

intellectual property, sale of income streams, deductibility of interest expense, limited partnership losses and a more complicated general anti-avoidance provision in Sec. 61A (see Chapter 10).

- (7) Husbands and wives are treated as independent persons for Profits Tax, Property Tax and Salaries Tax purposes except that an election may be made for a combined Salaries Tax assessment in circumstances where this would result in less tax being payable (see section 3.6.2). In the case of Personal Assessment, the income of a wife who is not living apart from her husband is aggregated with that of her husband.
- (8) There are no true withholding taxes, either on dividends or on any other source of income, whether paid to residents or non-residents. There are instances, however, where an assessment on a non-resident may be made on or through an agent or payer in Hong Kong who is required to retain the tax out of payments due to the non-resident (see Chapter 4).

Brief summaries of the taxes covered in this book follow.

1.3 Estate Duty (EDO)

Estate Duty has been abolished in respect of persons dying after 10 February 2006, and only a nominal amount of \$100 is chargeable in respect of dutiable estates of persons dying between 15 July 2005 and 10 February 2006. Nonetheless, the *Estate Duty Ordinance* continues to apply and impose *ad valorem* rates of duty in respect of persons who died before 15 July 2005. As the importance of Estate Duty is now significantly diminished, however, a discussion of the charge is no longer contained in this book.

1.4 Stamp Duty (SDO)

Stamp Duty is a tax on instruments, with the instruments to which it applies being specified in the four Heads of Sch. 1 to the SDO. The four Heads cover certain instruments dealing with:—

- the transfer or lease of immovable property in Hong Kong;
- the transfer of Hong Kong stock;
- the issue of Hong Kong bearer instruments; and
- duplicates and counterparts of instruments themselves dutiable.

The most common types of Stamp Duty payable in practice are as follows:—

- (1) Stamp Duty at *ad valorem* rates up to a maximum of 4.25% of the consideration is payable on conveyances on sale (essentially the legal assignment) of immovable property in Hong Kong. In addition to actual conveyances on sale, certain other transactions are deemed to be conveyances on sale at market value, most notably certain gifts of immovable property or sales of such property at less than full value.
- (2) In respect of residential property, Stamp Duty at *ad valorem* rates up to a maximum of 4.25% of the consideration is payable on agreements for the sale and purchase, and not merely on the legal assignment. For the purpose of this provision, notes or memoranda evidencing an unwritten agreement for sale and purchase of residential property are themselves deemed to be dutiable agreements for sale. A legal assignment in pursuance of a properly stamped sale and purchase agreement of residential property is, however, only subject to Stamp Duty at a flat rate of \$100. Again, a deed of gift or an agreement for the purchase and sale of residential property at less than market value is deemed to be an agreement for sale and purchase at market value. The imposition of Stamp Duty on agreements for the sale and purchase of residential property was introduced as measure to dampen speculation on residential property. Note that with effect from 23 February 2013, the *ad valorem* Stamp Duty rates are to be increased to a maximum of 8.5% for both residential and non-residential property. The charging of *ad valorem* stamp duty is to be advanced on non-residential property transactions from the conveyance on sale to the agreement for sale. Any residential property (except that acquired by a Hong Kong permanent resident [HKPR] who does not own any other residential property in Hong Kong at the time of acquisition) and non-residential property acquired on or after 23 February 2013, either by an individual or a company, are to be subject to the new rates of *ad valorem* stamp duty. Legislation to implement the proposal had not been enacted at the time of writing, but was expected to be gazetted in July 2014.
- (3) A lease of immovable property in Hong Kong is subject to Stamp Duty at *ad valorem* rates of up to 1% of the average annual rent. If the lease provides for payment of a lump sum premium, such amount is generally dutiable at the rates applicable to a conveyance on sale (i.e. at *ad valorem* rates of up to 4.25%).

terms of the relevant agreement. Generally, however, the date of acquisition of ownership is normally the date on which the purchase and sale agreement is concluded or when it becomes unconditional, if later.

Taxpayers may be required to produce evidence of title and change of ownership and documentation is therefore important because, although ownership is not contingent upon registration at the Land Registry, instruments in connection with the sale of land must be so registered and failure to do so can give rise to legal problems. This is particularly important in cases of "beneficial ownership" where there has been no formal conveyance of title. It would be usual, therefore, lacking any other evidence, to produce documents amounting to a purchase and sale agreement although these must be duly stamped under the SDO before they can be valid as an instrument of sale (Sec. 15 SDO). Note the decision in *D 7/85* where the facts were obscure as to whether a company or its director was the owner. It was held that acts undertaken by the director in respect of the property were as agent for the owner.

2.5 Exemptions and Reliefs

Various forms of exemption and relief from the charge are provided in the IRO and elsewhere and these are discussed in the following sections.

2.5.1 Governments

As a matter of practice, Property Tax is not levied where the owner of property is the Hong Kong Government. Furthermore, under the *Consular Relations Ordinance* prescribed foreign powers owning property are also exempt from the charge, but this is only applicable to property actually used for consular purposes, or as the residence of a consular employee. In practice, however, this exemption has no effect since such premises do not generate rental income and, therefore, since 1983/84 would have no assessable value.

2.5.2 Corporations and other persons carrying on business

A corporation which is carrying on a trade, profession or business in Hong Kong is normally liable to Profits Tax on its profits (see Chapter 4) and if it owns land or buildings which satisfy certain conditions, it can apply for exemption from Property Tax (Sec. 5(2)(a)). Such an application must, however, be in writing and will only be granted where the Commissioner is satisfied as to the facts of the case. Following the decision in

Harley Development Inc. & Anor. v CIR [1993] (1 HKRC 90-069), [1994] (1 HKRC 90-071) and [1996] (1 HKRC 90-079), it is clear that it should not be assumed that an exemption has been granted unless written notification of such exemption has been received. In particular, a taxpayer should not assume an exemption has been granted simply because an application for exemption has been made, or because Profits Tax returns have been filed. Note, however, the unusual facts of that case.

A corporation is defined by Sec. 2 as:—

"Any company which is either incorporated or registered under any enactment or charter in force in Hong Kong or elsewhere but does not include a co-operative society or a trade union."

The conditions for exemption under this provision are set out in proviso (a) to Sec. 25 and are that either:—

- (1) the profits from the property are part of the profits of the trade, profession or business carried on by the corporation; or
- (2) the corporation occupies the property for the purposes of producing profits subject to Profits Tax.

The exemption applies only whilst the relevant conditions continue to be fulfilled. In most cases, this means that the exemption will be lost if the profits from the property cease to be assessed to Profits Tax, although this would be rare in practice. It is interesting to note that in the *Harley Development* case (supra), the Commissioner argued that for the exemption to apply, the profits from the property had to be included in the owner's assessable profits, rather than just the profits of the owner's trade, profession or business as suggested by the statutory provision. Moreover, the Commissioner argued that the exemption applied only if there was actually Profits Tax payable in the year of assessment for which the exemption was sought and, therefore, would not apply if there was a loss sustained for tax purposes. These points were not, however, ruled upon by the courts as the case concerned an application for judicial review, which was rejected, and it was held that the Board of Review was the only appropriate venue to hear the substantive issue of the availability of the exemption from Property Tax.

Because of the statutory definition in Sec. 2 of the term "business" (see Chapter 4), it appears that every corporation with rental income is in a position to claim exemption from Property Tax in respect of the property from which it gains such rental income; similarly, a corporation which holds property for use in a trade or business from which assessable profits are generated can claim exemption from Property Tax. At first glance,

Hong Kong Government pensions, the part of a pension which is attributable to services outside Hong Kong is to be exempt (Sec. 8(2)(ca)), that the place where services were rendered is not a criterion in determining source because, if it were, the exemption clause would not be necessary.

The IRD adopts the view that the dominant factor in determining the source is the location of the fund from which payments are made. This can of course be the location of the employer's business if it funds the pension itself, or the location of an independent fund.

When it is necessary to divide a pension between service in Hong Kong and service elsewhere, this is normally done by simple time apportionment but it may be appropriate, where possible, to make the division on some other factual basis.

3.3.5 Seafarers and aircrew

The IRO lays down special rules for seafarers and aircrew because of their special position as regards performance of duties outside Hong Kong. Sec. 8(1A)(b)(i) denies them the exemption granted by Sec. 8(1A)(b)(ii) for services performed wholly outside Hong Kong, as extended by Sec. 8(1B), where duties are performed in Hong Kong during visits of not more than 60 days. Instead, they are granted exemption under Sec. 8(2)(j) where the rules in fact extend to a test of physical presence in Hong Kong over two years of assessment.

The tests for exemption for a crew member of a ship or aircraft are that he must not have been present in Hong Kong for more than:—

- (1) a total of 60 days in the year of assessment (Sec. 8(2)(j)(i)); and
- (2) a total of 120 days over 2 consecutive years of assessment, one of which is the year under review (Sec. 8(2)(j)(ii)).

The test is one of physical presence, irrespective of whether duties are performed, as is the case for the sixty-day rule applicable to other employees under Sec. 8(1B). The question of what constituted "present in Hong Kong" for the purposes of Sec. 8(2)(j) was considered in *D 45/09*. The case considered the case of a crew member who flew in to Hong Kong but did not pass through the Hong Kong Border and Passport Control before departing for Macau. The Board of Review held that the word "present" should be given its ordinary meaning. Once the crew member landed in Hong Kong, he was "present" as provided for, and set out in, Sec. 8(2)(j). The crew member during such period of transit in Hong Kong was neither present in Macau nor in any "no man's land" such that he must have been, and was, "present in Hong Kong." The precise

time at which the taxpayer becomes "present in Hong Kong" could be accurately ascertained as being the specific time at which the aircraft touched down on Hong Kong soil. The IRD has confirmed that it agrees with the Board's interpretation that transit days should be counted as days present in Hong Kong and will assess air crew or sea crew accordingly. In reviewing the position of a year of assessment under test (2) above, there are in fact two tests to be applied; first, physical presence during the year of assessment and the immediately preceding year must be aggregated and, second, a similar calculation must be undertaken for the year of assessment and the immediately succeeding year. Although it could be interpreted that it is necessary to satisfy the 120-day test in respect of both possible pairs of years, the IRD interpretation is that satisfying one pair of years is sufficient for exemption to be granted. These rules apply whether or not the employment is in Hong Kong but if the employment is outside Hong Kong and the individual fails the exemption tests, his liability cannot exceed tax on the remuneration which relates to services performed in Hong Kong. If the employment is in Hong Kong, failure to satisfy the exemption tests will mean the whole of the earnings are subject to tax except to the extent that foreign tax has been paid in the country where the services were rendered.

Notwithstanding the above, income of a crew member of a ship or an aircraft operated in international traffic may be exempt from Salaries Tax, irrespective of the individual's physical presence in Hong Kong, pursuant to an international agreement. For example, the income of a crew member of a ship operated by a resident of the Netherlands is exempt from Salaries Tax irrespective of the individual's physical presence in Hong Kong, provided that tax has been paid in respect of the income in the Netherlands. Similar provisions exist in the agreements covering shipping and air transport concluded with Singapore and Sri Lanka, although under those agreements the exemption is not dependent on tax being paid in the other jurisdiction. In the case of the agreement with Singapore, however, a Hong Kong resident employed on board a ship or aircraft operated by a Singaporean enterprise may still be subject to Salaries Tax in addition to Singaporean tax.

Additionally, Hong Kong's comprehensive double tax agreements provide that the remuneration of a person employed on board a ship or aircraft operated by an enterprise of a contracting state is taxable only in that state. In other words, the remuneration of a person employed on board an aircraft operated by, for example, a Thai airline, will be taxable only in Thailand irrespective of the extent of the person's physical

3.4.2.5 Payments on commencement of employment

As with certain payments on termination of employment, some payments made at the commencement of employment may also be outside the scope of Salaries Tax. For example, in *Pritchard v Arundale* (47 TC 680) a payment made to an individual, not as a reward for future services but as an incentive to encourage him to leave an existing gainful occupation and commence service with a new employer, was held not to be taxable. This decision is in line with the principle discussed above that if a payment is made for past, present or future services it is taxable, whereas if it represents consideration for something else it is not taxable. It is, therefore, surprising to find that in two decisions (*D 19/92* and *D 36/92*) the Board of Review has reached the opposite conclusion on facts which they have found, in substance, were the same as in the *Pritchard v Arundale* case. In the latter of these two cases, the IRD again argued that notwithstanding the *Pritchard v Arundale* decision, as a matter of law, the charge to Salaries Tax was not restricted to payments for services rendered or to be rendered; unfortunately, the Board of Review did not fully address this argument directly, but found for the IRD on the ground that the amount was a perquisite of the employment which was taxable under Sec. 9(1)(a). See, however, the discussion in previous paragraphs for examples of later decisions where the argument that “perquisite” includes all or most sums paid by an employer has been rejected.

See also *D 124/02*, where an employee was liable to pay his former employer an amount in lieu of three months’ notice when he terminated his employment to take up a new position. The employee’s new employer agreed to make (the majority of) the payment to the former employer on the employee’s behalf and this amount was held to be taxable on the basis that it was a perquisite of the employee’s new employment and that it was paid at least partly in discharge of the employee’s personal liability.

3.4.2.6 Payments other than from the recipient’s employer

It is not only payments which come to an employee from his employer which are within the scope of Salaries Tax; the principle of “reward for services” extends to a reward coming from any person so long as it is in return for the services which the employee is required by his employer to perform. The obvious example is “tips” which a customer may give to a taxi driver or waitress in return for good service. This is in any event covered by the inclusion in Sec. 9(1)(a) of the words “. . . whether derived from the employer or others . . .” but apart from that, the principle was established in *Calvert v Wainwright* (27 TC 475).

3.4.2.7 Perquisites

Before the enactment of Secs. 9(1)(a)(iv) and 9(2A) it was necessary to make substantial reference to UK law case for an understanding of when and how “benefits-in-kind” were to be subject to tax. Nevertheless, there are still some areas of case law relevant to the meaning of “perquisite” in Sec. 9(1)(a) and this is dealt with in section 3.4.5. See also DIPN 16.

A particular type of perquisite which sometimes arises is a loan waiver. For example, an employer may make a loan to an employee on the understanding that the repayment of the amount will be waived if, for example, the individual remains in employment for a minimum specified period. Such a waiver is probably deemed assessable by the specific provisions in Sec. 9(1)(a) (which is discussed in section 3.4.5). The matter has, however, also been dealt with by the UK courts in *Clayton v Gothorp* (47 TC 168), which held the amount to be taxable, and it was on the basis of this authority that a loan waiver was held by the Board of Review to be taxable in *D 83/00* and *D 119/02*.

3.4.2.8 Other issues

Although not provided for by either statute or case law, as an apparent extra-statutory concession the Commissioner, prior to the 2012/13 year of assessment, treated long service or severance payments under the *Employment Ordinance* as exempt from Salaries Tax. For a discussion of this concession, and how the Board of Review considered it should be applied in practice in the interests of consistency, see *D 38/94*.

Nonetheless, in *D 51/01* and *D 81/01* the Board of Review interpreted this concession narrowly. In particular, those decisions involved employees who would have been entitled to payments under the *Employment Ordinance* but for the fact that they also received a contractual gratuity, which reduced their entitlement under the *Employment Ordinance* to nil. The Board of Review, by majority only in both cases, rejected the proposition that such part of the gratuity as did not exceed the amount which would otherwise have been payable under the *Employment Ordinance* should be exempt from Salaries Tax. The grounds for the Board’s majority decisions were essentially that the Commissioner’s extra-statutory concession only relates to amounts actually paid pursuant to the *Employment Ordinance*, whereas in the cases before them the taxpayers had no entitlements under that ordinance as the amounts arose from employment contracts.

A contrary conclusion was, however, reached in *D 68/05*, and this was upheld by the Court of First Instance in *CIR v Tsai Ge Wah* [2008] (1

schemes (see (3) and (6) above), provided all the requirements under the IRO which would normally need to be met for a payment to receive such exemption are fulfilled in granting the benefit. Put another way, the provision merely deems certain retirement schemes operated by the Hong Kong Monetary Authority, which would not otherwise qualify, to be recognised occupational retirement schemes for Salaries Tax purposes when considering the assessability of benefits received therefrom by the specified class of members;

- (18) **Holiday warrants or passage allowance:** Up until, and including, the 2002/03 year of assessment Secs. 9(1)(a)(i) and (ii) exempted the value of any holiday warrant or passage granted to an employee or any allowance for the purchase of such provided that it was expended for that purpose. There was no limit to the amount or frequency of such tax free benefits; the only qualification was that it was actually expended for the given purpose. Indeed, it seemed that it was not even necessary for the allowance to have been *only* available to be used for holiday travel; rather, in *D 21/00* it was held that the only requirement was that it be expended for that purpose if the exemption from Salaries Tax was to apply and that the exemption could apply even if the whole amount of the allowance was not expended for the intended purpose (although, of course, the exemption applied only to the amount actually so expended). In that decision, the Board of Review rejected the submission of the Commissioner's representative that an allowance which could be expended at the discretion of the taxpayer could not qualify for the exemption. Interestingly, the Board of Review also rejected the Commissioner's representative's submission that the amount of the allowance should be treated as taxable salary on the grounds that the terms of the relevant employment had changed to effectively convert a portion of what had previously been the taxpayer's assessable salary into a holiday allowance.

An exemption was also granted in respect of any allowance for the transportation of personal effects in connection with journeys as discussed above, although again only to the extent that the allowance is expended for such purpose (Sec. 9(1)(a)(iii)).

As Secs. 9(1)(a)(i), (ii) and (iii) were repealed with effect from the 2003/04 year of assessment, the above exclusions from assessable income no longer apply. Moreover, provisions have been

introduced to render holiday travel benefits taxable even where under the general rules dealing with perquisites the amounts would not otherwise be taxable (see point (9) in section 3.4.1);

- (19) **Housing benefit:** Sec. 9(1A)(a) exempts refunds of rent to an employee in respect of his residence or rent paid direct to a landlord on behalf of an employee. A taxable benefit may arise in these cases under a separate formula; see section 3.4.3 above;
- (20) **Payments to third parties:** Sec. 9(1)(a)(iv) exempts amounts paid by an employer to a third party in discharge of a contractual obligation incurred by the employer (provided that no person has given a surety in respect of that obligation) even though the payment gives rise to a benefit (not convertible to cash) for an employee of the person making the payment. This is to counteract the effect of the decision in *CIR v David Hardy Glynn* (3 HKTC 245) which would otherwise have included such a benefit to an employee within the definition of "perquisite." The reason for the qualification relating to those cases where the liability is guaranteed by the employee or any other person is unclear, although it is to be noted that such a surety was, in fact, given by the taxpayer in the *Glynn* case;
- (21) **Income taxed in other countries:** Income earned in another country is exempt under Sec. 8(1A)(c) where that income is subject to tax in the country where the services are performed and the Commissioner is satisfied that the tax has been paid in that other country. For a more detailed discussion on this provision, see section 3.3.2.2; and
- (22) **Salary paid by certain service companies:** Sec. 9A(5)(b) exempts salary paid to an individual by a service company or trust where the amounts earned by that company or trust for the provision of the individual's services are deemed under Sec. 9A(1) to be income of the individual. See further section 3.8.1 below.

Although not specifically provided for under the IRO, by way of an extra-statutory concession the Commissioner accepts long service or severance payments under the *Employment Ordinance* as exempt from Salaries Tax. For a discussion of this concession, see section 3.4.2.8.

The following example brings together many of the issues discussed in section 3.4.

2013/14 Provisional Salaries Tax

Net Assessable Income	\$520,000
Personal Allowances (Self & Wife)	240,000
	<u>\$280,000</u>
Tax Thereon	\$ 35,600
Total Tax Payable	<u>\$ 37,381</u>
Due on:— 8 February 2015	\$ 28,481*
8 May 2015	8,900

*(75% × \$35,600 plus \$1,781)

He has a child born in August 2014 and can therefore apply for a holdover as follows:—

Additional allowances for child	\$140,000
Reduces Provisional Tax by	\$140,000 @ 17% = <u>\$23,800</u>

Holdover notice issued by IRD:—

Tax Due	8.2.2015	8.5.2015
2013/14 Final	\$ 1,781	
2014/15 Provisional	<u>26,700</u>	<u>\$8,900</u>
	\$28,481	\$8,900
Less: Holdover (75%/25%)	<u>17,850</u>	<u>5,950</u>
Due and Payable	<u>\$10,631</u>	<u>\$2,950</u>

Notes:—

- If the baby had been born after 11 January 2014 or he had otherwise missed the 28-day deadline (assuming the notice of assessment had been issued prior to 29 December 2013), the \$23,800 would be wholly held over against the second instalment.
- No further tax is payable until the final liability for 2013/14 is established when Provisional Salaries Tax paid of \$11,180 (Tax payable of \$35,600 less Provisional Salaries Tax of \$23,800 on amount heldover) will be credited and any balance due will be payable in early 2015.

3.8 Other Issues

3.8.1 Treatment of payments to service companies and trusts

Sec. 9A is a legislative provision which was first foreshadowed by the former Financial Secretary in his 1994 Budget Speech and is aimed at overcoming Salaries Tax planning arrangements involving individuals providing their services through a company which they (or their associates) control, a trust of which they (or an associate) are a beneficiary or a company controlled by such a trust. Such companies and trusts are commonly referred to as service companies and trusts and, prior to the introduction of this legislation, potentially allowed many individuals to obtain tax benefits through being able to structure employment contracts in a more tax efficient manner than was offered by their employer.

Sec. 9A is applied mechanically to all service company arrangements,

irrespective of whether they were established principally to derive tax benefits. Interestingly, however, it is arguably not necessary to strike down those more blatantly tax motivated arrangements, which it is clear were the category of arrangements which the former Financial Secretary found offensive and the reason for the introduction of the provision. In this regard, see *Cheung Wah Keung v CIR* [2002] (1 HKRC 90-116) and [2003] (1 HKRC 90-124) which concerned a service company arrangement in years of assessment before the introduction of Sec. 9A. In that case, the Court of First Instance upheld the decision of the Board of Review that the general anti-avoidance provisions of both Sec. 61 and Sec. 61A (see Chapter 10) could apply to deem the fees received by a service company to be salary income of the individual who controlled the service company and rendered all the services on behalf of the service company. On appeal, the decision of the Court of First Instance was upheld by the Court of Appeal.

Essentially, Sec. 9A seeks to “look through” such arrangements by deeming the amounts paid to the service company or trust to be income of the individual providing the services from employment with the person making the payments; where the provision operates, all the provisions of the IRO, including the reporting requirements contained in Sec. 52 and the associated offence provisions, are deemed to apply.

More specifically, Sec. 9A(1) applies where a person (known as the “relevant person”) who is carrying on, or is deemed to be carrying on, a trade, profession or business or an activity prescribed by the Commissioner under Sec. 9A(6), has entered into an agreement for the provision of services by an individual (known as the “relevant individual”) under which remuneration is paid or credited to either:—

- a company controlled by the relevant individual and/or one or more associates of the relevant individual;
- a trustee of a trust estate under which the relevant individual and/or one or more associates of the relevant individual are beneficiaries; or
- a company controlled by such a trustee.

For the purpose of the above tests, “associate” of a relevant individual is widely defined in Sec. 9A(8) as:—

- a relative of the individual;
- a partner of the individual and any relative of such a partner;
- a partnership in which the relevant individual is a partner;
- a company controlled by either the relevant individual, a partner

International Wood Products Ltd. (HKTC 551). That case concerned the question of source of commission income and the court held that this was the place where the services were rendered to earn the commission. The court went on to note that the source of commission was offshore where agents overseas undertook the services for which the commission was in substance paid, even though those agents were paid by the taxpayer for their services and the taxpayer undertook certain ancillary services in Hong Kong. Once again, the court rejected the argument that the commission had a Hong Kong source because the taxpayer's principal place of business was in Hong Kong. The reasoning in this case of looking to the overseas agents to see what was done to earn the relevant income was endorsed by the Board of Review in *D 14/96*. In the slightly later case of *D 71/97*, however, the Board was less willing to accept such a view. The taxpayer in that case was a securities broker who charged customers a commission for executing securities transactions abroad, and then engaged a broker in the relevant overseas jurisdiction to actually carry out the transaction. Because of a reduced rate of commission charged by, or a rebate received from, the overseas broker, the taxpayer in Hong Kong derived a profit and it was the source of that profit which was in dispute in the case. The taxpayer's representative pointed out that the overseas broker was the agent of the taxpayer for the purposes of executing the transaction, and this was, at least partly, accepted by the Board. Somewhat confusingly in view of earlier authorities and without any clear explanation, however, the Board of Review concluded that the activities of the overseas broker had to be looked at separately from the activities of the taxpayer and, therefore, that the activities of the overseas broker could not be viewed as those of the taxpayer.

The decision in the *International Wood Products* case should be contrasted with the earlier decision in *CIR v Karsten Larssen & Co. (HK) Ltd.* (HKTC 11) where, somewhat similarly, commission was earned by a ship broker for finding charterers and concluding charter agreements. Where the work was carried out abroad by an agent appointed by the taxpayer, the profit retained by the taxpayer was found to have a Hong Kong source. The difference between the two cases, however, is that in the *Karsten Larssen* case the agreement for the payment of the commission to the taxpayer separately named the overseas agent and identified the portion of the total income which was to be paid to that agent; in other words, the agreement was, in reality, for the payment of two amounts of commission and the amount earned by the taxpayer was considered only possibly attributable to services rendered in Hong Kong.

The question of the relevance of activities undertaken by agents of the taxpayer has been considered in a number of subsequent cases, although on the basis of the *ING Baring Securities (Hong Kong) Limited* and *Indosuez WI Carr Securities Limited* cases (which are discussed below) it seems that current judicial views are that such activities are to be treated as activities of the taxpayer for the purpose of ascertaining the source of profits. Indeed, in the former of these cases the Court of Final Appeal indicated that it is permissible to look to the activities of any party undertaking profit generating transactions on behalf, and on the instructions, of the taxpayer when determining the source of the taxpayer's profits. Nonetheless, a somewhat contrary view was adopted by the Court of Final Appeal in *Kim Eng Securities (Hong Kong) Limited v CIR* [2007] (1 HKRC 90-190) which suggested that it may not always be appropriate to consider the acts of an agent to be those of a principal when determining the source of profits, although the rationale for this conclusion was not comprehensively explained.

The distinction between the place where a business is carried on and the source of the profits from that business became blurred due to a number of court and Board of Review decisions during the 1980s. These decisions tended to flow from that of Hunter J in *CIR v Sinolink Overseas Ltd.* (2 HKTC 127) as this was the first case to throw doubt on some aspects of what may be considered relevant operations to be taken into account when determining source of profits. In particular, Hunter J adopted an "operations test" but, rather than focusing on the operations which in substance gave rise to the profits (i.e. the test from the *Smidth v Greenwood* case), divided the whole of the company's activities in relation to the profits in question into four broad categories and then looked at where each of the categories was undertaken. Inevitably, this approach meant that the central place of a company's business became an important factor in determining the source of that company's profits yet, as we have seen, this is clearly not the intention of the legislation. Hunter J was, however, insistent that the case should not be seen as a test case and was strongly critical as to the lack of evidence on material issues (the Board of Review having been bypassed and no evidence beyond the limited facts in the Commissioner's determination was adduced); accordingly, little of significance to other cases should have been able to be deduced from it. Nonetheless, the case was discussed and applied in a number of subsequent decisions which served to further confuse the issue. Although the correctness, at the time, of the decision in the *Sinolink* case is arguable, it seems to have been subsequently over-ruled by the decision of the Privy

tax “profits” and, therefore, any amount not considered profit under generally accepted accounting principles (which the amount should not be if excluded from the profit and loss account) should not be taxable unless caught by one of the deeming provisions. Note that this was essentially the position in *Lo Tim Fat v CIR* [2005] (1 HKRC 90-165); however, the taxpayer, as an individual, did not prepare accounts in accordance with normal accounting principles. In deciding that the amounts received but which were refundable if the taxpayer’s service did not continue for a specified period were nonetheless assessable in full, the court did not consider the correct accounting treatment of the amount (which would likely be not to recognise them fully), but decided the matter solely on the basis of an old UK authority. Given the increasing reliance on normal accounting principles to ascertain assessable profits, the failure of the court to consider accounting principles is noteworthy.

Although there is no statutory foundation for the practice, accounts for some professions are prepared and accepted for Profits Tax purposes on a cash, rather than an accruals, basis.

4.5.2 Treatment of capital profits

In many tax jurisdictions, capital receipts or profits are excluded from the charge to income tax, although they may be subject to a separate capital gains tax regime. Under the IRO, however, Sec. 14 excludes only profits from the sale of capital assets and, therefore, in the circumstances where a receipt is of a capital nature but is not from the sale of an asset it seems there is no authority to exclude it if it arises from the trade, profession or business. This point has been considered by the Privy Council in the case of *CIR v Far East Stock Exchange* (HKTC 1036) and although that case was decided on another point, the Privy Council appeared to suggest that the exclusion in Sec. 14 was not to be read any wider than its literal meaning.

In practice, however, the IRD appears to accept the exclusion of a wide range of capital receipts, although whether this is a concessional extension of the specific exclusion in Sec. 14 or stems from a view that capital receipts do not arise from the carrying on of a person’s trade or business (i.e. by their nature they arise outside the ordinary course of such business) is not clear. If, however, the practice stems from the latter view, it is arguable that the exclusion in Sec. 14 would not be necessary, other than for the avoidance of doubt, as the sale of a capital asset is not a transaction in the normal course of a person’s trade or business.

If the exclusion from Profits Tax contained in Sec. 14 is to be read literally as applying only to profits from the “sale” of capital assets, it could not be relied upon to exempt a compensation payment which was of a capital nature, such as an amount received for the destruction or impairment of a capital asset or a contract which formed the essence of a business; again, however, it is open to argument whether such an amount is a receipt or profit from a trade or business or a receipt from the loss or diminution in a trade or business. In this regard, see, for example, *D 12/90* where a lump sum compensation payment for giving up a part of the taxpayer’s business was held to be of a revenue nature and taxable. Compare this, however, with the decision in *D 64/98* where the opposite conclusion was reached. These two contrasting decisions merely serve to emphasise that, like many other tax issues, the issue of the nature of a compensation receipt will depend largely on the facts of the particular case. When ascertaining the assessability of a compensation payment, as a general rule it is important not to confuse the basis of calculation of the amount with the reason for its payment. For example, compensation may be paid for the destruction of all or a substantial part of a business but may be calculated on the basis of lost profits; although the profits may have otherwise been taxable, the compensation should still be considered of a capital nature and not assessable.

Aviation Fuel Supply Company v CIR [2011] (1 HKLR 90-241) illustrates that Sec. 14 of the IRO, the charging section, is far from straightforward and the importance of properly characterising the nature of a taxpayer’s trade or business to determine whether a receipt is of a capital or revenue nature. The case leapfrogged the Board of Review to the Court of First Instance which was asked to decide whether a lump sum payment received by the taxpayer on termination of a franchise agreement was assessable or a non-taxable capital receipt.

The taxpayer concluded a Franchise Agreement with the Airport Authority in 1995 to finance, design, construct and commission the aviation fuel supply system at the airport (the Facility). The arrangements included:—

- A Lease Agreement between the taxpayer and the Authority in respect of the area on which the Facility was built;
- An Operating Agreement between the Authority and a nominee operator of the taxpayer (the Operator) wherein the Operator was responsible for operating and maintaining the system;
- A License granted by the taxpayer to the Operator to enable the Operator to have the exclusive right to access the Facility to perform its duties.

interest and related expenditure were deductible can be broadly divided into four classes according to:—

- (a) the status of the borrower;
- (b) the status of the lender;
- (c) the application of loan funds; and
- (d) the nature of the loan.

The restrictions imposed by Sec. 16(2) in respect of an amount incurred prior to 25 June 2004 are as follows:—

- (a)(i) There is no limitation upon interest paid by a financial institution, as defined (see section 4.7.7) (Sec. 16(2)(a)).
- (ii) There is also no limitation upon interest paid by the public utility companies listed in Sch. 3 of the IRO (presently the Hong Kong Electric Company, Ltd., China Light and Power Company, Ltd. and The Hong Kong and China Gas Company, Ltd.) provided that the rate of interest paid does not exceed a rate prescribed from time to time by the Financial Secretary and published in the *Gazette* (Sec. 16(2)(b)). Historically, an actual interest rate was prescribed by the Financial Secretary. From 1 December 2002, however, the relevant rate is prescribed as being the highest interest rate on Hong Kong dollar savings account as quoted from time to time by the banks set out in the Schedule to the *Legal Tender Notes Issue Ordinance*.
- (b)(i) Where the funds have been borrowed other than from a financial institution as defined (see section 4.7.7), or an overseas financial institution, the interest is deductible if the lender is liable to tax thereon under the IRO (Sec. 16(2)(c)). This essentially means that the lender must be subject to Profits Tax on the interest. For the purpose of this provision, an overseas financial institution is defined as a person (which includes a company) engaged in the business of banking or deposit-taking outside Hong Kong other than a person which the Commissioner, in accordance with the powers vested in him by Sec. 16(4), determines shall not be recognised as an overseas financial institution (Sec. 16(3)(c)); Sec. 16(4) provides that the Commissioner may determine that a person shall not be recognised as an overseas financial institution where their banking or deposit-taking business is, in his opinion, not adequately supervised by a supervisory authority. This proviso is to thwart the formation of a group finance

company in a tax haven which may be argued as being a financial institution.

It was held in *D 30/93* that for the purpose of this provision, the amounts did not have to be taxable in the hands of the lender in the same period as that in which the deduction was granted. In particular, in that case the amounts were incurred but not actually payable until certain other loans taken out by the borrower had been repaid; in finding that the amounts were deductible, the Board held that the amounts were still “payable” and were chargeable to the former Interest Tax, notwithstanding that such liability would not arise until the amounts were actually paid or credited (and, in fact, never arose because of the abolition of Interest Tax). This decision was upheld by both the High Court and the Court of Appeal in *CIR v National Mutual Centre (HK) Limited* [1997] (1 HKRC 90-086) and [1998] (1 HKRC 90-094).

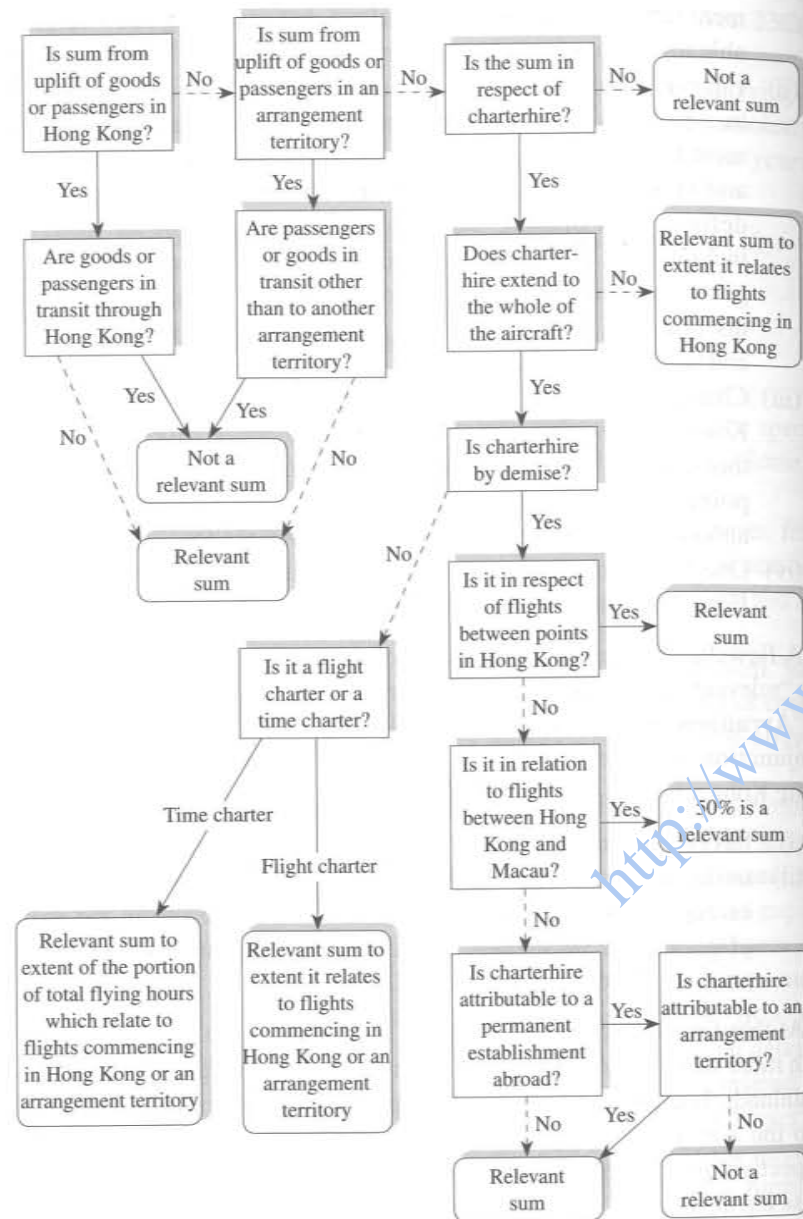
- (ii) Where the funds have been borrowed from a financial institution as defined (see section 4.7.7) or an overseas financial institution (see (i) above), the interest is deductible provided that the repayment of neither the principal nor the interest is secured or guaranteed, in whole or in part, directly or indirectly, by or on behalf of the borrower or an associate of the borrower against a deposit with any financial institution or overseas financial institution where the interest on that deposit is not chargeable to Profits Tax (Sec. 16(2)(d)).

Following the granting of an order under Sec. 87 by the Chief Executive in Council to abolish payment of Profits Tax on bank interest accrued after 22 June 1998 (see point (16) in section 4.5.3), the effect of this provision could have been diminished. This is because bank interest technically remained chargeable to Profits Tax where it had a Hong Kong source notwithstanding that an exemption from the payment of such tax had been granted. To avoid this result, however, the Chief Executive’s order contains a clause which denies the exemption where the relevant deposit secures or guarantees a loan, the interest on which is deductible.

For the purposes of this provision, “associate” of a person is extensively defined in Sec. 16(3) as follows:—

- (a) Where the person is a natural person:—
 - (i) a relative of that person. The term “relative” is also

Figure 4.1 Determination of relevant sums in respect of resident aircraft owners



Note: This is intended to be a diagrammatic summary and must be considered in conjunction with the text.

were earlier agreements incorporated into the Air Services Agreements. Additionally, agreements dealing with both airline and shipping profits have been entered into with Singapore and Sri Lanka.

“Charterhire” is a term with a specific meaning for the purposes of Sec. 23C. It refers to sums accruing to an owner or charterer of an aircraft under a charter party by demise. It does not, however, apply to the somewhat exceptional circumstances where the charter party does not extend to the whole of the aircraft.

Accordingly, any other type of charter income, i.e. the following, does not fall within the definition of “charterhire” income as used in the definition of “relevant sums” (see above):—

- Where the charter party is not by demise;
- Whether by demise or not, where the charter party does not extend to the whole of the aircraft.

In the case of charter income arising under (b) above, so far as it is attributable to flights commencing in Hong Kong it is to be included with income under (i) of “relevant sums” (see above) (Sec. 23C(3)).

In the case of charter income arising under (a) above, a proportion is to be included with income under (i) of “relevant sums” (see above). The proportion is as follows:—

- In respect of a “flight charter,” the amount attributable to any outward flight commencing in Hong Kong (Sec. 23C(4)(a)).
- In respect of a “time charter,” the total income under the charter party is apportioned on the basis of:—

$$\frac{\text{Total flying hours on flights commencing in Hong Kong}}{\text{Total flying hours under the charter party}}$$

(Sec. 23C(4)(b)).

“Goods in transit” in relation to Hong Kong refers to goods clearly specified in an air waybill or post office delivery bill as emanating from, and going to, a territory other than Hong Kong, and brought to Hong Kong by air solely for the purpose of onward carriage and any freight charges for the onward carriage are not payable in Hong Kong. Note, therefore, that goods may be in transit through Hong Kong to an arrangement territory yet the revenue earned in connection therewith may still not be a relevant sum. In relation to an arrangement territory, goods are considered as in transit if they are specified in an air waybill or post office delivery bill as emanating from, and going to, a territory other than an arrangement territory, are brought to the relevant arrangement territory

worldwide profits to conform to Profits Tax principles and apportioning them on the basis of Hong Kong turnover to worldwide turnover.

- (3) Failing either (1) or (2), which would be exceptional, the assessor is empowered to fix the assessable profits as a fair percentage of the Hong Kong turnover. Clearly this is an arbitrary method and a tax payer would normally strive to ensure that his assessable profits could be ascertained under (1) or (2).

Rule 5 is part of the IRO and therefore any assessment made under its authority is subject to the objection and appeal procedure in the same way as assessments made under the authority of Part IV of the IRO.

■ Example 4.44

Ahso Ltd. is a Japanese company which sells portable radios around the world. It has no branch or office in Hong Kong but has appointed an independent wholesale agent in Hong Kong to represent it and accept orders from retailers on its behalf. Ahso ships orders direct to the retailers. The results for a year of assessment indicate the following:—

Worldwide profit (as adjusted)	\$1,470,000
Turnover — Sales to Hong Kong retailers	\$ 840,000
Worldwide sales	\$5,880,000

If no branch accounts are prepared, the assessable profit is:—

$$\frac{840}{5,880} \times \$1,470,000 = \underline{\underline{\$210,000}}$$

Notes:—

- (a) The worldwide profit will have been adjusted in accordance with the rules of Profits Tax as required by Rule 5(2)(c).
- (b) If, for example, sales were being made into Hong Kong at a lower price than elsewhere, perhaps to break into the market, it would pay Ahso to prepare branch accounts as the profit is likely to be smaller than \$210,000.
- (c) If the agent only solicited orders which he then submitted to Japan for formal acceptance, Rule 5 would not apply and any assessable profits would need to be ascertained by more traditional means, although there may in fact be no assessable profits in such circumstances.

Rule 3 of the IRR is in principle similar to Rule 5 except that it applies specifically to banks whose head office is elsewhere than Hong Kong. There is no reference to “permanent establishment” in Rule 3, presumably because in the special nature of banking business it is quite clear whether or not a non-resident bank has a branch in Hong Kong. In any event, a license is required from the Banking Commissioner before a banking

business can be carried on in Hong Kong.

The methods of ascertaining assessable profits of the Hong Kong branch of a non-resident bank are, apart from straightforward branch accounts, not quite the same as for other types of business under Rule 5. The methods laid down in Rules 3(2) and 3(3) are:—

- (1) If branch accounts are kept which show the true profits arising in Hong Kong, these are adopted and adjusted in accordance with the rules of Profits Tax.
- (2) Failing the provision of accounts for the branch, or where the accounts do not show the true position for the Hong Kong branch, the assessable profits may be ascertained by adjusting the worldwide profits to conform to Profits Tax principles and apportioning them on the basis of the total Hong Kong assets to worldwide assets. Note that in the case of other types of business under Rule 5, the basis of apportionment is turnover.
- (3) Failing either (1) or (2), which would be exceptional, the assessor is empowered to estimate the Hong Kong profits. This is even more arbitrary than the similar provision for the businesses under Rule 5 where at least a fair percentage is applied to Hong Kong turnover, but it would be unusual for a bank to be unable to satisfy (1) or (2).

Rule 3 is part of the IRO and therefore any assessment made under its authority is subject to the objection and appeal procedure in the same way as assessments made under the authority of Part IV of the IRO.

See section 4.7.7 for details of the special provisions which apply in ascertaining the assessable profits of banks.

4.8.2 Goods on consignment

Goods on consignment which are held in Hong Kong on behalf of a non-resident principal and which are sold on behalf of that principal give rise to an automatic tax liability, often loosely referred to as consignment tax, which is akin to a withholding tax (Sec. 20A(3)). It is important to note that the section is not a charging section; rather, it is concerned with the collection of tax. The IRD's view appears to be that the agent should comply with the provision irrespective of whether the non-resident principal is actually liable to Profits Tax under the general charging provision of Sec. 14.

Sec. 20A(3) requires an agent who makes such consignment sales to submit a quarterly return to the Commissioner showing gross proceeds of

Tax. It is important to note that such amounts would not normally be deductible under the Property Tax provisions and, therefore, the availability of this deduction is an important encouragement for individuals to elect for Personal Assessment where they own rent producing property.

A deduction for interest expense incurred in a particular year of assessment is only possible if incurred to finance a property from which rental income was derived in that year of assessment. It is not possible to claim a deduction on the basis that the property generated rental income in a past year, or is expected to generate income in a future year (see *D 86/99* and *D 96/01*). It also appears from the drafting of the provisions that the interest expense deductible under this provision is limited to the amount of income from property which has been included in the total income calculation under item (1) above; any excess interest appears not to be able to be offset against other income incorporated into the Personal Assessment calculation or carried forward. Such an interpretation has been upheld by the Board of Review in *D 4/01*. This case is also interesting in that the Commissioner's representative appears to have argued that the amount of deductible interest should be determined on a property by property basis, rather than by aggregating all property income and allowing a deduction for the aggregate of all interest expenses incurred in respect of those properties for the purpose of determining the limit on deduction. However, this point was not critical to the analysis of the case and the Board of Review, as in *D 2/91* where the point was previously raised, did not make a clear ruling on whether such an approach is correct. In *D 51/04*, however, the Board of Review specifically addressed the point and agreed with the IRD's view that a global deduction of interest expenses against the aggregate net assessable income from property was not allowed. In other words, the Board confirmed that the allowable interest deduction was to be calculated in respect of each property and was limited to the amount of the net assessable income from the property to which the interest related.

Although this provision does not extend to interest incurred in the production of income subject to Profits Tax, such interest would generally have been deducted in arriving at the amount to be included under item (3) above. For a case concerning the level of evidence required to support an interest deduction under the

provision, see *D 103/89*. See also *D 50/96* where the Board of Review confirmed that the money borrowed must be used for the purpose of producing income chargeable to Property Tax and it was not sufficient merely that the loan in question was secured by mortgage over a property the income from which was chargeable to Property Tax if the borrowed funds were used for a non-income producing purpose. In that decision the Board of Review noted that the "purpose" for which the money was borrowed was determined on the basis of the person's design or intention. In that case, it was held that the purpose of the borrowing was to finance the purchase of a property as a family residence in order to improve the family's living conditions, notwithstanding that a consequence of acquiring that property was that the former family residence was let out to generate assessable rental income. The generation of that assessable rental income, it was concluded, could not be considered a "purpose" in the context of the deduction available for interest expenses under the proviso to Sec. 42(1). This line of reasoning was also followed in *D 39/01*.

From this total income, the following are deducted to arrive at a net total income:—

- (A) The amount of the individual's loss, or share of loss when he or she is a partner in a partnership, for the year of assessment as computed for Profits Tax purposes (Sec. 42(2)(b)). See section 4.5.16 for a discussion as to the computation of losses for Profits Tax purposes. If the amount of such loss exceeds the total income as computed under (1) to (3) above, as reduced by allowable interest expenses as described in (4) above, the excess can be carried forward and set off against the total income of the individual for future years of assessment (Sec. 42(5)). Where spouses are jointly assessed (which is required under Personal Assessment unless the spouses are living apart), any loss must first be set off against the income of the other spouse before the excess can be carried forward and set off against the total income of the person and their spouse (provided that the spouse is then not living apart from the person) for future years. Note, however, that in computing the loss to be carried forward, no deduction is permitted for otherwise allowable charitable donations, elderly residential care, home loan interest expenses or contributions to recognised retirement schemes as are discussed in (B) below (Sec. 42(5)(a)).

guarantee must be provided within 14 days of the order, or by the due date of payment of the tax, whichever is later. Failing any of these requirements, the tax becomes due and payable on the due date (Sec. 71(9)).

Interest chargeable in the case of a bank guarantee or where an unconditional holdover has been granted is charged at the rate fixed from time to time under section 50 of the *District Court Ordinance* (Sec. 71(11)).

In any case where the Commissioner considers that an objection has little or no merit, he may choose to grant no holdover, although he would hardly lose by ordering the purchase of a Tax Reserve Certificate because the revenue is fully protected. Where no holdover is granted, but the objection is ultimately allowed, there is no provision for the payment of interest on the tax which then becomes refundable. This was confirmed by the Court of First Instance in *Weson Investment Limited v CIR* [2005] (1 HKRC 90-148) and upheld by the Court of Appeal [2006] (1 HKRC 90-183). These arrangements do not apply to holdovers of Provisional Salaries, Profits or Property Tax which are governed by separate sections of the IRO. The above policies are further explained in DIPN 6.

Where the Commissioner has granted a holdover and subsequently, before determination of the objection or appeal, discovers that the tax is likely to become irrecoverable or that the person assessed is unreasonably delaying settlement of his objection or appeal, the Commissioner can rescind the holdover and make such other order as he sees fit (Sec. 71(3)).

If the Commissioner rescinds a holdover order or, if tax previously held over becomes payable, either in the same, a lesser or a greater amount, the Commissioner must send a notice specifying a new date of payment and any tax not paid by that date is deemed to be in default (Sec. 71(4)).

8.5 Recovery of Tax

Apart from surcharges which may be added to tax which is in default there must, of course, be statutory provisions to enable collection of tax to be enforced. In all of the enforcement provisions discussed in the following sections, the tax collectible includes the surcharges and also any fines, penalties, fees or costs incurred in enforcement as well as any interest charged on tax held over and subsequently found to be payable (Sec. 72).

8.5.1 District Court procedure

The Commissioner can take action to recover tax in default through a civil debt action in the District Court (Sec. 75). Although there is normally a

limit on the amounts which can be recovered in a District Court action, there is no such limit to an action by the Commissioner.

As evidence of the debt upon which the Court can give judgement, it is sufficient authority for the Commissioner to sign a certificate giving the address of the defaulter and particulars of the tax which he owes. The taxpayer cannot plead that the tax is excessive because there are sufficient options open to him under the IRO to dispute the assessment (i.e. the objection and appeal procedure) and the Court is only concerned with the enforcement of debts not the accuracy of them. For cases where the Commissioner has successfully sought to strike out defences filed by taxpayers on the basis that an assessment is excessive or incorrect, see *CIR v Choy Sau Kam and Chan Yun* (2 HKTC 10), *CIR v Lai Yin Ha formerly trading as China Skin Specialist Clinic* (2 HKTC 374) and *CIR v Ewig Industries Co. Limited* [2006] (1 HKRC 90-179). However, in the case of a penalty under Sec. 51(4B)(a) which is referred to the Court, because it is the Court's function to determine the quantum of penalties as opposed to debts, the Court may give judgement in a smaller amount.

Where the Court has given judgement on tax in default, collection proceeds in accordance with those avenues of the law which apply to the enforcement of judgement debts.

8.5.2 Collection from debtor of taxpayer

Where tax is in default or the taxpayer has left Hong Kong or is likely to leave Hong Kong without paying his tax, there is a procedure for recovering tax from any third party who:—

- (1) owes or is about to pay money to the defaulter;
- (2) holds money for or on account of the defaulter;
- (3) holds money on account of some other person for payment to the defaulter; or
- (4) has authority from some other person to pay money to the defaulter.

The Commissioner may commence recovery by issuing a notice to the third party, with a copy to the defaulter, requiring him to pay over to the IRD either the sum which he owes, holds, etc. or the amount of the tax in question if it is less (Sec. 76(1)). The requirement relates to all such monies in his possession or due from him at the date of the notice or at any time within 30 days after its issue. In the case of a bank, this extends to the balance due to an account holder and even where there is a joint account and only one of the parties is the debtor, the bank must still hand over any sum up to the amount of the balance; in this regard, see *The Hongkong and Shanghai Banking Corporation v The Attorney-General*

prepares the written determination and, therefore, the delay between the hearing and the written determination depends upon the workload of the chairman.

Penalty assessments under Sec. 82A are also subject to the appeal procedure (see Chapter 7). As such assessments have to be made by the Commissioner or a deputy commissioner personally, disputes proceed direct to the Board of Review because the objection procedure would be a mere formality.

The unsuccessful party to a Board of Review hearing, whether it be the appellant or the Commissioner, is entitled, in certain circumstances, to appeal to the Court of First Instance or the Court of Appeal but, in the absence of such further appeal, the assessment becomes final and conclusive in accordance with the Board's decision.

9.3.2 Appeal against decision of Board of Review

If either the appellant or the Commissioner disagrees with a decision of the Board of Review he may apply in writing to the Clerk to the Board requiring the Board to state a case for the opinion of the Court of First Instance. Where a couple have been jointly assessed, it seems that both must apply for a case stated as an application by one only will be considered invalid (see *D 90/06*). Sec. 69(1) provides that the application must be made within one month of the Board's decision, although if that decision is notified to the appellant or the Commissioner in writing, the one month period runs from the date of the communication notifying the relevant party of the decision. In *D 30/06*, this was interpreted as meaning that the one month period commenced on the date on which the communication reached the address to which it was sent. The application must also be accompanied by the fee specified in Part I of Sch. 5, which is currently \$770. The amount of this fee may be amended at any time by order of the Secretary for Financial Services and the Treasury.

Sec. 69(1) specifically provides that the opinion of the Court of First Instance can only be obtained on a point of law, as the Board of Review is intended to be the last arbiter on questions of fact. For cases where the courts have dismissed appeals on the grounds that they did not concern any points of law, see *CIR v Asia Securities International Limited* [1991] (1 HKRC 90-052) and *Aust-Key Company Limited v CIR* [2001] (1 HKRC 90-109). As to what constitutes a question of law, see the discussion in *CIR v Karsten Larssen & Co. (HK) Ltd.* (HKTC 11) and the more recent Board of Review decision of *D 26/05*. In this latter decision, the Board of Review,

quoting from an unpublished decision (but which actually involved the *Indosuez WI Carr Securities Limited* case, which is discussed in Chapter 4), stated that it should not accede to a request to state a case unless the applicant could show that a proper question of law can be identified. The Board went on to note that a proper question of law was one which:—

- (a) was a question of law;
- (b) related to the decision sought to be appealed against;
- (c) was arguable; and
- (d) would not amount to an abuse of process if submitted to the court for consideration.

Nonetheless, the Board of Review considered that the threshold for the appellant to satisfy was low and suggested that a case should be stated unless the point of law sought to be submitted to the court was plainly and obviously unarguable.

Although a case may not generally be stated in respect of findings of fact by the Board of Review, if those findings are clearly unreasonable in light of the evidence presented this becomes a question of law on which a case may be stated. For example, in *CIR v Karsten Larssen & Co. (HK) Ltd.* (supra), the court noted that “. . . it is always a question of law whether the primary facts include any material upon which the conclusion could reasonably be found.” The more commonly quoted authority for the proposition, however, is the House of Lords judgement in *Edwards (Inspector of Taxes) v Bairstow & Anor.* (36 TC 207) in which Lord Radcliffe stated:—

“. . . it may be that the facts found are such that no person acting judicially and properly instructed as to the relevant law could have come to the determination under appeal. In those circumstances, too, the Court must intervene.”

This principle has subsequently been widely adopted in Hong Kong. See, for example, the High Court decision in *CIR v Waylee Investments Ltd.* (2 HKTC 483) where Barnett J noted:—

“. . . the Court can set aside the decision of the Board only if it is clear that the Board have misunderstood the law and consequently misdirected themselves; or because their findings are perverse, that is to say, where the only true and reasonable conclusion contradicts the Board's findings.”

In other words, the Board of Review has a duty imposed upon it to act reasonably in finding facts even though the IRO gives the Board extremely wide powers to accept or reject evidence and specifically provides that it is not bound by the legal rules of evidence (Sec. 68(7)).

If a party to an appeal wishes to dispute a finding of fact by the Board

and provides guidance to tax administrations and taxpayers with regard to what documentation is relevant or appropriate to establish arm's-length prices for transactions in order to avoid or resolve disputes. The report favours an approach of requiring taxpayers to prepare contemporaneous documentation in support of their transfer pricing policies. Such a requirement has been adopted by many tax jurisdictions and typically requires a group to undertake a full transfer pricing study to support the transfer pricing policies adopted. Such a study would generally identify and describe:—

- the transaction together with its specific terms and conditions;
- the relationship between the parties, the functions performed, the assets used and the risks assumed by each party;
- the transfer pricing methodology adopted and the comparable data used (together with an assessment of the comparability of that data and any adjustments required to enhance that comparability); and
- any assumptions, strategies and policies affecting the transfer price.

Although such studies are often a statutory requirement, even where they are not they can remain a very valuable exercise for taxpayers as they may protect the taxpayer from penalties if a transfer pricing adjustment is made. Moreover, they may reduce the time taken to deal with a transfer pricing dispute and possibly shift the onus of proof to the tax authority to demonstrate that a transfer price adopted is incorrect.

Although a contemporaneous transfer pricing study has many advantages, it will not generally guarantee that a tax authority will not seek to make an adjustment. A higher level of certainty can, however, be obtained by entering into an advance pricing agreement (APA). An APA is an agreement between a taxpayer group and a tax authority as to the determination of transfer prices in relation to a specified group of transactions. An APA may be entered into with only a single tax administration, in which case it is referred to as unilateral, or with two or more tax authorities (i.e. it may be bilateral or multilateral). Which is appropriate depends in any particular case on the taxpayer group's operations, transactions and whether relevant DTAs exist. Often only a unilateral APA will be appropriate where, for example, there is manufacturing in a low tax jurisdiction with the product all being sold to a related party in a higher tax jurisdiction. A bilateral or multilateral APA on the other hand may be appropriate if a manufacturing company in a low tax jurisdiction is selling to related parties in a number of high tax jurisdictions, or in the case of global trading of financial instruments by a financial institution, being a situation which can give rise to difficulties regarding the allocation of the overall

profit between jurisdictions.

APAs are intended to be binding agreements, although they are generally prospective rather than retrospective and also are typically valid only for a specified period. The existence of an APA, however, does not guarantee that a transfer pricing audit will not be undertaken by the tax authority, although the purpose of such an audit would generally be to ensure compliance with the APA. Also, although intended to be binding, a tax authority will generally retain the power to cancel an APA if it found that it is not being correctly implemented, or that there were instances of fraud or misrepresentation during the negotiation process.

In March 2012, the IRD issued DIPN 48 which builds on the IRD's transfer pricing guidelines, namely DIPN 46: *Transfer Pricing—Methodologies and Related Issues*. DIPN 48 provides guidance for enterprises seeking an APA. The DIPN explains the APA process and its terms and conditions. The Commissioner agrees that the arm's length principle is the international transfer pricing standard and should be used as a benchmark to determine the arm's length consideration or profits in relation to controlled transactions. The IRD will ensure that enterprises operating in Hong Kong declare a level of profit from controlled transactions commensurate with the functions carried out, the assets used, and the risks assumed in Hong Kong.

The APA process is voluntary and supplements the objection, appeal and other DTA mechanisms for resolving transfer pricing issues. The IRD considers that the APA process will give enterprises the opportunity to reach agreement with the Commissioner on the method of applying the arm's length principle to controlled transactions. This will allow a more efficient resolution of transfer pricing issues and prevent costly and time consuming audit and litigation of transfer pricing issues covered by the APA.

The key features of DIPN 48 include:—

Scope: The APA programme is initially focused on the negotiation of bilateral and multilateral APAs where Hong Kong has a Double Tax Agreement (DTA) with the counterparty jurisdiction(s). Unilateral APAs are available to taxpayers in cases where the DTA partner(s) in a bilateral or multilateral process do not wish to participate or continue the process; a bilateral or multilateral APA could not be agreed between the Competent Authorities; a non-DTA state is prepared to give a unilateral APA regarding transactions which are integrally linked to the controlled transactions covered by the bilateral or multilateral APA.

The DIPN also includes thresholds for each year covered in the APA—HK\$80 million if the controlled transactions involve the sale and purchase