



TECH HIGHLIGHTS

Every month TechWatch provides a comprehensive briefing covering all the latest standards and regulatory announcements from the Institute and other relevant organisations in Hong Kong. The full publication is available as a pdf file on the Institute's website.



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▶ Financial reporting

New disclosures about financial instruments and capital: The IASB's Exposure Draft ED 7 Financial Instruments: Disclosures resulted in a new standard addressing disclosures for financial instruments and an amendment to HKAS 1 to incorporate disclosures about capital:

- HKFRS 7 Financial instruments: Disclosures is based on its IFRS equivalent and will supersede HKAS 30 Disclosures in Financial Statements of Banks and Similar Financial Institutions. It is effective for annual accounting periods from 1 January 2005 and requires all entities to disclose risks arising from all financial instruments, except those covered by more specific standards.
- Amendment to HKAS 1 is effective for annual accounting periods from 1 January 2007. The amendment adds requirements for all entities to disclose the entity's objectives, policies and processes for managing capital; quantitative data about what the entity regards as capital; whether the entity has complied with any external capital requirements, and if it has not complied, the consequences of such non-compliance.

Amendments to standard on financial guarantee contracts: Changes to HKAS 39 Financial Instruments: Recognition and Measurement and HKFRS 4 Insurance Contracts – Financial Guarantee Contracts are effective for annual accounting periods beginning from 1 January 2006.

New IFRIC interpretation: The Institute has issued HK(IFRIC)-Int 6 Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment. HK(IFRIC)-Int 6 is effective for annual accounting periods beginning from 1 December 2005 and deals with accounting for waste management costs under an EU directive.

▶ Audit and assurance

New standard on comfort letters and due diligence meetings: The Institute will issue Hong Kong Standard on Investment Circular Reporting Engagements (HKSIR) 400 Comfort Letters and Due Diligence Meetings on Financial and Non-financial Information. It covers engagements on investment circulars dated from 1 January 2006.

Preliminary announcements: The Institute has issued an exposure draft of proposed Practice Note (PN) Guidance for Auditors Regarding Preliminary Announcements of Annual Results.

Submissions To IAASB: The Institute has made submissions to the IAASB on areas for consideration before finalising the revised ISAs. These cover:

- Proposed revised ISA 260 The Auditor's Communication with Those Charged with Governance.
- Proposed revised ISA 600 The Audit of Group Financial Statements.
- Proposed ISA 705 Modifications to the Opinion in the Independent Auditor's Report and ISA 706 Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report.

▶ Legislation and government initiatives

Financial Reporting Council Bill: The Institute has made a submission on the Financial Reporting Council Bill to the LegCo Bills Committee and has issued a circular to members clarifying some of the issues it is working on.

Law Reform Commission consults on conditional fees: The Law Reform Commission has released a consultation paper on conditional fees. One proposal is to lift prohibitions against conditional fees in certain types of civil litigation.

▶ Corporate Finance

SFC amends definitions of regulated activities: The SFC has published Consultation Conclusions on proposed amendments to Schedule 5 to the Securities and Futures Ordinance in relation to the definitions of “asset management” (Type 9 regulated activity), “dealing in securities” (Type 1 regulated activity), “advising on securities” (Type 4 regulated activity) and “advising on futures contracts” (Type 5 regulated activity).

Submission to the SFC on the regulation of sponsors and compliance advisers: The Institute has responded to an SFC consultation paper on a set of proposed additional requirements regarding sponsor obligations, and proposed arrangements for sponsors to prepare for the proposed requirements.

▶ Insolvency and corporate restructuring

New Insolvency Guidance Notes: The Institute announced the publication of the first set of Insolvency Guidance Notes (IGNs). These establish good practice for members undertaking insolvency work. The notes cover:

- The scope and authority of the IGNs
- Liquidator’s investigation into the affairs of an insolvent company
- Preparation of insolvency office-holders’ receipts and payments accounts
- Disqualification of directors – statutory reports

The IGNs are effective for insolvency appointments from 1 October 2005.

High court reminds nominees in individual voluntary arrangements to submit reports: The registrar of High Court has asked the Institute to remind members to check their compliance with Rule 122Z of the Bankruptcy Rules (Cap. 6A). This rule specifies requirements on the submission of accounts and reports by a nominee. The court may take defaults on Rule 122Z into consideration when reviewing future nominees.

▶ Taxation

Annual meeting with IRD commissioner: The Institute will hold its annual meeting with the Commissioner of Inland Revenue in January 2006 to discuss matters relating to tax practice and procedure. Suggestions for the agenda should be forwarded, along with an explanation, to John Tang, the Institute’s assistant director, Specialist Practices, by 14 November 2005.

Council rules on registration and practising matters

The Institute has drawn up a list of criteria to evaluate the suitability of a membership applicant, as required under section 24(1)(b) of the Professional Accountants Ordinance. Character referees of prospective members should consider these criteria when giving their opinion on the fitness and propriety of the applicant.

Under section 29A(2)(a) of the PAO, the Institute will not issue a practising certificate unless the applicant satisfies the Council that they are ordinarily resident in Hong Kong. The Institute has expanded the conditions for deeming a person as ordinarily resident in Hong Kong to cater to the circumstances of certificate holders based in mainland China.

Quick links

- ▶ **Institute homepage:**
www.hkicpa.org.hk
- ▶ **For full details of Hong Kong standards and updates:**
www.hkicpa.org.hk/ebook/main.php
- ▶ **Law Reform Commission:**
www.hkreform.gov.hk
- ▶ **Securities and Futures Commission:**
www.sfc.hk



DOUBLE TAXATION:
COMPARING HONG KONG'S
AGREEMENTS WITH

Belgium



Hong Kong signed its first comprehensive agreement for avoidance of double taxation with a European country in 2003. The Hong Kong-Belgium double taxation agreement (DTA) was the most extensive agreement of its kind ever signed by the Inland Revenue Department. The agreement became operative on 1 April 2004 for Hong Kong taxes. Hong Kong recently signed another landmark DTA, this time with Thailand. If each side manages to ratify the agreement by the end of 2005, the Hong Kong-Thailand DTA will take effect from 1 April 2006 for Hong Kong taxes. Both these agreements deal with the taxing of income of the resident of one contracting party (the residence jurisdiction) derived from another (the source jurisdiction).

While a jurisdiction will devise a model agreement as the starting point for its discussions, DTAs are concluded through bilateral negotiation and therefore tend to vary from one to the next in their detail. Below we outline six key differences in the agreements with Belgium and Thailand.

1 Definition of resident: Hong Kong adopts a territoriality basis of taxation, whereas most countries, including Belgium and Thailand, adopt a residence basis. The DTAs with Belgium and Thailand both spell out their definition of Hong Kong resident. In the Hong Kong-Belgium DTA, paragraph 2 of the Protocol includes the qualifying criteria for a Hong Kong resident. The Protocol forms an integral part

of the DTA, so the DTA and the Protocol have equal legal force both internationally and domestically.

The Hong Kong-Thailand DTA lists the criteria for a Hong Kong resident under Article 4. This defines companies or other entities as residents of Hong Kong, if they are normally managed or controlled in Hong Kong. Under the Protocol to the Hong Kong-Belgium DTA, companies or other entities qualify as Hong Kong resident if they have their central management and control in Hong Kong, a narrower scope compared to the Thai agreement.

2 Shipping Transport: For income derived from the operation of ships in international traffic, the Hong Kong-Thailand DTA states that income



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derived in the source jurisdiction may be taxed in the source jurisdiction with the tax liability reduced by 50 percent. The Hong Kong-Belgium DTA, however, allocates exclusive taxing rights to the residence jurisdiction.

3 Gains from shares: Both DTAs contain, under Article 13, a provision that awards taxing rights to both contracting parties on gains derived by a resident of a contracting party from the alienation of shares of a company deriving more than 50 percent of its asset value from immovable property situated in the other contracting party. The difference lies in the existence of three exceptions to this taxing rule in the Hong Kong-Belgium DTA. The Hong Kong-Thailand DTA, however, contains no such exceptions.

4. Independent personal services: The Organisation for Economic Co-operation and Development (OECD) deleted Article 14 from its Model Convention in 2000. The article, concerning the taxation of independent personal services, is now dealt with under Article 7 on Business Profits. No differences, in practical terms, were intended by the change. Article 14 of the Hong Kong-Thailand DTA specifically deals with the taxation of independent personal services, as Thailand wants to maintain consistency with its other DTAs. Under that Article, income derived by an individual from exercising independent personal services is only subject to tax in the residence jurisdiction unless the individual has a fixed base regularly available in the source jurisdiction for the purpose of performing their activi-

ties or their stay in the source jurisdiction amounts to or exceeds an aggregate 183 days in any twelve-month period. The Hong Kong-Belgium DTA follows the OECD Model Convention by deleting the former Article 14, with independent personal services being dealt with in Article 7.

5 Entertainers or sportspersons: Under Article 17(3) of the Hong Kong-Thailand DTA, remuneration paid to an entertainer or a sportsperson by the residence jurisdiction can escape taxation in the source jurisdiction, if the visit to the source jurisdiction is substantially supported by public funds of the residence jurisdiction. Such a provision is absent from the Hong Kong-Belgium DTA.

6 Non-government pensions: The taxing rights of the two contracting parties on non-government pensions also varies. Under the Hong Kong-Thailand DTA, non-government pensions made under a public scheme (which is part of the social security system of the source jurisdiction) or under a retirement scheme (which is recognised for tax purposes in the source jurisdiction) are taxable only in the source jurisdiction. Under the Hong Kong-Belgium DTA, both jurisdictions have the right to tax non-government pensions.

These are the most significant differences in the DTAs, although treatments for withholding tax rates on passive income, such as dividends, interest and royalties, also vary slightly. The differences highlight the importance of paying close attention to the provisions of each DTA when assessing tax liabilities from cross-border activities.

Quick link

▶ Full texts of the DTAs can be viewed at:

www.ird.gov.hk



TECH FEATURE

Foreign-invested commercial enterprises:

Investing in China in the WTO era

By Stella Cho

China's commitment to allow full trading rights to foreign investors, as part of its World Trade Organisation (WTO) membership, has led to dramatic changes in the regulatory environment governing the formation, application and approval of foreign-invested commercial enterprises (FICEs). In the last two decades, foreign investment enterprises (FIEs) have been the main vehicle for foreign direct investment in China, particularly in the manufacturing and export-oriented sectors. Until recently, FIEs were unable to establish wholly foreign commercial enterprises outside of free trade zones, where they could set up wholly owned wholesaling enterprises. In essence, foreign-invested distribution and trading businesses were forced to rely on representative offices, trading business joint ventures and manufacturing enterprises selling their own products. These barriers limited foreign investors' access to markets and their opportunities to expand distribution channels.

New measures for FICEs

The promulgation of the 'Measures for the Administration of Foreign Investment in the Commercial Sector' Order No. 8 [2004] by the Ministry of Commerce represented a significant change. They allow the creation of FICEs to engage in wholesaling, retailing, agency services and franchising businesses across China.

Foreign investors are now free to establish wholly owned distribution and trading entities as well as joint venture trading entities. As set out in Articles 21 and 22 of the Measures, this means the formation of a wholesaling and retailing FICE is no longer subject to geographical restrictions. The Measures fulfill China's WTO commitment to allow full trading rights to foreign investors with effect from 11 December 2004.

There was also good news for Hong Kong. Article 25 specifically refers to the Closer Economic Partnership

Arrangements (CEPA) signed with Hong Kong and Macau. Investors from Hong Kong and Macau can invest in China according to the Measures, and also have a head start to invest in designated trading and service businesses.

The lowering of market restrictions since the implementation of CEPA has made it easier for Hong Kong and Macau service companies to expand their businesses, particularly into Guangdong. According to the Guangdong Department of Industrial and Commercial Administration, 1,259 Hong Kong and Macau service companies registered for business in the province in 2004. Their total investment amounted to US\$2.89 billion, a 56.9 percent increase over 2003.



The scope of business and restrictions for FICEs

Under Article 3 of the Measures, the business scope of FICEs covers:

- Agency services such as contracted services and goods provided by agents, brokers, auctioneers or other wholesalers and related subordinated services
- Wholesaling services, commercial and industrial companies and related subordinated services
- Retailing services to individuals in fixed outlets or through television, telephone, mail order, internet, and vending machines
- Franchising services granting the right to use trademarks, trade names, business concepts and business modes, in exchange for remuneration or franchising fees

A FICE must obtain approval from the Ministry of Commerce or its delegated provincial counterparts. The Measures indicate that this process should take four months from the date of application. In an effort to hasten this process, provincial authorities such as in Guangdong may do away with prior approvals and give a guarantee that applications can be approved or submitted to the Ministry of Commerce for approval within five working days.

Article 9 clarifies the permissible scope of wholesaling and retailing services. Wholesalers can sell merchandise in the capacity of commissioned agents and can import and export goods produced either by themselves or by other suppliers or manufacturers. In contrast, retailing enterprises can only import goods and procure domestic goods for export on their own account.

Restrictions still apply on the trading of certain goods, including salt and tobacco. But the Measures lift the restrictions imposed on many other products. For example, the restrictions on wholesaling of pharmaceutical products, pesticides and mulching films were relaxed with effect from December 2004. And, Article 17 stipulates that restrictions on chemical fertilisers, processed oil and crude oil will be lifted with effect from December 2006. However, a 49 percent foreign partici-

pation cap still applies to a FICE which owns more than 30 shops and engages in retailing of books, newspapers, magazines, motor vehicles (restriction due to be removed from December 2006), pharmaceutical products, pesticides, mulching films, fertilisers, processed oil, crude oil, sugar, and cotton.

Requirements for formation of FICE

Although the Measures do not specify the minimum registered capital requirements for the formation of all FICEs, Article 7 has stipulated that a FICE must meet the following conditions:

- The minimum registered capital must comply with the Company Law requirements, namely Rmb500,000 for wholesalers and Rmb300,000 for retailers
- It must comply with the required ratio between total investment and registered capital
- In general, the duration of operations may not exceed 30 years, or 40 years in the central and western parts of China

Article 6 of the Measures states that in considering the approval of a FICE, consideration will be given to the credit standing of the foreign investor and whether it has violated any PRC laws or regulations. Foreign investors with “relatively strong economic strength, advanced commercial management experience and marketing technology, and an extensive international sales network,” are encouraged to set up a FICE.

Outlook

The Measures represent a long-awaited step towards opening up China’s wholesale and retail markets. They show the commitment of the Chinese Government to liberalise the distribution sector. The result is a radical change in the way foreign companies can sell goods and services in China. Minimum asset and annual business volume requirements have been lifted. FICEs may be established at a much lower minimum registered capital. Upon approval by the Ministry of Commerce, foreign investors can establish wholly

foreign-owned commercial subsidiaries.

Existing FIEs can now consider applying to expand their scope of business, to engage in distribution and trading business. Looking ahead, it will be interesting to see how foreign companies adapt to these regulations, to take advantage of the huge domestic distribution markets in China, while ensuring their transactions are structured in a tax-efficient manner.

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Tax considerations for FIEs and FICEs

Under existing income tax laws, a qualified FIE receives a two-year tax exemption and three-year tax reduction. Such preferential tax treatments do not exist for a FICE.

According to *Guoshuifa* [國稅發 1994] 209, if a FIE’s income from productive business does not exceed 50 percent of its total business income, it is denied tax exemption or reduction benefits. So when a productive FIE expands its business to trading and distribution of goods, it may lose its tax benefits.

VAT compliance and planning are also crucial. To qualify as an ordinary VAT taxpayer, the FICE must satisfy more stringent requirements laid down in the circulars, *Guoshuifa Ming Dian* [國稅發明電 2004] 37 and 62. According to these circulars, large- and medium-sized enterprises with registered capital higher than Rmb5 million and with more than 50 employees can apply to be ordinary VAT taxpayers. Smaller enterprises must satisfy the Rmb1.8 million annual revenue test before they can apply for the ordinary VAT taxpayer status, and are subject to a monitoring period of six months before the tax status is finally confirmed.