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Hong Kong Tax Spotlights

Issue 1
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This is the first issue of a quarterly Hong Kong tax newsletter prepared by Deloitte Hong Kong, Tax Division. This newsletter aims to give readers a periodic update on news about tax practices; development of tax cases and serves as a platform to communicate any news regarding our own tax practice to the business and professional community.

Section A: Hong Kong tax updates of the second quarter of 2011

1. Hong Kong tax treaty network

On 6 June 2011, Hong Kong SAR government signed its 21st comprehensive agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income (CDTA) with the Czech Republic.

Hong Kong first signed a CDTA with Belgium in December 2003, then with Thailand in September 2005; with China in August 2006 (that superseded the one signed in 1998); with Luxembourg in November 2007

and with Vietnam in December 2008. In March 2010, the Hong Kong SAR government enacted the Inland Revenue (Amendment) Ordinance 2010, which took effect from 12 March 2010, enabling the Hong Kong SAR government to adopt the 2004 OECD version of Exchange of Information (EoI) article. Such move put Hong Kong on the same footing as many other OECD member countries in terms of power to obtain information from taxpayers that is related to foreign taxes. This legislative amendment also facilitated the CDTA negotiation process and in the year 2010 alone, the Hong Kong SAR government signed another 13 CDTAs with its trading partners, for example, France, Ireland, Japan and the UK. It was a phenomenal growth. In the first half of 2011, our government has signed CDTAs with Spain, Portugal and Czech Republic.

Hong Kong continues to expand its treaty network. There are countries with which CDTA negotiations with Hong Kong are in process, for example, Italy, Korea and India. The newest CDTA negotiation commenced this week on 27 June 2011 in Ottawa, with the Government of Canada. Without a doubt, Hong Kong would play a more active role in the region and promote international trade and business with its trading partners in many parts of the globe via its comprehensive CDTA network.

2. Five CDTAs are about to put into force

On 13 May 2011, the Hong Kong SAR government gazetted five orders made by the Chief Executive in Council under the Inland Revenue Ordinance (IRO), which implement the CDTAs with Liechtenstein (a country in Central Europe, bordered by Switzerland to the west and south and by Austria to the east); France; Japan and New Zealand, and the Protocol to the CDTA with Luxembourg. These orders have been tabled at the Legislative Council for negative vetting. The respective CDTAs and the Protocol will only be put into force after both Hong Kong and the treaty partners have completed their ratification procedures.

3. Hong Kong enterprises engaged in processing trade operations

It has long been a debatable issue between enterprises engaging in processing trade with manufacturing operations in China, and the Hong Kong SAR government. The crust of the question is whether the Hong Kong enterprises, which had been engaging themselves in “contract processing” for years but during the past few years, after they have transformed from “contract processing” to “import processing” trade, but in substance they continue with their existing mode of operations, could still enjoy the 50:50 apportionment of profits and the depreciation allowances in relation thereto.

The transformation was partly driven by the policy shift from the Chinese government. The Chinese relevant tax authorities proclaimed that from 1 July 2009 to 30 June 2011, a foreign investment enterprise (FIE) which is transformed from contract processing factory can enjoy import duty and value-added tax relief on transferred equipment if such equipment was contributed by a foreign investor to the FIE as registered capital and was imported and provided to the contract processing factory previously without any consideration.

The stance taken by the Hong Kong SAR government is quite clear. The Secretary for Financial Services and the Treasury, Professor K C Chan, has reiterated in various occasions that, in essence, Hong Kong adopts “territorial source principle” of taxation, 50:50 apportionment of profit would be applicable to enterprises when their relevant activities fully meet the mode of operation of “contract processing”, also a 50% of the corresponding tax depreciation allowance for their plant and machinery used would be allowed for.

Thus, Hong Kong enterprises that are currently engaging in import processing trade (though they claimed that they had transformed from contract processing and the basic mode of operations after the transformation remains substantially unchanged) would

not be considered as engaging in manufacturing operation and their chargeable profits were actually derived from selling the goods purchased from the production enterprises (i.e. the suppliers) in China. For the plant and machinery purchased by the Hong Kong companies but used by the production enterprise in China, the related depreciation allowances are denied by the Inland Revenue Department (IRD) under sec 39E of the IRO since the assets were used outside Hong Kong by a person other than the taxpayer, even though the profits are chargeable to profits tax in Hong Kong.

4. **Special stamp duty (SSD) approved**

The Legislative Council approved on 22 June 2011 to impose a SSD on quick re-sale of flats. The legislation amendment states that a SSD of 15% will be levied on residential properties sold within six month of purchase; 10% will be payable on those resold within a year and 5% on those resold within two years.

Note: SSD was effective from 20 November 2010 but subject to the enactment of the new legislation. In this regard, with respect of agreements for sale executed between 20 November 2010 and the date when the Stamp Duty (Amendment) Ordinance 2011 was published in gazette, i.e., on 30 June 2011, any applicable SSD has to be paid within 30 days from this date. The government will review the policy every two years.

5. **Inland Revenue (Amendment)(No.3) Bill 2011**

The Bill was passed on 8 June 2011 to implement the proposal contained in Hong Kong Budget 2011/12. Among other changes, it includes a reduction of salaries tax and tax under personal assessment for 2010/11 by 75%, subject to a ceiling of $6,000 per case; increased by 20% child allowance, dependent parent/grandparent allowances and the deduction ceiling for elderly residential care expenses for salaries tax and tax under personal assessment.

6. **Raise the rates for first registration tax for cars**

   The Legislative Council passed the government's proposal on raising the first registration tax rates for cars on 15 June 2011. The highest marginal rate becomes 115% on the taxable value of cars over $500,000. The change includes an increase in tax concessions for environmental-friendly petrol cars from 30%, subject to a cap of $50,000 per car, to 45%, subject to a cap of $75,000 per car.

7. **Inland Revenue (Amendment)(No.2) Bill 2011**

   The Bill was gazetted on 25 February 2011 and was put to the Legislative Council for First Reading on 9 March 2011. Under the existing provisions of the IRO, when an enterprise purchases intellectual property rights (IPR), the purchase consideration, which is capital in nature, is generally not deductible **except** for the capital expenditure incurred on the purchase of patent rights and rights to any know-how, sec 16E of the IRO.

   The proposed amendment aims at promoting a wider application of the IPRs by enterprises, to encourage innovation and upgrading and to facilitate development of creative industries in Hong Kong. It provides deduction for capital expenditure, i.e., the purchase costs (including legal expenses and valuation fees) incurred on purchase of copyright, registered design or registered trade mark for the use in the production of chargeable profits.

   However, there are issues yet to be solved before the Bill could be put to the Legislative Council for further readings. One of which is about the tax deduction arrangement for the IPRs involved in cross border activities, i.e., a Hong Kong company owned IPRs, but used by licensed users outside Hong Kong. A Bills Committee of the Legislative Council was formed on 8 April 2011 to discuss the issue further. The next scheduled meeting will be held on 7 July 2011.

8. **Alert on fraudulent website**

   The IRD alerts the public to a fraudulent website, URL: **www.irdhongkong.com**. The IRD has no connection

with this website and it has reported the case to the Hong Kong Police Force.

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Section B: Hong Kong tax case development

1. Court of Appeal reaffirms denial of 50:50 apportionment of profits for import processing arrangement

The Hong Kong Court of Appeal (CA) issued a decision on 7 March 2011, confirming that the 50:50 apportionment of profits concession only applies to contract processing arrangements and not to import processing arrangements (Commissioner of Inland Revenue v CG Lighting Limited HCIA8/2009). The CA upheld the 2010 ruling of the Court of First Instance and reiterates that a taxpayer's profits derived from the sale of goods acquired under an import processing arrangement with a subsidiary in Mainland China are subject to Hong Kong profits tax in full. In essence, the decision reconfirms that legal form ultimately outweighs substance. Our Tax Analysis Hong Kong Tax Issue H40/2011 – 9 May 2011 refers.

2. Court confirms decision in ING Baring concerning source principle with regard to commission income

On 18 April 2011, the Court of First Instance of the Hong Kong SAR handed down its judgment in Commissioner of Inland Revenue v Li & Fung (Trading) Limited HCIA 3/2010. The decision was in favor of Li & Fung (Trading) Limited, and it confirmed the earlier decision of the Board of Review that Li & Fung (Trading) Limited's commission income with respect to goods sourced from foreign suppliers was offshore and, therefore, not chargeable to Hong Kong profits tax. The significance of this case is that the judge confirms the Court of Final Appeal's decision on ING Baring Case. The principle upheld was that any antecedent or incidental activities, including mere monitoring,

supervisory or decision-making functions (usually referred as “brain analogy”) generally are not considered relevant in determining the source of profits. The correct focus has to be the activities that give rise to the relevant gross profits. Our Tax Analysis Hong Kong Tax Issue H39/2011 – 5 May 2011 refers.

3. Advance Ruling Case

The IRD published the Advance Ruling Case No.45 in respect of sec 14 of the IRO, i.e., source of profits on 27 May 2011.

The case was about a Hong Kong incorporated company (the Company), which has non-resident directors and its board of directors’ meetings will all be held outside Hong Kong; it maintains no office, does not employ any staff nor appoint any agent in Hong Kong, with regard to service fee income it receives for websites services offered to content providers, i.e., allowing the content providers to use the websites it operates. The IRD decided that the service fee income derived from the arrangement will not be chargeable to Hong Kong profits tax under sec 14.

The Company is one of the subsidiaries of a group. The group operates a number of websites (Group Websites) which are offered to content providers to upload their internet contents. These internet contents are created by the content providers that would be accessible by the viewers.

The Group Websites are owned by Company C within the group in Country Y. Company C confers the right to operate the Group Websites to the Company for free. Both the content providers and the viewers need to register with the Company online via the internet. Under the service agreement between the content providers and the Company, whenever the content providers have charged a fee to the viewers, the Company is entitled to X% of such fee as service income.

Also, the Company has entered into a service contract

(which was concluded outside Hong Kong) with its parent company, Company B in Country X, for which the above mentioned service the Company was obliged to provide to the content providers is wholly subcontracted to Company B. The billing is completely handled by Company B, whereby the fee charged to the viewers by the content providers is firstly billed by Company B on behalf of the Company. And, the Company is required to pay the entire service fee received from the content providers to Company B pursuant to this service contract.

The daily operations of the Group Websites, including web and IT development services, customer and sales support services are all performed by Company D, a wholly owned subsidiary of Company B in Country Z. And, the Group Websites have never been and will not be supplied to any content providers and/or viewers in or through Hong Kong.

Our observation is that under the broad guiding principle of source of profits, that was established under the Hang Seng Bank Case, i.e., what the taxpayer has done to generate the profits in question and where he has done it, the Company only plays the role as the contact point which is visible to the content providers and the viewers. The services of maintaining and operating the Group Websites, which were in substance responsible for the generation of the service fee income, were performed by Company B and D outside Hong Kong. Hence, we consider the advance ruling is a correct ruling on sec 14.

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Section C: Tax topical topic corner

"To rethink the locality of profits"

Hong Kong has long been adopting the territorial principle of taxation for more than half of a century. It is generally believed as an effective way to attract foreign direct

investment from foreign investors, and particularly the multi-national corporations to establish their regional headquarters here.

For Hong Kong profits tax purposes, the territorial principle of taxation is grounded on sec 14 of the IRO. The provision stipulates the conditions of basic scope of charge of profits tax:

"… profits tax shall be charged … on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong …"

The basic principle is that only profits obtained by a taxpayer derived from Hong Kong, i.e., with a Hong Kong source, would be assessable to profits tax. Such basic principle has been around for many years, however, the practical issue on whether a particular piece of income is in fact "arising in or is derived from" Hong Kong, and shall be assessable to profits tax in Hong Kong remains a controversial one and the debate between taxpayers and the IRD never ends.

Looking at the development of source rules or principles derived from the judgment of court cases handed down over the years, we have gone through different "paradigms", from the operations test used by the Hutchison Whampoa Dock Case in 1960; simple contract tests that were used to determine the source of profits of trading entities to a "totality of facts approach" before the ING Baring Case, which was decided by the Court of Final Appeal in 2007.

Though the broad guiding principle of determining source of profits held by the Lord Bridge of Harwich in Hang Seng Bank Limited Case of 1990 remains clear and unchanged, i.e., one looks to see what the taxpayer has done to earn the profit in question and where he has done it, it is often difficult to objectively identify income generating activities. The ways that the court judges look at the factors or activities that were contributing to the generation of profits in question are often inconclusive.

Until the Court of Final Appeal decision in ING Baring Case, it represented a shift of paradigm with regard to the application of the source rule away from the totality of facts approach. In ING Baring Case, even though the company has business and perform certain commercially significant activities in Hong Kong, these did not undermine its claim that the relevant service fee income was offshore because there were more proximate activities responsible for the generation of the said income that were performed outside Hong Kong.

The judges summarized two conditions that were applicable to the source principle in the judgment of the case. Firstly, the operations in question must be the operations of the taxpayer, and it includes those performed by the agents or other persons acting on their behalf under certain conditions; and second of all, only the operations that directly produce the profit in question, rather than the taxpayer's whole operation or business activities, are relevant, i.e., the antecedent or incidental activities are not relevant for the purpose of source of profit determination even though these activities were commercially essential to the operations and profitability of the company's business.

After the ING Baring Case, the IRD issued its Departmental Interpretation and Practice Notes (DIPN) No. 21 (Revised) – Locality of Profits in December 2009, however, it does not give many practical examples of what these antecedent or incidental activities might be for various types of income. In this regard, the application of source rules regarding locality of profits continues to be a contentious issue between the IRD and taxpayers.

Source of profits is a "dynamic" concept and we have been observing how it evolved. In the above DIPN No. 21 (Revised), it is noted that the IRD has taken a different view with respect to source of profits over certain types of income. The revised DIPN takes the position that certain re-invoicing operations could be chargeable to tax in Hong Kong since the re-invoicing profit could be considered as service type income, but not trading profit; and if such "mark-up" services are performed in Hong Kong, the entire re-invoicing profits is treated as having Hong Kong source and chargeable to profits tax in Hong Kong. It is contrary to

our earlier belief that income relating certain re-invoicing activities carried out in Hong Kong would not be taxed, given that the activities were restricted to issuing and accepting invoices in respect of contracts of purchase and sale effected by overseas associates outside Hong Kong.

In another occasion, under the processing trading engaged by the Hong Kong enterprises, the position taken by the government with regard to source of profits 50:50 apportionment claim was confirmed by Datatronic Case in 2009 and the above mentioned C G Lighting Case in 2011. Hong Kong enterprises that are currently engaging in import processing would not be considered as engaging in manufacturing operation and their chargeable profits were actually derived from selling the goods purchased from the production enterprises (i.e. the suppliers) in China. Hence, the apportionment of profits is not available to taxpayers that are engaging in import processing trade. The government placed no significance to the substance behind the arrangement. The decisions of both cases essentially reconfirmed that legal form ultimately outweighs substance.

The above examples show that the government has been taking an aggressive stance to limit the application of source rules in the determination of source of profits. Also, it seems that the IRD has started to revisit their positions concerning the source rules that have been used for a while earlier over certain types of income, e.g., re-invoicing activities and apportionment of profits under contracting processing.

Thus, it is high time for taxpayers to take a more proactive approach and rethink about how locality of profits would impact their tax exposure. It is particularly important to have regular reviews over their existing mode of operations such that they would be able to secure and defend their offshore claims properly, where appropriate.

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Section D: Showcase of tax publications and events

1. **Tax Analysis**

- Issue P142/2011 - 13 June 2011
  Chinese tax authorities stress quality requirements for transfer pricing documentation

- Issue P141/2011 - 2 June 2011
  Government further clarifies registration requirements for Equity Investment Enterprises

- Issue P140/2011 - 27 May 2011
  CSRC issues discussion draft on material asset restructuring and associated issues

- Issue H40/2011 - 9 May 2011
  Court of Appeal reaffirms denial of 50:50 apportionment of profits for import processing arrangement

- Issue H39/2011 - 5 May 2011
  Court confirms decision in ING Baring concerning source principle with regard to commission income

- Issue P139/2011 - 27 April 2011
  Update on Supervision of Private Equity in China

- Issue P138/2011 - 11 April 2011
  China releases clarification rules on Circular 698

- Issue P137/2011 - 1 April 2011
  Resource tax reform expands to western region

2. **Upcoming tax event**

Deloitte and CCH will jointly organize a tax seminar on Wednesday, 6 July 2011, from 9am to 5pm at the Excelsior Hotel, Hong Kong. The seminar will cover the topics of **'Hong Kong Annual Tax 2011: Guide to Cross-borders Transactions in the New Era of**

Taxation of Hong Kong' in the morning session and **'China Tax: Transfer Pricing Challenges and Opportunities in a Fast-Changing Environment'** in the afternoon session, which will be presented by Deloitte's tax experts. If you register for the whole seminar or the morning session, you will receive a free copy of the latest 'Hong Kong Master Tax Guide 2011/12'. Please contact **Lorenz Law** for more details.

Note: The above sections of Hong Kong Tax Spotlights contain information of the events that have taken place up to the date of this newsletter.

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