

Issue 1 2009

# Tax talk



## In this issue

- 1 Editorial
- 2 Advance Rulings
- 3 Personal Assessment
- 4 Salaries Tax Relief for taxes paid outside Hong Kong

The global financial crisis has affected the Hong Kong economy with adverse consequences for the Hong Kong community.

As a result Hong Kong is facing a number of business problems and an increasing unemployment rate contributing to reducing incomes and a decline in the property market.

In the 2009/10 Budget Speech, the Financial Secretary indicated the Government's Consolidated Account

will incur deficits of HK\$4.9 billion and HK\$39.9 billion for the years ending 31 March 2009 and 2010 respectively. The deficit on the Operating Account is expected to continue up to 2011/12.

A summary of the budget proposals is set out in our Budget notes 2009/10.

The Government recognises that the financial crisis will have a significant impact on the Hong Kong economy and Government revenues and has undertaken a series of initiatives seeking to limit the impact of the global financial crisis, including a Special Loan Guarantee Scheme to help the funding needs of small and medium enterprises.

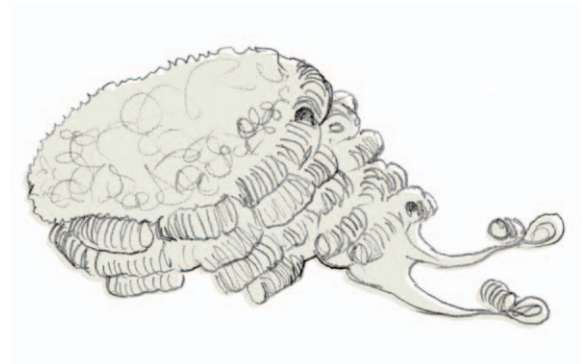
There were no major concessions for taxpayers in the Budget (with only a small rebate for Salary Taxpayers for 2008/09) and taxpayers should therefore be exploring ways in which to take advantage of existing provisions in the Inland Revenue Ordinance (IRO) to ensure they claim all available reliefs.

In this edition, we look at tax relief under Personal Assessment, Section S8(1A)(c) of the IRO and tax credits.

During times of difficulty, everyone seeks greater certainty – including in their tax affairs. However, there are several fundamental areas of our tax law where the interpretation of the law by the Hong Kong Inland Revenue Department (IRD) is not clear and thus creates uncertainty. This issue of Tax talk contains an article on the use of Advance Rulings to provide greater certainty regarding the tax consequences of a transaction or arrangement before it is entered into.

Finally, please check our Tax notes Issue 28 which has the tax filing deadlines for 2008/09 Tax Returns.

# Advance Rulings



One aim of the Hong Kong tax system is to provide certainty on how our tax laws are applied. However there are some areas where the implementation of the IRO is open to dispute, and this can lead to a prolonged correspondence with the IRD until the matter is settled – which in turn may result in a long period of uncertainty for the taxpayer.

However, there is a system of Advance Rulings whereby the Commissioner of Inland Revenue (the Commissioner) will give a “ruling” on the tax treatment of an actual transaction or arrangement based on full disclosure of the transaction or arrangement before the transaction or arrangement is entered into. If the taxpayer then adheres to the structure and documentation provided to the Commissioner when implementing the transaction or arrangement, then the taxpayer can rely on the ruling as the basis for preparing its Tax Returns.

A taxpayer applying for an Advance Ruling is required to submit various documentation including a detailed description of facts, assumptions, provisions of the IRO in respect of which the ruling is sought and law and authorities (if any) relied upon, together with a draft ruling, as well as payment of a fee.

An Advance Ruling can cover any matter relating to the IRO (such as the locality of income, service companies, and the anti-avoidance provisions of Sections 61A and 61B). However, the Commissioner may refuse to provide a ruling if:

- the matter involves the imposition or remission of a penalty, the correctness of a return or other information supplied by any taxpayer, the prosecution of any taxpayer, or the recovery of a debt owed by any taxpayer;
  - the transaction is hypothetical;
  - the Commissioner is required to establish any question of fact, make any assumption, or give any opinion about generally accepted accounting principles, commercial practices or foreign laws;
  - the matter is subject to an objection or appeal; or
  - the matter is the subject of a return that is due to be filed, or of a tax payment that is due.
- The Commissioner cannot issue a ruling if:
- the applicant does not seriously contemplate entering into the arrangement described;
  - the application is frivolous or vexatious;
  - the applicant is currently the subject of a tax audit;
  - the applicant provides insufficient information; or
  - it would be unreasonable to expect

the Commissioner to make a ruling, in view of the resources available to the Commissioner.

A ruling issued by the Commissioner will include full details of the relevant law, the arrangement in question, the applicable period, and the assumptions made.

Taxpayers who obtain and rely on an Advance Ruling should disclose its existence when they file their tax return. They should also state whether there have been any material changes to the arrangements described in the ruling. If there have been, the Commissioner may not be bound by it.

One common misconception regarding an application for an Advance Ruling is that it may unnecessarily draw the IRD’s attention to the arrangement or transaction concerned. However, taxpayers already have an obligation to disclose all relevant information relating to the tax treatment of their income when they file a tax return, and the disclosures they are obliged to make when applying for an Advance Ruling should not be any greater. So, if the tax treatment of a transaction or arrangement is likely to be open to interpretation, a taxpayer should seriously consider applying for an Advance Ruling.

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# Personal Assessment

Hong Kong's tax system is territorial and schedular. There is no single income tax. Instead, Hong Kong has three direct taxes - Profits Tax levied on profits from a trade, profession or business, Property Tax levied on rental income and Salaries Tax levied on income from employment.

Although these three taxes are assessed separately, it is possible for a taxpayer to elect for Personal Assessment (PA), which can, in certain circumstances, reduce his or her total tax liability by combining all three taxes under one Assessment, and claiming deductions for:

- business losses incurred for the year being assessed;
- concessionary deductions (e.g. home loan interest); and
- interest payable on financing a property that is subject to Property Tax.

Tax is then calculated on the basis of the taxpayer's combined income after applying the personal allowances available to the taxpayer.

It is usually advantageous for taxpayers to elect for PA if, during the tax year concerned:

- they have received only rental income, in which case they can claim mortgage interest and personal allowances;
- the taxpayer is a sole proprietor who has both business losses and employment income in which case they can offset the business losses against the employment income; or
- in the case of married couples, one spouse has taxable income which is less than his or her personal allowances, or has sustained business losses, in which case the unabsorbed personal allowances and/or business losses can be offset against the other spouse's income.

If a taxpayer is married, both spouses are normally required to elect for PA. Their combined income will be used to determine the amount of tax that is payable under PA, although the tax will then be allocated between the two spouses on the basis of their respective incomes.

The right to elect for PA is available only to a person aged 18 or above who is either a Hong Kong permanent resident or "temporary resident" as defined in the IRO.

Normally both spouses should be eligible under the above requirements, but there are special provisions in which only one spouse will qualify.

Election for PA can be made in the relevant section of the taxpayer's Individual Tax Return. It may also be made in writing within two years from the end of the year of assessment to which the election refers, or within two months after the issue of a notice of assessment for the relevant year, whichever is later. The same time limit applies if a taxpayer wishes to withdraw his or her PA election.

Electing for PA can, in appropriate circumstances, reduce the total Hong Kong tax liability of taxpayers and this relief should not be overlooked. However, the question of whether PA will actually provide a tax saving will depend on the individual circumstances of the particular taxpayer and his or her spouse.

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# Salaries Tax Relief for taxes paid outside Hong Kong

In recent years the Government of the HKSAR has sought to negotiate and enter into comprehensive Double Tax Agreements (DTA) with various trading partners. DTAs seek to eliminate the double taxation of income of the residents of the two jurisdictions which are parties to the DTA. Thus if a Hong Kong resident taxpayer is subject to tax on all or part of his income in both Hong Kong and the other jurisdiction which is party to the DTA, the DTA will provide for a **tax credit** to be given in respect of the tax paid in the other jurisdiction when calculating the taxpayer's Hong Kong tax liabilities.

However, where a Hong Kong resident is subject to both Salaries Tax and tax in an overseas jurisdiction with which the HKSAR has entered into a DTA it is not necessarily the case that claiming a tax credit under the DTA will offer the best relief for Salaries Tax.

There is an alternative relief under Section 8(1A)(c) of the IRO which applies even when Hong Kong does not have a DTA with the jurisdiction in which the tax is

paid and is not dependent on tax credits or the existence of a DTA.

Section 8(1A)(c) IRO provides for an exclusion from Salaries Tax for income which is derived "from services rendered in any territory outside Hong Kong where-

- (i) by the laws of the territory where the services are rendered, the income is chargeable to tax of substantially the same nature as [Salaries Tax]"

Whereas a tax credit is calculated by reference to the **tax actually paid** in the overseas jurisdiction (and the effective rate of Hong Kong Salaries Tax), Section 8(1A)(c) IRO operates to **exclude income** from Salaries Tax. In some cases this exclusion can provide a greater measure of relief than a tax credit under the relevant DTA.

For example, if an employee derived part of his income in Mainland China and pays tax in the Mainland on that income. He would potentially be eligible to claim a tax credit for Salaries Tax purposes under the Agreement with Mainland

China for the Avoidance of Double Taxation in respect of the tax he has paid in China. But it may be more advantageous to claim relief under Section 8(1A)(c) IRO.

The final decision will depend on the individual's particular circumstances – including income, marital status and effective tax rate.

The IRD is aware that there will be cases where it will be more beneficial for an individual taxpayer to apply for the exemption under Section 8(1A)(c) IRO rather than a tax credit under a DTA.

However, the decision as to which relief to claim is for the individual taxpayer to make and there is no obligation on the part of the IRD to advise taxpayers that there is an alternative relief which may provide a lower tax liability.

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## About Tax talk

The aim of Tax talk is to alert taxpayers to recent developments. The information is general in nature and it is not to be taken as a substitute for specific advice. Accordingly, Grant Thornton accepts no responsibility for any loss that occurs to any party who acts on information contained herein without further consultation with ourselves.

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