Welcome to our new look for the Tax Quarterly Newsletter. Web savvy readers would note that this interface includes features such as search, download as a pdf file and email selected text.

What remains the same is we share our views on noteworthy tax developments in China and Hong Kong. In this edition, we begin our China review with Bonanza! announcing a new record Circular 698 tax collection and introducing the related proposed Circular 41. In Go West Young Man, we look at the tax incentives offered to investors interested in the western regions of China. In Double No More, we explain the new individual income tax treatment which eliminates the double taxes borne by Hong Kong and Macau resident employees previously.

Hong Kong had a busy quarter in tax litigation. In Damage Control, we look at the aftermath of the 15-year-old Li & Fung case with respect to the source of commission agent income. In Sins Of The Father and All The Same, we comment on the interesting legal principles which the Court of Appeal’s analyzed in the Moulin Global case and the Lee Yee Shing Jacky and Yeung Yuk Ching case. We also discuss in the other articles a recent advance ruling, the IRD’s recent press conference and educational seminar and tax updates such as abolition of capital duties and tax treaties.

We welcome your feedback and please do not hesitate to contact us for further information about the contents of this edition.

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1 As usual, we have to caution that, under current Chinese regulations, foreign lawyers such as DLA Piper are not formally admitted to practise law in the People’s Republic of PRC and, as a result, we are not permitted to render legal opinions on matters of PRC law. Our comments herein should not be construed as legal advice on any of the topics discussed herein. Furthermore, there is no official translation of the Enterprise Income Tax law, the Implementing Rules or the notices and circulars referred to herein; the translations from Chinese are our own rather than official translations. We do not take any responsibility on whether or not the translated expressions properly convey the exact meaning of their Chinese counterparts. Ultimately, only the Chinese version is relevant and you should not act upon anything you may read herein without further consultation with a proper advisor.
PEOPLE’S REPUBLIC OF CHINA
Circular 698\(^1\) was issued on 10 December 2009 to provide that (amongst others) foreign investors who indirectly dispose of shares of a PRC enterprise in certain conditions must satisfy stringent reporting requirements. From there, where the foreign investor is unable to establish that the transaction had adequate business purposes, the PRC tax authorities will assert jurisdiction to apply domestic anti-avoidance principles to look through the intermediate vehicle and tax the transaction as if it had been a direct sale of the shares of the PRC enterprise.

We are now two and a half years into this brave new world and the verdict, at least from the tax authorities’ perspective, is an unmitigated success. Since Circular 698, we have seen a succession of records in amounts collected on indirect transfer transactions and, indeed, in 2011, the tax authorities collected more than RMB 1 billion on such transactions, a 400% increase from 2010. Going forward, looking at the pace new records are being set for individual transactions, we have no doubt that 2012 will continue to evidence the continuing success of the new regime for the tax authorities.

**NEW RECORD COLLECTION**

Recently, the Jincheng State Tax Bureau (Jincheng STB) in Shanxi province reported that it had secured collection of capital gains tax of an amount of RMB 403 million (!), the latest single largest indirect transfer tax collection ever (but only so far!).

The PRC target was a coal enterprise established in Shanxi province in 2000 that, at the time, was the first large-scale Sino-foreign joint venture involving the coal industry. By the time of the impugned transaction, the Seller, a BVI company, held 56% equity of the PRC target via a wholly-owned Hong Kong subsidiary (HK Holdco). In March 2011, even though the sale was not reported as required under Circular 698, the Jincheng STB, through its regular monitoring of “major tax sources”, became aware that HK Holdco had been sold to another company based in Hong Kong for a consideration of USD 669 million. In no time, the Jincheng STB issued Notices of Tax Matters to the Seller and Buyer and carried out thorough on-site inspections at the Chinese target to obtain more information about the transaction.

Upon investigation, the Jincheng STB concluded that, to the extent that HK Holdco had no real economic substance and no commercial activities, using HK Holdco involved an abusive use of organizational form solely aimed at avoiding tax in the PRC and, thus, they were entitled to impose capital gains tax on the Seller. The finding then led to extensive negotiations with the Seller’s representatives and its accountants but no agreement could be reached. In due course, the Jincheng STB turned to the Buyer and “requested” its assistance to withhold the tax from unpaid amounts of the transaction price. That step eventually forced the Seller to “agree” to pay RMB 403 million as capital gains tax (approximately 10% of the consideration).

\(^1\) Guo Shui Han [2009] No. 698 titled Circular on Strengthening the Administration on Collection of Enterprise Income from Enterprise Transfers by Non-resident Enterprises and issued by the State Administration of Taxation of PRC
A few points of interest about the case.

- As mentioned above, RMB 403 million is yet another record for tax collection on an indirect transfer. The record until then had been a tax of RMB 306 million on the transfer of the shares of Master Kong’s Drinks by a Japanese company. With the previous record being less than a year, we have no doubt that this new record will not last for very long either.

- When the tax authorities did not succeed immediately against the Seller, they had no hesitation to turn to the Buyer for “assistance” in obtaining information and recovering the outstanding tax. This is intriguing because there is no clear provision in the current legislation allowing the tax authorities to seek “assistance” as they did. While the matter here was outside the purview of Circular 698 (indeed, the fact is that the Seller had not complied with Circular 698), would the tax authorities have acted any differently had Circular 698 been respected? One can fear that they would not and that they would use any and all means at their disposal (whether legal or extra legal) to ensure collection of outstanding taxes. This places a buyer in the difficult position of having to negotiate not only due compliance by the seller to the reporting requirements of Circular 698 but also indemnities and escrows for some time after the transaction in anticipation of potential “demands for assistance” by the tax authorities.

- The report of the case does not provide much details on the investigative technics used by the Jincheng STB to uncover the transaction or on how one acquires the dubious distinction of being a “major tax source”. What we do know is that the tax authorities are becoming ever more savvy and organized at ferreting out information. Provincial and local tax collectors have extensive leeway to make use of any source they see fit to gather information leading to transactions potentially subject to tax and to pursue any lead however unlikely it may be. An extreme example may well be a case earlier this year where a Hengshui STB officer learnt about an indirect transfer involving a French company through a casual conversation with a friend. The officer reported his conversation to his supervisor and, in due course, it led to the establishment of a special task force, headed by no less than the Head of the Hengshui STB, to investigate the matter. In due course, the Hengshui STB imposed RMB 59 million capital gains tax on the seller. They say talk is cheap but this one was certainly worth it.

Moreover, the tax authorities are also improving internal cooperation between departments with the specific objective of facilitating the exchange of relevant tax information. By way of example, it was recently announced that the State Administration of Taxation and the State Administration for Industry and Commerce are joining efforts to create information exchange protocols specifically for the purpose of tax management and collection. Similar efforts are also progressing all over the bureaucracy: for instance, the Anhui Bureau of Commerce and Anhui State Tax Bureau recently set up protocols for sharing information found in approval documents of equity transfers. All those initiatives are aimed at ensuring that the tax authorities will improve their ability to uncover transactions on which they think tax should be imposed.

- The amount payable by the Seller was reported at approximately 10% of the amount of the gain, that is the effective tax rate normally applicable to a capital gain. This therefore suggests that the tax authorities treated with leniency the failure of the taxpayer to report the indirect transfer pursuant to Circular 698. This seems to have been generally the attitude of the tax authorities so far in the face of breaches of the Circular 698 reporting requirements. Obviously, because Circular 698 is still relatively new and still in development on a number of fronts, we welcome the benevolence of the tax authorities but we caution that the attitude may be changing even as we write these lines. Indeed, in a recent case in Beijing, the tax authorities imposed tax of RMB 26 million on an unreported transaction and then slapped a penalty of RMB 24 million on top of the tax payable (i.e. 93% of the tax outstanding!). It is clear that, as the new regime ages, the tax authorities will undoubtedly come to expect strict compliance and use the full extent of the law against delinquent taxpayers.

PROPOSED CIRCULAR 41[^1]

On a different but connected note, on 27 April 2012, the PRC tax authorities issued for the first time written comments in the form of proposed Circular 41 on how they intend to strengthen the PRC’s international tax administration in the areas of anti-avoidance, inbound and outbound tax

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[^1]: Guo Shui Fa [2012] No. 41 titled 国家税务总局关于加强国际税收管理体系建设的意见
administration and exchange of information. Even though proposed Circular 41 was not yet public at the time of writing, it is by now common knowledge that it targets specifically increasing tax collection from non-resident taxpayers who derive PRC-sourced income.

With respect to non-resident taxpayers, proposed Circular 41

- instructs tax authorities at all levels to set up special units dedicated to tax collection from non-resident taxpayers
- encourages local tax authorities to find income tax sources from non-resident companies closely involved in the management of resident companies (the SAT believes that the income of non-resident enterprises is often closely connected to the activities of their local affiliates and can therefore be legitimately brought to taxation in the PRC)
- encourages local tax authorities to classify non-residents (e.g. whether they are doing business in the PRC permanently or temporarily) and analyse the risks in tax collection so as to take actions accordingly (e.g. closer monitoring and more active withholding at source)
- instructs tax authorities to ensure that non-resident taxpayers seeking tax treaty benefits for their PRC-sourced dividends, interest income and royalties do so only when they can establish that they meet the beneficial owner requirements set out in Circular 601
- invites local tax authorities to obtain tax information from any public means at their disposal such as the internet, television, regulatory disclosures of domestic or foreign listed companies, etc.
- encourages cooperation with other government agencies and banks in order to closely monitor taxpayers’ transactions

Proposed Circular 41 also announces that, by the end of 2013, the PRC tax authorities will establish an anti-avoidance specialist team capable of performing investigations into various industries. The PRC tax authorities will widely apply quantitative analysis methods and establish a team of economic analysts to study and resolve difficult issues in areas such as market premium, supply chain analyses and the valuation of shares and intangibles.

Ever since the tax authorities have discovered how lucrative it may be to look closely at taxation of non-residents, they have worked on developing and improving their systems and procedures to ensure that non-residents will not escape their tax liabilities. Given their success to date, non-residents can definitely expect continuing scrutiny from the tax authorities.

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1 Guo Shui Han [2009] No. 601 titled Notice On Interpretation And Determination Of Beneficial Owner Under Tax Treaties
For taxpayers interested in investing in the western regions of the PRC, on 6 April 2012, the PRC tax authorities issued Announcement 12 to clarify various tax incentives implementation issues in the PRC’s West Development Strategy.

By way of background, the Western Development Strategy was introduced in 2000 to speed up the process of development for the West Region with the hope that it can eventually catch up to the level of wealth and development of the coastal areas. As was the case for the coastal area development strategy, the backbone of the plan is an array of favorable tax measures.

According to Article 1 of Announcement 12, taxpayers established in the West Region can enjoy a preferential enterprise income tax (EIT) rate of 15% up to 31 December 2020, provided that (i) the taxpayer is engaged in a business within the scope of the Catalogue of Encouraged Industries in Western Regions and (ii) the revenue from such encouraged business accounts for more than 70% of the taxpayer’s total annual revenue.

Further, a taxpayer may apply for the preferential EIT rate along with the tax holidays, for instance, the “three-year tax exemption and three-year half reduction” policy for investment in infrastructure, electricity and environmental protection projects. This is exceptional because the general rule is that preferential EIT rates and tax holidays cannot be applied together (for example, for high and new technology enterprises, if the preferential EIT rate of 15% is applied, the tax holidays would not be available at the same time, thereby forcing a choice between one and the other).

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1 Announcement of the State Administration of Taxation [2012] No. 12 titled Announcement of the State Administration of Taxation on Issues of Enterprise Income Tax Concerning In-depth Implementation of Western Region Development Strategy

2 Geographically, the West Region includes 12 provinces (please refer to the map) and 3 minority autonomous regions (Xiangxi of Hunan, Enshi of Hubei and Yanbian of Jilin).
Investors who prefer investing more heavily in the more developed East Region may yet enjoy the tax incentives to some extent by establishing branches in the West Region. Generally, the tax incentives of the West Development Strategy are only offered to headquarters and branches which are physically located in the West Region. When determining whether the tax incentives may apply, the revenue of the headquarter and its branches are accounted for independently. This is another exception to the existing EIT regime as EIT is normally computed on a legal person (the company as a whole as one legal person) basis i.e. the revenue of the headquarter and its branches are consolidated to become one set of financial accounts.

Let’s take an example. If an investor based in Beijing (non-West Region) establishes branches in Chongqing (West Region) and Shanghai (non-West Region), the Chongqing branch would be treated as an independent unit when determining whether the preferential conditions are met. If more than 70% of the revenue of the Chongqing branch comes from the encouraged industries, the tax incentives would be applicable, but only to the revenue of the Chongqing branch. The revenue of the Beijing headquarter and the Shanghai branch would not be considered.

Clearly the tax incentives of the West Development Strategy are attractive, but we expect some issues in practice. One is that there is yet no Catalogue of Encouraged Industries in Western Regions and the list of Encouraged Industries is drawn by referring to four other catalogues at present: (i) the Industry Structure Adjustment Guidance Catalogue (2005), (ii) the Industry Structure Adjustment Guidance Catalogue (2011), (iii) the Foreign Investment Industry Guidance Catalogue (2007) and (iv) the Advantageous Industry Catalogue of Central and West Region (2008). But now item (iii) has been replaced by a 2011 version so which catalogues actually apply continues to be ambiguous and it will probably remain so until a unified and specific catalogue is released.

In addition, Announcement 12 requires the investor to seek verification and confirmation from the tax authority in charge in order to qualify as an operator in the encouraged industries. But when the tax authority is doubtful in such determination, it may ask the investor to seek and provide certification issued by the department in charge at the provincial level (e.g. the Department of Commerce). The confusion as to who is to provide the required oversight adds to the uncertainty and the compliance burden.

Announcement 12 takes effect retrospectively from 1 January 2011 and is definitely a positive but a word of caution. We referred in the previous article to proposed Circular 41 and its invitation to local tax authorities to keep a close eye on non-resident taxpayers. Well, proposed Circular 41 specifically mentions non-resident taxpayers invested in the central and west regions as potential targets for inquiries. It is clear that the tax authorities are trying to rein in the free for all that prevailed in the initial stages of development of the coastal areas when avoidance of PRC taxes on exit was as easy as setting up a BVI company. Not this time around: proposed Circular 41 is the clear warning that the tax authorities are on the lookout to ensure that the West Region development will not turn into the Wild West.
On 26 April 2012, the PRC tax authorities released Announcement 16\(^7\) in response to concerns raised in a meeting between them and the Hong Kong Inland Revenue Department a couple of years ago. At the time, the Hong Kong tax authorities raised various unresolved scenarios of double taxation affecting Hong Kong and Macau tax residents deriving PRC-sourced employment income.

With Announcement 16, the SAT introduces a special IIT application which they say is based on an interpretation of the PRC/Hong Kong and PRC/Macau tax arrangements. For the first time, the SAT has agreed to adopt a pure “physical day presence basis” to apportion a taxpayer’s salary and bonus income where someone who resides in Hong Kong/Macau carries on most but not all of his/her duties of employment in the PRC. The new policy will now align with the prevalent practices of the Hong Kong tax authorities and should resolve most of the remaining instances of double taxation involving HK and Macau residents.

The special IIT treatments for Hong Kong and Macau residents are as follows.

- For an individual physically present in the PRC for less than 183 days in any 12-month period, his/her IIT payable will be calculated as follows

\[
\text{IIT payable} = \frac{\text{IIT on total employment income}^8 \times \text{Days physically present in the PRC}\,^9 \times \left(\frac{\%}{\text{of income borne by the PRC employer}}\right)}{\text{Calendar days in the month}}
\]

- For an individual physically present in the PRC for more than 183 days in any 12-month period, his/her IIT payable will be calculated as follows

\[
\text{IIT payable} = \frac{\text{IIT on total employment income} \times \text{Days physically present in the PRC}}{\text{Calendar days in the month}}
\]

Without the special IIT treatment, Hong Kong and Macau resident employees who returned to Hong Kong during weekends and holidays and who would occasionally attend meetings/work in Hong Kong were required to pay (i) PRC IIT in full and (ii) Hong Kong salaries income tax on a “physical day presence basis”. Ultimately, double taxation was inevitable but is now resolved by Announcement 16.

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\(^7\) Announcement of the State Administration of Taxation [2012] No. 16 titled Announcement of the SAT on Relevant Issues Concerning Individual Employment Income in the Implementation of the Taxation Agreement between Mainland PRC and Hong Kong and Macau

\(^8\) IIT on total employment income as calculated by taxable income from wages and salaries earned in and out of mainland PRC during the current 12-month period \(\times\) applicable tax rate – quick calculation deductions.

\(^9\) Including public holidays, personal leave days and training time. The day of arrival, day of departure and same day travel are counted as half a physical presence day in the PRC.
Announcement 16 also resolves the problem of double taxation of employees’ bonus. Previously, PRC IIT laws allowed the portion of the bonus attributable to a given period (usually expressed in terms of calendar month(s)) to be excluded from IIT only when a Hong Kong/Macau resident employee did not spend any workday in the PRC during that period. The formula is changed to

\[
\text{IIT payable} = \frac{\text{Bonus income} \times \text{Days physically present in the PRC during the earning period of the bonus}}{\text{Calendar days during the earning period of the bonus}}
\]

(e.g. 365 days for an annual bonus)

Announcement 16 extends the special IIT treatment referred to above only to Hong Kong and Macau tax residents who are (i) employed by a Hong Kong/Macau company or (ii) concurrently employed by both a Hong Kong/Macau company and a Chinese company. In other words, Hong Kong and Macau tax residents employed only by Chinese companies who work mostly in the PRC are not eligible to enjoy the special IIT treatment. On the other hand, foreigners who meet the qualifying conditions for Hong Kong/Macau tax residency under the respective PRC/Hong Kong and PRC/Macau tax arrangements are entitled to the special IIT treatment.10

Readers will also note that Announcement 16 does not apply to certain wages and salaries such as those earned by employees who do not have permanent addresses in China. For them, previous law continues to apply.11

A qualifying Hong Kong/Macau resident employee must comply with the various record filing requirements of Guo Shui Fa [2009] No. 12412 and Gui Shi Han Fa [1995] No. 12513 to secure the special IIT treatment. The administrative burden will undoubtedly be time consuming and challenging at times. Nonetheless, Announcement 16 is welcome in resolving lingering double taxation issues affecting specifically Hong Kong and Macau tax residents.

Announcement 16 applies on salaries earned on or after 1 June 2012.

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10 Readers may refer to Guo Shui Han [2007] No. 403 on the determination of tax residency of an individual who is a temporary tax resident of Hong Kong/Macau and a tax resident of another jurisdiction at the same time.

11 Such as Articles 2, 3 and 6 of Guo Shui Fa [1994] No. 148 titled Circular on Questions Concerning Tax Payments for Wage and Salary Income Gained by Individuals Without Residence Within the Territory of PRC and Articles 1 and 2 of Guo Shui Han Fa [1995] No. 125 titled Notice of the State Administration of Taxation on Several Problems Concerning Personal Income Tax of Individuals without Residence in PRC.

12 Titled Circular on Questions Concerning Tax Payments for Wage and Salary Income Gained by Individuals without Resident within the Territory of China.

13 Ibid at 11.
Ever since the enterprise income tax reform in 2008, the PRC’s tax regime has become more and more complex, particularly in the area of tax avoidance where rules have been in a constant state of flux, most often with little guidance from the tax authorities. The uncertainty has been the source of great frustration for taxpayers and it often strained the interaction between the tax authorities and taxpayers. Thankfully, there now seems to be an emerging trend on the part of the tax authorities to improve their relations with taxpayers.

In a recent e-forum in Shanghai14, Mr. Gu Ju, Head of the Shanghai Office of the SAT and the Shanghai Local Taxation Bureau reaffirmed that priorities of the PRC tax authorities include:

- creating a broad and pragmatic communications mechanism between the tax authorities and taxpayers
- establishing an open and transparent brand
- devising a pre-settlement mechanism for tax disputes

In addition, as part of this welcome shift to openness and transparency, the SAT issued on 17 April 2012 a document titled *Opinions of the Shanghai Municipal Office of the State Administration of Taxation and Other Department on the Establishment of Pilot Pre-Settlement Mechanism for Tax-Related Disputes*.15

Article 1 of the Opinions encourages taxpayers and the tax authorities to:

- build a harmonious relationship between the tax authorities and taxpayers
- show respect to the taxpayers’ right of choice
- reduce the settlement costs of tax disputes
- encourage self-improvement of the tax authorities

The Opinions propose the use of a “pre-settlement mechanism” to lay out the principles, methods and procedures to be adopted by the relevant tax departments for handling and resolving tax disputes. This is intended to be different from mainstream disputes resolution mechanisms in trying to anticipate and resolve disputes ahead of time (i.e. akin to a ruling system).

The Opinions provide that taxpayers, third parties having a direct interest in a matter and competent tax authorities are eligible applicants for the pre-settlement mechanism. With respect to scope, Article 4 approves a broad scope of tax matters such as tax registration, declaration, inspection, administrative penalties and credit ratings.

Article 6 asks the tax services departments to pre-settle tax disputes they received within seven work days from the date of acceptance. Article 7 requires the tax authorities to give clear explanations and answers, based on laws, regulations or policies, in their opinions and replies and promptly correct their errors (where applicable) to avoid the disputes being escalated.

The Opinions are not going to remove all of the long-standing reasons for disputes between the tax authorities and taxpayers but they are good news in providing a mechanism for settling in advance the tax consequences of a transaction. The certainty it will bring is indeed a useful way to lead to a more friendly and harmonious relationship between taxpayers and the tax authorities.

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15 Hu Guo Shui Na [2012] No. 7 titled *上海市国税局等关于试点建立涉税争议前置处理机制的意见*
OMINOUS?

We report later in this newsletter record tax revenue collected by the Hong Kong tax authorities. The same holds true for the PRC but for how long has become the question. The PRC’s Ministry of Finance recently reported that the country’s total tax revenue in the first quarter of 2012 rose to a new record of RMB 2.6 trillion (USD 410 billion) but the 10% year-on-year growth it reported is the slowest rate in the past three years (by contrast, in Q1-2011, the year-on-year growth was 32%). On the bright side, tax on natural resources and tax on land occupation boomed with year-on-year growth of 63% and 78% respectively but laggards were found in stamp and deed taxes with drops of 30% and 14% respectively.

The Ministry of Finance cited four major reasons for the growth slowdown in Q1-2012

- The slower economy is leading to a slowdown in the growth of related tax revenues
- Falling prices in Q1-2012 are affecting the tax revenues
- Lower sales of real property impacted stamp and deed taxes
- The tax relieving measures announced in Q4-2011 are hitting their strides

Here is a breakdown of the tax collection.

<table>
<thead>
<tr>
<th>Key Tax Item/Total</th>
<th>Revenues (in RMB ‘000)</th>
<th>YoY Change (in RMB ‘000)</th>
<th>YoY Change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic VAT</td>
<td>6,602</td>
<td>337</td>
<td>5</td>
</tr>
<tr>
<td>Domestic Excise Tax</td>
<td>2,392</td>
<td>313</td>
<td>15</td>
</tr>
<tr>
<td>VAT and Excise Tax of Imported Goods</td>
<td>4,162</td>
<td>478</td>
<td>13</td>
</tr>
<tr>
<td>Customs Tariff</td>
<td>780</td>
<td>69</td>
<td>10</td>
</tr>
<tr>
<td>Returned VAT and Excise Tax for Exported Goods</td>
<td>(2,551)</td>
<td>(226)</td>
<td>10</td>
</tr>
<tr>
<td>Business Tax</td>
<td>4,014</td>
<td>282</td>
<td>8</td>
</tr>
<tr>
<td>EIT</td>
<td>4,139</td>
<td>705</td>
<td>21</td>
</tr>
<tr>
<td>IIT</td>
<td>1,911</td>
<td>(127)</td>
<td>(6)</td>
</tr>
<tr>
<td>Stamp Tax of Stock Exchange</td>
<td>92</td>
<td>(40)</td>
<td>(30)</td>
</tr>
<tr>
<td>Real Estate Tax</td>
<td>317</td>
<td>90</td>
<td>40</td>
</tr>
<tr>
<td>Vehicle Sales Tax</td>
<td>565</td>
<td>102</td>
<td>22</td>
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<tr>
<td>Tax on Land Use of Cities and Towns</td>
<td>376</td>
<td>94</td>
<td>34</td>
</tr>
<tr>
<td>Land VAT</td>
<td>610</td>
<td>26</td>
<td>5</td>
</tr>
<tr>
<td>Tax on Land Occupation</td>
<td>401</td>
<td>155</td>
<td>63</td>
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<tr>
<td>Tax on Natural Resources</td>
<td>249</td>
<td>109</td>
<td>78</td>
</tr>
<tr>
<td>Deed Tax</td>
<td>663</td>
<td>(105)</td>
<td>(14)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>25,858</strong></td>
<td><strong>2,419</strong></td>
<td><strong>10</strong></td>
</tr>
</tbody>
</table>
On 24 April 2012, the PRC tax authorities issued Announcement 15¹⁶ to clarify the deductibility of certain expenses and the treatment of certain income vis-à-vis the calculation of EIT. Announcement 15 contains nine short articles clarifying the treatment of expenses as disparate as expenses related to the employment of seasonal, temporary and retired employees, expenses related to the issuance of bonds and other financing instruments, handling fees and commissions paid by telecommunication companies, entertainment expenses incurred prior to the start of operations, claiming previously unclaimed eligible expenses, etc. Even if there is no rhyme or reason to the expenses commented upon, we always welcome clarifications from tax authorities on potentially contentious issues.

¹⁶ Announcement of the State Administration of Taxation [2012] No. 15 titled Announcement of the SAT on Certain Issues Relating to the Tax Treatment of Taxable Income for Enterprise Income Tax Purposes
HONG KONG
Readers will recall that, on 19 March 2012, the Court of Appeal (CA) dismissed the Commissioner of Inland Revenue’s appeal in *Li & Fung (Trading) Limited v Commissioner of Inland Revenue*.17 The Commissioner has now decided (wisely, we think!) not to appeal to the Court of Final Appeal (CFA). So, 15 years after first raising issues on the taxpayer’s business structure and its receipt of commissions for its sourcing agent activities, the Commissioner has now finally ended its challenge of the taxpayer.18 Yet, the Commissioner, even after having lost every battle along the way, could just not help himself and needed to have the last word. On 18 May 2012, the Commissioner posted on the IRD website a frequently-asked-questions (FAQ) page to provide his “spin” on what the case should mean for taxpayers.19 Unfortunately, many of the comments made in the FAQ are no more than a re-statement of the theories the Commissioner tried unsuccessfully to defend in the *Li & Fung* saga.

**BACKGROUND**

The taxpayer is a global sourcing agent assisting its customers in finding suppliers in the Asia Pacific region (but principally in the PRC) for a wide range of products such as clothes, toys, furniture etc. It offers comprehensive supply chain management services ranging from overseeing the manufacturing of the products to the delivery to its customers and is well known for its work for Walmart and Marks & Spencer. To assist it in the performance of its services, the taxpayer established a network of foreign affiliates to provide on location services where the manufacturing of the products takes place. Typically, customers paid 6% of the FOB value of total export sales to the taxpayer out of which it passed on 4% to its overseas affiliates, retaining for itself the remaining 2%. The taxpayer is headquartered in Hong Kong from where it orchestrates and oversees the sourcing activities.

By a determination dated 14 June 2004, the Commissioner imposed tax of approximately HKD 110 million for years of assessment 1992 to 2002 on the 2% commission it retained from what it charges to its customers. The taxpayer objected on the basis that the relevant profits were offshore and therefore not chargeable in Hong Kong but the Commissioner stuck to its position forcing the taxpayer to resort to judicial appeals to resolve the dispute. There followed in succession of resounding victories for the taxpayer at the Board of Review (BOR)20, the Court of First Instance (CFI)21 and the CA.

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17 See CACV 86/2011. Please refer to the article titled “Strike Two!” in TQN March 2012. We note that the title of that article has become completely inaccurate. Strike Two was in fact an out!

18 We have also previously shared our views on the decisions made before the Board of Review and the Court of First Instance. Please refer to the articles titled “Justice Delayed is…Well, Not All That Bad Sometimes” and “Elementary” in TQN June 2009 and TQN June 2011 respectively.

19 See http://www.ird.gov.hk/eng/faq/lifung.htm. FAQs are another way for the IRD to provide public guidance on issues of interest. The Commissioner had acted likewise after the decision in *ING Baring* (10 HKCFAR 417) in trying to curtail the impact of the decision. Interestingly, the Commissioner had then argued that the *ING Baring* approach applied only to the brokerage industry but we note that the *Li & Fung* decision is a pure application of the *ING Baring* approach in a much wider field than brokerage.

20 See BOR 39/04

21 See [2011] HKCFI 260
SOURCE OF PROFITS OF COMMISSION AGENT BUSINESS

The Hong Kong tax system follows a territorial approach to taxation. Section 14 of the Inland Revenue Ordinance makes it clear that the taxpayer’s residence is irrelevant and only profits arising in or derived from Hong Kong (often referred to as “sourced in Hong Kong”) can be chargeable to profits tax.22 To define the basic principles applicable to the ascertainment of the source of a profit, one usually refers to the seminal decision of the Privy Council in CIR v Hang Seng Bank Limited.23 Lord Bridge first pointed out that three conditions must be met before a profits tax liability arises.

- The person must carry on a trade, profession or business in Hong Kong
- The profits to be charged must be from such trade, profession, or business carried on by the person in Hong Kong
- The profits must be profits arising in or derived from Hong Kong

The third condition refers to the question of the source of a profit. Lord Bridge made it clear that the question whether a profit arising from a particular transaction arose in or derived from Hong Kong or another place is always a question of fact depending on the nature of the transaction. Lord Bridge explained that it is impossible to lay down precise rules of law applicable to all transactions but the broad guiding principle should be one looks to see what the taxpayer has done to earn the profit in question and where he has done it. While formulating the test in this way is useful but it still begs several questions. For instance, exactly what operations should be taken into account and perhaps more importantly whose operations should be taken into account?

In the landmark ING Baring decision, the CFA held in no uncertain term that it would be legally irrelevant to investigate every facet of the taxpayer’s business to assess qualitatively the relative importance of its various operations – what matters is the effective causes for earning the profits without being distracted by antecedent or incidental activities. Lord Millet also said, …in considering the source of profits, however, it is not necessary for the taxpayer to establish the transaction which produced the profit was carried out by him or his agent in the full legal sense. Instead, it is sufficient that it was carried out on his behalf and for his account by a person acting on his instructions.

It is no surprise that the IRD attempts to restrict Lord Millet’s comment to the securities brokerage business in ING Baring by way of its revised Departmental Interpretation and Practice Note (DIPN) 21.24 The IRD takes the view that whether one is acting for another or on his behalf and for his account is a hard, practical matter of fact. The IRD, quoting the CFI in Consco Trading Co Ltd v CIR25, said, …it was correct to take a global view of the evidence, including the finance arrangements, the payment for raw material and processing fees, the arrangement for receipt of payment from purchasers for the finished products and pre-contract negotiations, to conclude that the profits generating activities were performed in Hong Kong, despite the appointment of an agent for the operation of business outside Hong Kong.

Clearly, we have not reached the end of disputes.

The IRD is of the view that the CA’s decision for LFT simply reconfirmed the prevailing legal position and did not represent a change of law or overturn any judicial precedents. In its reply to Will the Department change its assessment practice regarding the taxation of profits derived from sourcing and agency activities?, the IRD emphasized that the CFA held in Ngai Lik26 that sourcing and agency activities in Hong Kong may give rise to assessable profits. Whether profits would be considered offshore would turn on the facts of each case.

Other points of interest in the FAQ.

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22 Interested readers may refer to the articles titled “A Ruling”, “Another Ruling on Section 14” and “Tidbit: Another ruling on Section 14” in TQN September 2010, TQN March 2011 and TQN June 2011 respectively for three related advance rulings published by the IRD.


24 Paragraph 17(m) of the revised DIPN 21. Interested readers may refer to the article titled “Hanging out with the Wrong Crowd” in TQN September 2009 for a DIPN 21 application on manufacturing profits and the article titled “A New Old Friend” in TQN December 2009 for our views on the revised DIPN 21.

25 [2004] 2 HKLRD 818

26 [2009] 5 HKLRD 334
Have the Courts considered the entire facts of the case?

The Commissioner replied that the Courts did not have the chance to consider the entire facts of the case and gave the example of the Harvard Business Review reports showing that some of LFT’s activities in the standard agency agreements were performed in Hong Kong. But the Commissioner was missing the point — the Courts held in different cases that it would be legally irrelevant to evaluate every facet of the taxpayer’s business.

Why didn’t the Commissioner appeal to the Court of Final Appeal?

The Commissioner’s two reasons are: (i) the tax amount would not determine the question whether leave should be granted as of right and (ii) the CA’s decision would be final unless the case involves questions of great general or public importance or there are exceptional circumstances necessitating the CFA’s exercise of discretion to grant permission to appeal before the CFA (such questions or circumstances absent here). The reasons are an application of the CFA’s interpretation of section 22(1) of the Hong Kong Court of Final Appeal Ordinance in C G Lighting and worrying in the sense that it may equally preclude a taxpayer’s right to appeal before the CFA.

Is the case of wider application?

The Commissioner reckoned that because there is no change in law on source of profits and the case was decided on its own facts, the CA’s decision does not have wider application to other source cases. But we see quite the opposite! The CA’s decision shows that the courts are ready to adopt the legal principles in ING Baring and CIR v Hang Seng Bank Limited for taxpayers offering services much wider than brokerage.

Obviously, we cannot blame the Commissioner for trying to shape the debate and have the last word, in spite of his string of defeats. But ultimately his words in the FAQ are just words and the only forum where he could have put some weight to his theories would have been before the CFA. He did not do so and thus, until further notice, it seems to us that his theories remain wanting and, rather, from our perspective, the FAQ shows that the Commissioner has not yet properly heeded the lessons of the courts on how to approach source of profits and how to deal with “agency” (after all, if the Commissioner had been right all along in his approaches, would the courts not have recognised it already). As a result, this FAQ may well have same shelf life as the one on ING Baring which by now has been mostly discredited by the CA’s decision in Li & Fung. The only problem is that it will probably take a determined taxpayer to debunk some of the (erroneous) conclusions the Commissioner has gathered from his defeats in Li & Fung.

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27 Please refer to the article titled “End of the Road” in TQN September 2011 for the CFA’s reasoning in C G Lighting.
In Moulin Global Eyecare Trading Ltd v the Commissioner of Inland Revenue and Another 28, the CA clarified the legal principles governing the attribution of directors’ knowledge and activities to the company for which they act. The CA held in favor of the Commissioner in an application for judicial review brought by the liquidators of the taxpayer against profits tax assessments made based on financial accounts and tax returns prepared by directors involved in fraudulent activities against the interest of the company.

BACKGROUND

The taxpayer was part of a global eye care group. Upon winding-up petitions presented against the taxpayer in June 2005, Mr Roderick John Sutton was appointed first as the provisional liquidator and eventually, in August 2006, as the liquidator. In August 2005, the Commissioner issued four notices of assessment against the taxpayer, covering years of assessment from 1999/2000 to 2004/2005. In November 2005, a notice of assessment was issued for 2005/06 so that the aggregate of the five tax assessments amounted to profits tax payable of approximately HKD 10 million. The liquidator did not file notices of objection against the assessments.

Then came a series of tit-for-tat in relation to the assessments.

First, in a letter sent to the Commissioner on 30 November 2005, the liquidator notified the Commissioner that it had uncovered evidence of fraudulent activities by the former directors of the taxpayer.29 The liquidator advised that the former directors had reported significant fictitious sales and had deliberately caused the taxpayer to overstate its profits. The liquidator requested that the Commissioner reassesses the taxpayer based on its real profits rather than profits reflecting the fraudulent activities of its former directors. The Commissioner refused the request and the liquidator did not pursue the matter.

Then, in August 2006, the Commissioner sent to the liquidator a proof of debt for the outstanding tax assessments of HKD 10 million. The liquidator rejected the proof of debt on the basis that it was based on inappropriate assessments calculated on fictitious profits that the taxpayer had never earned. The Commissioner did not agree and considered that the assessments on their face were proper evidence of a debt that the liquidator had to take into account. In due course, the Commissioner took the matter to court leading to the CA 30 finding in his favor, effectively because of the presumption that an un-appealed, un-objected assessment is deemed to be valid on its face pursuant to section 70 IRO.31 On that basis, it was inappropriate for the liquidator to look behind the assessments to justify his decision to reject the proof of debt submitted by the Commissioner. In other words, to the extent that the assessment is deemed valid, the proof of debt must also be valid.

Then, in November 2009, well after the expiry of the time limit to file an objection, the liquidator tried to lodge formal notices of objection against the tax assessments. The liquidator argued that he had been “prevented” from filing notices of objection earlier because it took him time to fully unravel

28 CACV 64 of 2011
29 The former directors were eventually sentenced to imprisonment from 9½ to 12 years for frauds. The presiding judge, Line J, commented that their conduct was “commercial crime of the worst kind”.
31 Section 70 of the IRO provides that where no valid objection has been lodged within the time bar, the assessments as made… shall be final and conclusive for all purposes of this Ordinance as regards the amount of such assessable… profits…
the fraudulent conduct of the former directors. The Commissioner had none of it and summarily rejected the objections. The Commissioner noted in particular that the notice of objection could not be accepted because the fraudulent behaviour of its former directors in (i) reporting overstated profits and (ii) failing to file on time notices of objection against the assessments were fully attributable to the taxpayer. Accordingly, irrespective of the fraudulent behaviour, there was simply no ground to re-open the matter.

The liquidator was of course not particularly impressed with the approach of the Commissioner and he decided to take the matter to the CFI by way of judicial review. He argued on two fronts.

- **Section 64 IRO**
  The liquidator argued that he had shown sufficient cause that he had been prevented to file notices of objection on time and, thus, that the Commissioner had improperly refused to grant an extension of time for filing the objection.

- **Section 70A IRO**
  To the extent that a fraud had been committed, filing on the basis of fictitious sales was clearly an error or omission within the meaning of section 70A IRO.

The liquidator initially managed to convince the CFI to rule in his favour. Reyes J held that the former directors’ fraudulent knowledge should not be imputed to the taxpayer because, as established in *re Hampshire Land Company*,32 the knowledge of an agent should not be attributed to his principal where the agent is defrauding the principal in the relevant transaction. As a result, the Commissioner should have entertained the objection and consider the merit of a review based on the actual profits of the taxpayer rather than the fictitious profits reported by the former directors. Unfortunately for the liquidator, the Commissioner appealed.

The CA fully accepted the appeal and rejected in their entirety the late-filed notices of objection of the liquidator. The key to the reasoning of the CA revolves around how and when the act of another can be attributed to a taxpayer. The CA first identified the relevant principles and to do so, referred to the attribution rules identified by Lord Hoffman in *Meridian Global Funds Management Asia Ltd. v Securities Commission*.33 In that decision, Lord Hoffman identified three scenarios when acts of another can be attributable a taxpayer.

1. **Primary rules of attribution**
   Under this approach, one identifies who can act for the taxpayer according to the governance structure of the taxpayer (say, as found in the Articles and Memorandum of Association of a company). Obviously, directors of companies come immediately to mind as potential candidates to trigger attribution.

2. **General agency rules of attribution**
   The key question here is who has been specifically authorized to act for and on behalf of the taxpayer. For instance, a taxpayer would be bound by the acts of its duly appointed agents according to the legal principles of agency or vicarious liability.

3. **Special rules of attribution**
   Where scenarios 1 and 2 do not apply, a court may yet come to the conclusion that the scheme of a particular legislation requires that the acts of particular persons be attributed to another. This requires a close analysis of the legislation, its drafting and the policy underlying it.

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32 [1896] 2 Ch 743
33 [1995] 2 AC 500
The CA then proceeded to its analysis. The CA first agreed that, as it pertains to scenario 2, the Hampshire Land principle should apply in the circumstances so that the taxpayer as a principal should not be attributed the fraudulent knowledge its former directors, as its agents. Things were looking good for the liquidator but unfortunately that was not the end of the analysis. In the view of the CA, Reyes J had erred in limiting its analysis to attribution in the context of agency and in failing to consider the other potential scenarios for attribution. It then ruled as follows.

- For scenario 1, the CA noted that, according to the Articles of Association\textsuperscript{34} of the taxpayer, its board of directors was fully responsible for the management and control of the taxpayer and, in particular, for its financial reporting. As a result, the governance documents of the taxpayer clearly provided that its directors were by law the directing mind of the taxpayer. Accordingly, any knowledge, even fraudulent, must be fully attributed to the taxpayer.

- For scenario 3, the CA noted that taxation requires finality and certainty and, thus, the scheme of tax legislation itself was such that the former directors’ knowledge ought to be attributed to the taxpayer. In the view of the court, the need to achieve closure in tax matters predicated that the Commissioner needed to be entitled to rely on the validity and appropriateness of the tax filings made by whoever is responsible for the tax affairs of the taxpayer.

On that basis, the CA ruled that it could not be said that the liquidator had been “prevented” from giving a notice of objection within the time limit period, notwithstanding the fraud of its former directors.

As to the argument that the fraud of the directors had caused an “error or omission” within the meaning of section 70A IRO, the CA adopted the same principles. It ruled that, where the person responsible for the tax filings deliberately chooses to file based on fraudulent accounts rather than the actual profits of the taxpayer, it is a choice not an “error or omission” within the meaning of section 70A IRO. Given the conclusion on the issue of attribution, the conclusion here is a natural extension of the same reasoning.

We have not yet heard the final word in this story. The liquidator has now filed an application for leave to appeal to the CFA whose hearing is scheduled for 23 January 2013. Furthermore, the liquidator may yet follow up on the suggestion of the CA to try to recover any amount it may have to pay on the proof of debt of the Commissioner by suing either its former directors for breach of fiduciary duty or the auditor for breach of professional duty for failing to exercise reasonable care to detect the fraud.

\textsuperscript{34} The taxpayer adopted Table A in the First Schedule to the Companies Ordinance as its Articles of Association.
Article 35 of the Basic Law provides that

_Hong Kong residents shall have the right to…access to the courts_

In _Lee Yee Shing Jacky and Yeung Yuk Ching v Board of Review (Inland Revenue Ordinance) and Commissioner of Inland Revenue_\(^{35}\), the taxpayers, a husband and wife, challenged the constitutionality of section 69 IRO, the provision requiring that an appeal from the BOR must proceed by way of case stated.\(^{36}\) The taxpayers were arguing that, because a case stated only allows for appeals on questions of law, they were limited in their access to the courts.

**HISTORY OF THE CASE**

The taxpayers had jointly elected for personal assessment. For the years of assessment 1993/94 to 1997/98, the taxpayers claimed that the husband’s losses on dealings in securities and futures (some 5.6 million transactions with a value of HKD 300 million) had been incurred in the carrying on by him of a trade or business and were therefore properly deductible from their gross income. The IRD rejected the taxpayers’ claim and the taxpayers appealed.

The taxpayers lost their appeals all the way before the CFA\(^{37}\) but, still not satisfied that they had had their day in court, they then applied for judicial review arguing that section 69 IRO is unconstitutional. The CFI dismissed their application in February 2011 and, on March 2012, so has the CA.

**THE CA’S DECISION**

Before dealing with Article 35 of the _Basic Law_, the CA found it relevant to note that Article 10 of the _Hong Kong Bill of Rights_ provides that

_All persons shall be equal before the courts and tribunals. In the determination of any…of his rights and obligations in a suit at law, everyone shall be entitled to a fair and public hearing by a competent, independent and impartial tribunal established by law. …_

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\(^{35}\) [2008] CACV 49/2011

\(^{36}\) See http://www.hklii.hk/eng/hk/legis/ord/112/s69.html

\(^{37}\) _Lee Yee Shing v Commissioner of Inland Revenue_ (2008) 11 HKCFAR 6
The CA held that, along with the District Court in *Nam Tai Trading*\(^{38}\) and the CFI in *Yue Yuen Marketing*\(^{39}\), an appeal to the BOr is Article 10-compliant in its exercise of administrative power as a facts-finding tribunal.\(^{40}\) The CA further held that appeals by way of case stated are an acceptable limitation on a taxpayer’s right of access to the courts under Article 35 of the *Basic Law*. The CA adopted Lord Hoffman’s views in *Runa Begum*\(^{41}\),

...The concern of the court...is to uphold the rule of law and to insist that decisions which on generally accepted principles are appropriate only for judicial decision should be so decided. In the case of decisions appropriate for administrative decision, its concern, again founded on the rule of law, is that there should be the possibility of adequate judicial review. For this purpose, cases like Bryan and Kingsley make it clear that limitations on practical grounds on the right to a review of the findings of fact will be acceptable.

The CA was of the view that any difference between an appeal by way of case stated and a full right of appeal to be more apparent than real. Even with a full right of appeal, it would not be easy for an appellate court which has not seen the witnesses to differ from the decision-maker on questions of primary facts. As noted by Ribeiro PJ in *Kwong Mile Services Ltd v Commissioner of Inland Revenue*\(^{42}\),

*Just because there is no appeal on facts, it does not mean that the appellate court is precluded from detecting and correcting errors of law buried beneath conclusions ostensibly of fact.*

Particularly for this case, the CA agreed with the CFA’s view that imposing conclusions contrary to that reached by the BOr would be difficult because the taxpayers who contended for such contrary conclusions bore the onus of proof. The material facts were peculiarly within the taxpayers’ knowledge but the husband was regarded as an evasive witness.

The CA endorsed the position of Lam J in the CFI when in *Yue Yuen Marketing* he said:

...the Case Stated procedure is cumbersome and perhaps inefficient (in the sense of being more costly and time consuming for the parties), but whether such procedure has the effect of watering down the Applicants’ right of access to court is quite a different issue. ...

Indeed, in its decision back in 2008, the CFA already remarked that the case stated procedure, originated in the days when tribunals and courts seldom had access to transcripts and there were no appeals, seems an anachronism now. Often enough, dissatisfaction with the content of the case leads to interlocutory litigation. Nonetheless, the view taken by the CA is clear that it see

...no significant difference in substance between an appeal by way of case stated, judicial review or an appeal on law only although procedurally they are different.\(^{43}\)

In each case, the procedure meets the requirement of the protection of the *Basic Law*. We did not know at the time of writing whether the taxpayers would try to appeal to the CFA but one would think that the CFA will have a hard time finding flaw with the CA’s reasoning. One would also think that, with taxpayers having now failed on three different occasions, we must be getting close to the end of constitutional challenges based on the appeal scheme of the IRO. Bottom line is then that the appeal scheme of the IRO may well be awkward but it does not make it unconstitutional.

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\(^{38}\) [2008] DCTC 4250/2008

\(^{39}\) [2008] HCAL 49/2009. Please refer to our previous articles titled “Now We Know” in TQN March 2010 for another judicial review action in relation to profits tax assessment and “Waiting for the Other Shoe to Drop…Not!” re disputing IRO assessments.

\(^{40}\) Readers may wonder: The BOr, apart from the chairman and 10 deputy chairmen who are legally trained and experienced, has a panel of 96 members currently. Among them, 50 are legally qualified and 10 with accounting qualifications. Others are academics and business people. The BOr decides by a majority.

\(^{41}\) *Runa Begum v Tower Hamlets LBC* [2003] 2 AC 430

\(^{42}\) (2004) 7 HKCFAR 275

\(^{43}\) Paragraph 73 of the CA’s decision
Section 18E IRO governs a taxpayer’s change of its accounting date and apportionment of profits between different basis periods. It provides that where a taxpayer’s assessable profits are computed by reference to a financial account made up to a certain day in a year of assessment (say, 31 March) and the taxpayer fails to make up the same account on the corresponding day in the following year of assessment, the assessable profits from that source for (i) the current year of assessment and (ii) the immediately preceding year of assessment will be computed on such basis as the Commissioner thinks fit.

In exercising his discretion under section 18E IRO, the Commissioner’s practice is to:

- adopt a basis period using the new accounting date as the last date of the basis period as soon as reasonable and expedient, having regard to factors such as the trend of the taxpayer’s profits and the desirability of maintaining the normal 12 months basis period
- produce a result which will not unduly prejudice either the taxpayer or the IRD

Previous advance rulings show that the most common circumstances where the Commissioner exercises his discretion are (i) where a subsidiary changed its accounting date to become consistent with its group companies or (ii) to comply with a statute or requirements given by a competent authority. The recent Advance Ruling Case 49 falls into (i).

The applicants were a parent company and its five Hong Kong subsidiaries. All of them had 31 March as their accounting date up to and including the year ended 31 March 2011. However, the parent company also controlled a number of subsidiaries and sub-subsidiaries in the PRC, which had 31 December as their accounting date. In late 2011, the parent company’s board of directors resolved to change its accounting date and that of its subsidiaries outside PRC from 31 March to 31 December. The purposes were threefold:

- to be consistent with its Chinese subsidiaries
- to reduce the time pressure preparing the consolidated financial accounts
- to facilitate financial analysis with a view to assist with making forward plans

The Commissioner agreed that the applicants could use a nine-month period from 1 April 2011 to 31 December 2011 as the basis period for the year of assessment 2011/12 and the twelve-month period from 1 April 2010 to 31 March 2011 as the basis period for 2010/11.

While a taxpayer has no statutory duty to ask for the IRD’s views before changing its accounting periods, it may indeed be helpful to synchronize with the IRD early to avoid tax inquiries later on.
On 2 May 2012, the Commissioner held a rare press conference (rather than the customary press release) to speak on (i) 2011/12 tax revenue collections and (ii) green filing and (iii) international tax treaties and advance pricing arrangement (APA).

**PRESS CONFERENCE**

1. **Record high tax revenue**

The IRD collected HKD 238 billion in tax revenue in the year of assessment 2011-2012, representing a record high year-on-year increase of HKD 29 billion (14%). Profits tax soared by 27% to HKD 119 billion while salaries tax climbed 17% to HKD 52 billion. Amongst all, one highly profitable company accounted for 3% of the total profits tax received (HKD 4 billion) and big contributors like this company may indeed indicate that Hong Kong has a narrow tax base) and the city’s biggest taxpayer (assumed Mr Canning Fok, Group Managing Director of the Hutchison Whampoa empire) handed over HKD 79 million in salaries tax.

In contrast, stamp duty dropped 13% (HKD 44 billion). The IRD retrospectively collected HKD 6 billion from tax evasion cases and related penalties (some cases went as far back as a decade).

2. **Green filing**

The Commissioner encouraged filing tax returns online via eTAX. The Commissioner marketed that the e-filing service comes with the functionality of pre-filled data fields for personal particulars and allowances according to the data previously provided in a taxpayer’s e-return. Income data as reported by a taxpayer’s employer will also be pre-completed.

3. **International tax treaties and APA**

The Commissioner reported the current state of Hong Kong’s tax treaties and reintroduced the launch of the APA mechanism in April 2012 and the related DIPN No. 4844.

**TAX SEMINAR**

On 11 June 2012, the IRD hosted an ad-hoc seminar called “The Mainland’s Recent Tax Policy and Updates on Hong Kong’s Tax Treaty” and offered about 600 participants from the business and accounting sectors a better understanding on how PRC’s recent tax policies assist with alleviating double taxation and promoting trade.

Renowned speakers from the SAT included the Chief Economist also the Director General and Directors of the International Taxation Department. They discussed PRC’s recent tax developments including the change from business tax to VAT, tax incentives for low-profits small enterprises and international tax policy.

On the other hand, the IRD Commissioner and Deputy Commissioners presented on the development of Hong Kong’s tax treaty network, APA mechanism and updates on mapping out a legal framework for Hong Kong to enter into tax information exchange agreements (TIEAs).

In his opening remarks, the Commissioner thanked the SAT’s support particularly with respect to Announcement 16 (please refer to Double No More above). Hong Kong tax residents engaged in cross-border employment must have applauded the same.

**44 Readers may find details in our previous article titled “Welcome Developments” in TQN March 2012.**
COMING ALONG

The (Amendment) Bill 2012 was gazetted on 27 April 2012 and introduced to the Legislative Council on 9 May 2012. The (Amendment) Bill aims to amend the IRO in order to implement the concessionary revenue measures proposed in the Financial Secretary’s 2012-13 Budget. It is expected that about 1.5 million taxpayers will benefit from the proposed reduction of salaries tax and tax under personal assessment and almost 120,000 taxpayers will benefit from the proposed reduction in profits tax.

BYE BYE!

As announced in 2012-13 Budget, and with effect from 1 June 2012, capital duty has been abolished. The abolition is now reflected in the table of fees in the Eighth Schedule to the Companies Ordinance (CO).

Previously, under section 304(1) CO, a local company having a share capital had a duty to pay an ad valorem capital duty at a rate of HKD 1 for every HKD 1,000 (capped at HKD 30,000/case) on

1. the amount of its nominal share capital at registration
2. the increase in the amount of its nominal share after incorporation
3. the amount of premiums where its shares are issued at a premium

The primary purpose of the abolition is to encourage investors to set up companies in Hong Kong to raise capital and expand their business. The abolition is now applicable to local companies lodging the following documents

a. Form NC1 – Incorporation Form (Company limited by shares)(for 1 above)
b. Form SC4 – Notification of Increase in Nominal Share Capital (for 2)
c. Form SC1 – Return of Allotments (for 3)

45 Readers may find details in our previous article titled “The Budget” in TQN March 2012.
The comprehensive double taxation agreements (CDTAs) with Indonesia, Spain and Portugal have come into force on 28 March, 13 April and 4 June 2012 respectively. All three CDTAs will have effect in Hong Kong for any year of assessment beginning on or after 1 April 2013.

Hong Kong signed CDTAs with Malaysia on 25 April 2012 and Mexico on 18 June 2012. The orders to implement the CDTAs previously signed with Kuwait, Switzerland and Malta were tabled at the Legislative Council on 23 May 2012 and are in the process of completing the ratification procedures.

Now Hong Kong has signed CDTAs with 25 countries including

**Hong Kong’s CDTA Partners**

- Austria
- Belgium
- Brunei
- Czech
- France
- Hungary
- Indonesia
- Ireland
- Japan
- Jersey
- Kuwait
- Liechtenstein
- Luxembourg
- Mainland of PRC
- Malaysia
- Malta
- Mexico
- Netherlands
- New Zealand
- Portugal
- Spain
- Switzerland
- Thailand
- United Kingdom
- Vietnam

The IRD is continuing negotiations with several other countries.
The Inland Revenue Department recently published its performance annual report under the motto *Tax by the Law, Service by the Heart*. It then proudly announced that it has successfully achieved all of the targets in its Performance Pledge 2011/12.

The report highlights in particular the successful extension of the eTAX service to include annual returns filings by employers and the new e-registration service allowing e-lodgment of registration of stock borrowing and lending agreements for the purpose of stamp duty relief. It also notes how the department teamed up with the Companies Registry to enhance “one-stop” e-services for business registration and stamping of documents such as amending registered office address and business address in one go.

We are of the view that the IRD deserves accolades for its work and performance but we remain skeptical of any organization which manages to meet all of its objectives as it may then well be a case of low standards rather than high performance. Furthermore, when one looks at how long it took for a matter such as *Li & Fung* (please refer to *Damage Control* above) to be resolved, one has to think that there was a clogged artery or two in the delivery of the service!

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Please refer to the article titled “Mission Accomplished (!!!)” in TQN September 2011.
Our Tax Group has been acknowledged as follows.

- Ranked by Asia Pacific Legal 500 (2006 to 2012) as a leading law firm in Hong Kong tax and trusts.
- Ranked by Chambers Asia Pacific (2007 to 2012) as a leading international tax firm in China.
- Daniel Chan is a leading tax lawyer in Hong Kong and mainland China recognized by various legal directories include Asia Pacific Legal 500 (mainland China & Hong Kong), Chambers Asia Pacific (mainland China) and PLC Which Lawyer Global 50 (mainland China & Hong Kong).
- Patrice Marceau is a leading tax lawyer recognized by Chambers Asia Pacific (Hong Kong), PLC Which Lawyer Global 50 (Hong Kong) and CityWealth Magazine as a Hong Kong City Wealth Leader 2011.
- Stephen Nelson is a leading tax lawyer recognized by Chambers Asia Pacific (mainland China) and PLC Which Lawyer Global 50 (mainland China).