

taxtalk

newsletter

Grant Thornton 
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Businesses evolve over time. Often today's business model or structure will be very different from that in the past and will change again in the future. Therefore, an effective corporate structure will be one that recognises this fact and allows flexibility. Typically, this will be a balancing act, taking into account various commercial and tax issues.

Some of the more significant issues affecting the structuring of an international business are set out below:

- The costs of establishing and maintaining the group structure.
- The shareholders' personal goals and aspirations as well as their retirement and tax planning.
- The choice of parent company's jurisdiction.
- The choice of trading vehicles, e.g. the choice between a company (including a subsidiary, a branch, or a representative office) and a partnership or a variation such as a limited liability partnership.
- Profit extraction within the group, distribution to shareholders as dividends or enhanced share values.
- The impact of foreign currency policies, foreign exchange

restrictions or licensing requirements.

- Immigration issues such as work visas and individual income tax exposure for foreign employees.
- Funding e.g. debt or equity.
- The impact of anti-avoidance provisions such as management and control tests for corporate residence, Controlled Foreign Company Legislation, and transfer pricing provisions. (This edition of Tax Talk explores the process through which companies should set their transfer prices).
- The ownership and licensing of brands.

Many corporate structures have not been properly planned in advance, so they are overly complicated with little flexibility. This can result in expensive costs to maintain the structure, unnecessary tax compliance burdens, investigations and queries, and immigration problems.

It is therefore important to structure your business in advance, and then to regularly review both the corporate structure and your tax planning strategies. This edition of Tax Talk contains a number of year end planning tips which can significantly benefit companies.



Transfer pricing — the nuts and bolts



Most tax jurisdictions, including Hong Kong, require taxpayers to maintain adequate documentation to support the income and profits they report to the relevant Revenue Authorities. In recent years, this burden of proof has become more onerous. Nowhere is this more prevalent internationally than in the area of transfer pricing.

What is transfer pricing?

Transfer pricing describes the process through which companies in the same group set the prices at which they trade with each other.

Companies within the same group have the ability to establish special conditions in their intra-group transactions. Revenue Authorities will therefore seek to ensure (and hence companies will need to prove) that transfer prices have not been set to manipulate profits in order to avoid taxes or to reduce the group's tax burden e.g. by shifting profits from a higher tax jurisdiction to a lower tax jurisdiction. Basically, the prices charged for intra-group transactions should be comparable to those set for unrelated parties. That is, they should be "arm's length" prices.

Setting your transfer price

The theory is simple, but in practice deciding how to set transfer prices

and keep sufficient documentation can be difficult.

Although by no means a definitive guide, the following steps should be taken as a minimum checklist in this area:

- Identify and document the transactions carried out between group companies, including determining how transfer prices have been set in the past, obtaining copies of existing agreements and considering the accounting treatment.
- Identify comparable transactions with independent third parties. Such transactions may be within your group or may involve considering comparable data obtained from other sources, such as industry data.
- Perform a functional and risk analysis of related party transactions. This will include determining how related and unrelated party transactions actually take place and analysing differences, such as who bears the risk of default, who performs the critical functions, for example, quality control and shipping etc.

- Document and review your transfer pricing policies on a regular basis.

Although historically there have been very few transfer pricing cases in Hong Kong, partly because most groups have sought to book profits in Hong Kong with its lower tax regime, there is an increasing trend by the Inland Revenue Department to use the anti-avoidance provisions in the Inland Revenue Ordinance (IRO) to investigate the shifting of profits between Hong Kong and other jurisdictions. This encompasses a review of the prices charged between companies in a group. Thus, although there are no transfer pricing provisions in the IRO, the Inland Revenue Department does have the power to undertake a transfer pricing review based on the anti-avoidance provisions in the IRO. Taxpayers in Hong Kong should therefore ensure that they have sufficient records to justify their prices to group members compared with third parties.

In addition, there are at least two jurisdictions involved in these transactions; so not only do you have to consider the tax exposure in Hong Kong, but you also need to consider the transfer pricing legislation in the second country.

Is the UK a tax haven for non-domiciled individuals?



For non-UK domiciled individuals, the United Kingdom continues to offer a particularly generous tax regime as outlined in the table below. With advance planning, the UK can be a tax haven for non-UK domiciled individuals with non-UK income and investments.

The key to accessing this tax haven is domicile, and in particular a non-UK domicile. Unfortunately, this can be one of the more difficult areas in UK tax planning, as there is no specific legislation or single definition for “domicile”. In general, a person is considered to inherit a domicile of birth from his or her parents. This can be changed to a new domicile by abandoning links with that country and establishing a permanent home elsewhere.

Some of the planning opportunities for non-UK domiciled individuals are as follows:

1. Remittance basis planning

A simple yet effective method of deferring UK tax liabilities on overseas income/capital gains is to open separate bank accounts.

(i) UK bank account

This account should be used for UK income. As such income will be fully taxable in the UK in any event, it would be used first.

(ii) A capital bank account

This capital bank account should be set up outside the UK and

used for keeping the fund balances in all bank accounts as at the date when the individual moves to the UK. Remittances out of this account to the UK will not be chargeable to UK income tax or capital gains tax.

(iii) Capital realisation account

This capital realisation account should be set up outside the UK and used to hold the proceeds from sale of overseas assets after the individual’s arrival in the UK. Gains from such sales may be subject to capital gains tax if remitted into the UK.

(iv) Overseas income account

This overseas income account would be used to receive income from sources outside the UK. Remittances from this account to the UK will be taxable in the UK.

2. Purchasing UK assets via a corporate entity rather than by individuals

For non-UK domiciled individuals it may be advantageous to hold UK assets via an offshore company. In this manner, it may be possible to convert assets which have a UK situs and are potentially liable to UK

Inheritance Tax, to assets which have a non-UK situs and not liable to UK Inheritance Tax.

3. Gifts

For married couples, there may be an advantage in making gifts between spouses if one spouse is UK domiciled and the other is not. However they need to be aware of potential Inheritance Tax liabilities.

4. Trust planning

Depending on the assets and the net wealth involved, it may be advantageous to establish an offshore trust. As well as succession planning advantages, an offshore trust may also achieve savings in Income Tax, Capital Gains Tax, and Inheritance Tax.

As demonstrated above, the UK tax system is very generous for foreign nationals who are non-UK domiciled provided that appropriate planning is undertaken at the outset. However, as a word of caution, the UK Inland Revenue has issued a consultative document on domicile, and changes could be made to this favourable UK tax system in the future.

	Non-domiciled	Domiciled
UK income and capital gains	Taxable	Taxable
Overseas income and capital gains	Taxable only if remitted to the UK	Taxable
UK assets	Chargeable to Inheritance Tax	Chargeable to Inheritance Tax
Overseas assets	Not chargeable to Inheritance Tax	Chargeable to Inheritance Tax

Year end tax planning for corporations



Aside from structuring your business in advance and reviewing your tax planning strategies on a regular basis, companies should be conducting a tax planning review prior to year-end, as such a review can help to identify opportunities to save taxes. This is equally true in Hong Kong as it is in other countries. Although each country has its own tax rules and anti-avoidance legislation, there are various tax planning strategies that corporations may consider:

1. Reviewing fixed assets policies

In addition to ensuring that assets are properly categorised to achieve the maximum write off in value for tax depreciation purposes, companies should consider advancing capital commitments in order to take the depreciation allowance one year earlier. In order to maximise this tax benefit, companies should ensure that they purchase the assets that would receive the highest tax depreciation rates first.

For example, if a Hong Kong company is planning to purchase fixed assets just after its year end, it

should consider bringing forward expenditure on such assets as computer equipment, or “prescribed fixed assets” first, as they qualify for 100% deduction in the year the expenditure is incurred. In contrast, expenditures for industrial buildings or commercial buildings receive a much lower level of depreciation allowances.

2. Advancing repairs and maintenance expenditures

Bringing forward revenue expenditure, such as repairs and maintenance, will advance the tax relief to the year in which the expenditure is incurred.

3. Bad and doubtful debts

Different countries have different rules for treating bad and doubtful debts. Hong Kong allows bad trading debts to be written off for tax purposes only if all the appropriate steps have been taken to recover the debts. Therefore, companies should review their outstanding debts prior to the fiscal year-end and ensure they have sufficient documentation in place to justify any bad debt provisions that are made.

4. Accrued expenditure

Following the issue of the Hong Kong Inland Revenue Department’s Departmental Interpretation and Practice Note No. 40 (DIPN 40) on the treatment of prepaid or deferred revenue expenditure, companies should ensure that they have made an accrual for all expenditure incurred during the year. Our Spring 2003 edition of Tax Talk contains an article entitled “DIPN 40 – Prepaid or deferred revenue expenses...”, which explains the provisions of DIPN 40 in more detail.

5. Bonuses

If your company has a bonus programme based on the year’s performance, try to evaluate the performance and determine bonus amounts in the fourth quarter, instead of waiting until after the year-end. Even if the bonus will be paid subsequent to year-end, the bonus expense will be deductible for the company if accrued before year-end.

By considering the above measures, companies may obtain a permanent tax saving or tax deferral.

Grant Thornton 均富會計師行

13th Floor, Gloucester Tower, The Landmark, 11 Pedder Street, Central, Hong Kong
T +852 2218 3000
F +852 2218 3500
E tax_enquiries@gthk.com.hk
W www.gthk.com.hk

The Hong Kong member of Grant Thornton International

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If you have any comments or require further information please contact:

Paul Chow
T +852 2218 3188
E paul.chow@gthk.com.hk

David Southwood
T +852 2218 3103
E david.southwood@gthk.com.hk

Tom Corkhill
T +852 2218 3167
E tom.corkhill@gthk.com.hk

Brenda Cheung
T +852 2218 3136
E brenda.cheung@gthk.com.hk

Gary James
T +852 2218 3137
E garyjames@gthk.com.hk