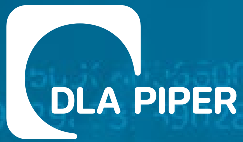

TAX NEWSLETTER

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EDITORIAL NOTE

Welcome to the latest issue of our Tax Newsletter.

A number of developments have taken place in the PRC and Hong Kong that could be of legal and tax significance to your businesses.

In the PRC, the People's Bank of China ("**PBOC**") issued a circular allowing two-way cross border RMB cash poolings to be open to multinational corporations nationwide. The Ministry of Finance ("**MOF**") and the State Administration of Taxation ("**SAT**") also jointly issued a circular confirming the continuance of preferential income tax treatments for Advanced Technology Service Enterprises ("**ATSE**") for the period from 1 January 2014 to the end of 2018. Further, the SAT promulgated a public notice to clarify certain implementation issues on accelerated depreciation of fixed assets and a public announcement to codify individual income taxation treatments on capital gains of various equity transfers. With regards to the Shanghai-Hong Kong Stock Connect program ("**Stock Connect**"), the China Securities Regulatory Commission ("**CSRC**"), MOF and SAT jointly released a notice concerning PRC tax treatments on investments via Stock Connect. In order to enhance anti-avoidance tax laws, Zhejiang issued a circular to strengthen the supervision on various cross-border transactions. Various consumption tax policies were also adjusted by the finance and tax authorities. Last but not least, the newly signed China-Switzerland double taxation agreement came into force on 15 November 2014 and applies to income derived from 1 January 2015 onwards.

In Hong Kong, a comprehensive double tax agreement was signed with the United Arab Emirates. Further, notes were exchanged between the HKSAR Government and the Japan Government regarding their existing double tax agreement. The intergovernmental agreement with the United States, which facilities compliance with the US Foreign Account Tax Compliance Act, has formally been entered into. In order to promote the development of exchange traded funds ("**ETFs**"), the HKSAR Government proposed to waive stamp duty for the transfer of ETFs shares or units. In addition, the Study Group on Asian Tax Administration and Research established a task force to allow the Asia-Pacific region to engage in discussions and remain updated on international developments. Also, the annual meeting between the Inland Revenue Department ("**IRD**") and the Hong Kong Institute of Certified Public Accountants ("**HKCPA**") was held where many important issues were discussed. Finally, the IRD has reported some tax avoidance cases during the two months.

We welcome your feedback and any questions you may have about this issue of the Tax Newsletter.

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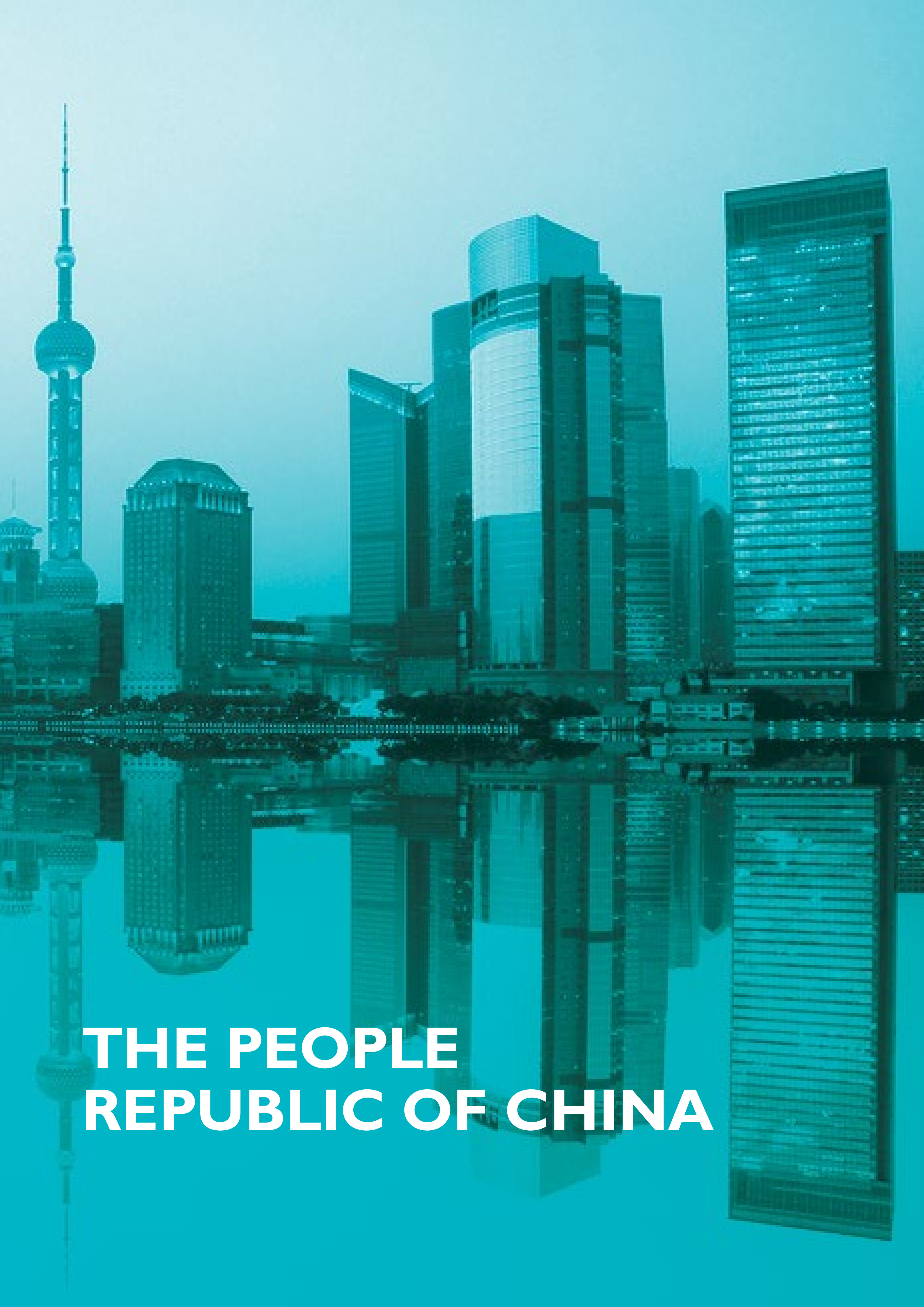

THE PEOPLE REPUBLIC OF CHINA

TWO-WAY CROSS BORDER RMB CASH POOLING ALLOWED FOR MNCS NATIONWIDE IN CHINA

On 1 November 2014, the PBOC issued the *Circular on Matters Relating to Centralized Operation of Cross-border Renminbi Funds Carried out by Multinational Enterprises Groups* (Yin Fa [2014], No. 324, hereinafter the "**Circular**") to accelerate the internationalization of the RMB. The Circular makes the centralized operation of the cross-border RMB funds open to multinational groups nationwide, following the success of the pilot scheme in the China (Shanghai) Pilot Free Trade Zone in early 2014.

The Circular allows the operation of multinational groups' cross-border RMB funds in China, including:

a) two-way cross-border RMB cash pooling; and

b) centralized cross-border RMB settlement under the current account items.

The following are the highlights of the Circular:

1. The eligibility of multinational groups for implementation of the two-way cross-border RMB cash pooling:

- Both onshore and offshore participating member companies of the multinational group shall have operated for more than three years;
- Total revenue for the preceding year of the domestic member companies should be no less than RMB 5 billion; and
- Total revenue for the preceding year of the overseas member companies should be no less than RMB 1 billion.

2. The restrictions on the two-way cross-border RMB cash pooling:

- In principle, a multinational group may only set up one RMB cash pool via a special RMB account in China. If several cash pools are set up with various banks, a recordal with the PBOC will be required. In addition, each domestic member company is merely allowed to attend one of the cash pools;
- RMB funds in the cash pool(s) shall not be used to invest in securities, financial derivatives and properties not for self-use purpose, or purchase financial products or offer entrusted loans to non-member companies;
- PBOC sets an upper-limit for the net cross-border RMB inflows of the cash pool, which is based on the owner's equity, but no limit on the outflow for the time being.

3. The operation of the two-way RMB cash pool is subject to a recordal filing with the PBOC's competent local counterparts.

4. A multinational group may, through one domestic member company, open RMB settlement accounts with several banks in China to handle centralized receipts and payments of cross-border RMB under the current account items for its member companies.

With the implementation of the Circular, we believe multinational groups may better support their regional and global operations through the aforesaid cash pooling arrangement which undoubtedly would increase the efficiency and decrease the related costs in respect of funds flowing in and out of China. There are still some unclear issues in the Circular about the practical operations and implementation. We will closely monitor the development and provide up-to-date information.

ADVANCED TECHNOLOGY SERVICE ENTERPRISES CONTINUE TO ENJOY PREFERENTIAL INCOME TAX TREATMENTS

The MOF and the SAT jointly issued the *Circular on Issues regarding Improving Enterprise Income Tax Policies for Advanced Technology Service Enterprise* (**"Circular 59"**), which has been effective from 1 January 2014. Circular 59 confirmed the continuance of the preferential income tax treatment for ATSE for the period from 1 January 2014 to end of 2018.

According to Circular 59, an enterprise which satisfies the following requirements may qualify as an ATSE.

- A legal person registered and operating in one of the 21 listed cities;
- Engages in one or more Advanced Technology Services ("**ATS**") specified in the *Recognition Scope of Technologically Advanced Services (Trial Version)*, by using advanced technologies or with relatively strong research and development capacity;
- More than 50% of its employees have academic degrees of junior college or higher ;
- More than 50% of its annual income is generated from undertaking ATS activities; and
- At least 35% of annual income is generated from undertaking ATS activities provided to offshore service recipients, i.e. "Offshore Outsourcing Services" including Information Technology Outsourcing ("**ITO**"), Business Process Outsourcing ("**BPO**"), and Knowledge Process Outsourcing ("**KPO**").

Under Circular 59, qualified ATSEs registered and operated within the prescribed cities[1] may continue to enjoy the following preferential enterprise income tax ("**EIT**") treatments, as previously provided to ATSEs by Caishui [2010] No. 65 ("**Circular 65**").

- A reduced EIT rate of 15%; and
- Deduction on expenditures related to the statutory employees' education fee (not exceeding 8% of total salaries and wages) upon calculating the taxable income. The remaining amount exceeding 8% can be carried forward to following tax years.

In comparison with the previous Circular 65, Circular 59 has relaxed the percentage requirement on Offshore Outsourcing Services from 50% to 35%, which apparently will entitle more service enterprises which are focusing on China domestic markets to enjoy the aforesaid preferential tax treatment.

The actual ATSE certification procedures will be subject to the adjustment and clarification by local authorities in the relevant 21 listed cities. Service enterprises that may benefit from this policy should be alert and check with the application window in relation to the relevant certification requirements from now on up to the period for the 2014 annual income tax filing.

FURTHER CLARIFICATION ON THE IMPLEMENTATION OF ACCELERATED DEPRECIATION OF FIXED ASSETS

Following the issuance of Caishui [2014] No. 75 ("**Notice 75**") in relation to the guideline of accelerated depreciation treatments for fixed assets, the SAT promulgated Public Notice [2014] No. 64 ("**Notice 64**") to further clarify certain implementation issues for accelerated depreciation treatments, which has been effective retroactively from 1 January 2014.

According to Notice 64:

- The six specified industries stated under Notice 75 eligible for accelerated depreciation of fixed assets shall be determined according to the industrial classifications issued by the National Bureau of Statistics. To be qualified to apply for the accelerated depreciation method, enterprises in these six specified industries shall derive more than 50% of their total revenue from their main business in the year of using the acquired fixed assets.

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[1] The Circular only applies to enterprises registered and operated in the following 21 Service Outsourcing Demonstration Cities: Beijing, Tianjin, Shanghai, Chongqing, Dalian, Shenzhen, Guangzhou, Wuhan, Harbin, Chengdu, Nanjing, Xi'an, Jinan, Hangzhou, Hefei, Nanchang, Changsha, Daqing, Suzhou, Wuxi and Xiamen.

- R&D activities indicated under Notice 75 should be assessed according to the criteria stipulated for R&D super-deduction or the guidelines for recognition of New and High Technology Enterprises.
- For fixed assets with a unit price of less than RMB 5,000, the depreciation expense could be deducted in one lump sum.
- Enterprises could select the most favorable accelerated depreciation policy in respect of the relevant fixed assets, however, such policy cannot be changed once selected.
- To simplify the application formalities, qualified enterprises only need to submit a statistical form during their provisional EIT filings to enjoy the above treatment. Nevertheless, a post record-filing administration will be imposed on the annual EIT filings.

Notice 64 aims to provide certainty and more detailed guidelines with respect to the accelerated depreciation policy for the relevant fixed assets. It also aims to reduce the administration burden on the enterprises, as well as improving their cash flow position.

CHINA TIGHTENS INDIVIDUAL INCOME TAXATION ON CAPITAL GAINS FROM EQUITY TRANSFER

The SAT recently promulgated the Public Announcement [2014] No. 67, *Administrative Measures for Individual Income Tax on Income from Equity Transfers (for Trial Implementation)* ("**Equity Transfer Measures**"), effective on 1 January 2015. The Equity Transfer Measures superseded certain recent rules issued in 2009 and 2010 on the individual income tax ("**IIT**") on capital gains from equity transfer.

As background, the PRC Individual Income Tax Law ("**IIT Law**") categorizes income of individual taxpayers into different categories and applies different IIT rates respectively. Transfer of equity is generally taxed under the category of transfer of properties. The net income or gains from such transfer are subject to IIT at the flat rate of 20%.

The Equity Transfer Measures will be applicable to transfer of shares or equity in PRC registered enterprises (excluding sole proprietorships and partnerships). However, the transfer of stock in publicly listed companies through stock exchanges in Shanghai and Shenzhen are excluded and not subject to the Equity Transfer Measures. Under the current policy, the capital gains from trading of stock in public companies listed in Shanghai and Shenzhen stock exchanges are exempt from the IIT.

The Equity Transfer Measures are so far the most comprehensive IIT rules on equity transfer, consisting of six chapters including General Principles, Recognition of Income from Equity Transfer, Determination of Basis of Equity, Tax Declaration, Tax Collection and Administration, and Miscellaneous.

The Equity Transfer Measures have codified the current IIT rules, and clarified certain technical issues on how to calculate the capital gains from equity transfer (such as income recognition and determination of basis). They have also introduced some new procedural requirements, which will help the collection of IIT on capital gains by the PRC tax authorities, but will increase the compliance burden on individual taxpayers (transferors), withholding agents (the transferees), as well as underlying companies of which the equity is transferred.

For overview of the Equity Transfer Measures, please refer to our recent Client Alert issued on 16 January 2015 in the following link:

https://www.dlapiper.com/en/hongkong/insights/publications/2015/01/china-tightens-individual-income-taxation/

PRC TAX TREATMENT ON SHANGHAI – HONG KONG STOCK CONNECT PROGRAM

The MOF, the CSRC and the SAT jointly released Caishui [2014] No. 81 ("**Notice 81**") on PRC tax treatments with respect to Stock Connect.

Under Notice 81:

- HK investors investing in China A- shares via Stock Connect could be temporarily exempted from PRC EIT or IIT on capital gains derived from transfer of A-shares, while HK investors would be subject to 10% PRC withholding income tax on dividends received from investing in A-shares.
- For PRC individual investors, capital gains derived from transfer of HK stocks could be temporarily exempted from IIT, while dividends received from HK stocks would be subject to IIT at 20%.
- For PRC corporate investors, both the capital gains derived from transfer of HK stocks and the dividends received from investing in HK stocks would be subject to EIT. Nevertheless, the PRC corporate investors could still enjoy EIT exemption on the dividends received from investing in H-shares which have been held for no less than 12 months.
- Business Tax on capital gains derived from transfer of A-shares or investing in HK stocks would also be temporarily exempted.

Notice 81 has come into effect on 17 November 2014 since the Stock Connect was launched. It is applauded that Notice 81 has provided more certainty and preferential tax treatments to investors in the stock market.

ZHEJIANG IMPLEMENTS NEW REGULATIONS ON CROSS BORDER TRANSACTIONS

China has demonstrated tremendous interests in strengthening the laws on anti-avoidance since 2014. Zhejiang, as one of the most important provinces, has recently issued a circular of *Opinions of Zhejiang Provincial Office, SAT on Reinforcing the Administration of Cross-border Tax Sources* ("**Opinion**"), about further strengthening the supervision on cross-border transactions. The Opinion has been effective from 6 November 2014.

Transfer Pricing

The Opinion provides that the tax authorities shall specifically scrutinize the following six types of pricing arrangements:

- *Buy-sell price:* For instances, situations where gross margins of PRC resident entities may be controlled by the overseas parent companies through fixing of non-independent buy-sell prices.
- *Royalties:* For instances, situations where values of overseas Intellectual Properties ("**IP**") may be overly stated while PRC subsidiary's contribution to IP has not been properly accounted for; or MNCs may set up shell companies in tax havens and arrange for transfer of profits under licensing payments.
- *Service fees:* For instances, situations where service fees may be inadequately allocated to the PRC entities.
- *Compensation for provision of onshore services not justifiable:* For instances, situations where PRC subsidiaries, which bear the related costs for buy-sell from providing services to their parent companies, are not adequately compensated.
- *Mis-match of functional profile with economic substance and profit level:* For instances, situations where PRC entities need to assume non-routine functions after supply chain integrations, however, the profit levels of the PRC entities would not be adjusted accordingly.
- *Assuming "invisible" costs and expenses without adequate compensation:* For instances, situations where some MNCs may structure the strategies such that the PRC subsidiaries would need to bear certain "invisible" costs and expenses leading to a marginally profitable or even loss position over the period of time.

In addition, the Opinion stipulated that the tax authorities shall pay attention to debt-financed enterprises to ensure they are in compliance with the thin-capitalization rules; cross border transactions with entities located in tax havens, etc. It is also noted that the tax authorities shall use every possible means to identify anti-avoidance cases, as well as strengthen administration on contemporaneous documentation and formulate schemes against anti-avoidance cases.

Management of Non-Resident Enterprises

The Opinion stipulated further measures in respect of non-resident enterprises with or without establishments in China.

- For non-resident enterprises with establishments in China, tax authorities shall specifically review their sources of tax income.
- For non-resident enterprises without establishments in China, tax authorities shall specifically review their withholding tax source.
- The Opinion also required tax officials to stringently review the permanent establishment and beneficial ownership status of non-resident enterprises, etc. under the relevant tax treaties.

Last but not the least, in light of the increasing outbound investments into overseas markets, the SAT has implemented measures to strengthen the reporting system to ensure overseas taxable income of PRC originated enterprises is duly reported.

CONSUMPTION TAX POLICIES ADJUSTED BY THE FINANCE AND TAX AUTHORITIES

The MOF and SAT jointly issued the *Circular on Adjusting Consumption Tax Policies*, (Caishui [2014] No. 93, "**Circular 93**"), *Circular on the Increase in Consumption Tax on Refined Oil* (Caishui [2014] No. 94, "**Circular 94**") *and Circular on the Further Increase in Consumption Tax on Refined Oil* (Caishui [2014] No. 106, "**Circular 106**") on 25 November, 28 November and 12 December 2014 respectively.

Consumption tax is levied on luxury, non-essential or energy intensive goods and is considered as a major means to influence taxpayers' certain consumption patterns.

Based on Circular 93, effective from 1 December 2014, small-displacement motorcycles with a cylinder capacity of no more than 250ml, vehicle tyre, leaded gasoline and ethanol are no longer subject to consumption tax. The adjusted consumption tax policy is intended to alleviate the burden of low and medium income people in counties and villages, and to eliminate potential double taxation and thus reducing the overall manufacturing costs of certain industries.

On the other hand, Circular 94 and Circular 106 have increased the consumption tax charges on refined oil, including gasoline, naphtha, mineral spirits and lubricants (from 1 yuan per litre to 1.4 yuan per litre), and diesel, jet fuel and fuel oil (from 0.8 yuan per litre to 1.1 yuan per litre), effective from 13 December 2014. The increase in consumption tax charge on refined oil is to encourage energy saving and new energy development. This is also consistent with the government's intention to curb the over-exploitation of natural resources and environmental damage.

NEW CHINA-SWITZERLAND DOUBLE TAXATION AGREEMENT COMES INTO FORCE

The new Sino-Swiss Avoidance of Double Taxation Agreement ("**DTA**"), signed in Beijing has come into effect on 15 November 2014. The newly signed DTA replaced the previous version in 1990 and applies to income derived from 1 January 2015 onwards.

Salient points of the new DTA are as follows

1. Permanent Establishment ("PE")

A building site or construction, assembly or installation project will constitute a PE only if it lasts more than 12 months, which is more favorable than the 6-month period under the old provisions.

For cross border services, a PE will be constituted only if such activities continue for more than 183 days within any 12-month period (as opposed to 6 months within any 12-month period).

2. Business Profit Adjustment between Related Parties

Related parties transfer pricing adjustments made to the enterprise by the tax authorities of one Contracting State have to be reflected accordingly by the tax authorities in charge of the associated enterprise of the other Contracting State. The relevant tax authorities of the Contracting States shall consult each other for such adjustments if necessary.

3. Withholding Tax Rates on Passive Income

- ***Dividends*** – If the beneficial owner directly holds at least 25% of the total equity of the entity paying the dividends, gross dividends may be taxed by the source State at the rate of 5%. 10% rate would be applied in all other cases. Dividends paid to central bank or government agencies that are mutually agreed would be exempted from withholding tax by the source State.
- ***Interests*** – Interests may be taxed in the source State at the rate of 10%, which is consistent with the old provisions. Tax exemption would continue to apply in the source State to interest payment involving governments or governmental (or state) institutions.
- ***Royalties*** – Royalties under the new DTA is taxed in the source State at the rate of 9%.

A "limitation of benefit" clause has been agreed and included in the relevant sections on passive income under the new DTA as a measure for avoidance of tax treaty abuse.

4. Capital Gains

The new DTA gives the source State the right to tax capital gains from equity transfers in the following circumstances:

- The equity being disposed of represents more than 50% of the seller's interest in real properties (direct or indirect) in the source State; or
- The seller, at any time during the 12-month period prior to the equity disposal, has held at least 25% of the equity (direct or indirect) in the resident enterprise of the source State.

Under the old provisions, in the case of equity transfer, the source State only has the right to levy tax if the resident enterprise whose shares are transferred is land-rich, (i.e. majority of assets of the resident enterprise are comprised of real properties).

In the recent years, China has re-negotiated DTAs with various European countries, including Germany, UK, Netherlands, Denmark, etc. In addition to the above highlighted tax treatments, it is noted that the relevant re-negotiated DTAs have introduced clauses with an aim to prevent treaty abuse and enhance information exchange between the treaty countries.

HONG KONG

COMPREHENSIVE DOUBLE TAX AGREEMENT WITH THE UNITED ARAB EMIRATES

Hong Kong's double taxation arrangement network has reached 32 in number on 11 December 2014, as Hong Kong and the United Arab Emirates (the "**UAE**") signed a comprehensive double tax agreement (the "**DTA**").

In the absence of the DTA between the UAE and Hong Kong in the past, income earned by the UAE residents in Hong Kong is subject to both the UAE and Hong Kong income tax. In addition, Hong Kong companies with profits attributable to a permanent establishment in the UAE may be liable for tax in both places if the profits are considered to be sourced in Hong Kong.

With the signing of the DTA, such double taxation will be avoided. Tax paid by the UAE residents in Hong Kong will be allowed as a credit against the tax payable in the UAE. Also, any UAE tax paid by Hong Kong companies will be allowed as a credit against the tax payable in Hong Kong.

HONG KONG EXCHANGES NOTES WITH JAPAN REGARDING COMPREHENSIVE AGREEMENT ON AVOIDANCE OF DOUBLE TAXATION

With reference to the Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income entered into between the Government of the Hong Kong SAR and the Government of Japan on 9 November 2010 (the "**Agreement**") and the Protocol which forms an integral part of the Agreement, the two Governments exchanged notes regarding Article 25 of the Agreement on Exchange of Information ("**EoI**") on 10 December 2014.

The purpose of the exchange of notes between the two Governments is to expand the coverage of tax types under the EoI arrangement provided in the Agreement. In addition to the income taxes covered by Article 2 of the Agreement, information concerning the following taxes of Japan shall also be exchanged in accordance with the EoI provisions under the Agreement:

a. the inheritance tax;

b. the gift tax;

c. the consumption tax; and

d. any identical or substantially similar taxes that are imposed after the signing of the notes in addition to, or in place of, the existing taxes referred to in (a), (b) and (c) above.

Such exchange of notes will come into effect after the completion of ratification procedures and notification by both Hong Kong and Japan. In the case of Hong Kong, an order, which is subject to the Legislative Council's negative vetting, is required to be made by the Chief Executive in Council under the IRO.

INTERGOVERNMENTAL AGREEMENT WITH THE UNITED STATES FORMALLY SIGNED

Further to our May/June 2014 Newsletter, where we discussed Hong Kong and the United States' agreement over the substance of an intergovernmental agreement ("**IGA**") to facilitate compliance with the US Foreign Account Tax Compliance Act, the IGA was formally signed on 13 November 2014.

Under the IGA, foreign financial institutions ("**FFIs**") in Hong Kong are required to report account information of US taxpayers to the US Internal Revenue Service ("**IRS**") directly. Group requests can also be made by the IRS, on a need basis, for exchange of information at the government level. Further, the IGA requires FFIs to conclude separate individual agreements with the IRS and to obtain consent from account holders who are US taxpayers for reporting their information to the IRS.

PROPOSED STAMP DUTY WAIVER FOR EXCHANGE TRADED FUNDS

ETFs are not defined under any laws in Hong Kong. With regards to the nature of their operation in Hong Kong, they refer to open-ended collective investment schemes with shares or units listed or traded on the Stock Exchange of Hong Kong. Currently, Hong Kong imposes stamp duty on the transfer of ETF shares and units for ETFs with their registers of holders maintained in Hong Kong and with more than 40% of Hong Kong stocks in their portfolios. The buyer and the seller each needs to pay 0.1% of the transaction value as stamp duty (0.2% in total).

In order to promote the development of ETFs, the Hong Kong Government proposed to waive the stamp duty for the transfer of all ETFs shares or units in the 2014-2015 Budget. The Stamp Duty (Amendment) Bill 2014, which seeks to amend the Stamp Duty Ordinance (Cap.117), was gazetted on 5 December 2014 and was introduced into the Legislative Council for First Reading of the Bill on 17 December 2014. The proposed stamp duty waiver will be effective when the Stamp Duty (Amendment) Ordinance is published in the Gazette after its enactment by the Legislative Council.

ASIA PACIFIC TAX ADMINISTRATION TASK FORCE ESTABLISHED

The Study Group on Asian Tax Administration and Research ("**SGATAR**"), an organization consisting of tax administrators in the Asia-Pacific region[1], held a meeting on 24-27 November 2014. Issues discussed during the meeting included globalisation and the erosion of the tax base, the operation of multinational entities, seamless exchange of information and the use of bulk data, and opportunities for capability development across all fields of tax administration.

During the meeting, SGATAR resolved to create a task force to allow the Asia-Pacific region to engage in discussions and remain updated on international developments. The task force will promote cooperation and support the development of cohesive tax systems by enabling SGATAR members to share best practices and experiences, seek assistance and implement initiatives.

2014 ANNUAL MEETING BETWEEN THE INLAND REVENUE DEPARTMENT AND THE HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

The minutes of the 2014 Annual Meeting between the IRD and the HKCPA has been published recently. The key issues discussed in the meeting includes:

1. Source rule for determining dividend income [Part A(a)]

In the 2011 Annual Meeting, the IRD stated that where the Inland Revenue Ordinance ("**IRO**") Section 26 exemption for dividends received from company chargeable to profits tax in Hong Kong did not apply, only those dividend income that was sourced in Hong Kong would be assessed under Section 14 of the IRO. The IRD elaborated that dividends received from the mere holding of an investment or interest in an entity will be taxable depending on the place of operation of the entity. For asset management company deriving management fees and performance fees, if the fees are made payable in the form of dividends, such dividends would be sourced and taxable in Hong Kong if the asset management services were rendered in Hong Kong.

2. Share-based payments [PartA (f) and (g)]

If the Hong Kong branch of an overseas listed company incurred costs in acquiring its own shares from the overseas market as treasury stock, and uses the acquired treasury stock to grant share options/awards to its employees as share-based payment, the expense would be deductible. On the contrary, if the company is a Hong Kong incorporated company instead, the shares it bought back would be treated as cancelled under the Companies Ordinance and the subsequent issue to its employees is considered a new issue of shares. The expense would therefore not be deductible as share-based expense for fulfillment of stock option or share award granted to employees by issuing new shares is not an "outgoing" or "expense" deductible under Section 16(1) of the IRO.

SGATAR members: Australia, Cambodia, People's Republic of China, Hong Kong SAR, Indonesia, Republic of Korea, Macau SAR, Malaysia, Mongolia, New Zealand, Papua New Guinea, The Philippines, Singapore, Chinese Taipei, Thailand, Vietnam

For group companies with senior employees centralized at an employing company and provide services to other operating group companies, if the employing company operates a share-based scheme, the share-based expense recognized as an accounting expense during the vesting period is not an outgoing or expense already incurred under Section 16(1) of the IRO. Further if, the service fees payable by the employing company to the operating company were based on the costs incurred or cost plus, at arm's length and not excessive, no tax adjustment which applies to the employing company (i.e. only allowing amount recharged on the date of vesting) would be made for the operating company.

3. Corresponding amendments to IRO as a result of the introduction of new amalgamation procedures under the New Companies Ordinance [PartA (h)]

The new Companies Ordinance introduce a new court-free procedure to amalgamate companies within a group. The IRD has been studying the relevant tax issues (including late filing of return by the amalgamating entity, the penalty issue and tax reserve certificate issue) relating to the new regime and suggest taxpayers might in the interim seek an advance ruling on how the provisions of the IRO would apply to a company amalgamation.

4. Application of Section 61B to change in indirect shareholding in corporation with accumulated tax loses [PartA (j)]

Section 61B of the IRO disallow set off of tax losses where there is "any change in the shareholding in a corporation", the IRD explained that the wording were potentially very wide in scope and could include changes in beneficial interest. The IRD will however normally only invoke Section 61B for changes in shareholding for shares that were transferred from one person to another.

5. Taxation of Investment managers/advisors [PartB2]

It has come to the IRD's attention that in some cases, even though the investment managers/advisors performed significant functions and bore significant risks in generating the profits of the funds, the management and performance fees paid to the investment managers/advisors who offered professional services in Hong Kong to hedge funds or private equity funds established outside of Hong Kong, were computed on a cost-plus formula, far below the arm's length rate. However, it is unclear as to what amounts to bearing significant risks in generating the profits of the funds. Hopefully, the IRD can provide additional guidance on this.

Nevertheless, the IRD is of the view that even though the compensation structures for the investment managers/advisors may vary from fund to fund, the "2 and 20" (i.e. the lead fund managers took 2% of the fund's assets each year as a management fee, and 20% of the total profits as a kind of performance bonus) will be considered as the standard pay formula Therefore, remuneration arrangement different from this standard pay formula is more likely to be subject to scrutiny by the IRD.

CONVICTIONS ON SALARIES TAX EVASION

Under the Inland Revenue Ordinance (Cap.112) ("**IRO**"), tax evasion is a criminal offence. The maximum penalty for each charge, upon conviction, is three years' imprisonment, a fine of HK$50,000, and a further fine of three times the amount of tax which has been undercharged as a result of the offence. Two recent convictions on the evasion of salaries tax resulting in suspended jail sentences are describe below.

1) False claims for deductions of expenses for self-education and approved charitable donations

Expenses of self-education paid for prescribed courses or examination fees paid to specified education providers and donations made to any charitable institutions or trust of a public character which is exempt from tax under section 88 of the IRO or donations made to the Hong Kong SAR Government for charitable purposes are tax deductible. The documentation evidence supporting the claims for tax deduction should be retained for seven years. Taxpayers will be asked to produce the relevant supporting evidence when their claims are selected for random audit checks conducted by the IRD.

On 19 November 2014, a managerial staff at a hotel in Hong Kong (the taxpayer), was convicted on eight charges of evading salaries tax. Contrary to section 82(1)(c) of the IRO, the defendant, wilfully with intent to evade tax, had made a number of false statements in relation to claims for deductions in his tax returns for the years of assessment 2003-04 to 2010-11.

The defendant had claimed deduction of expenses of self-education and approved charitable donations in each of his tax returns for the years of assessment 2003-04 to 2010-11. The total deduction claims for self-education and approved charitable donations for these eight years of assessment were HK$699,150 and HK$58,000 respectively. In particular for the years of assessment 2008-09 to 2010-11, he had alleged that:-

a. the expenses of self-education were paid to assist the education of his relative; and

b. the charitable donations were given to a family member to distribute to various charities.

The IRD's investigation subsequently reveals that the defendant failed to produce any details or documentation in support for his tax deduction claims for expenses of self-education and approved charitable donations. The total amount of the false deduction claims for the eight years of assessment from 2003-04 to 2010-11 was HK$757,150, and the total amount of tax evaded was HK$82,285. The defendant pleaded guilty to all eight counts of evading tax and was consequently sentenced to two months' imprisonment, suspended for three years.

2) False claims for additional dependent grandparent and additional dependent parent allowances

Similarly on 26 November 2014, a taxpayer was convicted on a total of nine charges of salaries tax evasion. Contrary to section 82(1)(c) of the IRO, the defendant had wilfully and intentionally evaded tax by making false statements in her tax returns relating to claims for additional dependent grandparent allowance ("**ADGA**") and additional dependent parent allowance ("**ADPA**") for the years of assessment 2003-04 to 2009-10 and years of assessment 2008-09 to 2009-10 respectively. She falsely declared that:

a. during the seven years of assessment from 2003-04 to 2009-10, her grandmother resided with her continuously for each full year; and

b. during the two years of assessment from 2008-09 to 2009-10, her parents resided with her continuously for each full year.

However, the IRD's investigation reveals the following facts:

a. The defendant herself resided at Wan Chai in particular for the years of assessment from 2008-09 to 2009-10;

b. The defendant had not resided with her parents continuously for any of the years from 2008-09 to 2009-10; and

c. The defendant's grandmother had resided in New York for years, and the relevant records from the Hong Kong Immigration Department shows that there had been no movement records for her grandmother since 2002.

The total amount of the defendant's false claims of ADGA and ADPA for the seven years of assessment from 2003-04 to 2009-10 was HK$330,000, and the total amount of tax involved was HK$57,066. The defendant pleaded guilty to all nine counts of evading tax and was consequently sentenced to two months' imprisonment, suspended for two years.

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