



# HONG KONG

## – Update on territorial tax issues

4 March 2019

---

**Vivien Teu  
& Co LLP**

張慧雯律師事務所  
有限法律責任合夥

---

***Boutique Law Firm***

*Asset Management*

*Financial Services*

*Securities & Regulatory*

*Corporate & Commercial*

*Tax & Trusts*

# Table of Contents

**Vivien Teu  
& Co LLP**

張慧安律師事務所  
有限法律責任合夥

- 1) HK's territorial tax regime (snapshot)**
- 2) Changing tax practice in Hong Kong**
- 3) (Increasing) scrutiny of offshore claims**
- 4) What to expect next in Hong Kong?**

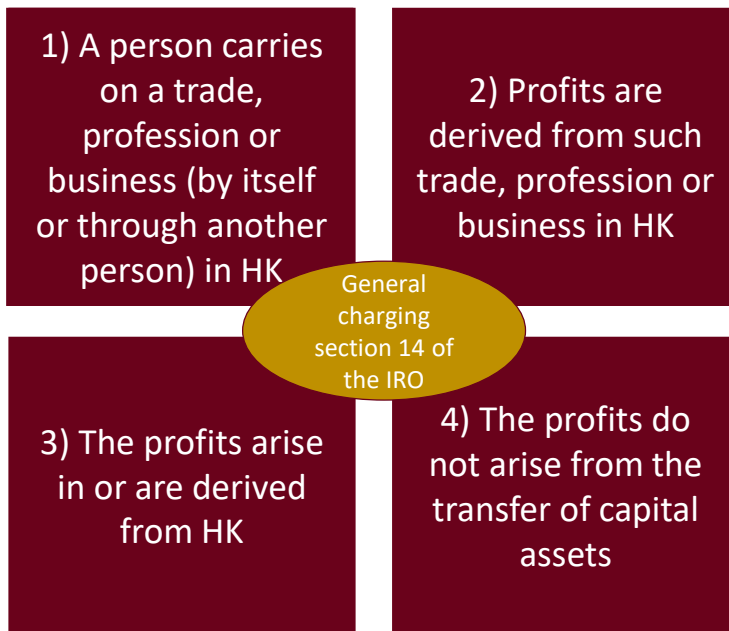
# 1) HK's territorial tax regime

## Snapshot

Vivien Teu  
& Co LLP

張基安律師事務所  
有限法律責任合夥

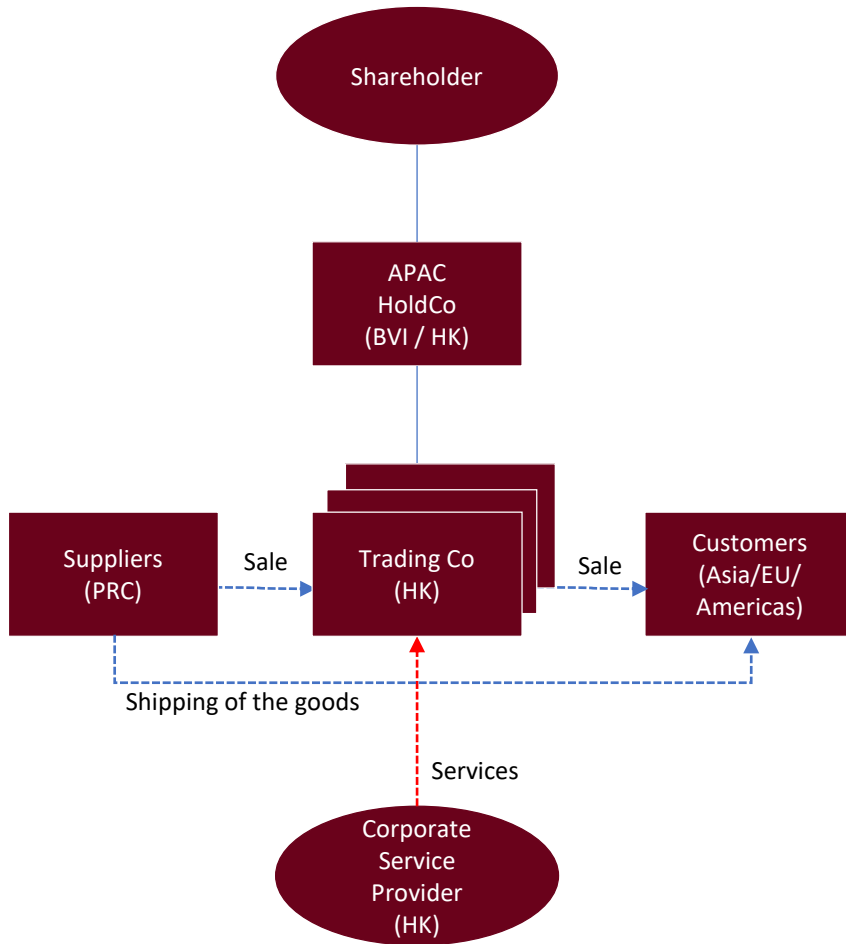
### Relevant (tax) considerations:



- Incorporated businesses chargeable to profits tax:
  - 16.5% for the part >HK\$2M of assessable profit;
  - 8.25% for the first HK\$2M of assessable profit;
  - 0% where offshore claim is accepted by the IRD.
- Cumulative criteria to assess chargeability to tax.
- Legal form or place of incorporation of the entity is irrelevant.
- The carrying on of a business in HK does not automatically bring the profits into the taxation net.
- Source (and nature) of profits are key factor(s).
- ‘Totality of facts’ as a general approach to assess the income from operations and transactions of a taxpayer.

# (Offshore) trading (or service) company

## *Simplified structure overview*



### A) Illustrative transactions

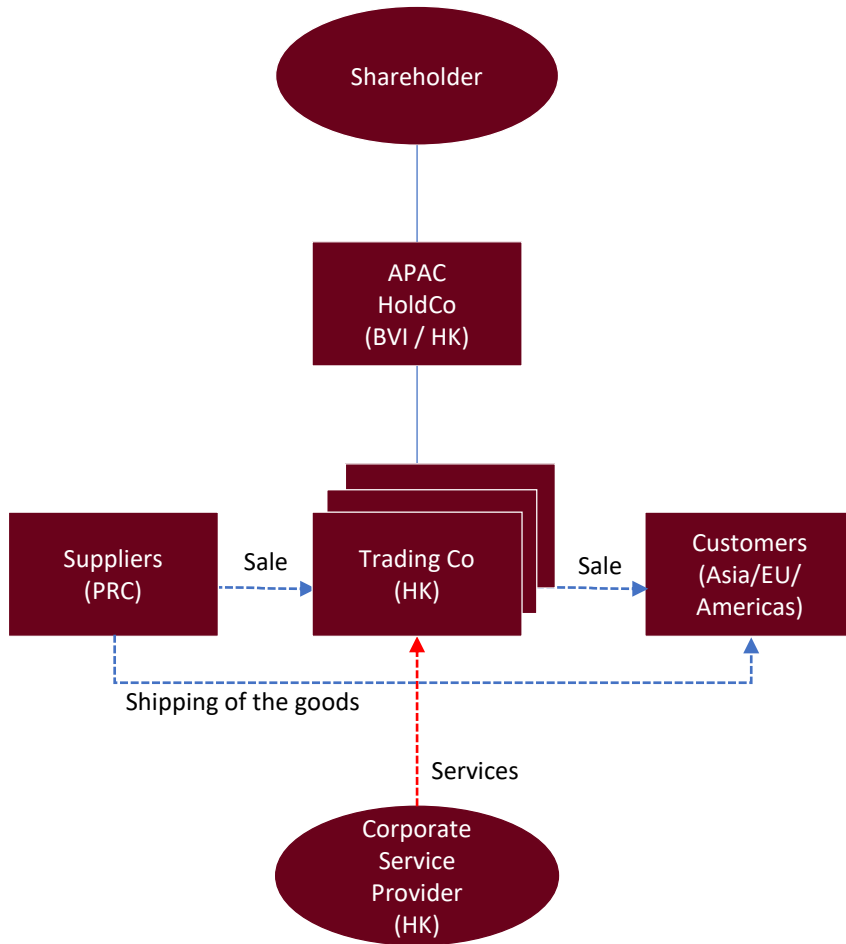
- Shareholder (e.g. individual, company, partnership, trustee) incorporates a HK Co.
- HK Trading Co purchases goods from PRC suppliers.
- HK Trading Co sells goods to EU customers;
- The goods will be delivered to customers without passing through Hong Kong.

### B) Potential tax benefits

- **Trading profits not taxable in Hong Kong.**
- (Similar structure also works for service fee income).
- Profits repatriation without tax-leakage.
- Tax-free exit.

# (Offshore) trading (or service) company

## *Simplified structure overview (cont'd)*



### C) Relevant tax considerations

- ‘Totality of facts’ approach applied by the IRD (both establishment & transactions).
- Role/responsibilities/authorities of directors, staff and (sub)contractors (incl. TCSP).
- Antecedent and/or incidental matters should be acceptable (e.g. bank account, admin).
- However, be cautious with purchase orders & sales confirmation.
- Transactions with HK persons (onshore deemed).
- Possible re-characterization as ‘re-invoicing centre’.
- Home country: double non-taxation or PE?
- Certificate of Resident Status for Trading Co, respectively, (BVI / HK) HoldCo?

## 2) Changing tax practice in Hong Kong

### International developments impacting Hong Kong:

- Adoption of (minimum) BEPS standards (Hong Kong has become an OECD associate).
- International cooperation in (automatic) exchange of information.
- Quickly expanding DTA & TIEA network.
- Exposed to pressure of blacklisting by EU and countries.

### Recognition of the IRD's changing attitude in practice:

- More aggressive approach of the IRD.
- Strict territoriality has been eroded in practice.
- (More) substance required to obtain a Certificate of Resident Status.
- Regular discussions with tax advisors (resulting in Practice Notes).

## 3) (Increasing) scrutiny of offshore claims

### A) Procedural steps:

- Claim in the profits tax return (“PTR”) that (a certain part of) the profit was offshore sourced;
- Expect an enquiry letter;
- Parallel with enquiries, IRD may also raise (additional) estimated/protective assessments;
- Where needed, lodge objection(s) to avoid these assessments to become final and conclusive;
- Expect request for the purchase of Tax Reserves Certificates (“TRCs”);
- Reply to the enquiries as soon as possible.

### B) Particular challenges:

- Onus of proof rest with the taxpayer as opposed to the IRD;
- Sufficient and appropriate documentation:
  - both regarding the business operation, specific transactions and other matters;
  - ‘form over substance’ approach whenever it works to the IRD’s benefit.
- If assessments are raised, objections will usually be followed by TRC demands;
- Field audit & investigation (“Unit 4”).

### 3) (Increasing) scrutiny of offshore claims (cont'd)

#### C) Typical reasons for being selected for tax audits:

- Frequent late filings of tax returns;
- Qualified opinion in audited financial statements (“AFS”);
- Fluctuations in onshore/offshore tax positions over the years;
- Exaggerated amount(s) of purchases;
- Transactions with closely connected non-resident persons;
- Excessive subcontracting fees (particularly paid to tax havens/low-tax jurisdictions);
- Long-pending disputes with the IRD.

#### D) What to do if things go wrong:

- Ensure objections *and* PTRs (supported by AFS) are filed on time;
- Engage tax representative/lawyer to negotiate with the IRD;
- Focus on technical basis and fact-based evidence (rather than verbal expressions by clients...);
- Strategically consider the purchase of TRCs;
- Be aware of freezing of bank accounts and assets held by others.



## 4) What to expect next in Hong Kong?

### A) Conclusion:

- Legislation has not (fully) caught up with an evolved tax and international environment, resulting in the IRD developing their own practice.

### B) Preservation of the territorial tax regime or reforming to a non-territorial system?

- Consequence of the former: overseas jurisdictions more likely to tax those profits.
- No signs of a fundamental tax reform coming soon (see, amongst others, the HK tax treatment of permanent establishments and e-commerce).

## 4) What to expect next in Hong Kong? (cont'd)

### C) Alternative “in-between” ways:

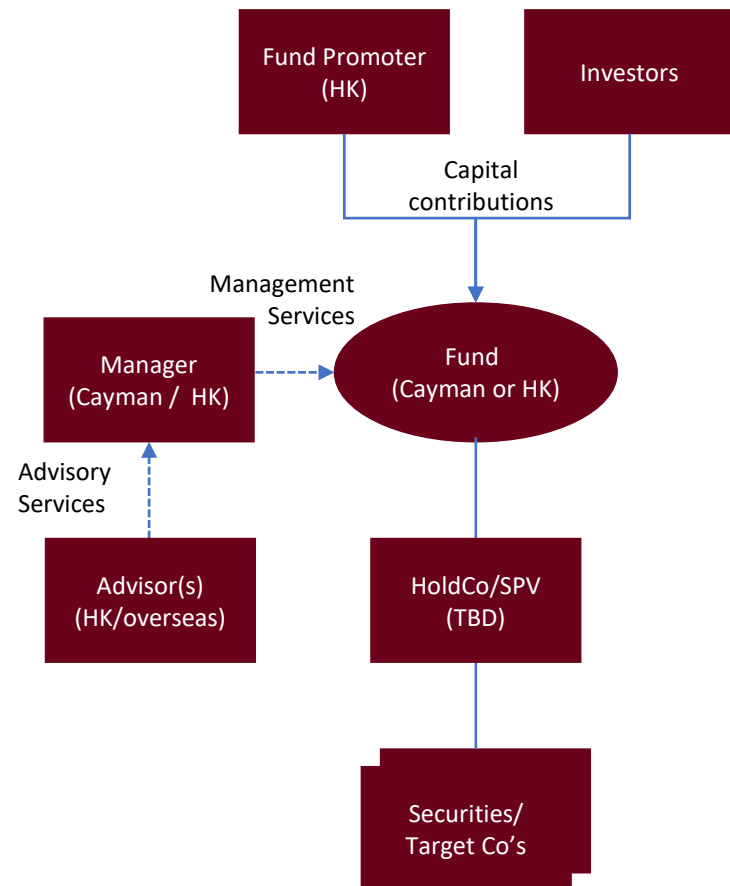
- 50% exemption for qualifying profits;
- ‘Time-based’ apportionment, thereby considering, amongst others, the:
  - number of directors and employees in Hong Kong v. overseas;
  - number of days spent by relevant persons in Hong Kong.
- Incentives to encourage ‘onshore’ businesses.

### D) Consequence of substance requirements for no or nominal tax jurisdictions:

- Scope of economic substance requirements may also bring a positive impact for Hong Kong (e.g. the investment funds/fund management business) [[see next slide](#)].

# Investment fund business

## *Simplified structure overview*



### A) Illustrative transactions

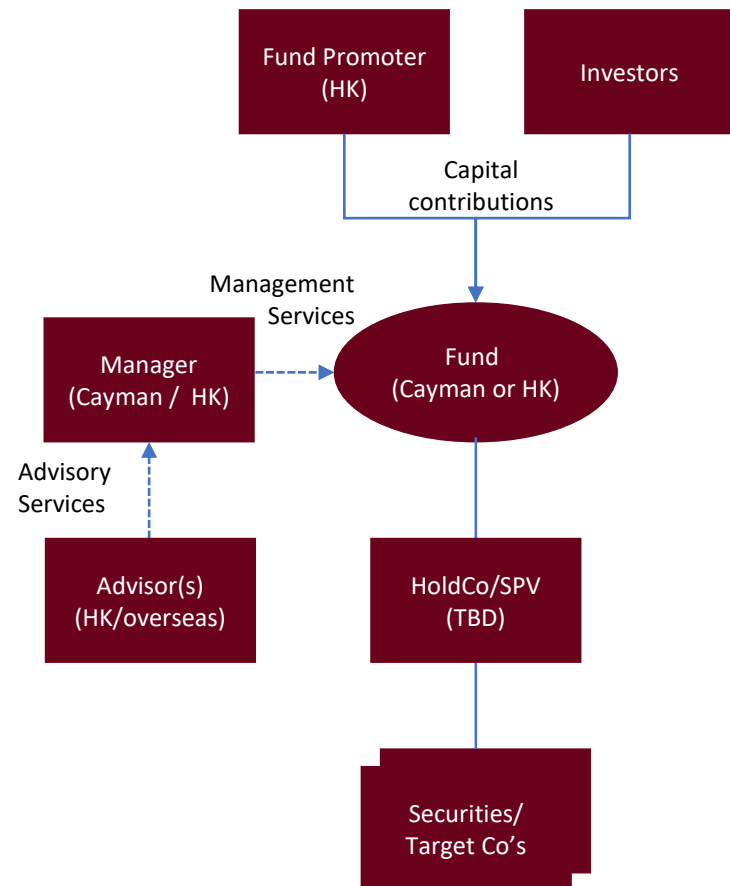
- Investors invest into the Fund entity.
- The Fund (or its sub-fund) invests (directly or indirectly) into overseas securities or private equity.
- The Manager manages the assets, including making investments and divestment decisions, in consideration of management and performance fees.
- The Advisor(s) performs research, deal sourcing and making investment recommendations, providing advice to the Manager in consideration of advisory fees.

### B) Potential tax benefits

- Investment profits of the Fund exempt from HK profits tax (despite persons involved in the operation of the fund, management or advisory activities in HK).

# Investment fund business

## *Simplified structure overview (cont'd)*



### C) Primary tax considerations

- Funds tax exemption (obviously subject to conditions).
- Exemption (expected) to become available for both offshore and onshore funds on the same basis under the Inland Revenue (Profits Tax Exemption for Funds) (Amendment Bill) 2018.
- In short, they should:
  1. meet the definition of “fund”;
  2. carry out its transactions by a SFC licensed person; and
  3. invest in qualifying assets (which also includes private companies).

### D) Other relevant tax considerations

- CIT exposure in (other) jurisdictions.
- Chargeability of fees (where management or advisory work is done).
- Related party transactions/transfer pricing.
- Local withholding taxes (on investee level).
- Tax implications of a carried interest scheme.

# Questions?

**Vivien Teu  
& Co LLP**

張慧安律師事務所  
有限公司律師行合夥

## Contact

Kenneth Yim, Consultant (Tax)

Address: 17/F, 29 Wyndham Street, Central, Hong Kong

Main Line: 852 2969 5300

Direct Line: 852 2969 5318

Mobile: 852 9196 8796

Email: [kenneth.yim@vteu.co](mailto:kenneth.yim@vteu.co)