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By email (dwylo@legco.gov.hk)

13 December 2018

Ms Doris LO
Clerk to Bills Committee
Legislative Council Secretariat
1 Legislative Council Road
Central, Hong Kong

Dear Ms Lo,

Bills Committee on Inland Revenue (Amendment) (No. 7) Bill 2018

Thank you for your email dated 3 December 2018 enclosing the list of follow-up actions arising from the 1st Bills Committee meeting on 30 November 2018. Please find the Government's response at **Annex**.

Yours sincerely,

(Ms Pecvin Yong)
for Secretary for Financial Services and the Treasury

c.c.
Commission of Inland Revenue (Attn: Mr KK CHIU)
Department of Justice (Attn: Miss Betty CHEUNG
Ms Carmen CHAN)

Annex

Inland Revenue (Amendment) (No. 7) Bill 2018 ("Bill")

Government's response to the follow-up issues raised at the Bills Committee meeting on 30 November 2018

At the meeting of the Bills Committee on 30 November 2018, the Government was requested to –

(a) advise whether the proposed amendments in Part 2 of the Bill for aligning tax treatment of financial instruments with their accounting treatment would result in unrealized profits including revaluation gains being taxed on a fair value basis and in effect reversing the Court of Final Appeal's ("CFA") judgment in *Nice Cheer Investment Ltd v Commissioner of Inland Revenue* (2013) 16 HKCFAR 813 ("Nice Cheer case");

(b) clarify whether the definition of "visiting teacher or researcher" under the proposed section 8(1D) or that under the law of the visited territory with which Hong Kong has entered into a Comprehensive Avoidance of Double Taxation Agreement (or Arrangement) ("CDTA") containing a Teachers and Researchers Article ("Teachers' Article") shall apply in determining whether or not a person is a visiting teacher or researcher; and

(c) provide examples to illustrate the operation of the proposed section 8(1AB), including whether assessable income derived from services rendered by a person as a visiting teacher or researcher in the visited territory will be subject to salaries tax in Hong Kong in circumstances where tax is exempted or assessed to be nil in respect of such income in that territory.

Aligning the tax treatment of financial instruments with their accounting treatment

2. In Nice Cheer case, the CFA held that "profits" referred to actual or realized (not potential or anticipated) profits. Having regard to the basic principles of tax law and the fact that the prevailing provisions of the Inland Revenue Ordinance ("IRO") does not expressly allow profits

in respect of financial instruments to be computed, for tax purposes, on a fair value basis, the CFA ruled that the unrealized profits (i.e. increases in the value of the company's trading stock of marketable securities) though recognized as accounting profits were not assessable to tax under the IRO.

3. The proposed amendments in Part 2 of the Bill seek to make express provisions to provide taxpayers an option which allows them to compute assessable profits from financial instruments based on their fair value so as to ease the practical difficulties encountered by taxpayers if their profits for taxation purposes are to be computed separately. The proposed provisions allow, on the taxpayer's election, profits in respect of financial instruments be computed for taxation purposes on a fair value basis. To elaborate –

(a) For accounting purposes, taxpayers are required to account for financial instruments on a fair value basis in accordance with applicable accounting standards.

(b) For tax purposes, they can choose under the proposed section 18H whether the proposed sections 18I to 18L apply to them, i.e., whether to have their profits from financial instruments assessed on a fair value basis or on realization basis –

(i) For taxpayers who have chosen to have their assessable profits computed on a fair value basis, the profits/loss (including any unrealized gains/loss) recognized in accordance with the specified accounting standards would be taxed or allowed accordingly subject to the provisions of proposed sections 18H to 18L.

(ii) For taxpayers who have not elected to have their assessable profits computed on a fair value basis under the proposed section 18H(2), they remain entitled to exclude any unrealized profits in their tax return. Hence, this is consistent with the legal position under CFA's judgment in the Nice Cheer case. Accordingly, no tax will be charged on such unrealized profits that are so excluded. Therefore, the proposed amendments do not seek to reverse the CFA's judgment in the Nice Cheer case.

Avoiding potential double non-taxation of income of visiting teachers and researchers

4. In determining a person's salaries tax liability in Hong Kong, the Inland Revenue Department would consider whether the person falls within the scope of "visiting teacher or researcher" as defined under the proposed section 8(1D), i.e. person who visits that territory and is present in that territory for the sole or primary purpose of teaching or conducting research at an educational institution or scientific research institution (including a university, college or school) in that territory. The scope so defined under the proposed section 8(1D) is modelled on the common coverage of the Teachers' Article in other CDTAs worldwide that contain a Teachers' Article. A Teachers' Article in any CDTAs signed between Hong Kong and another jurisdiction would have to be implemented by enacting the CDTAs concerned as subsidiary legislation under the IRO. For terms that are not defined in the CDTA (e.g. "educational institutions"), reference should be made to the meaning under the law of the visited jurisdiction in accordance with the provisions of the CDTA as implemented by the subsidiary legislation[1].

5. The proposed amendments in Part 5 of the Bill seek to avoid the double non-taxation of Hong Kong sourced income, which is in line with the international effort to combat base erosion. The amendments only concern the Hong Kong sourced income of a person visiting another jurisdiction for the purpose of teaching or research where the CDTA between Hong Kong and that other jurisdiction provides for an exemption from tax in that other jurisdiction on the income of a visiting teacher or researcher in that other jurisdiction.

6. Some illustrative examples for teachers and researchers employed by a Hong Kong institution but with services rendered wholly outside Hong Kong are given below –

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[1] Generally, a CDTA contains a rule of interpretation regarding the application of the CDTA by a Contracting Party that, unless the context otherwise requires, a term not defined in the CDTA has the meaning that it has under the law of that Party for the purposes of the taxes to which the CDTA applies and any meaning under the applicable tax laws of that Party prevails over a meaning given to the term under other laws of that Party.

(a) Example 1 (income exclusion not enjoyed in Hong Kong as no tax is paid or payable in visited jurisdiction under exemption of Teachers' Article)

Mr A, a resident of Hong Kong, is a teacher employed by a local school in Hong Kong. The school pays Mr A an annual income of HKD500,000 in Hong Kong. Under a 2-year exchange program, Mr A is sent to a school in Jurisdiction F to teach courses. He enters Jurisdiction F on 1 April 2019 and leaves on 31 March 2021. Hong Kong and Jurisdiction F have an effective CDTA which contains a Teachers' Article providing for tax exemption for a visiting teacher and researcher in the visited jurisdiction for two years from the date of his first arrival in the visited jurisdiction ("the Exemption Provision").

Pursuant to the Exemption Provision, Mr A's income of HKD500,000 for each of the years of assessment 2019/20 and 2020/21 is exempt from tax in Jurisdiction F. As no tax is paid or payable in Jurisdiction F in respect of the income, under the proposed section 8(1AB), Mr A cannot be availed of income exclusion under section 8(1A)(b) even though the income is derived from services rendered wholly outside Hong Kong. In such circumstances where Mr A is a Hong Kong resident person, his employer is a school in Hong Kong and his income is paid in Hong Kong, his income of HKD500,000 for each of the years of assessment 2019/20 and 2020/21 is chargeable to salaries tax in Hong Kong.

(b) Example 2 (income exclusion enjoyed in Hong Kong as tax is paid or payable in visited jurisdiction)

Same facts as Example 1 except that the exchange program is a 3-year one and Mr A leaves Jurisdiction F on 31 March 2022.

Since the Exemption Provision covers only 2 years, Mr A pays tax in Jurisdiction F in respect of his income of HKD500,000 for the third year of assessment 2021/22. Under the proposed section 8(1AB), income exclusion under section 8(1A)(b) can apply to Mr A's income for the third year of assessment 2021/22

such that the income is not chargeable to salaries tax in Hong Kong.

(c) Example 3 (income wholly or partly covered by personal allowances in Hong Kong)

Mr B, a resident of Hong Kong, is a researcher employed by a local university in Hong Kong. The university pays Mr B an annual income of HKD500,000 in Hong Kong. Mr B enters Jurisdiction G on 1 April 2019 and stays in Jurisdiction G to conduct research work until the said employment ends on 31 March 2021. Hong Kong and Jurisdiction G have an effective CDTA which contains a Teachers' Article providing for tax exemption for a visiting teacher and researcher in the visited jurisdiction for one year from the date of his first arrival in the visited jurisdiction. Mr B is accordingly not required to pay tax in Jurisdiction G for the first year of assessment 2019/20 under the Exemption Provision.

Mr B duly reports his income for the second year of assessment 2020/21 to the tax authority of Jurisdiction G. It is subsequently assessed that Mr B is not required to pay any tax in Jurisdiction G for one reason or another under the prevailing tax policies (e.g. with income all covered by personal allowances provided by Jurisdiction G).

Mr B's income for both the years of assessment 2019/20 and 2020/21 may be wholly covered by personal allowances available to him in Hong Kong (as Hong Kong has a competitive tax system with a wide range of allowances and deductions available to taxpayers) such that no salaries tax is paid or payable for the two said years of assessment in Hong Kong. If, in the event that Mr B's income is not fully covered by personal allowances in Hong Kong, the remaining uncovered part of his income for the two said years of assessment would be subject to Hong Kong's salaries tax as he is a Hong Kong resident person, his employer is a university in Hong Kong and his income is paid in Hong Kong.