

taxtalk

newsletter

Grant Thornton 
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It is spring time in Hong Kong and changes are in the air.

In recent months we have seen a number of events which may have an impact upon the future of taxation in Hong Kong. On 10 December 2003 the Governments of the Hong Kong Special Administrative Region (HKSAR) and Belgium signed an Agreement for the Avoidance of Double Taxation (DTA). This is the first comprehensive DTA which the HKSAR has signed with another country and is currently the subject of approval by the Legislative Council in Hong Kong. Once approved, it will be effective from 1 April 2004. The DTA is the first of a network of DTAs currently being negotiated by the HKSAR Government. Further details are contained in our Tax Notes Issue 10.

The Hong Kong economy has shown signs of recovery recently. This enabled the new Financial Secretary, Mr Henry Tang Ying-yen, to announce in his 2004 Budget Speech a reduced projected government deficit of HK\$49 billion for the fiscal year to 31 March 2004 compared with his earlier projection of HK\$78 billion. Whilst the Budget Speech did not contain any immediate changes other than confirmation of minor increases in the rates of Salaries Tax, Profits Tax and Property Tax, the Financial Secretary put forward a number of proposals which could impact the taxation system in Hong Kong over the next few years.

For many years, there has been debate over the role of Estate Duty in Hong Kong.

Estate Duty is imposed upon assets which pass on the death of an individual. The important factor is therefore the locality of assets rather than the place of residence of the deceased. One of the Financial Secretary's ambitions is to promote Hong Kong as a Premier Asset Management Centre but there are concerns that Estate Duty could be a limiting factor. The Financial Secretary will review the role and impact of Estate Duty and will report his findings in his next budget speech in March 2005.

The Financial Secretary also recognised that Hong Kong has a narrow tax base and that Hong Kong is the only developed jurisdiction which does not have a consumption tax or Goods and Services Tax (GST) to broaden the tax base and produce a stable source of income. The Government has set up an internal committee to review the introduction of GST in Hong Kong. This committee will report to the Financial Secretary at the end of this year. It is expected that any proposals regarding GST would take at least three years to bring to implement.

However, whilst changes are under consideration some aspects of tax remain the same. The Commissioner of Inland Revenue has recently announced the filing deadlines for the Year of Assessment 2003/04 and will continue to impose penalties on late filers. A full list of the filing deadlines for taxpayers is set out in our Tax Notes Issue 11. We urge our clients to ensure they file their returns on time if they wish to avoid penalties.

Director's fees



Directors of Hong Kong companies could now be subject to Salaries Tax on their directors' fees following a controversial decision by the Board of Review even if they never visit Hong Kong and exercise central management and control of the company outside Hong Kong.

Salaries Tax is chargeable on income arising in or derived from Hong Kong from any office, employment or pension.

However different rules apply to the determination of the source of fees from the holding of an "office", such as director's fees, compared with remuneration from an employment such as salaries, wages etc.

The "office" of director is independent from the individual holding it and in determining the location of such an "office", the Inland Revenue Department ("IRD") has generally followed the judgement in an English case, *McMillan v Guest*, which held that the office of director is located at the place where the central management and control of the company is exercised. If that is located in Hong Kong then any fees from such "office" have a Hong Kong source and are chargeable to Salaries Tax.

However determining where a company is centrally managed and controlled has not always been straightforward and the decision in the Board of Review case D123/02 has created confusion regarding the source of director's fees.

In D123/02 the taxpayer and his wife were the only directors of a Hong Kong incorporated company. They were residents of Taiwan and received directors' fees from the company whose day-to-day business operations were conducted in Hong Kong. All directors meetings were held outside Hong Kong but the taxpayer visited Hong Kong for 107 days and 83 days during the years 1995/96 and 1996/97 respectively.

The taxpayer claimed that his director's fees should not be chargeable to Salaries Tax claiming that central management and control of the company was exercised where the directors held their meetings. As no directors' meetings were held in Hong Kong, the taxpayer claimed that the company was not resident in Hong Kong. He claimed all important business decisions were made in Taiwan rather than Hong Kong.

However the Board rejected the taxpayer's arguments that he and his wife exercised the company's central management and control jointly during the directors' meetings outside Hong Kong and held that the taxpayer's wife exercised little or no influence over the Hong Kong company. Rather control of the company was exercised by the taxpayer alone and the Board found that the taxpayer exercised this function in both Hong Kong and Taiwan.

However the Board then decided that the source of director's fees should not be determined only by reference to where a

company is centrally managed and controlled but relied upon the decision in the case of *CIR v Goepfert* to claim that a totality of facts test should be adopted to determine the source of the fees i.e. the location of the office.

Notwithstanding that the *Goepfert* case involved the determination of the source of an employment rather than an office, the Board accepted the Commissioner's contention that even if central management and control is outside Hong Kong a company can be resident in Hong Kong if it complies with Hong Kong laws, maintains a registered office and its statutory books and records in Hong Kong and engages a Hong Kong auditor. Given these "facts" and also that the company was carrying on substantial business operations in Hong Kong, the Board concluded that the company was resident in Hong Kong and therefore the directors fees had a Hong Kong source.

This decision is a radical departure from previous practice including the IRD's own practice note which states that the source of director's fees are located where the "office" is located and this is where the central management and control of the company takes place. The adoption of a totality of facts test using the factors adopted by the Board means that in future it will be difficult for any director of a Hong Kong incorporated company to claim that his director's fees have a non Hong Kong source even if central management and control is clearly situated outside Hong Kong.

Tax penalties for delinquent taxpayers



The Commissioner of Inland Revenue (“CIR”) has a wide range of powers to impose penalties on taxpayers who are delinquent in reporting their tax liabilities. These powers cover penalties in situations ranging from a delay in filing a tax return to mistakes in a tax return, and from failure to file a return to deliberate evasion.

As might be expected with such a range of “offences”, the penalties that can be imposed are diverse and can be confusing. However, one thing that is certain is that the CIR has increasingly resorted to penalties as a means of seeking greater compliance by taxpayers with the requirements of the Inland Revenue Ordinance (“IRO”).

From time to time the CIR issues policy guidelines on penalties and the following are examples of the type of offences and the penalties which they attract.

- Employers who fail to submit employer’s return or withhold money from departing employees are subject to a fine of \$10,000.
- Where a taxpayer, without a reasonable excuse:
 - 1) makes an incorrect return or statement;
 - 2) gives any incorrect information or;
 - 3) fails to advise his chargeability to tax or furnish a return on time;

The taxpayer may be subject to a fine of \$10,000 and treble the amount of the tax undercharged. Where the taxpayer has a “reasonable” excuse the CIR will review the penalties.

- If a person wilfully evades or assists any person to evade tax by committing any of the offences under Section 82 IRO including:
 - 1) Omits from a return any sum which should be included;
 - 2) Makes any false statement or entry in any return;
 - 3) Gives any false answer to any question or request for information asked or made in accordance with the provisions of IRO;
 - 4) Prepares false books of accounts; or
 - 5) Makes use of any fraud to evade tax.

The person is subject to a fine of \$50,000 and treble the tax undercharged, plus a possible 3-year imprisonment.

In general, offences that do not involve any wilful intent to evade tax are subject to monetary penalties rather than prosecution.

The amount of the penalties imposed usually depends on the circumstances of each case, and such factors as the background of the taxpayer, the level of sophistication of the business, whether the taxpayer shows genuine concern or is uncooperative during an audit or

investigation and whether the taxpayer has committed repeated offences, are all taken into account in levying the penalty.

In practice, the maximum penalties are not always imposed. Generally where cases do not involve a criminal intent but the Commissioner has had to resort to an investigation or the taxpayer has failed to fulfill his filing obligations for a number of years, a penalty of 100% of the tax undercharged is considered appropriate.

For cases that do not involve any field audits or investigations, the IRD usually impose a penalty of 10% of the tax undercharged for a first offence; 20% of the tax undercharged for a second offence within 5 years; and 35% of the tax undercharged for subsequent offences within 5 years.

One of the most common penalty offences is the late filing of a tax return, whether this is a Profits Tax Return, an Individual Tax Return or a Property Tax Return, and, especially in the case of a Profits Tax Returns, taxpayers with a history of late filing can expect increasing penalties.

Such penalties can be avoided with proper planning so that the relevant Tax Return and supporting documents are filed on time. The important filing dates for all taxpayers for 2003/04 are set out in our Tax Notes Issue 11.

Dependant visas and employment in Hong Kong



On 30 June 2003 the Government announced a number of important changes in immigration policy with effect from 1 July 2003. Included in these changes were restrictions on the right of persons who enter Hong Kong on dependant visas to take up employment in Hong Kong.

Under the Government's proposals, persons who entered Hong Kong on dependant visas after 1 July 2003 could no longer work or establish business in Hong Kong under the terms of the dependant visa. If a dependant visa holder wishes to do these things he or she will have to apply for their own employment or investment visa and the application will be assessed according to the same criteria as non dependant applicants.

These regulations have no effect on dependants who were already employed or who had lodged dependant visa applications prior to 1 July 2003. They also have no effect on dependant visa

holders employed before 1 July 2003 who wish to change jobs or to renew their visas after 1 July 2003.

Following representation by the British Chamber of Commerce in Hong Kong, the Immigration Department has relaxed the original proposals in respect of part-time or supply teachers in International Schools who arrived on dependant visas after 1 July 2003. Under the arrangement agreed with the Immigration Department by the British Chamber, any individual on a dependant visa who wishes to be engaged as a supply or part-time teacher by an International School must apply either individually or collectively through the employing school to the Immigration Department (Visa Control) for a letter of authority to teach. These application letters must include a letter from the relevant school certifying that the individual will be employed from time to time by the school in that capacity and that a teaching permit from the Education and Manpower Bureau has been,

or is in the process of being, obtained.

The Immigration Department will issue a letter of authority which will be sufficient to allow the applicant to work during the period of their ordinary dependant entry visa. The letter will be renewed automatically by the Immigration Department each time the "Right to Stay" visa is renewed. Schools will be able to employ anyone possessing the letter of authority as and when they require their services.

Whilst the concession for part-time international teachers offers welcome relief it must be stressed that this applies only to employment with International Schools. In all other cases dependant visa holders who arrived after 1 July 2003 will face penalties if they engage in employment in Hong Kong without applying for their own separate employment visa.

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