

Issue 3 - 2009

# Tax talk



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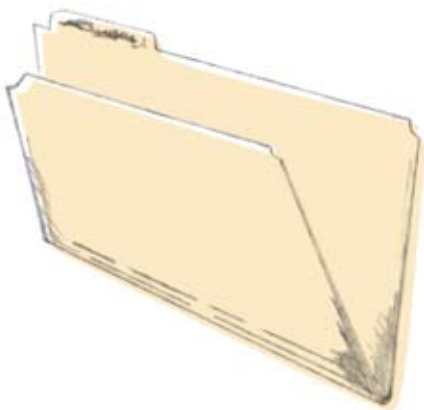
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Two controversial cases – CIR v Datatronic Co Ltd and Ngai Lik Electronics Co Ltd v CIR – have been the hottest Hong Kong taxation topics during the third quarter of this year, and both of them have far-reaching implications.

We previously published summaries of the Datatronic case as it progressed in Tax talk Issues 3, 2007 and Issue 3, 2008. After several victories, the company has now suffered a setback in the Court of Appeal, where it was denied its 50:50 offshore profits claim on the grounds that its manufacturing operations were not being operated under a contract-processing agreement with a PRC party. The previous Board

of Review (BOR) and court decisions had opened up an opportunity for other taxpayers who were operating through similar import-processing arrangements to those of Datatronic to put forward offshore claims. They may now have to hold off from any action until the Court of Final Appeal signals a change in this long-established practice. This issue of Tax Talk provides more details.

The Court of Final Appeal recently handed down another important decision concerning the Ngai Lik case. This concerned the Inland Revenue Department's (IRD's) power to apply an anti-avoidance provision under section 61A of the Inland Revenue Ordinance, and its validity. Although the Court held that the IRD improperly applied the provision by issuing additional assessments based on arbitrary amounts, it did not mean that the decision exemplified or agreed on the validity of any tax schemes.



As the economic tide gradually flows back to form an upward curve, many people may be planning to realise a return on their investments by selling properties. Our Spring 2005 issue provided details of the practical tests the BOR commonly applies to determine how the proceeds of property sales are treated in terms of Hong Kong tax liability. Our article in this issue reiterates the importance

of maintaining proper documentation to support claims that gains from such transactions are not taxable.

In the midst of the financial crisis, the Financial Secretary proposed a one-off reduction on Salaries Tax and Personal Assessments, subject to a cap of HK\$8,000, as a temporary relief measure. The IRD has now begun to issue assessments of tax payable

for 2008/09 that take this reduction into account to taxpayers in these two categories.

Finally, we recently published Tax notes Issue 30, which highlights potential PRC tax exposure for multinational corporations who dispatch their employees to provide services in China. If you are interested in obtaining a copy, please contact us via [info@gthk.com.hk](mailto:info@gthk.com.hk).

## Tax updates

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# Import-processing arrangements



On 15 July 2009, the Court of Appeal handed down its judgement on the CIR v Datatronic Limited case. This allowed an appeal by the Commissioner of the Inland Revenue against two previous rulings by Board of Review (BOR) and the Court of First Instance (CFI). Both these earlier rulings had concluded that Datatronic was carrying on a manufacturing business, even though it was being conducted in mainland China under an import-processing arrangement, and that it was therefore entitled to a 50:50 apportionment under Departmental Interpretation and Practice Note No. 21 (DIPN 21).

We have previously reported the rulings of the BOR (D43/06) and the CFI on this case. Please see Tax talk Issue 3, 2007 and Issue 3, 2008 for further details about them. Briefly, Datatronic was engaged in the manufacture and sale of electronic products. It concluded an import-processing arrangement with its wholly-owned subsidiary on the mainland. Datatronic was the subsidiary's sole supplier and customer, and it also supplied the subsidiary with its manufacturing plant and machinery. Datatronic also provided the subsidiary with support, in terms of design,

technical know-how, management and the training and supervision of local staff. The services were rendered by full-time Datatronic employees stationed on the mainland.

### The decision and its implications

The Court of Appeal held that Datatronic's profit-producing transactions consisted of purchases from the subsidiary and subsequent sales. These activities took place in Hong Kong, and the relevant profits derived by Datatronic were sourced in Hong Kong and taxable. In addition, the Court ruled that Datatronic's activities on the mainland were merely antecedent or incidental to its profit-generating activities, and they did not determine the source of its profits.

The Court considered that, in substance but not form, the subsidiary had carried out the manufacturing activities. It reiterated the view of the CFI and BOR that there was no agency relationship between Datatronic and the subsidiary, since Datatronic did not have a licence to carry out processing work on the mainland and thus it was not in a position to authorise the subsidiary to act as its agent in carrying out the

manufacturing work on its behalf. The activities carried out by the subsidiary were therefore not the activities of Datatronic.

The Court agreed that DIPN 21 did not have the force of law, and that the concession offered by the Inland Revenue Department of allowing a 50:50 apportionment claim did not apply to taxpayers who had an import-processing arrangement with a mainland entity.

Datatronic has now appealed to the Court of Final Appeal. Pending further developments in this case, clients who have similar import-processing arrangements should review their tax position and seek professional advice to clarify whether there are any differences between their circumstances and the Datatronic case before they consider if it would be appropriate to lodge an apportionment claim.

# Ruling may have major impact on transfer pricing assessments



On 24 July 2009, the Court of Final Appeal (CFA) handed down its judgement on *Ngai Lik Electronics Company Limited v CIR*, and directed the Commissioner of Inland Revenue (CIR) to issue fresh transfer pricing assessments on this taxpayer.

The origins of the case go back to 1991/92, when the Ngai Lik group was reorganised and three British Virgin Islands (BVI) companies were formed to take over its manufacturing business from its various Hong Kong companies. Two of these BVI companies manufactured components, while the third assembled them into finished products that were sold to the taxpayer. All this manufacturing work was conducted on the mainland.

The prices of the goods were fixed on an annual basis and after they had been delivered. The taxpayer also provided sourcing and agency services to the BVI companies. The latter booked substantial profits that were claimed to be offshore and non-taxable.

The CIR challenged this “scheme” under section 61A of the Inland Revenue Ordinance. It contended that its sole or dominant purpose was to enable the taxpayer to obtain a tax benefit. The CIR also raised additional assessments on the taxpayer under the same section for the years from 1991/92 to 1995/96. Based on administrative practices, the CIR treated 50% of the BVI companies’

profits as the taxpayer’s assessable profits. The taxpayer appealed against this.

The CFA emphasised that three interlocking conditions (transaction, tax benefit and dominant purpose) must be properly aligned and approached with the necessary degree of precision for section 61A to be applied properly.

The “scheme” identified by the CIR consisted of eight steps. The CFA considered steps 1 – 7 to be irrelevant, as they merely gave an account of the measures taken during the reorganisation, and they did not produce any tax benefits in themselves.

Step 8 concerned the group’s transfer pricing policy. The taxpayer had obtained a tax benefit under this step, as its trading profits were reduced through the annual price-fixing mechanism. Section 61A was applicable from 1993/94, when the transfer pricing policy was adopted.

The CIR was empowered under section 61A to raise assessments to counteract the tax benefits that could be obtained under the “scheme”. However, this power had to be exercised in a reasonable and rational way. The assessments could not be for arbitrary amounts.

The CFA held that the manufacturing operations which took place outside Hong Kong were the BVI companies’ operations. Even if the sourcing and

agency activities provided by the taxpayer were manufacturing-related, they were ancillary and incidental. The profits derived by the BVI companies were manufacturing profits sourced outside Hong Kong. Thus, they could not be treated as part of the taxpayer’s profits.

The CFA therefore annulled the additional assessments and remitted the case back to the CIR for fresh additional assessments to be raised in accordance with the directions mentioned above.

The taxpayer appears to have won the case, as the additional assessments raised by the CIR have been annulled. However, the issuing of new additional assessments in accordance with the CFA’s directions – that is assessments based on a “reasonable estimate” of the assessable profits that would have been earned by the taxpayer if it had paid an arm’s length price for the goods it purchased from the BVI company – may result in assessable profits that are higher than those shown in the original ones.

It will also be interesting to see how and on what basis the CIR will arrive at a “reasonable estimate”. We believe the basis it chooses and its underlying rationale will not only have significant implications for other taxpayers with similar operations. They will also provide useful yardsticks for formulating transfer pricing policies.

# Property sales gains: when are they taxable?



The Hong Kong property market is dynamic. Many people acquire a second property or other capital assets for investment purposes. Although there is no Capital Gains Tax in Hong Kong, and the Inland Revenue Department (IRD) does not normally tax gains on the sale of capital assets, it may seek to tax gains on the disposal of properties under Profits Tax if it deems the taxpayer is engaged in property trading.

We discussed the general principles of taxation concerning the sale of capital assets in Hong Kong in an article in the Spring 2005 issue of Tax talk. In it, we summarised the most important criteria – the so-called “six badges of trade” that the IRD normally takes into consideration when it determines whether or not a gain on the sale of a capital asset is taxable. They are:

- 1 The subject matter of realisation;
- 2 The length of the period of ownership;
- 3 The frequency of similar transactions by the same person;
- 4 Supplementary work on the property realised;
- 5 Circumstances leading to the realisation; and
- 6 Motivation.

Please refer to the abovementioned article for more details about these criteria. The point to remember is that no single and decisive factor will determine whether a transaction is revenue or capital in nature. In some cases, even a one-off transaction might be regarded as revenue in nature. However, among all these factors, intention always carries the greatest weight when the nature of a transaction is determined.

In *All Best Wishes Ltd v CIR* (1992), the Court concluded that “the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of the evidence”. Documentary evidence is therefore crucial in proving the taxpayer’s intention at the time when the property in question was acquired. Taxpayers are therefore strongly advised to maintain all relevant documents – such as mortgage or solicitor’s agreements, renovation invoices, board minutes and any other items that could support the intention of the acquisition – in a proper manner. If a dispute arises, the onus of proving that the assessment was excessive or incorrect will be on the taxpayer.

In a recent Board of Review case, D13/08, a taxpayer acquired certain

properties and parking lots prior to the completion of construction. He then sold all of them, because the quality, building materials, views, etc., were contrary to his expectations. After considering all the pertinent factors, including the taxpayer’s background, experience, behaviour and sincerity, the Board ruled he did not acquire the properties for resale. Hence, the gain on their disposal was not taxable.

But in case D47/08, the Board arrived at a contrary decision. It found in favour of the IRD that the sale of a property was “an adventure in the nature of trade”, as the taxpayer had failed to prove that the evidence he had presented was reliable.

The lack of contemporaneous documents to prove intention or any other relevant factors is always a major reason for determining that a capital gain is taxable. In many cases, this outcome could have been avoided if proper documents had been maintained.

Taxpayers are therefore advised to seek professional advice to ensure that they adequately maintain the applicable documentation in order to minimise the possibility of potential challenges by the IRD.

## About Tax notes

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