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taxtalk
newsletter

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The taxation highlight of the first quarter of the year in Hong Kong is the Budget Speech by the Financial Secretary. This year there was considerable speculation as to the contents of the Budget as the Financial Secretary had conducted reviews on a number of areas including Estate Duty and the duty on alcoholic beverages prior to the Budget. He had also set up an internal government committee to advise on the introduction of Goods and Services Tax (GST) in Hong Kong.

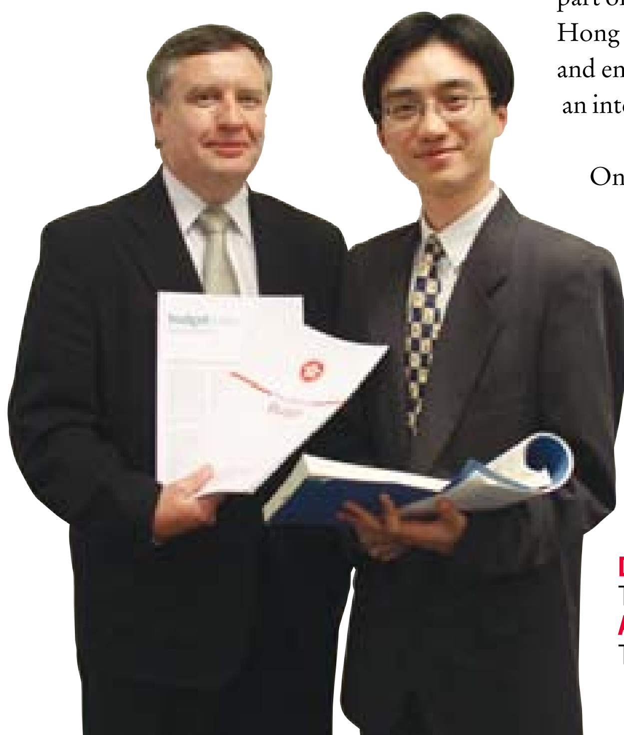
However, the Budget Speech turned out to be a relatively quiet event with the notable exception of the abolition of Estate Duty. The Financial Secretary indicated that "on balance" he was in favour of the abolition of Estate Duty as part of measures to further strengthen Hong Kong's financial services industry and enhance Hong Kong's position as an international financial centre.

On the question of GST, the Financial Secretary was far less forthcoming. He did not give any firm commitment as to whether GST would be introduced, stating that he would provide further information in a consultation document to be published later this year. The question of GST remains an area of uncertainty and it is to be hoped that the consultation period will be relatively short so that a firm decision on GST can be made within the next twelve months. A summary of the Budget is contained in our Budget Notes 2005/06.

One of Hong Kong's advantages is its simple and certain tax system and in this issue of Tax Talk there is an article on legislation introduced to clarify an area of uncertainty regarding the withholding tax on royalties paid to non Hong Kong residents. The legislation effectively reverses a decision in the Court of Appeal, but it provides certainty and, in that respect, it is to be welcomed.

An area which provides considerable uncertainty in practice is whether gains on the disposal of Hong Kong property are tax free capital gains or are trading profits subject to Profits Tax. Each year there are a significant number of cases heard at the Board of Review on this subject. In this issue we have summarised the practical tests which are applied by the Board of Review to determine the Hong Kong tax treatment of the disposal proceeds.

The second quarter of 2005 will see the commencement of the tax filing season for 2004/05. Details of the tax filing deadlines are set out in our Tax Notes No. 13 on filing deadlines. Please contact us if you have not received your copy of the Tax Notes.



David Southwood, Tax Principal (left) and **Anthony Chan**, Tax Manager (right).

Capital gain or taxable profit?

Hong Kong does not levy a Capital Gains Tax, and gains from the sale of capital assets are exempt from Profits Tax. Thus gains on the disposal of capital assets are free from Hong Kong Tax.

Therefore property owners who realise a gain on the sale of their Hong Kong property often assume that the Hong Kong Inland Revenue Department ("IRD") will not be able to tax that gain.

However, if the IRD believe that the property owner is not an investor, but a trader in property, the IRD will seek to treat any gain on the disposal of the property as a trading profit subject to Profits Tax.

The House of Lords judgement in Simmons (as liquidator of Lionel Simmons Properties Ltd) v CIR (53 TC 461) stated that:-

> "Trading requires an intention to trade. Normally the question to be asked is whether this intention existed at the time of the acquisition of the asset."

The most important factor in determining whether a property owner is investing in, rather than trading in, property is therefore the intention of that person at the time he acquires the property.

The IRD and the Board of Review usually refer to a number of factors in determining whether there is a trade.

The UK Royal Commission on the Taxation of Profits and Income formulated the "Six Badges of Trade" for considering whether the disposal of an asset is a trading profit or a capital gain:

1. The subject matter of realisation.
2. The length of the period of ownership.
3. Frequency or number of similar transactions by the same person.
4. Supplementary work on, or in connection with, the property realised.
5. Circumstances responsible for the realisation.
6. Motive.

The Board of Review also refers to the "Nine Features of Trade" formulated in the case of Marson v Morton 1986 WRL1343, namely:-

1. Was the transaction a one-off transaction?
2. Was the transaction related to the trade which the taxpayer otherwise carried on?
3. The nature of the subject matter?
4. The way in which the transaction was carried out?
5. The source of finance of the acquisition?
6. Was work done to the item purchased before it was resold?
7. Was the item resold in one lot, or broken down into saleable lots?
8. What were the purchasers' intentions at the time of purchase?
9. Did the item provide enjoyment for the purchaser?

In practice, there are a number of common tests in the two lists and they are usually applied together. Whilst no single factor is conclusive and all the facts and circumstances of each particular case should be looked at in order to determine the matter, most emphasis is placed on the purchaser's intention at the time of purchase.

The other tests, such as frequency of transactions, period of ownership, the financing of the purchases, are used by the IRD as a means of identifying that "motive" or "intention".

At the Board of Review the onus of proof is on the taxpayer to prove his case, and many individuals lack contemporaneous documents to prove their intention.

Individual investors acquiring Hong Kong property should maintain documentation of their intention in purchasing the property, such as letters to banks, solicitors and property agents, stating an intention to hold the property as a long term investment. Many individuals lose their cases due to a lack of such tangible evidence.

Companies should properly minute and document their intention and ensure that investment properties are disclosed as such in the company's audited accounts. The IRD is unlikely to accept an argument that a property was held for long-term investment if it is classified as a current asset in the company's financial statements.

Royalties paid to non Hong Kong residents

Under Hong Kong's territorial system of taxation, non Hong Kong residents who do not carry on business in Hong Kong are not, in general, subject to Profits Tax on Hong Kong source income. However, the Inland Revenue Ordinance ("IRO") contains various deeming provisions which seek to tax certain types of income received by non Hong Kong residents from Hong Kong resident businesses.

Section 15(1)(b) IRO deems "sums received by a person for the use or right to use in Hong Kong any patent, design, trademark, copyright material, secret process or formula or other property of a similar nature" to be profits subject to Profits Tax.

Section 21A IRO sets out the procedure for reporting and assessing royalties which are paid to non residents and which are deemed to be subject to Profits Tax under Section 15(1)(b) IRO.

Section 21A IRO requires the payer of the royalties to report details of the payment to the Hong Kong Inland Revenue Department ("IRD") and to withhold the relevant amount of Profits Tax from the payment to the non Hong Kong resident.

The relevant rate of Profits Tax is either 5.25% or 17.5% if the overseas recipient is a company or 4.8% or 16% for persons other than a corporation, using the criteria set out in Section 21A (1) IRO.

Irrespective of the Profits Tax rate imposed on the recipient, the Hong Kong payer receives a full deduction for the royalty paid against its Profits Tax liabilities.

Until recently, when a Hong Kong payer paid royalties to a non resident in respect of intellectual property which was not used in Hong Kong, Section 15(1)(b) IRO did not apply and no withholding tax was imposed in Hong Kong. This was confirmed in the decision in the case Emerson Radio Corporation v CIR.

In the Emerson Case, a Hong Kong company paid royalties to a company in the USA for using the trademark to manufacture goods to be sold outside Hong Kong. The taxpayer contended that as the royalties related to goods manufactured outside Hong Kong, the payment should not be chargeable to withholding tax. The Court of Final Appeal ruled in favour of the taxpayer.

The IRD was concerned that this court decision would lead to a significant loss of tax revenue if royalty payments were tax deductible in the hands of the Hong Kong payer, but non-taxable in the hands of the non-resident recipient and as a result a revision has been made to the IRO.

Following the enactment of the Inland Revenue (Amendment) Ordinance 2004, a new deeming section (Section 15(1)(ba)) has been introduced. The purpose of the new section is to impose Profits Tax on royalties paid for the use of, or right to use, the relevant intellectual property outside Hong Kong where the royalty payments are claimed as a deduction for Hong Kong Profits Tax purposes by the payer.

Thus, if the payer of royalties now wishes to claim a deduction for Profits Tax for royalties paid to non-residents, those royalties will be subject to withholding tax, regardless of whether they relate to the use of intellectual property inside or outside Hong Kong.

This amendment, which is a departure from Hong Kong's territorial-based tax regime because Profits Tax is imposed irrespective of the source of the income, applies to royalties that accrue to non-residents on or after 25 June 2004.

Hong Kong taxpayers who pay royalties to non residents for the use of intellectual property outside Hong Kong should examine their filing obligations. If the payer wishes to claim a Profits Tax deduction for such royalties then withholding tax will need to be applied and the non resident recipient will need to be notified.

The sixty day rule – tax relief for visitors

Hong Kong Salaries Tax is charged on an individual in respect of income arising in or derived from Hong Kong from an employment or office.

Where an individual has a Hong Kong source employment, he is subject to Salaries Tax on all of his income, even if he spends significant periods of time outside Hong Kong.

However, where an employee renders all of his services in connection with his employment outside Hong Kong, he is exempt from Salaries Tax under Section 8(1A)(b) of the Inland Revenue Ordiance, even if he has a Hong Kong source employment. This exemption is extended under Section 8(1B) IRO to taxpayers who perform services in Hong Kong during visits not exceeding 60 days in any Salaries Tax year (to 31 March). This is commonly known as the "sixty day rule".

To be eligible for the "sixty day rule" the taxpayer must be a person who visits Hong Kong. Thus, Hong Kong residents who have a base in Hong Kong are unlikely to be eligible for this exemption unless they can show that their main place of residence for the year in question is outside Hong Kong.

Secondly, the taxpayer must visit Hong Kong not exceeding 60 days in the tax year. The 60 day limit applies to all visits in the tax year, not just days during which services are rendered.

Thus, a taxpayer with a Hong Kong source employment who visits Hong Kong for 30 days on business and 40 days for rest and recreation, will be fully subject to Salaries Tax as his total of 70 days visits exceeds the 60 day limit.

There is no definition of a "day" in the IRO. The test adopted by the Board of Review for the sixty day rule is that if the taxpayer is in Hong Kong for any part of a day, then that will constitute a full day in Hong Kong. This is a different test from that used in "time out" or "time basis" claims.

For example, if an individual arrives in Hong Kong late Monday evening, works on Tuesday, and leaves early on Wednesday morning, this represents a visit of three days, even though he has spent less than 48 hours in Hong Kong.

This exemption does not apply to directors fees and other fees paid to office holders.

Non Hong Kong residents who are employed by a Hong Kong company in the dual capacities of executive and director of the company, and who perform some services in Hong Kong during visits not exceeding 60 days, should ensure their contract clearly separates directors fees from the salary and benefits paid to them as executive if they wish to claim the sixty day exemption. Failing this, all of the remuneration package may be treated as directors fees and will not qualify for the sixty day exemption.

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