

Mr Lloyd Deverall's letter to Hon TAM Heung-man

Dear Hon. Mandy Tam,

As requested, I have outlined briefly below some areas where I believe changes or clarity could be provided to the IRO which would greatly assist in the operation of the tax system in Hong Kong. Please note that the following items are not listed in order of importance.

1. Group relief should be introduced into the Hong Kong IRO. It makes no sense where a wholly owned group has profits in one subsidiary and a loss in another subsidiary that it cannot offset the loss against the profit. Group relief has also recently been introduced into the Singapore tax system. Group relief is also available in many of the advanced tax systems elsewhere in the world. Why not in Hong Kong?

2. The operation of Section 19C(5) of the IRO should be amended to make it clear that where a company is a partner in one partnership which makes a profit then it should be entitled to offset that profit against any loss it might make as a partner in a second partnership. Under the IRD's current interpretation of 19C(5), the share of a loss made in one partnership cannot be offset against a taxpayer's share of profits from another partnership. This is unfair and there is no good reason for having such a rule.

3. The basic structure of the Hong Kong tax system is to assess Hong Kong sourced profits but not to assess gains which are capital in nature. Similarly, deductions are not available for expenses of a capital nature. Unfortunately the key words adopted in Section 14(1) only exclude "profits arising from the sale of capital assets" which does not specifically exclude "profits of a capital nature". In contrast, the wording adopted to disallow deductions specifically disallows deductions for "any expenditure of a capital nature ..." [Section 17(1)(c) of the IRO]. To give a relatively simple example, if a building is sold that has been held for many years, any gain that arises is likely to be regarded as capital in nature. If however the building

is destroyed in a fire and the owner receives a compensation sum by way of insurance, as any resulting profit did not arise from the sale of a capital asset, it is not specifically exempt from taxation. Accordingly, the wording of the exemption contained in Section 14(1) should be expanded to cover “profits of a capital nature”.

4. Section 20(2) of the IRO should be deleted and replaced by a provision which introduces properly drafted transfer pricing legislation requiring transactions between related parties to take place at arms length. Section 20(2) is badly drafted and as a result is potentially toothless in combating non-arms length pricing. As a result Hong Kong is one of the few jurisdictions in the world which does not have properly drafted legislation requiring transactions between related parties to be conducted on an arms length basis. This is particularly relevant for transactions between related parties where one of the entities is located outside Hong Kong and therefore does not fall within the Hong Kong tax net.

5. The taxation of trusts remains a confusing and ambiguous area. Court judgements and Board of Review decisions that have needed to consider this issue have also resulted in confusing comments requiring, amongst other things, an analysis between a trading and non-trading trust. This matter should be given a lot more careful thought and clear rules established which, for example, could result in the profits made by a trust being specifically taxed in the hands of the beneficiary. In the event that no beneficiary is presently entitled to the income of the trust, then the IRO should provide for the income to be taxed in the hands of the trustee. This latter point would arise where income was derived by a discretionary trust and the beneficiaries had not been identified or nominated. Given Hong Kong’s important role as a financial centre, it is very strange that the laws within the IRO associated with the taxation of trusts have not been specifically addressed.

6. A huge area of uncertainty and lack of clarity in the legislation has arisen in respect of the Salaries Tax liabilities arising on the exercise of stock options particularly in respect of individuals who leave Hong Kong. Currently, attempts to patch up some of these uncertainties have been made in Departmental Practice Note No. 38 concerning “Employee Share Option Benefits”. It would be far more preferable to legislate for the manner in which “source” should be determined in respect of stock options. The Practice Note currently provides for source to be determined by reference to the extent to which the vesting of the stock option occurs while the person is working in Hong Kong. There is no reason why this matter should remain to be dealt with in a non-binding Practice Note.

Further, where an employee leaves Hong Kong and has not yet exercised the option, the Practice Note gives the employee the option to elect to have the option assessed as if it had been exercised on the date of departure. This results in the employee paying tax on an unrealised deemed gain at the time of his departure. If the employee actually makes a lower profit at the time of subsequently actually exercising the option, the Practice Note then allows the employee to request a refund from the IRD. It would be preferable if these rules were codified into the IRO rather than sitting in a non-binding Practice Note. Further, if an employee decides not to have the stock option deemed to be exercised at the date of his departure from Hong Kong, there is considerable doubt and uncertainty over whether the IRD can subsequently seek to assess profits and collect tax on the individual given that he has left Hong Kong. This whole area needs more thought. For example the IRO could make it clear that upon departure from Hong Kong, all holders of stock options will be deemed to have exercised those options at their appropriate market value. While this may lead to some discomfort in seeking to assess individuals when they have not yet exercised the option, the certainty of tax collection and the certainty in the operation of the law may well outweigh the downside.

7. Uncertainties continue to exist in relation to the classification of a profit as Hong Kong sourced or not. As you are aware, under the IRO, only Hong Kong sourced profits are subject to tax. The IRD has released Practice Note 21 with a view to overcoming some of those uncertainties. Unfortunately the IRD seems to be adopting ever more aggressive stances which result in it getting harder and harder to establish offshore claims even where a substantial element of offshore activities are involved.

One area where thought might be given to providing a broader exemption concerns trading profits where the buyer and seller are both located outside Hong Kong, where the goods are manufactured outside Hong Kong and where the goods do not pass through Hong Kong (other than for purposes of transhipment). In such a situation, thought should be given to assessing any resulting profit on a very low concessionary basis. This would enhance Hong Kong as a trading centre in the region and remove the legitimate planning opportunity of moving the trading operations from Hong Kong to Macau to take advantage of a concession provided in the Macau tax legislation for similar activities.

8. A very strange anomaly has arisen in the Salaries Tax regime in respect of

employees who are seconded by their existing Hong Kong employer to manage or oversee the Hong Kong employer's operations in China. Taking the following examples in turn:

- (i) If the employee after working in Hong Kong for a few years for the employer is seconded to the employer's subsidiary in China, even though he may work in China from 1 July to 31 March, he will be fully subject to Hong Kong salaries tax for the remuneration derived in that first nine month period. For the future years he is unlikely to be subject to tax either because he pays tax in China on the same income or visits Hong Kong for less than 90 days.
- (ii) Despite the exemption from Salaries Tax provided in the IRO for an employee who visits Hong Kong for less than 90 days in a tax year, the IRD's current interpretation of the word "visits" makes it difficult for people who were Hong Kong residents to avail themselves of this exemption. This seems against the spirit of the legislation.

Given the huge volume of Board of Review time and effort and the uncertainties created in this area, I think it is time that greater thought be given to clarifying the manner in which the legislation should operate for such employees.

9. An area which creates a lot of confusion and wastes a lot of time for taxpayers and tax practitioners concerns the operation of Section 50(5). In particular, the wording of Section 50(5) seems to suggest that, where a credit has not been granted in respect of foreign taxes, a deduction should be granted for the quantum of the uncreditable foreign taxes. However, without having provided any clear analysis of their interpretation of Section 50(5), the IRD seem to adopt a practice of denying such a deduction although not all Assessing Departments in the IRD adopted a similar practice. The IRD should be asked to clarify clearly their practice in this area and such a practice should be reconciled to the specific wording of Section 50(5).

10. Following the relatively recent case of Commissioner of Inland Revenue v Secan Limited, modern case law seems to be moving to a position in which unrealised gains can be assessed. Following the Court of Final Appeal decision in Secan, many IRD assessors are seeking to assess sizeable unrealised gains on the basis simply that those gains were recognised in the taxpayer's accounting profit and loss account. While this may be the interpretation placed by the judges on the wording of the IRO, this matter needs some fundamental re-thinking as I doubt whether the spirit of the

IRO is to assess a profit that has not yet been realised in cash and in respect of which the taxpayer may have little or no cash to pay the tax liability. This is a matter which therefore could benefit from substantial thought from a legislative position to see whether the result is what the legislature really intended.

Mandy, I hope the above comments are of assistance. Please note there will be many other issues which I could raise if I had more time to spend thinking about them; but given the tight time frame you have, I have come up with what I hope are some helpful suggestions.

Best regards,

Lloyd Deverall