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INTERNET NEWSLETTER

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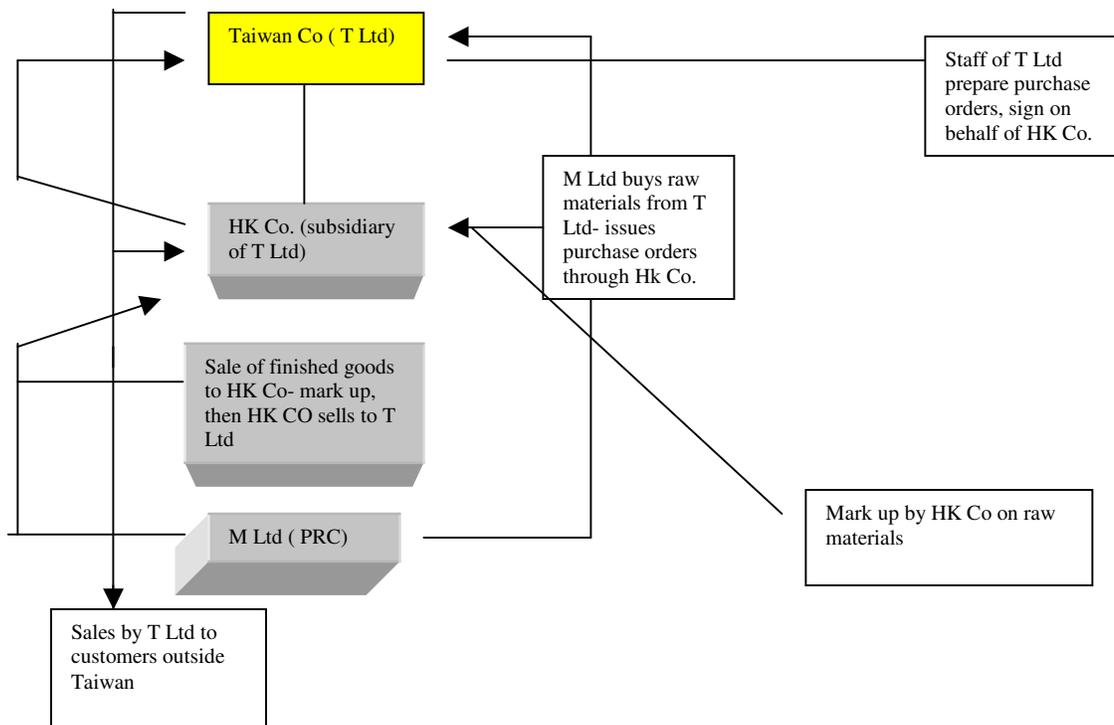
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Topical Tax Issues

(1) Advance Rulings

We continue to monitor the advance Rulings published by the HK IRD On their Web Site which provide a useful guide to current IRD thinking on typical re-invoicing structures using Hong Kong to capture group profits.

See Example 1 on the next page



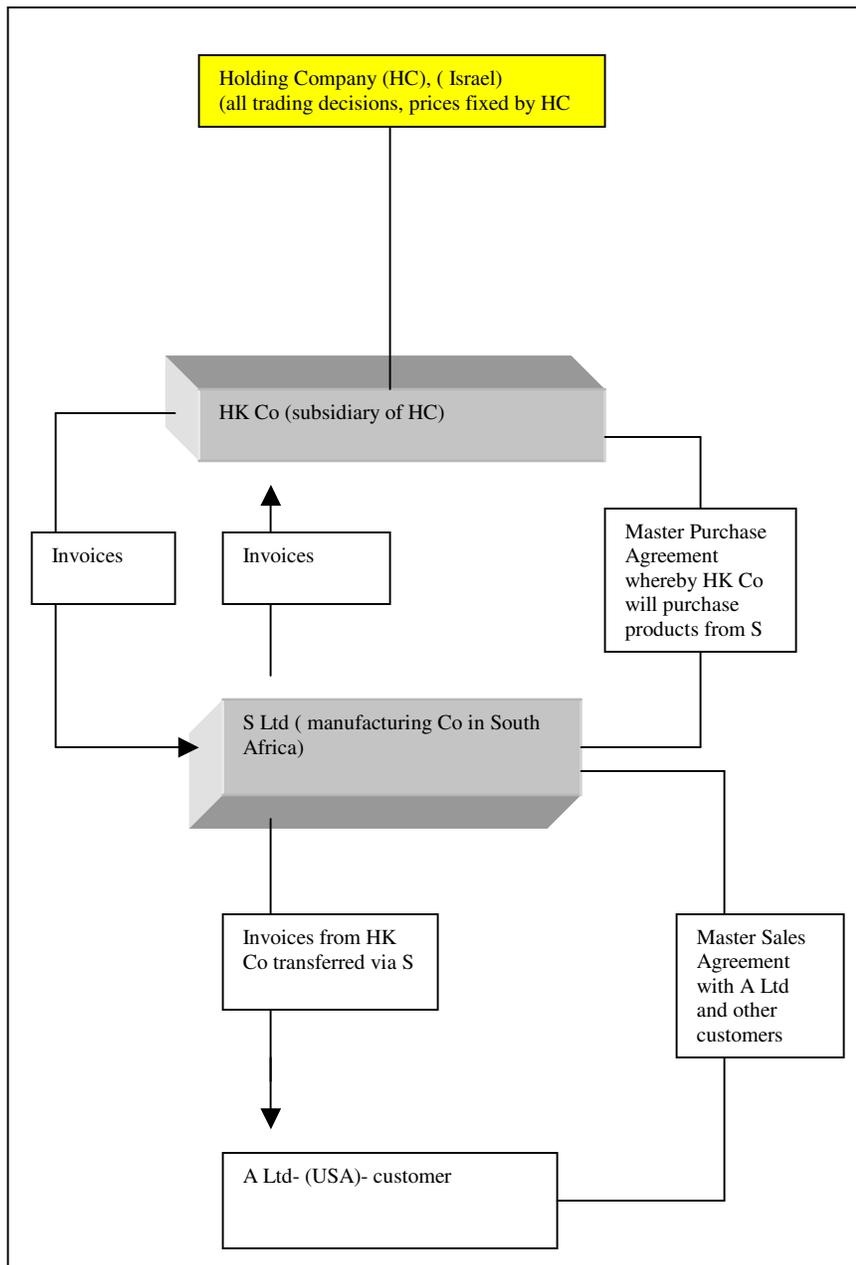
IRD Ruling:

The profits booked by HK Co in Hong Kong are not liable for HK profits tax.

Comment:

In our view this case example is a perfect illustration of the use of Hong Kong as no more than a ‘postbox’. The actual operations of the structure were in Taiwan and the PRC, and in the decision the IRD mentions that the use of the HK company is merely to ‘facilitate trading between Taiwan and the Mainland’. Most importantly, the Directors of T Ltd and M Ltd, although using the HK Co name on sale/purchase orders, signed the contracts outside Hong Kong thus avoiding the situation which can trap so many structures where a HK based Director signs the Purchase /sales orders in Hong Kong. Nor was there warehousing of the goods in Hong Kong although transshipments went through Hong Kong.

Example 2



IRD Ruling:

Profits of HK. Co. booked in Hong Kong are subject to Profits tax in Hong Kong.

Comment:

Although not all facts of the situation are known, on the face of it, is hard to reconcile the ruling with the previous example, as all decisions and presumably signature of purchase orders, sales were made outside Hong Kong and the Master Purchase /Sale Agreements were signed outside Hong Kong. However, possibly the fatal error was for the HK Company to own S Ltd As a subsidiary and for HK Co to have entered into the Master Purchase/Sale Agreements at all; no doubt the agreements added force to the argument by the IRD that the Agreements were the real source of Profits, and the actions of the HK Company were therefore instrumental in earning the profits. It would have been better for Sales contracts between S Td and A Ltd to have been set up separately out side HK on a one off basis with HC signing on behalf of HK Co. The example demonstrates how much care is needed when establishing a re-invoicing structure.

2. Housing Benefits- make sure that the Employment Contract is properly drafted and controls over the benefit put in place.

Most Employers and Employees are aware that a housing allowance granted by an Employer to an Employee is a non -taxable benefit, and may be provided for in the Employment Contract. In addition how and in what manner the Employee is to qualify for the benefit is usually set out in the Employment Contract.

The High Court case of IRD v Page is an example of not only how important it is to have the Employment Contract properly drafted, but for the parties to adhere to the terms of the Employment Contract so that the benefit granted is not lost through the actions of the parties which may amount to a variation of the terms agreed.

The facts, in brief, were that Page's Employers granted him a substantial housing allowance of over HK\$400,000.00, with a provision in the contract that proof of payment of the rental was to be produced to the Employer. The Employee did take up a tenancy and paid the rent, but did not produce any evidence of payment of it. Further, it was found as a fact that both the Employer and Employee had an understanding that although no rental might be paid or even if the rental was less than \$400,000.00, the Employee would still be entitled to receive the same sum of money.

The High Court, reversing the Board of Review, held that the understanding between the Employer and the Employee amounted to a variation of the Employment Contract, and since, pursuant to the private understanding between Employer and

Employer, there was no control over the way the allowance was to be spent, it amounted to a discretionary payment and the Employee could spend it in any way he thought fit. The allowance was therefore taxable.

In summary, proof of payment of the rental by the Employee is not enough, as the eligibility must be determined at the date the actual rental refund was made by the Employer. A refund connotes that the Employee will take some steps to ensure that the actual refund is what it is meant to be, and the Employer must insist on actual production of the rental receipts, and exercise control. Nor is it wise to have private understandings over the allowance which may amount to an unwitting amendment of the Terms of the Employment Contract. The case appears to have been decided correctly and reinforces a long line of Board of Review cases confirming the importance of controls in the Employment Contract and observance of them.

3. Companies Amendment Ordinance 2003

We referred briefly to the proposed amendments to the Companies Ordinance in our last Newsletter. The Ordinance has now however been passed and it may be helpful to highlight again the more important amendments which may affect your business operations. We do not intend to refer to all the amendments, some of which are largely technical and administrative- a full summary of the changes can be found on the Web site of the Companies Registry.

Most substantive amendments affect Directors and in particular:

- (a) Shadow Director- now redefined and can be anyone who can influence a majority of the the Directors;
- (b) A private Company may now have only one Director;
- (c) Where a private company has only one shareholder and that shareholder is the sole Director, a general meeting can nominate a person aged over 18 years to act as a reserve director after the death of the Existing sole director;
- (d) A director who appoints an alternate is now legally liable for the tortious acts of his alternate;
- (e) A director may now be removed by an ordinary members resolution and a special resolution involving a 75% majority is no longer required;
- (f) A sole director of a company who is also the sole shareholder, must sign a memorandum recording the terms of any oral contract with the company;
- (g) A company cannot in its articles exclude its officer and auditors from liability for

Acts of negligence, breach of duty etc, but it is now permissible for the company to pay for the cost of insurance to cover a director or officer against such claims except for certain claims relating to fraud of the director or officer.

Comment:

Most of the amendments mentioned are self explanatory. Of special significance are the changes in (f) (in a winding up it may be important for the private arrangements to be recorded unless they are to be void at the instance of a creditor) and (g), where there had been uncertainty whether a company was empowered to take out insurance on a director who committed breaches of fiduciary duty, breaches of trust. It also helpful that the cover may also include legal costs in defending any actions.

4. Property Speculation is back in Hong Kong- but can you avoid the profits being taxed ?

An improvement in the property market brings back speculators whose sole intention (although denied later)is to seek a capital profit free of Profits tax. Any cursory review however of the numerous cases decided in the Board of Review will soon show that in the vast majority of cases the Board and superiors courts have had little difficulty in deciding that the real intention was to buy for short term gain, and the profits have been held to be taxable on the basis that although Hong Kong has no Capital Gains tax, the purchase was in the nature of a trading activity the profits of which are taxable as a business.

Factors that have assisted the IRD in proving the trading nature of the property purchase has been speculative include the shortness of time between sale and purchase, a purchase entirely or substantially with cash, the listing of the property as trading stock in the balance sheet of the company, the appropriation of trading Stock to another purpose, or the absence of a compelling reason to sell other than the profit itself.

A significant factor can be the absence of comprehensive Board Resolutions not only when the property is purchased, but also when it is sold. Such resolutions, if properly prepared, can prove the intention of the purchaser and the factors taken into account when deciding to purchase or sell.

We have always astonished at the lack of proper Board resolutions in Hong Kong when a property is purchased or sold. Such resolutions that exist will invariably do no more than confirm the purchase and nominate a representative to sign the Agreement or Assignment. Secretarial firms in our view should take care that proper resolutions are prepared lest there is some suggestion later by a disgruntled client that properly prepared Board resolutions may have avoided imposition of profits tax.

In our view preparation of proper Resolutions which are signed before the documents relative to a purchase or sale are signed will very often deflect an attempt by the IRD to tax the profits of a sale. In fact, it is true to say that while the presence of the minutes will not save all transactions from tax, the absence of them in all but the clearest cases of true long term investment will mean it will very much more difficult to establish a long term, as opposed to speculative, intention to hold the property long term for investment purposes.

We have prepared comprehensive Board Resolutions which, amongst other matters, cover:

- (a) the intention in buying the property;
- (b) the criteria for investment;
- (c) The decision to record the property as capital stock in the accounts of the Company or as a long term asset to be held for investment purposes;
- (d) investment calculations based on the discounted cash flow value of the property say 3, 5, or 10 years away, and net present value calculations;
- (e) Calculations on gearing with a mortgage;
- (f) Evidence of discussions with valuers and agents on the long term value of the property;
- (g) A budget showing projected income, maintenance and mortgage costs over a long period and the effect of interest rate adjustments.
- (h) The above criteria will be repeated on a sale process and unexpected factors that have come up to render the long term intention to be frustrated and the long term budget rendered inaccurate may all be factors which a professional long term investor would consider when deciding to sell. Taking a profit that may be superior to a long term hold is an entirely logical decision and the fact that it happens in the short term does not always mean the profits are taxable.

In summary, an investor about to invest in a property would be unwise not to have comprehensive minutes covering the investment factors mentioned, and frankly crazy to try and make do with minutes that simply say that the property was purchased ‘ for long term capital gain” Even if the property is being purchased for personal occupation this factor should be mentioned, as later the property may well be used for rental purposes.

We are happy to prepare and advise on the form and content of Board resolutions to be used where there is the possibility of a sale of the property some time in the future.

5. Becoming Resident in Australia-can an offshore trust structure established before residency survive and be effective ?

As Australia is a popular destination for immigrants from Asia, UK and other countries we propose to mention briefly some of the difficulties in either establishing or maintaining an offshore Trust for the preservation of capital and income after the Settlor of the Trust becomes a tax resident of Australia We are also prompted to raise the issue as we are in the process of advising a client with an offshore Trust structure designed for another country who wishes to migrate to Australia and the whole matter is being considered in conjunction with advice from a leading Australian legal firm.

We do not propose to comment on the effectiveness or otherwise of structures designed to avoid exposure of the capital and accrued income to tax in Australia nor to discuss the Australian legislation in detail. Each case must be considered on its own merits, but we raise the following issues to highlight the difficulties in planning; the Australian legislation is crafted to deal particularly with offshore structures and in that sense it is somewhat different and more encompassing than the legislation in some other countries.

- (a) the nature of the Australian legislation places a premium on getting the initial structure right. More care is needed on how the structure is established.
- (b) How the Trust establishes and capitalizes any offshore company it may hold a controlling interest in is vital;
- (c) The manner of transfer of assets by the Settlor to the Trust structure is different than the traditional way of selling assets and taking a debt back;
- (d) The Australian legislation imposes difficult obstacles in using loan accounts which may have been set up when the Settlor sold assets to the Trust structure, and attempts to secure an income stream of a capital nature in Australia may fall foul of accrual rules which may effectively impose penal interest tax on any payment from the Trust structure;
- (e) Loan accounts may have to be declared for Australian accrual rules;
- (f) The legislation imposes tough rules for determining who controls a trust, and indirect controls traditionally used in the typical offshore trust may not be effective;
- (g) Income that is passive in nature, as opposed to income from a business, may be classed as ‘ tainted passive income ‘ and be attributed directly to tax in the hand

of the Settlor who subsequently becomes resident in Australia, and this whether the income is remitted to Australia or not;

- (h) Intending Settlers would be wise to transfer large amounts of capital and income accrued from it to Australia before they land to avoid certain provisions which can catch accrued income dated for some years before the Settlor becomes resident;
- (i) Loans from offshore companies may be classed as deemed dividends;
- (j) The tax residency rules are such that even a period of two months residency on a frequent basis where possibly business is carried out in that period may mean that the person concerned is legally a tax resident;
- (k) Tax residency in Australia can exist notwithstanding that the person is tax resident elsewhere.

Enough has be said to show that traditional planning and structures of the type routinely used in offshore structures may not work for Australia and indeed may create additional disclosure and tax issues. Even if it is determined that a structure may not be effective it may be that some changes are necessary to ensure that the tax to be imposed in Australia is not made worse by the particular structure that already exists.

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27th January 2004

