

# taxtalk newsletter

Grant Thornton   
均富會計師行

## Contents

- 1 Soaring Government revenues...but tax concessions deferred
- 2 The 60-day rule...a Salaries Tax trap for the unwary
- 3 The Salaries Tax treatment of share awards
- 4 Green Taxes – environmentally friendly and broad based?

## Soaring Government revenues...but tax concessions deferred

The taxation highlight of the first quarter of the calendar year in Hong Kong is normally the Budget Speech by the Financial Secretary. This year it has been overshadowed to some extent by other matters including the Double Tax Agreement with Mainland China, the election of the new Chief Executive and the public consultation exercise on the suitability of a Goods and Services Tax (GST) for Hong Kong.

The strength of public opposition to GST seemed to take the Government by surprise and the Government's emphasis in the consultation process has been changed to a general consultation on broadening Hong Kong's tax base.

Perhaps this influenced the Financial Secretary's cautious approach to his 2007 Budget. Despite announcing a projected budget surplus of HK\$55.1 billion for the fiscal year to 31 March 2007 (compared with an original projected surplus of HK\$5.6 billion) the Financial Secretary offered few tax concessions. Noticeably, he did not reverse the increases in the standard rates of tax introduced by his predecessor to address a series of budget deficits. Instead, he proposed

some minor concessions, noting that "in making any tax concessions we should, as far as possible, avoid narrowing our tax base further." It seems any major concessions or cuts in tax rates may have to wait for larger budget surpluses or a broadening of the tax base, they have certainly been deferred for now.

As a result, although there was a 50% reduction in the duty on alcoholic beverages and a number of "one off" concessions, there was little tax relief for the business sector.

Stressing the need for Hong Kong to consolidate its advantage of having Mainland China as its hinterland, the Financial Secretary announced measures to further enhance Hong Kong's development as a logistics hub and also to aid tourism, whilst stating that measures already in place will enable the financial services industry to become the most important sector of the Hong Kong economy.

A summary of the budget proposals is set out in our Budget Notes 2007/08.

The second quarter of 2007 signals the commencement of the tax filing season for 2006/07 in Hong Kong. Details of the tax filing deadlines are set out in our Tax Notes 17. Please contact us if you have not received your copy of these Tax Notes.

**Anthony Chan** (left) and **Cecilia Hung** (right),  
Tax Managers of Grant Thornton.



## The 60-day rule...a Salaries Tax trap for the unwary

### The Inland Revenue Ordinance (IRO) charges Salaries Tax on individuals in respect of their income arising in or derived from Hong Kong from any office, employment or pension, and income derived from services rendered in Hong Kong.

Section 8(1A)(b)(ii) IRO excludes from Salaries Tax, income where the employee renders **all** of his services outside Hong Kong in connection with the employment.

Section 8(1B) IRO extends this exemption by stating that in calculating whether or not all services are rendered outside Hong Kong for this purpose “no account shall be taken of services rendered in Hong Kong during visits not exceeding a total of 60 days in the basis period for the year of assessment”.

The interpretation of this so called 60-day rule has remained constant since the High Court decision in the case of CIR v So Chak Kwong, Jack in 1986.

The High Court decision was that the words “not exceeding a total of 60 days” qualified the word “visits” and not the words “services rendered”. Accordingly where an individual renders any services during visits to Hong Kong (no matter for how short a duration) **all** of the visits to Hong Kong in the basis period are counted towards the 60 days total even if no services are rendered on a particular day. Further, in calculating the number of days spent in Hong Kong any part of a day spent in Hong Kong counts as a full day.

For example, Mr A who has a Hong Kong source employment performed services during business visits to Hong Kong for a total of 45 days in the year ended 31 March 2007. He also spent 10 days in Hong Kong on vacation in the same year. As the total number of days (55) in Hong Kong is less than 60, Mr A is exempt from Salaries Tax for the year ended 31 March 2007.

However, if Mr A had extended his vacation by another 7 days his total visits to Hong Kong would be 62 days and **all** of his income would be subject to Salaries Tax even though his days of service were less than 60 days.

This can lead to perceptions of unfairness in the application of the 60-day rule.

One of the more extreme examples of the perceived unfairness of the 60-day rule was the subject of the Board of Review Decision D2/06. The taxpayer visited Hong Kong for 82 days in the year, using the accepted calculation of a day. But, with the exception of **one** day, she did not perform any services for her employment in Hong Kong during those visits. Thus 81 of the 82 days were for vacation, the exception being one day during which she attended her employer's office in Hong Kong.

As the taxpayer had performed services in Hong Kong (albeit for one day) the Board were obliged to follow the decision in the Jack So case and denied the taxpayer relief as her **total** number of **visits** exceeded 60 days.

The Board were clearly unhappy about their decision and stated that it was “with consideration unease and regret” that the Board had no alternative but to find in favour of the Commissioner.

In an unusual commentary on Hong Kong's tax laws, the Board stated its strong belief that it would be appropriate for the 60-day rule to be reconsidered by the Courts or the legislature.

But unless, or until that happens, taxpayers who perform even limited services during visits to Hong Kong should be aware that the 60-day rule can be a trap for the unwary. Visitors to Hong Kong who perform any services in Hong Kong should count the total number of days in Hong Kong if they wish to avoid a Salaries Tax liability. Alternatively, visitors should seek to ensure they perform no services at all in Hong Kong.

# The Salaries Tax treatment of share awards



**The Inland Revenue Department (IRD) has recently published its views on the deductibility of share based payments for Profits Tax purposes but there is a lack of IRD guidelines on the Salaries Tax treatment of the receipt of such share awards in the hands of employees.**

For accounting periods beginning on or after 1 January 2005 an entity with share based payment transactions is required by Hong Kong Financial Reporting Standard No 2 to recognise the fair value of such transactions as an expense in its accounts.

The Salaries Tax treatment of stock options is specifically identified in the Inland Revenue Ordinance (IRO). Share awards under a share purchase or stock award scheme also constitute taxable benefits and the taxation treatment draws on the legislation applicable to stock options.

Section 9(1)(d) IRO treats as subject to Salaries Tax “any gain realised by the exercise of, or by the assignment or release of, a right to acquire shares or stock in a corporation obtained by a person as...an employee of that or any other corporation”.

This section recognises that where an employee receives stock options (as opposed to share awards) there is no taxable benefit at the time of grant of the option. It is the exercise of the option, rather than the granting of the option, which is the taxable event.

The taxable gain arising on the exercise of an option is the difference between the amount which a person “might reasonably expect to obtain” from a sale in the open market at the time the shares are acquired and the consideration the individual paid for the shares and/or the option.

The IRD has set out its views on the taxation of stock options schemes in its Departmental Interpretation and Practice Notes No. 38 (DIPN 38).

The grant of share awards also constitutes a taxable perquisite but, as DIPN38 points out, the timing of the benefit and the valuation of the benefit for Salaries Tax purposes “will generally be determined by terms governing the awards and the circumstances under which the awards are granted”. A separate Practice Note on share purchase awards is to be issued and it is understood from the IRD that this is in progress.

As with the exercise of an option, the grant of shares under a share purchase scheme involves the taxation of a notional benefit. The taxable benefit is the notional gain representing the difference between the value of the shares and the consideration (if any) paid by the employee for the shares at the time the employee acquires the shares.

This involves consideration of two main points:

- When does the employee acquire the shares? This affects the time the benefit is taxable, which is important when shares awards are granted subject to restrictions. For example, shares acquired with restrictions on sale are normally considered to be acquired by the employee when the shares are awarded, whilst share awards which are granted subject to continued employment are usually treated as being acquired at the end of the vesting period.
- What market value should be placed on the shares? Here the guidelines on valuation in DIPN38 may be of assistance and discounts on open market value may be appropriate to reflect restrictions on title.

As share purchase schemes vary considerably in their terms and conditions, each scheme should be reviewed carefully to determine the correct Salaries Tax treatment.

## Green Taxes – environmentally friendly and broad based?



The term “Green Taxes” usually refers to taxes imposed on specific items of consumption on environmental protection grounds.

In recent years the use of Green Taxes has been proposed as a possible means of addressing environmental concerns in Hong Kong, including taxes on plastic bags and tyres. The Financial Secretary has repeatedly referred to his commitment to impose “Green Taxes” in accordance with the Government’s “Polluter Pays” policy.

Traditionally Green Taxes have not been considered as a suitable means of broadening the tax base as such taxes usually involve factors and objectives other than fiscal requirements, and can range from very narrow and specific taxes to more sweeping levies. The Advisory Committee on Broad Based Taxes specifically identified and excluded Green Taxes from its deliberations in preparing its Report for this reason.

However, with the second stage of the

Government’s public consultation on Broad Based taxes placing a lesser emphasis on Goods and Services Tax (GST) and a greater emphasis on alternative means of broadening the tax base, Green Taxes are now being considered as part of the solution to broadening the tax base.

If Green Taxes are to have a role in the debate on broadening Hong Kong’s tax base then the leading broad based option is some form of Utility Tax. That is, a tax on gas, electricity and/or water. Such a tax has the appeal that it would be broadly based and the collection costs would be low as the electricity and gas companies already have the billing mechanism in place. Similarly, the Government already has a billing system in place for water rates. These billing systems could easily be adapted to include a Utility Tax in each bill. Moreover, increasing or reducing the rate of the tax would be easily accommodated.

The Financial Secretary has already “thought aloud” about a tax on electricity in at least

one public forum, so extending this to gas and water would not be a quantum leap.

However, a Utility Tax could, to some extent, be “caught between two stools”. By increasing the cost of utilities this could lead to a reduction in consumption, thus helping the environment. But this in turn results in a lower tax yield.

However, whilst utility consumption may drop as costs increase it is unlikely to reduce to such an extent that the yield from a Utility Tax is insignificant, and such a tax could, with proper management, be both broad based and environmentally friendly.

As with GST, the introduction of a broad based Utility Tax would need to be offset by a comprehensive compensation package, including reductions in direct taxes and specific measures to compensate the less well off members of Hong Kong society. Based on the Government’s comments regarding GST, such a compensation package should be feasible.

### Grant Thornton 均富會計師行

13th Floor, Gloucester Tower, The Landmark, 15 Queen’s Road Central, Hong Kong  
T +852 2218 3000  
F +852 2218 3500  
E info@gthk.com.hk  
W www.gthk.com.hk

The Hong Kong member of Grant Thornton International

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.

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

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

**Gary James**  
T +852 2218 3137  
E gary.james@gthk.com.hk

**Michael To**  
T +852 2218 3046  
E michael.to@gthk.com.hk

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

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

**Daisy Ip**  
T +852 2218 3168  
E daisy.ip@gthk.com.hk

Published by Grant Thornton  
© 2007 Grant Thornton