

Press release

LCQ14: Taxation issues faced by Hong Kong enterprises

Wednesday, April 6, 2011

Following is a question by Dr Hon Lam Tai-fai and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (April 6):

Question:

Regarding the taxation problems faced by Hong Kong enterprises engaged in processing operations, will the Government inform this Council:

(a) given the judgment in the High Court case HCAL49/2009 has revealed that the Commissioner of Inland Revenue (Commissioner) demanded a certain enterprise to purchase Tax Reserve Certificates (TRCs) for a total value of \$430 million, upon the objections lodged by the enterprise against the tax assessments, which stood at approximately \$1.4 billion in relation to the years from 1997-1998 to 2002-2003 as assessed by the Inland Revenue Department (IRD), and the enterprise disclosed subsequently in its annual report that its tax disputes with IRD relating to the years from 1997-1998 to 2008-2009 were settled by paying a sum of less than \$200 million, what criteria are adopted by the Commissioner in determining the amount of TRCs which a taxpayer is required to purchase, as well as what mechanism is in place for monitoring the Commissioner's exercise of the statutory power to issue the "Conditional Standover Order";

(b) given the provision of the Inland Revenue Ordinance (Cap 112) (Ordinance) that upon the lodging of an objection or appeal against tax assessments by an enterprise, interest shall be payable on the tax held over at the "Judgment Interest Rate" (8% per annum at present) if the enterprise concerned fails the case eventually, whereas interest shall be payable on the TRCs it purchased at the interest rate on TRCs (0.0433% per annum at present) if the case is successful, whether the authorities have examined the reason for the substantial difference between the two interest rates; since the low interest rate on TRCs will lead to the relatively small amount of interest payable by the Government even when it fails the case, whether, as a result, the Commissioner will be

inclined to casually require enterprises to purchase huge amount of TRCs as cost risks are low; given that the authorities have prescribed that the interest payable on tax payment in unsuccessful cases is to be calculated at the "Judgment Interest Rate" which is a relatively high interest rate, whether it is meant to deter enterprises from exercising the right to lodge objections or appeals against tax assessments by charging a penal rate of interest; whether the authorities have assessed if such a practice is unfair to the enterprises;

(c) whether it has assessed if IRD's demanding enterprises to purchase huge amounts of TRCs or furnish bankers' undertakings before their tax disputes are settled will deal a severe blow to their cash flow and increase their expenditure on loan interests, thus imposing heavy cost and psychological burdens on them and putting them in a disadvantaged position in tax disputes;

(d) of the legal basis for IRD to adopt the current arrangement of "Assess First Audit Later"; whether there is any case to which this practice is not applicable; if so, of the cases and the reasons for that;

(e) given that under the existing "Assess First Audit Later" arrangement, the subsequent one-off recovery by IRD from enterprises of unpaid taxes accumulated over the past years without promptly informing them of the errors in their tax returns in the first place will create an unaffordable snow-ball effect on their tax burden, even though their errors are just a result of the differences in the views between them and IRD on tax legislation, whether the authorities have assessed if the arrangement of "Assess First Audit Later" can be replaced by that of "Audit First Assess Later" for controversial cases such as those concerning section 39E of the Ordinance (section 39E) and the assessment of Hong Kong profits tax on a 50:50 basis of apportionment; if they have not, of the reasons for that;

(f) given that at present, IRD grants special depreciation allowances for machinery outside Hong Kong for cases engaged in "contract processing", whether the authorities will grant the same special allowances for cases engaged in "import processing"; if they will not, of the reasons for that;

(g) given that in the case of *Davies & Anor, R v HM Revenue & Customs* (2010) in Britain, the Judge pointed out that the taxation authorities' published guidance was legally enforceable, whereas in the Departmental Interpretation

and Practice Notes (DIPN) No. 21 issued by IRD in 1998, it does not stipulate that the 50:50 basis of apportionment of profit tax applies only to enterprises engaged in "contract processing" but not to enterprises engaged in "import processing", whether the authorities have assessed if it is a fair and reasonable practice for IRD to impose penalty on those local enterprises that have made arrangements according to DIPN No. 21; if they have, of the details; if not, the reasons for that;

(h) given that some members of the commercial and industrial sectors have relayed to me that some assessors have told the enterprises which had raised objections or lodged appeals to tax assessments that if the enterprises do not comply with IRD's request of purchasing TRCs and compromise with IRD, they would pass their cases to the Field Audit and Investigation Unit of IRD for thorough investigations, whether the authorities have assessed if such a practice is appropriate and whether this will make the enterprises concerned feel uneasy, thereby affecting them in exercising their legal rights of lodging appeals or raising objections to tax assessments;

(i) given that the authorities invited the Joint Liaison Committee on Taxation (JLCT) in March 2010 to review the implementation of section 39E, and then they announced in November of the same year that they refused to accept all the recommendations made by JLCT, whether the authorities will assess the functions of JLCT and consider dismissing it;

(j) given that the authorities have refused to accept the recommendations of JLCT on the ground that it has not proposed effective measures to plug possible tax avoidance loopholes, whether they have conducted studies on their own on this subject; if they have, whether the report and information of the study can be disclosed to the public; if not, of the reasons for that; and

(k) given that the purposive approach, which has been recognised by the courts, and section 19 of the Interpretation and General Clauses Ordinance (Cap 1) both require that in interpreting law, the legislative intent must be established, and that in *Medical Council of Hong Kong v Chow Siu Shek David*, the Court of Final Appeal states, "When the true position under a statute is to be ascertained by interpretation, it is necessary to read all of the relevant provisions together and in the context of the whole statute as a purposive unity in its appropriate legal and social setting", and that the Commissioner also

holds the same view in the case of CIR v Sawhney (HCIA1/2006), whether the authorities have assessed if the decision made by the Board of Review on the case D61/08, which contains the comments that "From the provision (of section 39E) itself, it does not require an intention to avoid tax for its application", is a correct one; if they have assessed, of the details; if not, the reasons for that?

Reply:

President,

(a) to (c) and (h) In our reply to Dr Hon Lam Tai-fai's written question on March 9, 2011, we have already explained in detail the legal basis and relevant criteria for the Commissioner of Inland Revenue (the Commissioner) to issue, in relation to objection or appeal cases, "conditional stand-over orders" requiring taxpayers to purchase tax reserve certificates (TRCs) in the amount of tax held over, or to furnish banker's undertakings. Owing to the secrecy provisions in the Inland Revenue Ordinance (IRO), we would not make any comments or responses on individual cases.

Generally speaking, when determining the amount of tax held over, the Inland Revenue Department (IRD) will compare the tax attributable to the disputed item against the total tax payable. If taxpayers encounter financial difficulties in purchasing TRCs in the amount of tax held over in pursuance of "conditional stand-over orders", they may approach IRD to resolve the problem under the established mechanism, including application to IRD for payment of tax by instalments.

According to section 71 of the IRO, if taxpayers have purchased TRCs in pursuance of "conditional stand-over orders" in relation to objection or appeal cases, interest (the current interest rate of TRC is 0.0433% per annum) will be paid on these TRCs to the extent to which the TRCs are eventually not required to settle the tax held over, ie the parts in which the taxpayers' objection or appeal are successful. If the objections or appeals are withdrawn or determined against the taxpayers (wholly or in part), the taxpayers may tender the TRCs or a part of the TRCs in payment of the tax held over and found payable. No interest is payable upon any TRCs or part thereof so tendered.

If the taxpayers are granted with "unconditional stand-over orders", or "conditional stand-over orders" requiring the provision of banker's undertakings, issued by the Commissioner for their objection or appeal cases, and the taxpayers eventually withdraw the objections or appeals or the objections or appeals are determined against the taxpayers, the taxpayers would be required to pay interest on so much of the tax or any part held over which, upon the withdrawal or final determination of the objections or appeals, is found payable. The rate of interest payable is the judgment debt rate (the current rate is 8% per annum) prescribed in section 50 of the District Court Ordinance (Cap 336). The relevant provisions aim to protect tax revenue by preventing taxpayers from abusing the objection mechanism for the purpose of deferring tax payment.

All along, IRD handles tax matters in a fair, impartial and professional manner, without interfering with taxpayers' rights to lodge objections or appeals. If taxpayers disagree with the Commissioner's decision to require them to purchase TRCs or to furnish banker's undertakings in pursuance of the "conditional stand-over orders", they may seek judicial review in the High Court.

(d) and (e) According to section 59(1) of the IRO, an assessor is required to raise an assessment as soon as possible upon the taxpayer has furnished a tax return. Section 59(2)(a) of the IRO stipulates that where a taxpayer has furnished a return, the assessor may accept the return and make an assessment accordingly. An assessor is also empowered under section 60(1) of the IRO to raise additional assessment on any taxpayer who has not been assessed or has been assessed at less than the proper amount within the year of assessment or within six years after the expiration thereof. Hence, the "Assess First Audit Later" arrangement fully meets the legal requirements while enabling IRD to deploy resources in a flexible and effective manner. A taxpayer may, after furnishing a tax return, approach IRD if he prefers to have the information furnished in the return examined before an assessment is raised. IRD would make relevant arrangements as far as practicable.

(f) and (g) In response to Dr Hon Lam Tai-fai's oral and written questions, we have on a number of occasions explained to Members of the Legislative Council that Hong Kong enterprises maintain the buyer/seller relationship with their Mainland counterparts under the "import processing" arrangements. The

taxable profits of the Hong Kong enterprises in Hong Kong are derived from their trading transactions. Since the profits derived from the production activities in the Mainland under "import processing" are not attributable to the Hong Kong enterprises, IRD, according to the "territorial source" principle, would not charge profits tax on Hong Kong enterprises for the Mainland production activities. Based on the "tax symmetry" principle, the Hong Kong enterprises would not be granted with depreciation allowances for the machinery and plant solely used in the production activities in the Mainland.

In our previous replies to the written questions raised by Dr Hon Lam Tai-fai, we have indicated that IRD would update their Departmental Interpretation and Practice Notes (DIPNs) as and when necessary to provide explanations and illustrations for individual provisions, but such DIPNs do not have any legal effect and cannot change any provisions in the law. In this regard, the Court of Appeal reiterated in the case *CIR v Datatronic Ltd* (CACV 275/2008) that whether tax should be charged or otherwise should be determined by the provisions of the IRO, and that DIPN No. 21 issued by IRD in 1998 did not have any legal effect.

(i) and (j) The Joint Liaison Committee on Taxation (JLCT) is a discussion forum set up on the initiative of the accountancy and commercial sectors in 1987. It discusses various tax issues and reflects the views of the industry to the Government. JLCT is not an advisory body established or appointed by the Government, though Government officials are invited to attend its meetings. We are grateful to JLCT for its study and recommendations in relation to section 39E of the IRO. Nevertheless, owing to the established principles of "territorial source" and "tax symmetry" under the Hong Kong tax system and the issue of transfer pricing, we consider that there are no justifiable grounds to relax the existing restriction in section 39E.

(k) We respect the taxpayers' rights under the IRO to raise reasonable grounds of appeal against tax assessments to the Board of Review (Inland Revenue Ordinance) (the Board) and the court. We also respect the judgments made by the Board and the court of all levels.

Ends