[10-400] Statutory exemptions

Last Reviewed: 10 08 2020

Certain receipts which might normally be considered to be "income" are specifically excluded from a taxpayer's income computation under sec 8 and 9 of the Inland Revenue Ordinance. They are:

• **Consulate staff.** Official emoluments of consuls, vice-consuls and taxpayers employed on the staff of any consulate, who are citizens of the state which they represent (sec 8(2)(b)). In practice this exemption is extended to the staff of all official foreign Government agencies (Case I35 (1999)CNRC ¶80-604 (D81/98)).

• **Commutation of pension.** A sum received by way of commutation of pension under:

(i) a recognised occupational retirement scheme upon termination of service, death, incapacity or retirement;

(ii) the Pensions Ordinance;

(iii) the Pensions Benefits Ordinance; or

(iv) the Pensions Benefits (Judicial Officers) Ordinance (sec 8(2)(c)).

Certain limitations apply to the exemption from salaries tax of pensions which are received on termination of employment, see ¶11-040.

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[11-800] Exemption outlined

Last Reviewed: 10 08 2020

Any income that is derived by taxpayers who render all of the services for their employment outside Hong Kong is specifically exempt from salaries tax (sec 8(1A)(b)). The exemption, however, is not available for income derived by Government employees or the masters and crews of ships or aircraft. A separate, but similar, exemption applies to income earned by the latter (see ¶11-880).

The exemption for services rendered outside Hong Kong is applicable only to employment income. It does not apply to remuneration from an "office", such as directors' fees.

The full tax exemption for income derived from overseas service also does not apply when an employee has rendered services in Hong Kong during visits totalling more than 60 days. This restriction to the exemption is known as the "60 days rule". If an employee spends more than 60 days visiting Hong Kong and performs services during that time then his or her income can be charged to salaries tax wholly, if the taxpayer is a Hong Kong employee, or in part, if the taxpayer does not have Hong Kong employment (see further ¶11-840ff).

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Additional exemption prevents double taxation

An additional exemption is provided under the Ordinance which ensures that a taxpayer who has rendered services outside Hong Kong is not taxed twice on the same income in two different countries. If a taxpayer has paid tax in another country then the income on which he or she was taxed is salaries tax exempt in Hong Kong. This exemption is further explained at ¶12-000.

[11-820] Overseas secondment

Last Reviewed: 10 08 2020

If a taxpayer with Hong Kong employment (a "Hong Kong employee") is seconded to work overseas, and performs all of the services for his or her employment outside Hong Kong during a year of assessment, the income received by the taxpayer for those services will be exempt from salaries tax in accordance with sec 8(1A)(b).

The Board in Case L32(2002)CNRC ¶80-833 (D37/01) was satisfied that the taxpayer was truthful when he claimed that he had not rendered any services in Hong Kong. His assertion had been confirmed and corroborated by his employer. From the immigration records, the taxpayer was only in Hong Kong during working hours for 22 ½ days during the relevant year of assessment, despite the fact that he was physically in Hong Kong for 85 days. The taxpayer was in Hong Kong mostly over weekends or holidays and there was no regular pattern that he was in Hong Kong over a particular day of the week or at a particular time. His income is thus exempt from salaries tax.

However, it is the taxpayer's burden of proof to support whether he or she performs any services in Hong Kong. If the taxpayer has to come back to Hong Kong to visit suppliers of raw materials and customers for sales follow-up, and visits Hong Kong for more than 60 days, his or her salary under the Hong Kong employment will be subject to salaries tax (Case L30 (2002)CNRC ¶80-831 (D34/01); Case K9 (2001)CNRC ¶80-740 (D29/00); Case J46 (2000)CNRC ¶80-714 (D130/99); Case H19 (1998) ¶80-527 (D47/97 IRBRD Vol 12, 313)). The taxpayer in Case R25 (2008)CNRC ¶81-243 (D40/07) failed to convince the Board that he did not render any services in Hong Kong during the 55 weekdays out of his 77 days of

[11-840] Application of rule

Last Reviewed: 10 08 2020

The salaries tax exemption for income derived by a taxpayer who has rendered services outside Hong Kong (sec 8(1A)(b); see ¶11-800) only applies if that taxpayer has rendered all of the services in connection with his or her employment outside the territory. (See also Case N77 (2004)CNRC ¶81-053 (D2/04); Case N38 (2004)CNRC ¶81-014 (D27/03); Case M44 (2003)CNRC ¶80-909 (D162/01); Case M25 (2003)CNRC ¶80-890 (D138/01); Case L54 (2002)CNRC ¶80-855 (D73/01); Case K69 (2001)CNRC ¶80-800 (D128/00)).

In determining whether all of a taxpayer's services have been rendered outside Hong Kong no account is taken of services performed in Hong Kong during visits of less than a total of 60 days in a year of assessment (sec 8(1B)). In other words, a person who renders his or her services outside Hong Kong will normally have no liability to salaries tax on the income he or she receives for that service unless the time spent visiting Hong Kong exceeded 60 days in the relevant basis period and services were performed in Hong Kong during that period.

The meaning of "visit" is discussed at ¶11-860. For the meaning of "day" see ¶11-850.

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When a person renders services in Hong Kong during visits totalling more than 60 days two different results are possible, depending upon the location of his or her employment.

• If the person has Hong Kong employment he or she will be liable to salaries tax on the whole of his or her income derived in the assessment year (provided that a similar tax has not been paid on the same income

[11-870] Apportionment of non-Hong Kong employees' income

Last Reviewed: 10 08 2020

When a taxpayer with non-Hong Kong employment performs services during visits to Hong Kong which exceed a total of 60 days in a year of assessment, his or her income is apportioned. Another situation in which income may be apportioned is when a taxpayer with non-Hong Kong employment is seconded to Hong Kong but is required to travel outside Hong Kong in the course of performing his or her services.

Only the portion of income which relates to services rendered by the taxpayer in Hong Kong is subject to salaries tax in Hong Kong. If the income chargeable to salaries tax cannot be identified by reference to the services rendered, the "time-in, time-out" method of apportionment is applied (Case I61 (1999)CNRC ¶80-630 (D146/98); Case A139 (1991) 1CNRC ¶80-139 (D106/89 IRBRD Vol 6, 391)).

A taxpayer unsuccessfully challenged the apportionment of income on a time basis in Case E31 (1995) 1CNRC ¶80-328 (D49/94 IRBRD Vol 9, 285). The taxpayer argued for an alternative apportionment based upon certain cost allocation formulae established by his employer. The Board of Review stated that apportionment must be carried out on a basis, or according to a formula, which relates to the "services rendered in Hong Kong". As the cost allocation formulae bore no relation to the services actually rendered by the taxpayer they were rejected as a basis for ascertaining the taxpayer's income and the time basis was upheld. See also Case T23 (2010)CNRC ¶81-292 (D41/09); Case O10 (2005)CNRC ¶81-066 (D28/04).

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The following example demonstrates the time basis apportionment method.

Example

[10-100] Statutory definition of "income"

Last Reviewed: 10 08 2020

The basic charging section for salaries tax (sec 8) requires that salaries tax be charged on every taxpayer in respect of his or her Hong Kong sourced office or employment of profit and pension income. The Ordinance gives some aid in identifying payments which qualify as "income" for salaries tax purposes. It does not, however, provide an exhaustive definition of the term. "Income" is defined as including:

- wages;
- salaries;
- leave pay;
- fees;
- commissions;
- bonuses;
- gratuities;
- perquisites; and

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[15-100] Prerequisites for liability

Last Reviewed: 10 08 2020

Three criteria must be fulfilled before a person will be liable to profits tax under the basic charging section of the Ordinance (sec 14(1)):

(i) the person must have been engaged in a trade, business or profession;,

(ii) the person must have been carrying on that trade, business or profession in Hong Kong; and

(iii) the persons profit from that trade, business or profession must have arisen in or been derived from Hong Kong (CIR v Hang Seng Bank Ltd (1990) 1CNRC ¶90-044; CIR v Orion Caribbean Limited (1997)CNRC ¶90-089; Kwong Mile Services Limited v CIR (2004)CNRC ¶90-135; Kim Eng Securities (Hong Kong) Limited v CIR (2007)CNRC ¶90-190; ING Baring Securities (Hong Kong) Limited v CIR (2007)CNRC ¶90-195; Case A145 (1991) 1CNRC ¶80-145 (D32/91 IRBRD Vol 6, 74)).

Although the meanings of the terms "person", "trade", and "business" are defined in the Ordinance (see ¶15-120, ¶15-200 and ¶15-700), the definitions of "trade" and "business" are neither comprehensive nor exhaustive and so are of limited practical assistance. Consequently, the identifying features of "trade" and "business" which have been established by the courts are vital for ascertaining whether a person satisfies the first criteria for liability to profits tax (see ¶15-300 ff and ¶15-700 ff). In all cases, courts must make a determination of whether a taxpayer's activities constitute the conduct of a trade or business in Hong Kong based on the relevant facts.

[15-120] Persons assessable

Last Reviewed: 10 08 2020

Profits tax is charged on the Hong Kong-sourced profits of every "person" carrying on a trade, profession or business in Hong Kong (sec 14(1)).

"Person" is defined in sec 2 of the Ordinance as including:

• a corporation;

• a partnership;

• a trustee (whether incorporated or unincorporated); or

• a body of persons (sec 2(1)).

In practice the term "person" covers all possible trading concerns.

A "corporation" is any company which is incorporated or registered in Hong Kong or elsewhere. However, the term does not include a co-operative society or trade union (sec 2(1)). A "body of persons" is any body politic, corporate or collegiate or any company, fraternity, fellowship or society of persons whether corporate or not corporate (sec 2(1)).

"Trustee" is widely defined to include a guardian, curator, manager or other person exercising direction,

[16-730] Timing of assessment

Last Reviewed: 10 08 2020

The Inland Revenue Department follows the accounting treatment stipulated inCNAS 39 in recognising profits or losses in respect of financial assets of revenue nature. Valuation methods previously permitted for financial instruments, such as the lower of cost or net realisable value basis, will not be accepted.

HKAS 39 requires the following measurements after initial recognition (Departmental Interpretation and Practice Notes No 42, para 12):

(a) Financial assets at FVTPL, including derivatives that are assets, and AFS at their fair value without any deduction for transaction costs it may incur on sale or other disposal;

(b) L & R at amortised cost using the effective interest method;

(c) Held-to-maturity investments at amortised cost using the effective interest method;

(d) Financial liabilities at amortised cost, except for financial liabilities at FVTPL which are measured at fair value.

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Accordingly, the timing of assessment is as follows (Departmental Interpretation and Practice Notes No 42, para 13):

(a) For financial assets or financial liabilities at FVTPL, the change in fair value is assessed or allowed when

[16-750] Capital or revenue

Last Reviewed: 10 08 2020

The accounting treatment, by itself, cannot operate to change the character of an asset. Whether the asset is of capital or revenue nature is a question of fact and degree where all the surrounding circumstances, including the accounting treatment, have to be considered (Departmental Interpretation and Practice Notes No 42, para 23). The intention at the time of acquisition of the financial instrument is always relevant.

Typically a derivative will be classified as held for trading and the change in fair value and the gain or loss on disposal, recognised in the profit and loss account, are prima facie taxable or deductible. L & R, held-to-maturity investments and AFS are trading assets if the taxpayer is a financial institution or it carries on an insurance, money lending, securities dealing or finance business (Departmental Interpretation and Practice Notes No 42, para 24 and 25).

Specific provisions that apply to financial instruments under the Inland Revenue Ordinance, namely sec 14A, 15(1)(j), 15(1)(k), 15(1)(l) and 26A, shall not be affected by the accounting practice underCNAS 39 (Departmental Interpretation and Practice Notes No 42, para 26).

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[16-780] Hedge accounting

Last Reviewed: 10 08 2020

Hedge accounting is an exception to the usual rules used for accounting of financial instruments. An entity may choose to continue to apply the hedge accounting requirements of HKAS 39 or apply the hedge accounting requirements of HKFRS 9.

Compared with HKAS 39, the hedge accounting model in HKFRS 9 allows greater flexibility which aligns the treatment of financial and non-financial items to also allow the hedging of risk components in non-financial items, provided the component is separately identifiable and reliably measurable. 23.

Hedge accounting means designating a hedging instrument, normally a derivative, as an offset to changes in the fair value or cash flows of the hedged item which can be an asset, liability, firm commitment, forecasted future transaction or net investment in a foreign operation exposed to a risk of change in value or changes in future cash flows. Only contracts with a party external to the group or individual entity that is being reported on can be designated as hedging instrument. Hedge accounting matches the offsetting effects of the fair value changes in the hedged item and the hedging instrument. If the hedging relationship comes to an end, hedge accounting must be discontinued prospectively.

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There are three types of Hedge Relationship:

(a) "fair value hedge" is a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss;

[16-790] Imputed interest on interest-free loans and non-arm's length loans

Last Reviewed: 10 08 2020

After the issuance of the revised Departmental Interpretation and Practice Notes No 42, the Inland Revenue Department clarifies its position on imputed interest on interest-free loans and non-arm's length loans.

If a long-term loan or receivable does not carry interest, the fair value of the long-term loan or receivable will be measured as the present value of all future cash receipts discounted using the prevailing market rate of interest for a similar instrument with a similar credit rating.

The difference between the transaction price and the fair value at initial recognition is recognized as a gain or loss unless it qualifies for recognition as some other type of asset. As a result, there would be an imputed gain, loss, income or expense at initial recognition of the financial instrument and a corresponding imputed interest income or expense for amortization.

By virtue of section 18L(9), any such imputed profit, gain, loss, income or expenses computed in accordance with HKFRS 9 will not be chargeable to tax or allowable as a deduction. Instead, any actual profit, gain, loss, income or expenses computed in accordance with the contractual terms will be taxable or deductible.

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[18-920] Assessment of partnerships

Last Reviewed: 10 08 2020

The assessable profits of a partnership are computed in one sum and tax is charged in the partnership name as though the partnership is a separate legal "person" or assessable entity (sec 22(1); CIR v The Four Seas Co Ltd (1961) 1CNTC 41).

Identifying a partnership

Whether a partnership exists is a question of fact, although legal interpretation of documents or agreements is sometimes necessary. There are three identifying features of a partnership:

- a business relationship between two or more persons;
- the carrying on of a common business jointly; and
- the carrying on of business in order to make a profit.

These features originate from sec 22(1), which refers to a trade, profession or business carried on by two or more persons jointly, and the Partnership Ordinance (Ch 38) which defines "partnership" as: "the relation which subsists between persons carrying on a business in common with a view of profit" (sec 3(1)).

The sharing of gross receipts is not enough to establish a partnership (Cox v Coulson (1916) 2 KB 177). The joint ownership of property also does not, on its own, create a partnership. There must be other

[20-320] Qualifying capital expenditure

Last Reviewed: 10 08 2020

"Capital expenditure" is defined to include interest and commitment fees incurred in connection with a loan for the purpose of financing a commercial building or structure and to exclude any grant, subsidy or other financial assistance or any amount otherwise deductible pursuant to the Ordinance (sec 40(1)). However, the definition is not exhaustive and other expenditure may properly qualify (more on "capital expenditure" at ¶18-260).

Expenditure incurred on construction

To qualify for an initial allowance, a taxpayer must have incurred capital expenditure on the construction of a commercial building or structure.

An expenditure incurred on ordinary work done in preparation for the laying of foundations, or in the laying of drains, sewers and water mains for a building may be a qualifying capital expenditure (DIPN No 2, para 16). However, an expenditure incurred on the acquisition of land, or rights in or over land or related to demolishing an existing structure is not a qualifying capital expenditure (sec 40(3); D5/79 IRBRD Vol 1, 340).

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R13 (2008)CNRC 81-231 (D21/07) discusses the practice of the Commissioner to use the first assignment price as the basis for estimating cost of construction. In the matter, the taxpayer was claiming that cost of construction for allowance purposes should be based on his acquisition cost. The Commissioner disagreed

[21-000] Availability of allowances restricted

Last Reviewed: 10 08 2020

Section 39E restricts the initial and annual allowances for machinery or plant under certain lease arrangements. Section 39E denies initial and annual allowances to lessors when

• machinery or plant is purchased from and leased back to the same person (¶21-040et seq)

• a lease arrangement has been entered into in relation to the machinery or plant (except ships or aircraft) and the machinery or plant is used principally or wholly outside Hong Kong

• a lease arrangement has been entered into in relation to a ship or aircraft and the lessee is not an operator of a Hong Kong ship or aircraft, or

• the machinery or plant is acquired by way of a leveraged lease transaction, financed by a "non-recourse debt" (¶21-080et seq).

[32-200] Calculation of provisional tax liability

Last Reviewed: 10 08 2020

Provisional salaries tax

Provisional salaries tax for an assessment year is calculated on the taxpayer's net chargeable income for the preceding year, adjusted as follows:

• the amount of any loss which was set off in the calculation of the net assessable income (¶12-820), on which the net chargeable income was based, must be added; and

• the amount of any loss which may be set off in the year of assessment for which the provisional tax is payable must be deducted (sec 63C(1)).

Provisional salaries tax is calculated at the tax rates specified in the Second Schedule of the Ordinance. The amount of provisional tax imposed, however, must not exceed the amount which would have been chargeable if the standard tax rate (set down in the First Schedule) had been applied to the whole of:

• the net assessable income for the preceding year of assessment as reduced by concessionary deductions allowed under Pt IVA (Concessionary Deductions); or

• in the case of spouses who have elected personal assessment, the aggregate of their net assessable incomes for the preceding year of assessment reduced by concessionary deductions allowed under Pt IVA (Concessionary Deductions) (¶13-000).

[32-300] Application of provisional tax against final tax liability

Last Reviewed: 10 08 2020

Where a taxpayer is assessed to salaries tax, profits tax or property tax for a year of assessment, any provisional tax paid for that year is first applied in payment of the assessed liability (sec 63F, 63K and 63P). Any excess is carried forward and applied to the payment of the provisional tax liability for the subsequent year; any further excess, refunded.

Example

Mr X owns property which, in 2010/11, had a net assessable value of $500,000. In 2011/12 the net assessable value of property owned by Mr X is $600,000. Mr X's tax liability for 2011/12 is calculated as follows:

Year of Assessment 2010/11		$
Provisional property tax paid for 2011/12 (16% × $500,000)		80,000
Year of Assessment 2011/12		
Property tax liability (16% × $600,000)		96,000
LESS		
Provisional property tax paid for 2011/12 (16% × $500,000)		80,000
EQUALS		
Balance of tax payable		16,000
PLUS		
Provisional property tax payable for 2008/09 (16% × $600,000)	+	96,000

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[32-400] Holding over payment of provisional tax

Last Reviewed: 10 08 2020

A taxpayer who disagrees with a provisional tax assessment may apply to have the payment of provisional tax held over (sec 63E(1), 63J(1) and 63O(1)).

More on the holdover of tax generally at ¶30-500 et seq.

Grounds for holding over provisional salaries tax

For provisional salaries tax, the holdover application must be lodged with the Commissioner on or before the later of (i) 28 days before the provisional salaries tax is required to be paid, or (ii) 14 days after the date of the notice for payment of provisional salaries tax(¶32-220; sec 63E(1)).

A taxpayer may have ground for a holdover where

• he/she has become entitled to a personal allowance during the year of assessment which was not taken into account in determining the provisional tax liability (sec 63E(2)(a));

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• his/her net chargeable income for the year of assessment is (or is likely to be) less than 90% of the net chargeable income or estimated net chargeable income of the preceding year (sec 63E(2)(b));

• he/she has ceased (or will cease before the end of the year of assessment) to derive assessable income (sec 63E(2)(c)); or

[35-200] Requirements for a valid objection

Last Reviewed: 10 08 2020

Timing

A notice of objection must be received by the Commissioner within one month after the date of the notice of assessment (sec 64(1)). The Commissioner may extend the time limit for objection if the taxpayer was prevented from giving notice within the required period because of absence from Hong Kong, sickness or some other reasonable cause (sec 64(1)(a)).

The Board of Review does not have the power to grant an extension of time to lodge an appeal against a penalty tax assessment issued under sec 82A (Case N75 (2004)CNRC ¶81-051 (D105/03); Case I41 (1999)CNRC ¶80-610 (D98/98); Case H40 (1998)CNRC ¶80-548 (D96/97).

Before the 1993/94 year of assessment, in the case of provisional assessments (see "Payment of Tax • Provisional Tax • Double Tax Relief" tab), an assessment was required to have been confirmed by the Commissioner before the relevant taxpayer could object to it (former sec 59A). That requirement has been repealed.

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In Yee Aik Ee v Commissioner of Inland Revenue (2005)CNRC ¶90-156, the taxpayer applied to judicially review the decisions of the Commissioner of Inland Revenue in refusing to reconsider his late objections to the tax assessments. The taxpayer was the sole proprietor of Jianli Vacuum Forming Company ("Jianli"). Tax audit was conducted by the Inland Revenue Department and additional tax assessments were raised. The taxpayer offered "an additional tax liability for the years of assessment 1997/98 to 2001/02 of

[35-320] Determination by Commissioner

Last Reviewed: 10 08 2020

When a taxpayer and assessor fail to negotiate an agreement for the resolution of an objection in the preliminary stages (see ¶35-300) the objection is referred to the Commissioner for determination in accordance with sec 64(4). In such a case a draft statement of facts based upon all of the information available to the Revenue is sent to the taxpayer for comment, together with a request for further information or further arguments. The Commissioner will proceed to determine the objection if no reply is received in 21 days. For simple cases, or for cases which require urgent determination, no statement of facts is issued.

Authority to summon persons and request particulars

There is no formal hearing involved in the determination of an objection. The Commissioner is entitled, however, to summon any person who he believes is able to give evidence regarding the assessment in issue (see further ¶35-360). The Commissioner is also authorised to require the person who lodged the objection to furnish any particulars which are regarded as necessary and to produce any relevant books or documents which are in his or her custody (see further ¶35-340).

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Consideration within reasonable time

The Commissioner must consider every valid objection within a reasonable time (sec 64(2)). This requirement was addressed in the case of Nina TH Wang v Commissioner of Inland Revenue (1992) 1CNRC ¶90-059. In that case, there had been uncertainty about the role played by the taxpayer in

[35-380] Consequences of failure to object

Last Reviewed: 10 08 2020

When a taxpayer fails to object to (or appeal against) an assessment which has been raised against him or her, that assessment becomes final and conclusive (sec 70). The policy of the law is to force the taxpayer's hand (Mok Tsze-fung (1963) 1CNTC 166).

When a taxpayer fails to submit an acceptable return and fails to object to an estimated or additional assessment the assessment becomes final (sec 70). Even if the taxpayer would not have been liable to tax if a proper return had been furnished to the Department, an estimated assessment raised against him or her will become final if a valid objection is not made. For example, a company which did not furnish a profits tax return because it was not liable to profits tax became liable to profits tax calculated from an estimated assessment because it failed to make an objection to that assessment in Sun Yau Investment v CIR (1984) 2CNTC 17.

For more on the finality of assessments, see ¶36-700.

[52-100] Risk reduction

Last Reviewed: 10 08 2020

We have seen in ¶52-030 to ¶52-080 the criteria for choosing an optimal holding company in relation to investment holding which is pertinent to reducing overall taxation liabilities of a multinational group of operations. Similarly, an efficient operational structure for the underlying subsidiaries is also beneficial for the group to harness its limited resources and to reduce unnecessary business and taxation exposure. Typically, the underlying structure of a group represents its core productive operations from which the profits in substance arise. An effective and efficient underlying structure is important from at least two aspects, namely:

(i) asset and business protection; and

(ii) income tax minimisation,

which are core elements for a business to remain competitive and successful.

As mentioned in ¶52-010, it has been envisaged that a business usually grows and prospers from a small sole-proprietorship to a multinational conglomerate. During this expansion period, the nature of business will diversify with business operations ramified into overseas countries where customers and suppliers are located. For example, a typical regional enterprise in Asia could have its headquarters performing functions such as human resources, general administration, accounting in Hong Kong, manufacturing operations in the PRC, research and development centres in Taiwan/Korea and sales activities in the US and European countries. The nature of business may also grow from traditional manufacturing of low-tech

[52-110] Reduction in income tax exposure

Last Reviewed: 10 08 2020

Imagine a situation when all local and overseas activities are carried out by one single subsidiary. As this subsidiary carries on business and derives profits in different taxation jurisdictions, inevitably, it is liable to local and overseas income taxes. In addition, the subsidiary will have to prepare and submit different sets of tax returns on or before stipulated deadlines and to comply with the onerous taxation laws and regulations of relevant taxation authorities. Furthermore, its financial statements will be extremely cumbersome as a result of the voluminous amount of financial information (with sources coming from different geographical locations) that needs to be combined for reporting to shareholders and for submission to the tax authorities.

Apart from the above demerits, depending on the respective taxation laws of the jurisdictions, there is a possibility that the same profit be subject to income tax both in the home country in which the subsidiary is incorporated and in the country in which the relevant business operations took place. Double taxation could thus occur. Furthermore, no foreign tax credit may be available to set off foreign income tax paid (eg if the home country is Hong Kong, then no tax credit on foreign income tax paid could be allowed). A relief to avoid double taxation is usually found in a double taxation treaty. Under a typical tax treaty, the business profit of a tax resident of a contracting state (ie the home country) will be subject to income tax of another contracting state (ie the overseas tax jurisdiction concerned) only when it carries on business in the other contracting state through a permanent establishment. A permanent establishment defines the threshold level of activities that a foreigner of a contracting state can perform in another contracting state without having its business profits so derived to be subject to income tax in the latter's contracting state.

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[52-130] Cross-border transactions

Last Reviewed: 10 08 2020

In the diagram at ¶52-100, on the typical organisational structure of a manufacturing group, different functions including manufacturing, trading and asset holding are assigned to various operating subsidiaries. The benefits associated with such segregation of functions and hence responsibilities, namely individual companies and the group as a whole, have well been mentioned. Consequently, different functions are now carried out by different legal entities and inter-group company transactions must therefore occur in the normal course of carrying on the group's business. For example, a typical sales transaction would involve the following steps:

(1) raw materials required for manufacturing are first purchased by the trading company;

(2) with or without marking up for a profit, the raw materials are sold to the foreign investment enterprise in the PRC for manufacturing into finished products;

(3) the finished products are then sold domestically by the foreign investment enterprise or sold to the foreign invested party for export;

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(4) in order for the PRC manufacturing entity to have proper usage of the trademark (ie a kind of intellectual properties) in its production, the intellectual property holding company would license the use of such trademark to the manufacturing company in return for a royalty.

[52-140] Transfer pricing

Last Reviewed: 10 08 2020

Transfer pricing is concerned with prices charged between related parties for the transfer of goods, services and intangible property. The fundamental principle of transfer pricing requires that the allocation of income and expenses of a related-party transaction be made on an arm's length basis (i.e. the arm's length principle), by benchmarking with how independent enterprises deal with each other in the same circumstance.

In the cross-border transaction depicted in ¶52-130, each participating company is subject to the local income tax in which it is a tax resident and in which it carries on business. Under such transaction, a local tax authority would therefore only be able to tax the income or profits of its tax residents or profits, which are arisen in or derived from its jurisdiction. To protect against potential loss of tax revenue due to abusive cross-border transfer pricing policies, the taxation laws of the respective jurisdictions would ensure that the amount of taxable income and profit derived by its tax residents in cross-border transactions are fair and reasonable having regard to its surrounding facts and circumstances.

Generally speaking, most tax authorities, if not all, adopt the commonly known arm's length principle in determining whether the transfer pricing used in a particular cross-border transaction is fair and reasonable. If a pricing policy is acceptable by the relevant tax authority to be in order, no adverse taxation implication would arise and income tax would be assessed in the normal way based on the figures appearing in the tax return and financial statements. If, however, the pricing policy is proved to be

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[52-170] Manufacturing operations in the PRC

Last Reviewed: 10 08 2020

The open door policy of the PRC since 1970s has attracted foreign investors to set up manufacturing entities in the PRC to take advantage of the abundant supply of cheap labour for production operations and the huge potential of the domestic consumer markets comprising more than 1.2 billion population. As a further incentive, the State Administration of Taxation has promulgated different taxation incentives based on the nature of foreign investments established in the PRC. Nowadays, most manufacturers in Hong Kong have moved their production base to the PRC, mainly in the Guangdong province, to take advantage of its proximity to Hong Kong which is still an international re-export centre in the Asia-Pacific region. The Hong Kong office, on the other hand, is responsible for purchasing of raw materials required for production, sales of goods manufactured in the PRC and accounting and financial centres for the group.

A brief description of the two common types of manufacturing operations that a foreign party can perform in the PRC and their related taxation implications are summarised as follows.

Processing arrangement

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Processing arrangement is most common in the early days of the open-door policy. It is a kind of co-operation arrangement between a domestic PRC party and a foreign manufacturer for the manufacture of goods. Under the agreement, the PRC party is to provide local labour and factory premises and is responsible for the production of finished goods as specified by the foreign party in return for a processing fee. The foreign party, on the other hand, provides production plant and machinery, technical skills and

[52-200] Cost-sharing arrangement

Last Reviewed: 10 08 2020

To avoid the additional withholding tax that is payable on royalties for use of intellectual property owned by a fellow group company overseas, especially in the case when no favourable double taxation treaty is available for reducing such withholding tax, cost-sharing arrangement can bring beneficial tax savings in this area of international planning.

Cost sharing is a new arrangement and is currently not common in the Asia-Pacific region. Such international tax planning is more developed in the US and in some European countries. The Internal Revenue Service of the US has issued in 1995, final regulations with respect to cost-sharing arrangements for the development of intangible property. A qualified cost-sharing agreement is defined as an agreement for sharing costs of development of one or more intangibles in proportion to reasonably anticipated benefits from individual exploitation of interests in the intangibles that are developed.

The new enterprise income tax law in the PRC, which was effective from 1 January 2008, has introduced a new concept of cost sharing arrangement that allows participants to share the joint costs incurred for research and development of intangibles and provision or receipt of services.

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The primary benefit of a cost-sharing arrangement is that it will ordinarily preclude the US Internal Revenue Service from allocating royalty income with respect to the developed intangibles under the controversial commensurate with income standard. As a general matter, the tax authority will be restricted to making adjustments relating to cost-sharing ratios and considerations paid or payable for the