

Hong Kong Tax Controversy Insight

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What are the issues commonly scrutinized by the Inland Revenue Department (IRD) when it comes to tax audit?

The usual practice of the IRD when selecting a tax audit case and the normal tax audit procedures undertaken by the IRD have been covered in our previous Hong Kong Tax Controversy Insights. It would be more imperative to understand the common tax issues to be examined by the IRD under a tax audit case. Getting a better understanding of the issues that may be reviewed by the IRD will assist taxpayer to get well prepared for the tax audit and expedite closure of the tax audit case.



Source of profits

The question of source of profits is a practical, hard matter of fact and each case will need to be determined on its own facts. Even after a number of landmark cases where the Court in Hong Kong has reaffirmed the broad guiding principle of determining the source of profits, i.e. "what the taxpayer has done to earn the profit in question and where he has done it", there are still a lot of situations under which the IRD and the taxpayers have different views. Consequently, it would be reasonable to expect that for profits tax cases currently under tax audit, the IRD would seek to examine closely all relevant factual "operations" of a transaction, which might be seen as more far reaching and onerous approach than the principle endorsed by the Court.

Specifically, when assessing the source of a trading profit, the IRD may have a tendency to focus on those activities carried out in Hong Kong which may be considered as antecedent or incidental from the view of the taxpayers, such as business registration, opening and maintenance of bank accounts, book-keeping, business record keeping, etc. On the other hand, where a Hong Kong company does not have business presence on its own in any other non-Hong Kong jurisdictions, the IRD may simply disregard the functions or activities carried out outside of Hong Kong by its group companies.

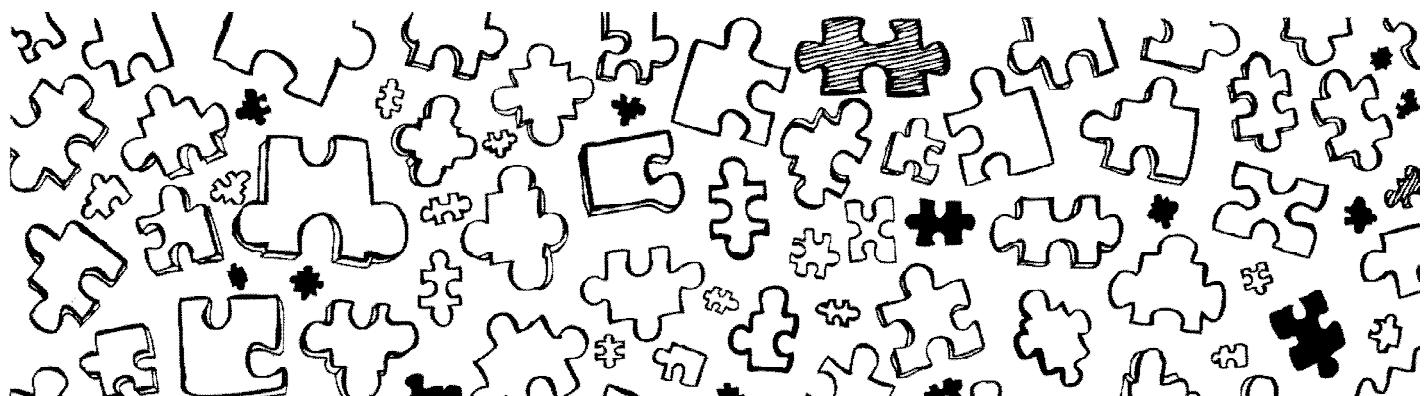
Similarly, when assessing the source of a manufacturing profit, complex issues may still arise as to whether the form or substance be followed. Such assessment are often more complicated in the case of a contract processing arrangement. Experience have shown that the focus of the IRD in those cases tends to be on whether there have been any changes to the manufacturing arrangement, such as the contractual parties, form of the arrangement (e.g. from contract processing to import processing), the business rationale/ other reasons prompting such change and the appropriateness of adopting the same tax treatment when there has been a change in the manufacturing arrangement (e.g. whether the 50:50 profit split basis for tax would still be appropriate).

Transfer Pricing

Transfer pricing governs the pricing basis of charges between associated enterprises for the transfer of goods, services and intangible property. Although Hong Kong has been regarded as a low tax jurisdiction generally, the IRD would not presume that a taxpayer carries out transaction with non-Hong Kong associated companies on an arm's length basis. The rapid development of the international tax regime creates significant impact to both the IRD and taxpayers to arrive at a mutually acceptable transfer pricing. More and more situations arise on the challenge by the IRD with respect to the selection of methodology, comparable search, as well as characteristics of the relevant entities. For example, in an import processing arrangement (where the IRD disagreed with the contention of "substance over form" as in the contract processing arrangement), gross profits arise from trading transactions whereby a Hong Kong company purchases finished goods manufactured by a foreign investment enterprise incorporated in the Mainland and sells them for a profit are subject to enquiries from the IRD.

It becomes more challenging when determining the pricing basis of charges with respect to those cross-border transactions which take place between a Hong Kong company and a related offshore company incorporated in a tax haven jurisdiction. For inter-company charges such as service, management fee, commission, views can be taken very differently between the Hong Kong taxpayer and the IRD on its charging basis and whether the pricing basis adopted by the taxpayer can be considered "at arm's length". It is therefore almost certain that the Hong Kong company would be requested to provide detailed information concerning the basis and nature of the transactions to the IRD.

Provision of supporting documentation and its sufficiency is also one of the challenges often faced by most taxpayers who are involved in a tax audit. Following the development of the Base Erosion and Profit Shifting (BEPS) initiative introduced by the Organisation for Economic Co-operation and Development (OECD) and adopted by Hong Kong, a new direction to resolve tax audit cases could be by way of using transfer pricing methodology. By selecting the most appropriate transfer pricing methodology supported by robust documentation, a defensible position could be well established to substantiate the reallocation of profits between the Hong Kong company and the related non-Hong Kong company.



Deductibility of expenses

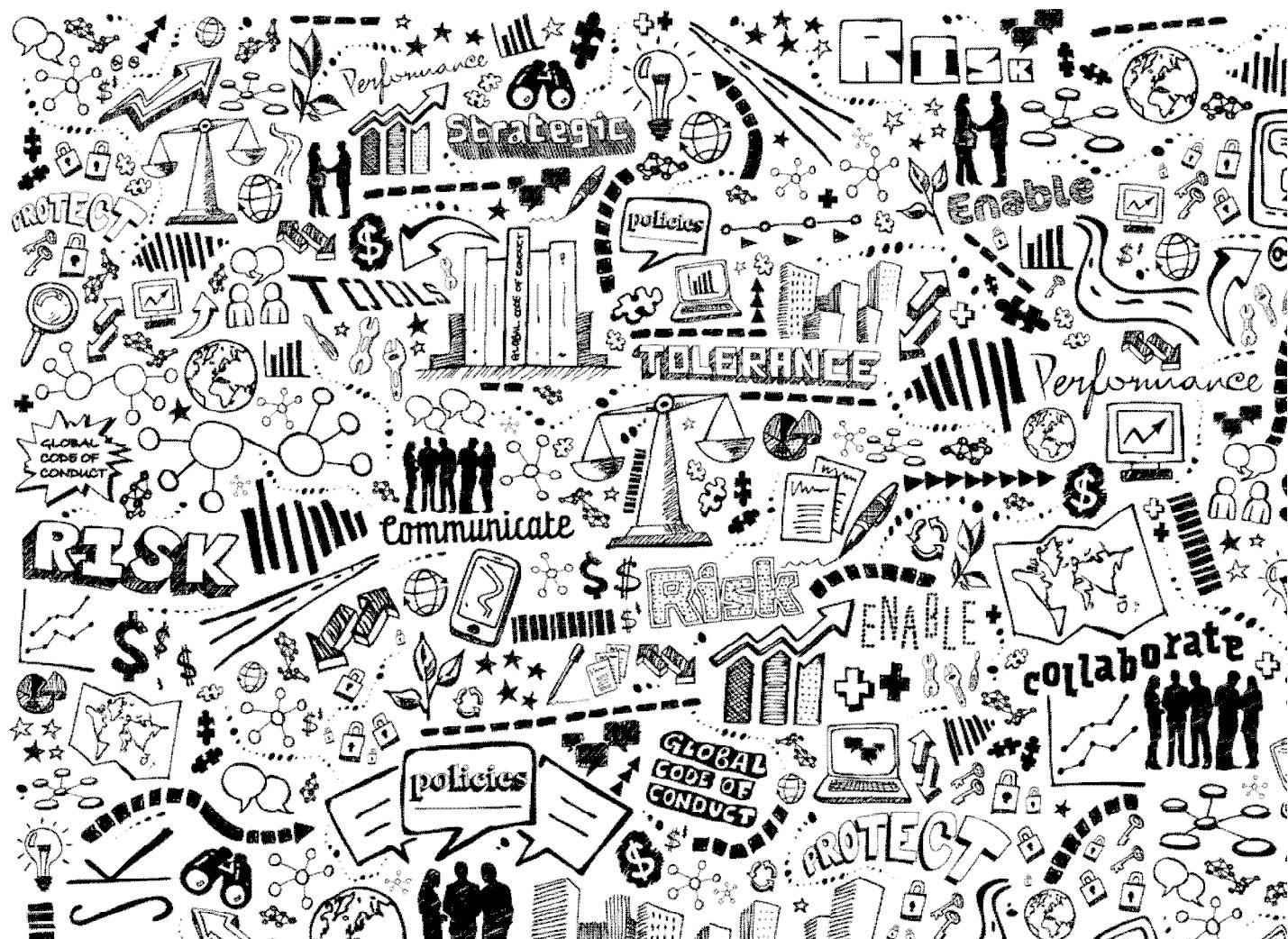
Generally, all outgoings and expenses, to the extent to which they have been incurred by the taxpayer in the production of chargeable profits, are allowed as deductions.

Where transactions involve payments to an offshore related company, the deductibility of such expenses or payments by the Hong Kong entity is usually subject to close scrutiny by the IRD in the event of a tax audit. Further, the IRD may also examine whether any part of such payments were incurred in the production of the related offshore company's profits.

This could extend the tax audit scope with respect to the chargeability to Hong Kong profits tax on the profits derived by the related offshore company.

What's next

Understanding the areas of concern of the IRD and the potential issues involved could make a difference in handling a tax audit. Our next Hong Kong Tax Controversy Insight will cover in more details each of the above common issues and how taxpayers could address the IRD's concern in a more effective and efficient manner.



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