by the Chief Executive in Council to implement the Second Protocol was gazetted on 18 April 2008.]

Agenda Item A5 – Departmental Policy and Administrative Matters

A5(a) Signing of profits tax returns and supporting documents

The Institute would like to know IRD's practice regarding the certification of management accounts in the case of a Hong Kong branch of an overseas-incorporated entity, in particular whether the signatory certifying the management accounts of a Hong Kong branch needed to be the same person who signed the profits tax return of the branch.

Mrs Chu advised that, as a rule, the person who signed a document should have actual knowledge of its content. The signatories should state their full names and positions held with the company. The person who signed the accounts (including the branch accounts) should be aware of the correctness of the accounts. The person who signed the return should be able to identify that the accounts attached to the return were the approved accounts of the company. The two persons in most cases were the same though they needed not be so. Members were reminded that the persons mentioned in section 57 of the IRO, namely the secretary, manager, any director or liquidator of a company, were answerable for doing all such acts, matters, or things that were required to be done under the IRO by the company. Hence, they were primarily the ones who would sign a tax return.

A5(b) Issuance of practice notes and guidelines

(i) DIPN update

The Institute would like to know the DIPNs that were being updated or to be issued by IRD. In addition, where a new DIPN was issued, or an existing DIPN was revised, the Institute would like to know if the new or revised DIPN would take effect from the issue date with no retrospective effect.

CIR advised that the IRD was in the course of updating DIPN 15, 21, 38 and 44.

CIR explained that a taxpayer's rights and obligations were governed by the law. The interpretation of laws and legal principles as perceived by the IRD did not affect his rights. In fact, each DIPN stated clearly on the front page that the DIPN had no binding force and did not affect a person's right of objection and appeal to the Commissioner, the Board of Review or the Courts.

Therefore, the time at which a DIPN was issued or amended would not affect a taxpayer’s rights and obligations under the IRO.

CIR further explained that the issue date of a new or revised DIPN had no relevance insofar as the commencement date of the IRD’s practice was concerned. Drafting and vetting a DIPN was a time-consuming process. There was generally a time gap between the commencement of a practice and the issue of the relevant DIPN. From time to time, the IRD might issue a new DIPN to set out its longstanding practice on certain issues of growing interest to taxpayers and their authorized representatives. The issue date of the DIPN was of no relevance at all, and there was no question of the DIPN taking effect retrospectively.

CIR pointed out that the IRD might issue a new DIPN or update its existing DIPN after the enactment of new legislations. The IRD’s interpretation of and practice in relation to the new legislations would apply from the date the new law took effect.

CIR advised that, where the IRD changed its practice following law amendments or judicial interpretations, the IRD would generally state in the new or revised DIPN the date/year of assessment from which the new interpretation and practice were to apply. Normally, assessments which were regarded as final and conclusive in terms of section 70 of the IRO would not be reopened for the purpose of reflecting the revised practice.

(ii) DIPN on the taxation of stock awards

The Institute would like to know the progress on the issuance of a new DIPN on the tax treatment of stock award schemes.

It was understood that the IRD held the view that, unlike conditional stock options, the taxable amounts of conditional stock awards derived from a non-Hong Kong employment could not be apportioned based on “the number of days of Hong Kong services plus attributable leave” to “the total number of days of the vesting period”. The IRD was of the view that apportionment could be based only on days-in-and-days-out during the year of assessment in which the conditional stock awards vested in the employee concerned.

In this regard, the Institute would like the IRD to explain the technical basis for according different tax treatments to conditional stock option and stock award schemes.

Mrs Chan advised that DIPN 38 would be revised to include a Part II on taxation of share awards. The revision was in progress. Regarding the apportionment in non-Hong Kong employment cases, there would be examples to illustrate. Explanation was normally given in the DIPN on the approach to be adopted.

[Post-meeting note – The revised DIPN 38 has been issued in March 2008.]

(iii) Application of section 61A and transfer pricing legislation

In Board of Review ("BOR") case *D83/06*, IRD appeared to apply section 61A of the IRO to deal with a transfer pricing issue of group companies.

Whilst the BOR upheld the section 61A assessments raised on the Hong Kong company (based on the combined trading and manufacturing profits of the Hong Kong company and other BVI incorporated companies on a 50:50 basis), it also found the BVI companies carried on business in Mainland China (and their profits were held by the BOR to be offshore in nature). Therefore the "alternative" assessments raised on the BVI companies under section 14 did not appear proper.

Based on the BOR's decision, it appeared that the application of section 61A to the Hong Kong company, charging part of the profits of the BVI companies to Hong Kong tax, might be inconsistent with the general practice as stated in DIPN 15. Paragraph 46 of DIPN 15 stated that "(t)he ultimate (section 61A) assessment to be made must be within the scope of the (IRO)". Applying section 61A to assess offshore profits to Hong Kong tax appeared to be against the general practice and might be the result of the absence of specific transfer pricing legislation in the IRO to deal with such cases. The Institute would like to know the IRD's views on the BOR decision.

The Institute would like to know whether IRD was preparing a practice note on transfer pricing and whether it would support the enactment of specific transfer pricing legislation in Hong Kong.

Mr Chiu advised that the subject matter in *D83/06* did not concern transfer pricing. The issue in that case was whether the Hong Kong company had entered into a transaction, to which section 61A applied, for the dominant purpose of obtaining a tax benefit. As the case was under appeal to court, the IRD did not find it appropriate to comment on it at this stage.

Mr Chiu explained that, generally speaking, where a taxpayer had carried out a transaction in terms of section 61A to alter an onshore profit into an offshore profit or to siphon off Hong Kong sourced profits into a tax haven entity, the Commissioner had the power to raise an assessment to counteract the tax benefit obtained.

Mr Chiu pointed out that, in *FCT v Spotless Services Ltd.* [1996] 186 CLR 404, the Australian High Court held that the sole or dominant purpose of making a short term deposit in the Cook Islands at a relatively low rate of interest was to obtain a tax benefit (i.e. exemption from Australian tax). It was concluded on the facts that if the company had not entered into the scheme it would have made a deposit at a similar rate of interest in Australia and held that an assessment could be raised on that basis.

Mr Chiu further pointed out that, in *CIR v Tai Hing Cotton Mill (Development) Limited*, FACV No. 2 of 2007, Hoffmann NPJ confirmed that the Australian High Court judgment was correct and the same principles applied in Hong Kong. Under section 61A(2)(b), the Commissioner had the power, in assessing the taxpayer to counteract the tax benefit, to adopt the hypothesis which the evidence suggested was most likely to have been the alternative transaction.

Mr Chiu advised that the provisions in section 61A could be applied to a transaction carried out to obtain tax benefits (e.g. reduction of Hong Kong profits tax) through improper transfer pricing or altering an onshore profit into an offshore profit.

Mr Chiu said that IRD did not see any imminent need for the enactment of specific transfer pricing legislation in Hong Kong. There was a wealth of case law which supported the stance that transactions between related parties should take place at arm's length. IRD was working on a DIPN on transfer pricing.

CIR explained that, by applying section 61A to raise an assessment in appropriate cases, IRD was merely seeking to assess the fair, but not the highest, amount of tax. The DIPN would explain the practice and rules to be adopted in making such an assessment.

Dr Cho asked whether the arm's length principle could be applied under section 20 of the IRO. Mr Chiu replied that it could.

A5(c) Field audit

(i) Some practitioners observed that some objection cases have been taken up by the Field Audit and Investigation Unit. The Institute would like to know if there was a change in IRD's policy, given that DIPN 11 (revised in October 2007) stated, at paragraph 5, "(t)he Field Audit and Investigation Unit within the IRD is primarily responsible for the audit and investigation of cases where tax evasion is suspected."

CIR advised that, all along, in some cases, the Field Audit and Investigation Unit had been processing objection cases. Officers of the Unit also drafted determinations and represented the Commissioner in BOR hearings. The division of work among units and the deployment of staff resources were entirely within the administrative prerogative of the position of the Commissioner of Inland Revenue.

(ii) The Institute also would like to know whether, following the decision in *Koon Wing Yee v. Insider Dealing Tribunal and the Financial Secretary* (CAVA 358 of 2005, 30 May 2007), the IRD intended to adopt "beyond a reasonable doubt" as the standard of proof when imposing penalties under the IRO. It was noted that, in imposing financial penalties for insider trading, the Court of Appeal applied the criminal standard of proof. Although the case in question was not a tax case, the same principles could also be applied to penalties imposed under the IRO. The Institute would like to know the IRD's views on this matter.

The IRD's views could be found in the October 2007 issue of Institute's journal "A Plus". As the case of *Koon Wing Yee v Insider Dealing Tribunal and the Financial Secretary* (CACV 358 of 2005) was under appeal to the Court of Final Appeal, the IRD did not find it appropriate to comment at this stage.

A5(d) Lodgment of tax returns and filing deadlines for 2007/08

The Institute would be interested to know the latest statistics on the filing of tax returns and the filing deadlines for 2007/08.

Mr Chiu advised that, according to Table 1 in Appendix A, IRD had issued more returns in the 2006/07 bulk issue than the previous years. Compared with 2005/06, more returns were filed after the due date. Table 3 showed the progressive filing results. The overall performance was not very encouraging. Tax representatives were urged to improve their performance in the coming years.

Bulk issue of 2007/08 Profits Tax Returns

Mr Chiu advised that the bulk issue of 2007/08 Profits Tax Returns for "active" files would be made on 1 April 2008. The extended due dates for filing 2007/08 Profits Tax Returns would be:

Accounting Date Code	Extended Due Date
"N" code	2 May 2008 (no extension)
"D" code	15 August 2008 (no change)
"M" code	15 November 2008 (no change)
"M" code – current year loss cases	13 February 2009 (changed)

For “M” code current year loss cases, the usual practice was to allow an extension to 31 January. Since the first day of the Chinese New Year holiday would fall on 26 January 2009, which would be close to the usual due date for submitting returns for “M” code current year loss cases, an extended due date for the “M” code current year loss cases was given.

Ms Law noted that the extended due date for “M” code cases, i.e. 15 November 2008, fell on a Saturday. Mr Chu said that returns could still be filed on a Saturday.

PART B - MATTERS RAISED BY IRD

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

Mrs Lai said that Table 1 in Appendix B was compiled to illustrate the specific problem areas detected in corporations with tax audits completed during the year ended 31 December 2007. Comparative figures for the years 2005 and 2006 were included.

Mrs Lai advised that, as shown in Table 1, Field Audit teams uncovered discrepancies in 232 corporation cases, of which 191 carried clean auditors’ reports. Amount of discrepancies detected in the clean report cases accounted for 83% (68% for 2006) of the total discrepancies detected in corporation cases completed during the year and total tax of $300 million was recovered from these cases. Average understatement per clean report case increased from $8.1 million (figure for 2006) to $9.8 million while tax undercharged per clean report case increased from $1.2 million (figure for 2006) to $1.6 million.

Mrs Lai advised that discrepancies resulted mainly from omission of sales, overstatement of purchases and overclaim of expenses. In the majority of cases, the discrepancies were detected after examining the business ledgers and source documents.

Agenda Item B2 - Date of Next Annual Meeting

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

Appendix A

Lodgement of Corporations and Partnerships Profits Tax Returns

Table 1
Lodgement Comparison from 2004/05 to 2006/07

		Y/A 2004/05	Y/A 2005/06	Y/A 2006/07	Comparison 2005/06 and 2006/07
1.	Bulk issue (on 2 April)	143,000	146,000	149,000	2%
2.	Cases with a failure to file by due date:-				
	'N' Code	1,600	1,600	1,700	6%
	'D' Code	4,000	4,000	5,200	30%
	'M' Code	7,900	8,500	10,000	18%
		13,500	14,100	16,900	20%
3.	Compound offers issued	5,700	5,500	6,700	22%
4.	Estimated assessments issued	4,300	5,200	6,800	31%

Table 2
2006/07 Detailed Profits Tax Returns Statistics

	'N'	'D'	'M'	Total
Total returns issued	16,000	41,000	92,000	149,000
Failure to file on time	1,700	5,200	10,000	16,900
Compound offers issued	700	2,300	3,700	6,700
Estimated assessments issued	700	2,000	4,100	6,800

Table 3
Represented Profits Tax Returns - Lodgement Patterns

Code	Lodgement Standard	Actual Performance 2006/07 PTRs	2005/06 PTRs
D - 15 August	100%	77% (1)	80%
M - 31 August	25%	10%	11%
M - 30 September	55%	14%	15%
M - 31 October	80%	30%	29%
M - 15 November	100%	78% (2)	81%

(1) 35% lodged within a few days around 15 August 2007 (31% lodged within a few days around 29 August 2006 for 2005/06 PTRs)

(2) 29% lodged within a few days around 15 November 2007 (31% lodged within a few days around 22 November 2006 for 2005/06 PTRs)

Table 4
Tax Representatives with Lodgement Rate of less than 78% of 'M' code Returns as at 15.11.2007

1,602 T/Rs have 'M' Code clients. Of these, 762 firms were below the average performance rate of 78%. An analysis of the firms, based on size, is:-

		Current Year Performance				Last Year Performance			
	No. of clients per firm	Total No. of firms	No. of firms below the average of 78%	No. of non-compliance cases	% of total non-compliance cases	Total No. of firms	No. of firms below the average of 81%	No. of non-compliance cases	% of total non-compliance cases
Small size firms	100 or less	1,466	715	6,060	74%	1,487	671	4,921	74%
Medium size firms	101 - 300	125	46	2,031	25%	124	42	1,646	25%
Large size firms	over 300	11	1	83	1%	11	1	67	1%
		1,602	762	8,174	100%	1,622	714	6,634	100%

Table 1

Analysis of Completed FA Corporation Cases for the years ended 31 December 2005, 2006 and 2007

Appendix B

	Number			**Discrepancy Amount by Nature**			**Tax Undercharged by Nature**		
Auditor's Report = Unqualified	**2005**	**2006**	**2007**	**2005**	**2006**	**2007**	**2005**	**2006**	**2007**
Sales omitted	21	40	22	20,591,422	43,147,687	18,704,524	2,897,294	7,411,410	3,068,088
Purchases overstated	4	7	12	1,728,123	14,841,154	22,921,812	350,862	1,366,542	4,052,183
Closing stock understated	4	1	3	1,598,848	36,712	461,730	169,850	5,874	74,531
Gross profit understated	31	17	31	63,387,464	50,669,617	100,563,642	9,968,242	8,878,418	16,630,189
Expenses over-claimed	37	57	69	10,131,095	60,645,475	56,692,872	1,145,114	10,133,289	7,731,967
Technical adjustments	47	45	56	10,082,151	26,384,452	51,475,474	2,420,874	4,305,811	7,445,844
Other	52	69	69	98,296,255	57,736,904	221,464,746	15,110,038	7,401,341	38,251,710
TOTAL	196*	236*	262*	$205,815,358	$253,462,001	$472,284,800	$32,062,274	$39,502,685	$77,254,512
TOTAL NUMBER OF CASES	139*	184*	191*						
AVERAGE AMOUNT PER CASE				$1,480,686	$1,377,511	$2,472,695	$230,664	$214,689	$404,474

FOR AUDIT YEAR ONLY

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

		Total Discrepancy for All Years			**Total Tax Undercharged for All Years**		
		2005	**2006**	**2007**	**2005**	**2006**	**2007**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$1,207,777,452**	**$1,496,676,285**	**$1,879,586,776**	**$184,399,144**	**$217,670,512**	**$300,156,626**
	AVERAGE AMOUNT PER CASE	**$8,689,046**	**$8,134,110**	**$9,840,768**	**$1,326,613**	**$1,182,992**	**$1,571,501**

	Number			**Discrepancy Amount by Nature**			**Tax Undercharged by Nature**		
Auditor's Report = Qualified	**2005**	**2006**	**2007**	**2005**	**2006**	**2007**	**2005**	**2006**	**2007**
Sales omitted	9	13	5	15,606,685	44,480,884	7,146,452	2,414,546	6,143,817	626,835
Purchases overstated	6	3	1	14,497,553	5,075,467	80,000	2,425,785	726,015	14,000
Closing stock understated	1	2	1	691,601	854,497	180,569	110,656	149,537	0
Gross profit understated	9	17	12	21,857,935	28,196,238	29,580,017	3,159,332	5,196,801	5,170,139
Expenses over-claimed	11	28	13	1,981,307	18,308,425	28,263,941	313,644	2,948,996	3,865,639
Technical adjustments	11	19	10	1,859,998	17,236,897	6,765,869	234,992	2,825,123	1,119,247
Other	8	24	15	9,966,248	16,361,033	26,844,036	688,498	2,482,117	3,511,863
TOTAL	55*	106*	57*	$66,461,327	$130,513,441	$98,860,884	$9,347,453	$20,472,406	$14,307,723
TOTAL NUMBER OF CASES	41*	70*	41*						
AVERAGE AMOUNT PER CASE				$1,621,008	$1,864,478	$2,411,241	$227,987	$292,463	$348,969

FOR AUDIT YEAR ONLY

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

		Total Discrepancy for All Years			**Total Tax Undercharged for All Years**		
		2005	**2006**	**2007**	**2005**	**2006**	**2007**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$307,994,676**	**$691,644,789**	**$475,624,462**	**$47,805,251**	**$104,635,184**	**$62,333,000**
	AVERAGE AMOUNT PER CASE	**$7,512,065**	**$9,880,640**	**$11,600,597**	**$1,165,982**	**$1,494,788**	**$1,520,317**

	2005	2006	2007
TOTAL NUMBER OF CASES	180	254	232

		Total Discrepancy for All Years			**Total Tax Undercharged for All Years**		
		2005	**2006**	**2007**	**2005**	**2006**	**2007**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$1,515,772,128**	**$2,188,321,074**	**$2,355,211,238**	**$232,204,395**	**$322,305,696**	**$362,489,626**
	AVERAGE AMOUNT PER CASE	**$8,420,956**	**$8,615,437**	**$10,151,773**	**$1,290,024**	**$1,268,920**	**$1,562,455**