

Tax

Hong Kong Tax Update

December 2009





This year is a year of change for taxes in Hong Kong. After serving eight years in the post, Mrs. Alice Lau, the previous Commissioner of Inland Revenue (“CIR”), retired in early December. A new CIR, Mr. Yam-yuen Chu, has been appointed to lead the tax administration in Hong Kong. Besides the change in the leadership of the Inland Revenue Department (“IRD”), there are several significant profits tax developments in 2009, most of which took place in the second half of the year. While some of these changes are welcome by taxpayers, some have stirred controversy and debate among the business community and tax practitioners. During the year, we have captured these major tax developments through the publication of our Hong Kong Tax News Flashes. This article recaps these developments.

Locality of profits remains uncertain and contentious

Revised DIPN 21 published

In December 2009, the IRD issued the much anticipated revised Departmental Interpretation and Practice Notes No. 21 – Locality of Profits (“revised DIPN 21”) to provide guidance on the latest views and positions adopted by the IRD on the sourcing issue. In the run-up to the publication of the revised DIPN 21, expectations were running high that the revised note would provide more guidance and added clarity to taxpayers on the determination of the source of profits. To the disappointment of those with high expectation, the revised DIPN 21 appears to create more uncertainty than clarity.

Overall, the content of the revised DIPN 21 suggests that a more restrictive, less flexible, and more stringent approach being adopted by the IRD going forward in determining the source of profits. For more details about the IRD’s views and positions expressed in the revised DIPN 21 and our comments and observations, please refer to our *Hong Kong Tax News Flash, December 2009, Issue 13*.

Developments in case law

Determining the source of manufacturing profits in different operational models has been an issue for years. The IRD’s different treatments of contract and import processing arrangements for Hong Kong profits tax purposes continue to be challenged by taxpayers. In 2009, decisions in two notable cases concerning apportionment of profits under an import processing arrangement were handed down.

A landmark case in this area is *CIR v Datatronic Ltd.* (“the *Datatronic* case”). In July 2009, the Court of Appeal (“COA”) held in the *Datatronic* case that the Board of Review (“BoR”) and the Court of First Instance (“CFI”) were incorrect in holding that the manufacturing activities performed by the taxpayer in the PRC were important operations attributable to the production of the taxpayer’s profits. It further held that the taxpayer derived its profits from the trading transactions carried out in Hong Kong so the profits are trading profits fully chargeable to Hong Kong profits tax. The taxpayer initially applied for leave to appeal to the Court of Final Appeal (“CFA”) but subsequently withdrawn its appeal. As a result, the decision of the COA in the *Datatronic* case currently represents the highest authority on the sourcing issue under an import processing arrangement. Please refer to our *Hong Kong Tax News Flash, July 2009, Issue 8* for a detailed discussion of the case.

Another case that is worth noting is BoR Case D51/08. The fact pattern of this case is similar to that of the *Datatronic* case. The case was handed down by the Board in January 2009 before the COA’s decision in the *Datatronic* case. The Board in this case looked at the practical commercial reality of the taxpayer’s operations and held that, *in substance*, the taxpayer’s participation in the production process located in the PRC is part of the taxpayer’s profit-producing transaction and therefore part of the profits should be offshore, despite the taxpayer’s arrangement taking the legal form of import processing. The Board was of the view that it is wrong to classify the taxpayer’s operation either as trading or manufacturing as the operation is a multi-facet one, and the precise characterisation of the operation is not important. The case is under appeal to the CFI and is scheduled to be heard on 15 April 2010. It will be interesting to see whether the CFI will follow the approach adopted by the COA in the *Datatronic* case in determining the source of profits and the outcome of this case. We will provide an update on this case when the CFI’s judgement becomes available.

The application of anti-avoidance provision

While source of profits continues to be the most litigious issue in corporate taxation in Hong Kong, we have seen a trend of increasing application of the general anti-avoidance provision (i.e. section 61A) of the Inland Revenue Ordinance (“IRO”) by the IRD in recent years. There have been four cases concerning the application of section 61A taken to the CFA since 2007, namely:

1. *CIR v Tai Hing Cotton Mill (Development) Limited*;
2. *HIT Finance Limited & HongKong International Terminals Limited v CIR*;
3. *Ngai Lik Electronics Company Limited v CIR*; and
4. *Shui On Credit Company Limited v CIR*.

The CFA handed down its decisions in the *Tai Hing* and *HIT* cases in 2007 and in the *Ngai Lik* and *Shui On* cases in 2009. It is pertinent to note that the IRD won three out of these four cases. The only exception being the *Ngai Lik* case, in which the taxpayer won the case but it remains to be seen whether the triumph represents a pyrrhic victory for the taxpayer.

The Ngai Lik case

While the *Ngai Lik* case was primarily an anti-avoidance case, the CFA’s decision in the case has brought about transfer pricing implications for taxpayers engaging in offshore related party transactions. The transfer pricing implications of the *Ngai Lik* case are discussed in the next section below.

So far as application of section 61A is concerned, the *Ngai Lik* case has established a few important principles, including the need to align the three interlocking conditions (namely, transaction, tax benefit and dominant purpose) under section 61A and the limitation of the CIR’s power under section 61A to that of counteracting the tax benefit identified, etc. In particular, the CFA held in the *Ngai Lik* case that the section 61A assessments in question were not validly raised as they were based on arbitrary amounts rather than counteracting the tax benefit obtained by the taxpayer from its transfer pricing arrangement. The CFA ordered that the assessments under section 61A be raised on the basis of a reasonable estimate of the assessable profits that the taxpayer would have derived if it had hypothetically dealt with its related parties at an arm’s length price. The amount of tax assessed on this basis can potentially be more than the amount previously assessed by the CIR. For a more detailed discussion of the *Ngai Lik* case, please refer to our *Hong Kong Tax News Flash, July 2009, Issue 9*.

The Shui On case

The CFA handed down its decision in the *Shui On* case on 30 November 2009, in which the taxpayer’s appeal was unanimously dismissed. The main thrust of the CFA’s decision in this case was not on the application of section 61A, as it was held that the deferred expenditure in question was capital in nature and not deductible for Hong Kong profits tax purpose; hence, consideration of the applicability of section 61A to this case was not necessary. However, the CFA made a few observations regarding application of section 61A in its *obiter dictum*, the two most important ones being:

1. If the supposed tax benefit would not have been achieved in the absence of section 61A (e.g. where the supposed tax benefit is a deduction but such deduction is not allowable under section 16 or 17), section 61A cannot be applied as there is no tax benefit in the statutory sense; and
2. In exercising the power under section 61A and coming up with the “reasonably postulated hypothetical transaction”, the CIR must be subject to public law constraints and act reasonably and avoid any arbitrary or exorbitant exercise of the statutory power.

The comments and observations made by the CFA in the *Ngai Lik* and *Shui On* cases should provide further clarification and guidance on the application of section 61A, which has been seen as a growing area of litigation between taxpayers and the IRD.

A new era of transfer pricing has arrived

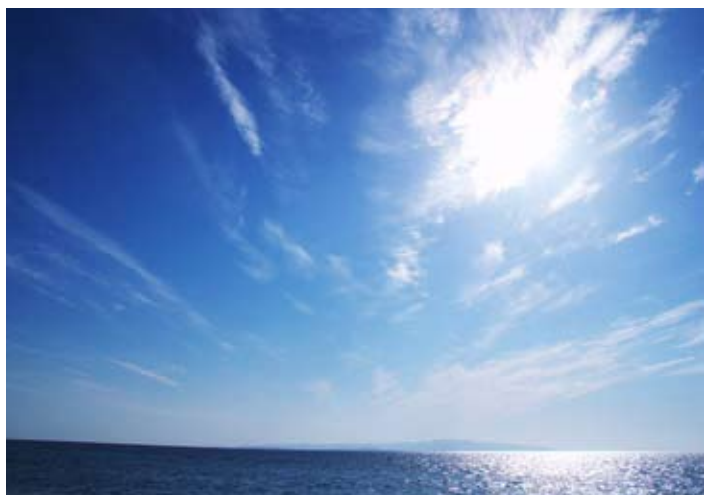
The transfer pricing landscape in Hong Kong has been reshaped in 2009. In April 2009, the IRD issued Departmental Interpretation and Practice Notes No. 45 on Relief from Double Taxation due to Transfer Pricing or Profit Reallocation Adjustments (“DIPN 45”). This was followed by the long-awaited Departmental Interpretation and Practice Notes No. 46 on Transfer Pricing Guidelines – Methodologies and Related Issues published in December 2009 (“DIPN 46”).

DIPN 45 explains how relief from double taxation due to transfer pricing adjustments and profit reallocation adjustments should be provided under a double tax agreement (“DTA”). DIPN 45 focuses on the administrative/procedural issues involved in providing such relief in a DTA context rather than addressing the transfer pricing related issues in general, such as the acceptable transfer pricing methodologies and the transfer pricing documentation requirements, as those issues are covered in DIPN 46. Please refer to our *Hong Kong Tax News Flash, May 2009, Issue 4* for details about DIPN 45 and our observations on its implications.

DIPN 46 outlines the IRD's view on the legislative framework for transfer pricing in Hong Kong, including the statutory provisions in the IRO and the articles in a DTA that are relevant to transfer pricing. It also provides guidance on numerous transfer pricing related issues such as the application of the arm's length principle, the acceptable transfer pricing methodologies, the documentation that taxpayers should consider retaining to support their transfer pricing arrangements, and the interaction between the transfer pricing doctrine and the sourcing rule in Hong Kong. Please refer to our *Hong Kong Tax News Flash, December 2009, Issue 12* for details about DIPN 46 with our comments and observations.

Besides the issuance of DIPN 45 and DIPN 46, the CFA decision in the *Ngai Lik* case discussed above also contains significant transfer pricing implications. Although just forming part of its *obiter dictum*, the CFA established in the *Ngai Lik* case that deduction of excessive amounts that are not paid on an arm's length basis should not be disallowed under section 16 or 17 of the IRO as long as they are incurred for the production of chargeable profits. This effectively means that the IRD is left with the anti-avoidance provisions in the IRO as the only legislative basis for challenging a transfer pricing arrangement in the absence of a DTA and for transactions not involving non-residents. Notwithstanding the comments of the CFA, the IRD takes a different view and has reiterated in DIPN 46 that sections 16 and 17 are among the statutory provisions in the IRO that provide a legal basis for raising transfer pricing adjustments. It is unclear whether the IRD's views on this are correct and it remains to be seen if these will be further tested in the courts.

In the meantime, one key message from the above developments is that transfer pricing has "arrived" in Hong Kong. It seems clear that transfer pricing is likely to become a more prominent issue for both taxpayers and the IRD going forward.



Proposed tax legislation changes on exchange of tax information

An important piece of proposed tax legislation in 2009 is the Inland Revenue (Amendment) (No. 3) Bill 2009 ("Bill"). The Bill seeks to introduce the necessary legislative amendments to the IRO for Hong Kong to adopt the internationally agreed standard of exchange of tax information. It represents a significant step taken by the HKSAR Government in responding to the request of the international tax community for Hong Kong to liberalise its exchange of tax information. More information about the recent developments in the international tax arena on liberalising the exchange of tax information and counteracting non-cooperative jurisdictions, including the actions taken by the Organisation for Economic Co-operation and Development ("OECD"), the G20 and the US Government can be found in our *Hong Kong Tax News Flashes, Issues 3 and 5* published in March and June 2009 respectively.

At the time of writing, the Bill is being considered by the Bills Committee of the Legislative Council. If the Bill is enacted, the amendments to the IRO will allow the IRD to exchange tax information with a jurisdiction that has signed a DTA with Hong Kong with a provision that requires disclosure of such tax information, even though the information may not be required by Hong Kong for its own domestic tax purposes. For details about the proposed amendments to the IRO, please refer to our *Hong Kong Tax News Flash, July 2009, Issue 7*.

One of the key concerns about the Bill expressed by business deputations and professional bodies is the safeguards that will be put in place to protect the privacy/confidentiality of the information exchanged and the rights of taxpayers in the process of information exchange. To address this concern, the HKSAR Government has proposed certain safeguards that will be adopted in exchanging tax information under a DTA, including, *inter alia*, the procedures that must be followed by the IRD in handling such information requests, the rights of the affected person(s) to be notified of such request and to request for amendments of the information to be exchanged. Please refer to our *Hong Kong Tax News Flash, November 2009, Issue 11* for a detailed discussion of these safeguards.

Please note that subsequent to the issuance of our news flash in November 2009, amendments have been made to the Bill, the draft Inland Revenue (Disclosure of Information) Rules and the draft DIPN on Exchange of Information under Comprehensive Double Taxation Agreements by the HKSAR Government in response to the comments received. The Bill is expected to be passed by the Legislative Council in early 2010.

Developments in tax treaty network

As of the first half of 2009, the treaty negotiations of the HKSAR Government were nearly put on hold due to the inability of Hong Kong to adopt the 2004 version of the exchange of information (“Eol”) article endorsed by the OECD. The Bill will pave way for the HKSAR Government to actively engage in treaty negotiations with the major trading partners of Hong Kong and to expand the treaty network of Hong Kong. The following table summarises the latest negotiations took place between the governments of Hong Kong SAR and other countries during 2009.

Country	Round of negotiation	Date of negotiation
France	3rd round	14 October 2009
Indonesia	1st round	4 December 2009
Ireland	1st round	9 October 2009
Spain	1st round	11 February 2009
United Arab Emirates	1st round	19 August 2009
United Kingdom	2nd round	26 November 2009

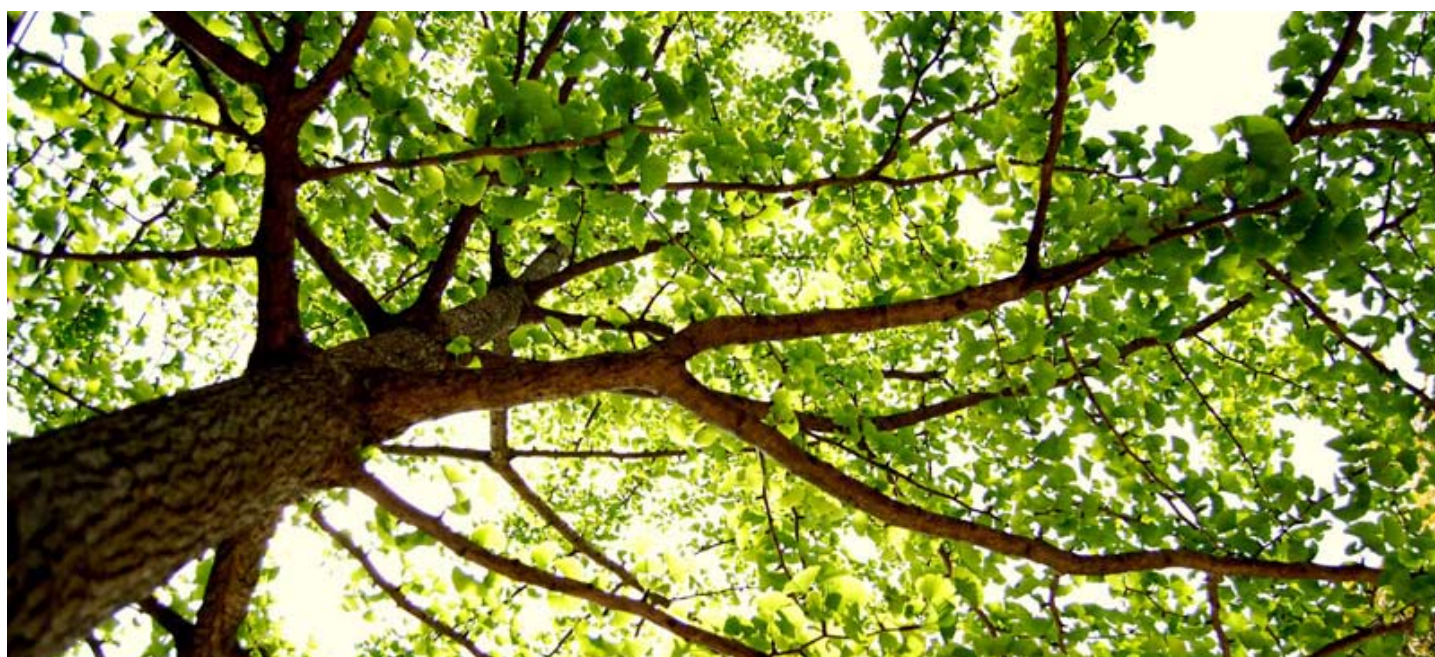
In addition, the DTAs that Hong Kong signed with Luxembourg and Vietnam became effective in January 2009 and August 2009 respectively. For the treaty benefits and potential investment opportunities available under these DTAs, please refer to our *Hong Kong Tax News Flash, January 2009, Issue 1* and *Hong Kong Tax News Flash, January 2009, Issue 2* respectively.

With the legislative amendments proposed in the Bill that will allow Hong Kong to adopt the more liberal 2004 version of Eol article, we believe Hong Kong would be able to make significant progress in expanding its treaty network after the enactment of those amendments.

Major developments in salaries tax

Two court cases concerning the taxability of termination payments were handed down in late 2009, namely, *Fuchs, Walter Alfred Heinz v. CIR* and *The executors of the estate of the late Mr. Murad, Mike M. v CIR*. The taxpayers lost in both cases primarily because the termination payments were made pursuant to the terms of the employment contracts and therefore were considered as emoluments from employment. The two cases share considerably similarities in terms of the facts, as well as the reasoning adopted by the courts in arriving at their judgments. Please refer to our IAS news publication issued in December 2009 for a discussion of the two cases and an analysis of the court decisions.

The IRD issued revised Departmental Interpretation and Practice Notes No. 33 on Insurance Agents in October 2009. The major revisions include (1) discussions on the taxability and timing of tax of a few common receipts (e.g. up-front payments, lump sum payments for cancellation/variation of contractual rights) for insurance agents as well as the deduction for up-front payments repaid by insurance agents and (2) reference to the recent BoR and court cases in relation to taxation of insurance agents. Please refer to our IAS news publication issued in October 2009 for more details.



PricewaterhouseCoopers scooped 12 wins at the International Tax Review Awards 2009



International Tax Review, a leading tax industry magazine focuses on international tax strategy, held its fourth annual Asia Tax Awards ceremony in Singapore on 24 November 2009, and PricewaterhouseCoopers again emerged a multiple winner.

The following is a summary of PricewaterhouseCoopers' achievements:

Firm of the Year Awards

- Asia Tax Firm of the Year
- China Firm of the Year
- Hong Kong Firm of the Year
- India Firm of the Year
- Singapore Firm of the Year
- Taiwan Firm of the Year
- Thailand Firm of the Year

Transfer Pricing and Indirect Tax Awards

- Australia Transfer Pricing Firm of the Year
- Indonesia Indirect Tax Firm of the Year
- Indonesia Transfer Pricing Firm of the Year
- Philippines Transfer Pricing Firm of the Year
- Thailand Transfer Pricing Firm of the Year

List of Hong Kong Tax News Flashes issued in 2009

Hong Kong Tax News Flash, January 2009, Issue 1 – Investment opportunities under the Hong Kong/ Luxembourg double tax agreement

http://www.pwchk.com/home/eng/hktax_news_jan2009_1.html

Hong Kong Tax News Flash, January 2009, Issue 2 – The double tax agreement between Hong Kong and Vietnam

http://www.pwchk.com/home/eng/hktax_news_jan2009_2.html

Hong Kong Tax News Flash, March 2009, Issue 3 – Liberalisation of exchange of tax information

http://www.pwchk.com/home/eng/hktax_news_mar2009_3.html

Hong Kong Tax News Flash, May 2009, Issue 4 – Guidance on granting relief from double taxation

http://www.pwchk.com/home/eng/hktax_news_may2009_4.html

Hong Kong Tax News Flash, June 2009, Issue 5 – Latest developments on countering international tax evasion

http://www.pwchk.com/home/eng/hktax_news_jun2009_5.html

Hong Kong Tax News Flash, June 2009, Issue 6 – China withholding tax paid on passive income – Hong Kong profits tax considerations

http://www.pwchk.com/home/eng/hktax_news_jun2009_6.html

Hong Kong Tax News Flash, July 2009, Issue 7 – A step towards liberalising the exchange of tax information in Hong Kong: The Inland Revenue (Amendment) (No.3) Bill 2009

http://www.pwchk.com/home/eng/hktax_news_jul2009_7.html

Hong Kong Tax News Flash, July 2009, Issue 8 – Legal principle was applied in the Court of Appeal judgment on Commissioner of Inland Revenue v Datatronic Limited

http://www.pwchk.com/home/eng/hktax_news_jul2009_8.html

Hong Kong Tax News Flash, July 2009, Issue 9 – Court of Final Appeal judgment on Ngai Lik Electronics Co Ltd v Commissioner of Inland Revenue – Pyrrhic victory for the taxpayer in an anti-avoidance case?

http://www.pwchk.com/home/eng/hktax_news_jul2009_9.html

Hong Kong Tax News Flash, October 2009, Issue 10 – China issued rules on treaty benefit claims by non-residents - What does it mean for Hong Kong tax resident companies?

http://www.pwchk.com/home/eng/hktax_news_oct2009_10.html

Hong Kong Tax News Flash, November 2009, Issue 11 – Progress in liberalising the exchange of tax information in Hong Kong

http://www.pwchk.com/home/eng/hktax_news_nov2009_11.html

Hong Kong Tax News Flash, December 2009, Issue 12 – Hong Kong issues detailed guidance on transfer pricing, methodologies and related issues

http://www.pwchk.com/home/eng/hktax_news_dec2009_12.html

Hong Kong Tax News Flash, December 2009, Issue 13 – The revised DIPN 21 on locality of profits – Adding clarity?

http://www.pwchk.com/home/eng/hktax_news_dec2009_13.html

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