Tax – National Technical Centre
Issue 2, December 2011

Hong Kong Tax Spotlights.

In this issue:

This is the second newsletter of our periodic issue on Hong Kong taxation prepared by Deloitte Hong Kong, Tax Division. This issue covers Hong Kong tax updates; news about tax practices; development of tax cases and news regarding our own tax practice to the business and professional community. Though it would not be covered in details, we also provide readers with certain important news/updates on PRC taxation during the period.

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

1. Hong Kong tax treaty network

Hong Kong continued to expand its tax treaty network during the second half of 2011. On 8 November 2011, Hong Kong SAR Government signed its 22nd comprehensive agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income (CDTA) with the Government of Malta. Also, the Commissioner of Inland Revenue (CIR) and his team have been engaging in different stages of CDTA negotiations with their counterparts of other countries, noticeably Italy (the third round negotiation was completed on 28 September 2011) and Finland (the second round negotiation was completed on 21 September 2011).

Furthermore, Hong Kong and its contracting partner jurisdictions have completed the ratification processes for the following tax treaties to come into force during the period. Currently, among the twenty-two signed CDTAs, fifteen of them have come into force.

- France;
- Japan;
- Liechtenstein;

- Luxembourg (Protocol signed on 11 November 2010);
- The Netherlands; and
- New Zealand.

2. Standalone tax information exchange agreement (TIEA)

The Global Forum conducts peer reviews of its member jurisdictions' ability to co-operate with other tax administrations in accordance with the internationally agreed standard. The standard provides for exchange of information on request where it is foreseeably relevant to the administration and enforcement of the domestic tax laws of the requesting jurisdiction. The Global Forum's peer review process examines both the legal and regulatory aspects of exchange (Phase 1 reviews) and the exchange of information in practice (Phase 2).

Under the existing policy of the Hong Kong Government, it would only engage in an exchange of information in respect of taxpayers under the framework of a CDTA, but not of a TIEA. Nevertheless, other jurisdictions, which either have not had or are not interested in having a CDTA with Hong Kong, may be interested in entering into a standalone TIEA with Hong Kong in order to obtain information that enables them to combat tax evasion carried out by taxpayers liable to tax in their jurisdictions.

On 26 October 2011, the Global Forum released the peer review report (Phase 1) on Hong Kong. Amongst all the findings and recommendations contained in that report, the Global Forum recommended that Hong Kong should enter into TIEAs with its all relevant partners [non-CDTA jurisdictions in particular] that are interested in having an information exchange arrangement with Hong Kong.

We are yet waiting for a response from the Hong Kong Government whether they would plan to conduct a public consultation on the move suggested by the Global Forum.

3. Proposed deduction for costs incurred on purchase of copyright, registered design or registered trade mark

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. The Bill aims at promoting a wider application of the intellectual property rights (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. It is to be deducted over 5 years from the year of assessment which the specified capital expenditure is incurred.

A Bills Committee of the Legislative Council was formed on 8 April 2011 to discuss certain contentious issues contained in the Bill. The main issues include the scope of specified IPRs covered by the proposed tax deduction, conditions for the proposed tax deduction, power of the CIR to determine true market value of any of the IPRs, scope and application of the proposed anti-avoidance provisions, and tax deduction arrangements for any of the IPRs involved in cross-border activities. Last meeting of the Bills Committee was held on 10 November 2011. The Second Reading debate on the Bill has been scheduled to resume on 7 December 2011.

4. Various Interpretation and Practice Notes revised

The following Departmental Interpretation and Practice Notes (DIPN) and Stamp Office Interpretation and Practice Note (SOIPN) were revised or issued during the period:

- DIPN No.31 (Revised) "Advance Rulings" was revised to provide more information to enable taxpayer to better understand the advance ruling service provided by the Inland Revenue Department (IRD).

- DIPN No.25 (Revised) "Service Company 'Type I' Arrangements – Salaries Tax" was updated in November 2011 to include Board of Review decisions concerning sec 9A of the Inland Revenue Ordinance (IRO) that is used to counteract arrangements made to avoid salaries tax by the use of service companies and to add examples to illustrate the coverage of sec 9A.

- DIPN No.32 (Revised) "Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the avoidance of double taxation on income" was revised in October 2011 to reflect the revisions made in DIPN No.10 (Revised) and DIPN No.21 (Revised) regarding locality of employment and locality of profits respectively.

- SOIPN No.5 (Revised) "Special Stamp Duty", which was first issued in July 2011, that set out the stamping requirements and the practices adopted by the Collector of Stamp Revenue in relation to Special Stamp Duty. It was revised in October 2011 to cater for the subsequent comments received from stakeholders.

5. Tax treatment for defined benefit retirement schemes

On 18 July 2011, the IRD revised its assessing practice over the defined benefit retirement schemes. Previously, the IRD would only allow the "Net Total" (i.e., the net position of the aggregate of four components prescribed under HKAS 19 "Employee Benefits", namely, the current service cost, interest cost, the expected return on any scheme assets; and actuarial gains & losses recognized in accordance with HKAS 19) charged as an expense to the income

statement as deductions, subject to a restriction of 15% of the employees' total emolument for the period covered, or would be taken as assessable profits if it was a credit to the income statement. The actual contributions paid would not be allowed for the deduction.

Now, the IRD adopts the following assessing practice starting from 18 July 2011:

a. Any component forming part of the "Net Total" (as described above) is not deductible or assessable;
b. The ordinary annual contributions paid are allowable under sec 16(1), subject to the 15% limitation prescribed in sec 17(1)(h); and
c. The special contributions paid are deductible in accordance with sec 16A at the rate of 20% in each of the years starting from the year of payment.

The IRD addresses also all assessments made according to the previous practice cannot be reopened if they have become final and conclusive. At the same time, the IRD adopts a pragmatic approach in dealing with 2010/11 returns. That is, if any taxpayer feels aggrieved by the change of the assessing practice, they can write to the IRD and provide a computation to show the overall difference in the amounts of assessable profits obtained under the two assessing methods. The assessor will consider deducting the difference, if any, from the assessable profits.

6. Annual meeting between the IRD and the Hong Kong Institute of Certified Public Accountants

Last annual meeting above was held in February 2011. Various matters concerning profits tax issues; salaries tax issues; cross-border tax issues; double tax agreements and departmental policy and administrative matters were discussed. The meeting minutes was published by the Hong Kong Institute of Certified Public Accountants in August 2011. Readers may download a copy of the meeting minutes from the IRD's official website. http://www.ird.gov.hk/eng/tax/taxrep_am.htm

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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 – further appeal of taxpayer dismissed

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.

The taxpayer's application for leave to appeal to Court of Final Appeal (CFA) was heard on 5 May 2011 but was rejected by Court of Appeal. The taxpayer has filed an application to CFA on 1 June 2011. The case was heard and dismissed on 24 August 2011. As such, the above decision handed down by CA was final.

2. **Court confirms decision in ING Baring concerning source principle with regard to commission income – wait for a hearing at CA in February 2012**

   On 18 April 2011, the Court of First Instance (CFI) 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 CIR has filed a notice of appeal to CA. The hearing is scheduled to be heard on 14 and 15 February 2012.

3. **Case on late objection and reopening of previous years' assessment – under appeal that will be heard in February 2012**

   On 15 February 2011, the CFI handed down its judgment in Moulin Global Eyecare Trading Limited (In Liquidation) [HCAL 29/2010] on the late objection and reopening of previous years' assessment. The decision was in favor of the taxpayer. The CIR filed a notice of appeal to CA. The hearing is scheduled to be heard on 2 and 3 February 2012.

4. **Court clarifies the relationship between unrealized gains and assessable profits – the CIR's appeal to CA will be heard in May 2012**

   The CFI issued its decision in Nice Cheer Investment Limited v Commissioner of Inland Revenue HCIA 8/2007 on 28 June 2011, regarding unrealized gains/losses in respect of trading securities. The taxpayer won the appeal case. The judge of the CFI ruled that the taxpayer's unrealized gains arising from the revaluation of trading securities that were recognized in accordance with accounting standards are not chargeable to profits tax under sec 14 of the IRO.

   The CIR filed a notice of appeal to CA on 26 July 2011. The hearing is scheduled to be heard on 22 and 23 May 2012.

5. **Case on termination payment for early termination of franchise agreement – yet to be confirmed by CA judges in November 2012**

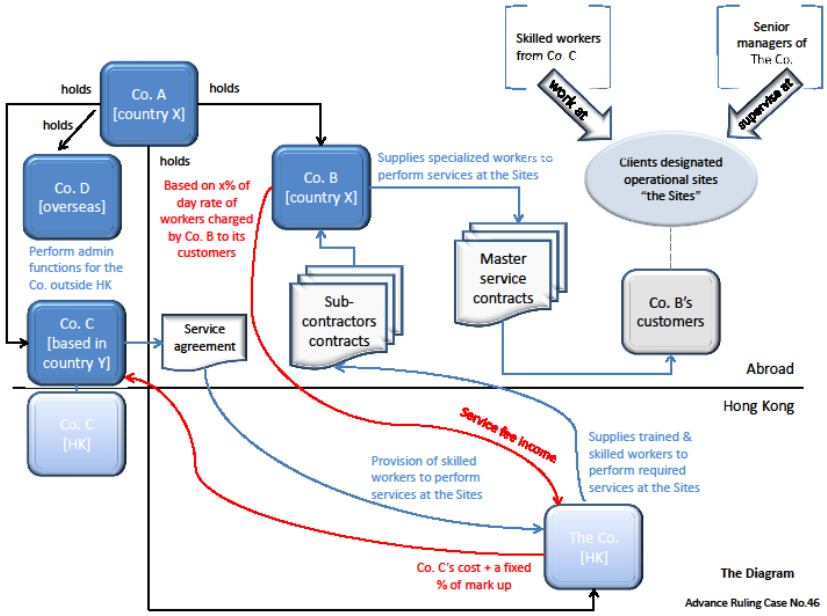
   The CFI issued its decision in Aviation Fuel Supply Company v Commissioner of Inland Revenue HCIA 6/2009 on 8 July 2011. The judgment was ruled in favor of the taxpayer. The payment for early termination of lease under a franchise agreement of a Build-Operate-

Transfer project was held as capital in nature, hence not taxable under sec 14 of the IRO.

The CIR filed a notice of appeal to CA on 5 August 2011. The hearing is scheduled to be heard on 13 and 15 November 2012.

6. Advance Ruling Case

The IRD published the Advance Ruling Case No.46 in respect of service income under sec 14 of the IRO, i.e., source of profits on 4 August 2011. It was ruled that the service income so derived is not chargeable to Hong Kong profits tax under sec 14 since the services that give rise to the fees were performed outside Hong Kong. Readers may refer to the diagrammatic illustration of the case below for the background information and the arrangement of the transaction under contemplation.



<u>The background and the arrangement</u>

The Company is a Hong Kong incorporated company. It does not and will not maintain any staff in Hong Kong nor perform any work in Hong Kong. Company B is a company incorporated in country X. It acts as a contractor for its customers to supply specialized workers to perform services (the Services) at its customers' designated operational sites outside Hong Kong (the Sites). The Company was thus set up to act as a subcontractor of Company B. Company A is the holding company incorporated in country X and it holds both Company B and the Company.

Company B has entered into service contracts with its customers. In turn, it entered into subcontracting agreements with the Company to subcontract part of the Services to the Company. The Company receives service income from Company B for the subcontracting services provided.

The Company will employ senior managers overseas who will be responsible for the supervision work at the Sites. The Company has also entered into a service agreement with a related company, Company C (which was incorporated in Hong Kong but based in country Y and does not maintain any staff in Hong Kong) for the provision of skilled workers required. In turn, the Company remunerates Company C at cost plus a fixed percentage of mark-up. The Company has engaged Company D, another overseas related company to carry out the necessary administrative functions outside Hong Kong. All the above agreements with its related companies, the Company negotiated and concluded them outside Hong Kong.

To summarize, the Company only derives income from Company B for the provision of services which are wholly performed by the Company's senior managers and Company C's staff outside Hong Kong.

Conclusion

For service fee income, the source of profits is the place where the services are performed which give rise to the fees, i.e., the geographic location where the income generating activities took place. It is consistent with the judgment in Hang Seng Bank Case (1990) and Li & Fung (Trading) Limited Case (2011).

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Section C: Important news on PRC tax

1. Value Added Tax (VAT) Reform Pilot Program in Shanghai

On 26 October 2011, State Council of the People's Republic of China (PRC) announced a VAT Reform Pilot Program that will be launched for transportation services, R&D and technology services, information and technology services, creative cultural services, logistics and ancillary services, leasing of moveable and tangible goods and attestation and consulting services in Shanghai on 1 January 2012.

The Ministry of Finance (MoF) and the State Administration of Taxation (SAT) jointly issued the Implementation Rules to the VAT Reform Pilot Program. Although this pilot program covers only taxpayers operating in Shanghai within certain specific service sectors, the program is meant to be a platform for a nation-wide VAT reform that will come out at a later stage. Therefore, readers are strongly encouraged to study the relevant provisions contained in the above Implementation Rules and follow up closely the developments in this respect.

2. Late verification of VAT invoices is allowed

The SAT issued Bulletin [2011] No.50 – the "Announcement on Issues Concerning Overdue VAT Deduction Vouchers Used for Input VAT Recovery" on 14 September 2011, that stipulates that effective from 1 October 2011, taxpayers will be allowed to claim VAT

vouchers (such as: VAT special invoices, import VAT payment certificates) which have not been verified within the prescribed time period due to "objective reasons". However, such late verification and claim must be approved by the relevant tax authorities and reported to the SAT. These procedures shall be done in accordance with the "Administration Measures for Overdue VAT Deduction Vouchers Used for Input VAT Recovery" attached to Bulletin [2011] No.50.

Possible objective reasons are listed as follows:

- Force majeure events such as natural disasters and local emergency events
- Incidents where the VAT vouchers were stolen or lost in mail delivery or mis-mailed
- VAT deduction vouchers were detained by relevant judicial or administrative departments or bureaus or the VAT deduction voucher verification procedures were not conducted timely due to IT system/network failure of tax authorities
- Situations where the VAT deduction vouchers were not delivered promptly due to contractual disputes between trading partners

Incidence where personnel of taxpayer that handles tax affairs are absent due to sudden death, injury, serious illness and unannounced leave from work such that work could not be handed over properly and timely.

3. Anti-dumping measures against imported photographic papers originated from European Union (EU), United States (US) and Japan

In August 2011, the General Administration of Customs of the PRC (GAC) issued Announcement of the GAC No.51 on originating in the EU, US and Japan imported paper products of the provisional anti-dumping measures. Essentially, effective from 10 August 2011, the GAC levies anti-dumping deposits and corresponding import VAT deposits on imported photographic papers originated from the EU, US and Japan (HS Code: 37031010, 37032010 and 37039010).

Sum of deposits is calculated as: (Dutiable price x anti-dumping rate) x (1 + import VAT rate); where anti-dumping deposit rates applicable to photographic papers are:

Place of origin	Name of the producer	Applicable rate
European Union	Kodak Limited	26.8%
	FUJIFILM Manufacturing Europe B.V	17.6%
	All others	26.8%
United States	FUJIFILM Manufacturing U.S.A., Inc.	18.2%
	All others	28.8%
Japan	Japanese companies	28.8%

Enterprises declaring import photographic papers shall submit certificates of origin to the GAC. If the origin is the EU, US or Japan, they need to provide the invoices issued by the original manufacturers.

4. The Individual Income Tax Law of the PRC (Sixth Amendment)

In June 2011, the 21st session of the Standing Committee of the Eleventh National People's Congress of the PRC passed the Amendment to the Individual Income Tax (IIT) Law of the PRC (the Sixth Amendment), which has come into effect from 1 September 2011.

According to the Sixth Amendment, there are changes on the monthly standard deduction (MSD) and tax rates for salaries and wages, as well as the filing and payment deadline for monthly PRC IIT return. The major changes are:

- The MSD for income from salaries and wages increases from RMB2,000 to RMB3,500; total deduction for foreign employees (including residents of Hong Kong, Taiwan and Macau) remained at RMB4,800;
- The filing and payment deadline for monthly IIT return are extended from the 7th day to the 15th day of the following month; and
- The IIT rates applicable to salaries and wages were changed from earlier nine bands to seven bands. The tax rates of 15% and 40% were removed and the lowest tax rate was reduced to 3%. In addition, the income level applicable to each tax rate was adjusted accordingly.

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Note: The above sections of Hong Kong Tax Spotlights contain the tax news and changes in the tax legislation that have taken place up to the date of this newsletter.

Section D: Showcase of tax publications and events

1. Tax Analysis

- Issue P149/2011 - 19 November 2011
  Detailed implementation rules released for VAT Reform Pilot Program in Shanghai
- Issue P148/2011 - 2 November 2011
  RMB-Denominated foreign investment further liberalized
- Issue P147/2011 - 30 October 2011
  VAT reform pilot program to be launched in Shanghai on 1 January 2012
- Issue P146/2011 - 21 October 2011
  SAT clarifies business tax treatment of asset restructuring transactions

- Issue P145/2011 - 15 September 2011
  Preferential income tax rate for high-new technology enterprises extended to offshore income
- Issue H41/2011 - 29 July 2011
  Court clarifies the relationship between unrealized gains and assessable profits in Nice Cheer Investment Ltd Case
- Issue P144/2011 - 13 July 2011
  New double taxation agreement signed with the U.K.
- Issue P143/2011 - 1 July 2011
  Tariff adjustment in 2011, what's next?

2. Upcoming tax event

Seminar on VAT Pilot Reform (December 7)

Deloitte will hold a seminar entitled, 'Are you ready to take off? Zoom in on VAT Pilot Reform' to discuss with you the detailed implementation rules of the pilot program which were released on 16 November 2011. During this seminar, experienced indirect tax experts who have lived through the planning of the Reform will navigate you through the new rules of the pilot program and share in-depth views of the program and practical planning opportunities with you. The seminar will be a unique platform for you to interact with our experts and will be held on Wednesday, 7 December 2011 from 2:30pm to 5:00pm. Registration starts at 2:00pm.

Asia Pacific Global Employer Services Conference (December 6 - 9)

Deloitte Asia Pacific GES Client Conference will be held from 6 to 9 December 2011 in Hong Kong. This year we will recognize and address some of the issues for global mobility as we continue to emerge from the global recession. In the current economic environment, global mobility functions are seeking to build their brand in the eyes of the broader business and explore new opportunities to develop their talent pool across the region.

Please contact **Lorenz Law** for more details.

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

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