Preface to 2011–12 Edition

The last edition highlighted the enactment of the *Inland Revenue Amendment Ordinance 2010*, which allowed Hong Kong to incorporate the latest international standard on exchange of information in comprehensive double taxation agreements (DTAs). Since then Hong Kong has signed a further 16 DTAs to bring the total to 21. Hong Kong's current focus is on concluding agreements with its major trading partners in the region and globally. Ideally emphasis should be given to concluding DTAs with key trading partners such as the USA, Australia and Taiwan and countries in South America and Africa which have been the focus of Chinese outbound investment. Negotiations are currently being held with a number of countries, including Canada, India, Italy and Korea. However, not all countries that Hong Kong has approached may be agreeable to entering into a DTA with Hong Kong.

The Budget for 2011–12, whilst containing reliefs aimed at helping the middle and less advantaged classes, was heavily criticised by the public and legislators. Less than two weeks later, the Financial Secretary was forced into an unprecedented u-turn to introduce a revised package of measures. These measures included a cash payment of $6,000 to all Hong Kong permanent residents aged 18 and above, plus a waiver of 75 percent of Salaries Tax and tax under Personal Assessment for 2010/11, subject to a ceiling of $6,000, to be deducted from the taxpayer's final tax payable for the year.

As a measure to cool the property market, the Financial Secretary in November 2010 announced details of a Special Stamp Duty (SSD) on transactions in residential property. The SSD is to be imposed at penal rates, ranging from 5 percent to 15 percent depending on when the property is brought and sold and will be effective for residential properties acquired on or after 20 November 2010 and resold within 24 months or less. The Financial Secretary also announced that deferral of Stamp Duty would no longer be permitted for residential property transactions valued

at $20,000,000 or below, reflecting the earlier measure for residential property transactions valued at over $20,000,000.

A Bill was finally introduced to give effect to the tax concession announced in the 2010–11 Budget to extend the categories of intellectual property rights qualifying for deduction to copyrights, registered designs and registered trade marks. Whilst the widening of the categories of intangibles that qualify for deduction is welcome, it is disappointing that the Government has not expanded the deduction provision to include expenditure on more categories of intangible assets. The provisions only apply to expenditure on the acquisition of copyrights, registered designs and registered trade marks, as opposed to 'in-house' expenditure on the development of such intangibles. Moreover, the Government has seen fit to introduce anti-avoidance measures that professionals view as excessive.

The ongoing saga in respect of the Profits Tax treatment accorded to import processing arrangements has been dealt yet another blow. The Court of Appeal affirmed the decision of the Court of First Instance in *CG Lighting Ltd v CIR* [2011] 1 HKRC 90-237 that the taxpayer was a trading company that bought and sold finished goods and subsequently refused the taxpayer leave to appeal to the Court of Final Appeal. In refusing leave the Court noted that in their judgment, they had endeavored to apply the decisions of the Court of Final Appeal in *ING Baring Securities and Ngai Lik Electronics Co Ltd* and that the solution lay in legislation rather than granting leave to appeal to the Court of Final Appeal.

However, it is doubtful that a legislative solution will be forthcoming, if the position with regards to section 39E is any guide. Notwithstanding that their profits are fully subject to tax in Hong Kong, Hong Kong manufacturers are currently denied depreciation allowances on machinery and plant made available free of charge for use by factories on the Mainland under import processing arrangements to manufacture goods for sale by the Hong Kong manufacturer. The Government has persistently refused to amend section 39E of the IRO to address this issue despite repeated calls from Hong Kong manufacturers and tax professionals.

The taxpayer fared better in *Li & Fung (Trading) Limited* [2011] (1 HKRC 90-238), where the Court of First Instance upheld the Board of Review's decision that the source of the commission income was outside Hong Kong. The Court's decision reaffirms the approach in *ING Baring* that to determine the source of a profit one must first identify the transaction which directly gives rise to the profits. That is, the focus should be on the effective causes to the exclusion of what may be antecedent or incidental matters. The arguments advanced for the Commissioner indicate reluctance

on the part of the IRD to apply the principles in *ING Baring* to cases that are not exactly the same. Rather, the IRD maintains that the final step in the process of profit generation is not always determinative of the source of profits, and that due regard must be given to prior steps. Although the decision in the *Li & Fung* case is subject to appeal, the case highlights that the *ING Baring* decision, despite the IRD's attempts to restrict its application, remains authoritative in determining the source of profits.

More recently, in *Nice Cheer Investment Ltd v CIR* HCIA [2011] 8/2007, the Court of First Instance has called into doubt the application of the decision in *CIR v Secan Ltd & Another*. The Court held that unrealised gains arising from the revaluation of securities to their respective market value at the balance sheet date and credited to the profit and loss account according to ordinary commercial accounting principles was not chargeable to Profits Tax. Profits chargeable to Profits Tax must be real profits, in the sense that they have been earned, ascertained or accrued. They do not include book or notional profits arising out of revaluation of trading stock. Interestingly, the Court noted in respect of *Sharkey and Wernher* that it was decided on the basis of a very different tax regime; is inapplicable to Hong Kong; and should cease to be quoted as an authority for the proposition that a man can trade with himself. The outcome of this case will be watched with interest because of its implications for how assessable profits are to be ascertained.

On the Salaries Tax front, the Court of Final Appeal dismissed the taxpayer's appeal in *Fuchs, Walter Alfred Heinz v CIR* [2011] (1 HKRC 90-234) upholding the judgment of the Court of Appeal. In reaching its decision, the reasoning of the Court of Appeal was largely followed, that income chargeable under section 8(1) of the Ordinance is not confined to income earned in the course of employment but embraces payments made "in return for acting as or being an employee," or "as a reward for past services or as an inducement to enter into employment and provide future services." If a payment, viewed as a matter of substance and not merely of form and without being "blinded by some formulae which the parties may have used," is found to be derived from the taxpayer's employment in the abovementioned sense, it is assessable.

On a personal note, I have added my husband's surname to my name during the year.

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