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Hong Kong: Source of Director's Fee Income

Summary

The recently published Board of Review Case D21/13 held that the director's fee received by the Taxpayer from a foreign incorporated investment holding company that was listed on the Stock Exchange of Hong Kong (the "Company") arose, was derived from, or was sourced in Hong Kong and subject to Hong Kong tax.

The Taxpayer argued that the director's fee was sourced outside of Hong Kong and not subject to Hong Kong tax on the following grounds:

- The Company was formed as an investment vehicle for its Mainland China subsidiaries;
- The majority of the Company's directors, including the chairman and CEO, were Mainland China residents, and the Company's head office was headquartered in Mainland China;
- Therefore, the Company's central management and residency were located outside of Hong Kong.

The Board dismissed the Taxpayer's appeal and held that, irrespective of whether the Company was also a resident elsewhere, the Company resided in Hong Kong, and hence, the director's fee the Company paid to the Taxpayer was sourced and taxable in Hong Kong. In determining the Company's residence, the Board has considered a number of factors in addition to the location of Board meetings, a factor that has generally been regarded as important when considering where a company's central management and control, and hence, residence are located.

The Board found that the Company resided in Hong Kong, as the Company's business and activities were substantially connected to Hong Kong, including, among other things:

- Maintaining its status as a listed company in Hong Kong in order to leverage the Hong Kong bank and financial infrastructure to obtain corporate finance;
- Maintaining its principal place of business, Branch Share Registrar, and the Transfer Office in Hong Kong;
- Holding some of the Company's directors' and committee meetings in Hong Kong;
- Maintaining staff and bank accounts in Hong Kong.

The Board meeting location is just one of the factors under the Board's consideration when determining the Company's residence, and accordingly, the source of the director's fee income for the Taxpayer.

Points to note

Residence of the company paying the director's fee – The source of director's fee for Hong Kong Salaries Tax purposes is governed by the place of residence of the company paying the director's fee. In determining a company's residence, the Inland Revenue Department (IRD) has commonly followed the case law principle of looking at where the "central management and control" [of a company] actually abides. In general, the location of where the directors hold board meetings takes precedence in determining where a company's central management, control, and accordingly, residence are located.

No single determinative factor for deciding residence – In the present case, many of the Company's Board meetings were conducted via teleconference. The Board considered that modern-day companies organized their activities in a wide variety of ways and no single factor was determinative. The factor, the "Board meeting location," is not so paramount to conclude that the Company's management and control location is in Mainland China, as contended by the Taxpayer.

Regarding determination of the source of director's fee income, and hence, where a company's central management and control are located, all the circumstances in which the company paying the director's fee conducts its business may need to be taken into account; although the weight to be applied to each factor will obviously differ from case to case.

A company can have more than one place of residence – In applying the location of management and control testing to a nontrading company such as the Taxpayer's, an investing holding company in this case, it may be doubly important to have regard for the nature of the company's corporate activities.

This case illustrates that the central management and control of a company can be divided, and may "keep house and do business" in more than one place. Like an individual who may clearly have more than one residence, a company can have more than one residence.

Deloitte's view

This case reminds us of the fact that source of income is always a hard, practical issue to determine. As mentioned in another earlier years' Board of Review decision:

> "Source of income is always fact dependent and should not be determined simply by formulae, such as by sole reference to the place the board of directors meets in cases involving the location of the office of a company director"

Professional tax advice is always recommended when facing contentious tax issues like source of income, whether it is employment or director's fee income.

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India:
Supreme Court dismisses Centrica's SLP against HC decision on employee secondment

Background

Fact pattern – Centrica India Offshore Private Limited (CIO), an Indian company and wholly owned subsidiary of Centrica Plc, UK, performed back office support functions outsourced by Centrica Plc and its other overseas subsidiaries in the United Kingdom and Canada. CIO was set up to provide a locally based interface between overseas entities and Indian service providers, and received service charges at cost, plus 15%, under a service agreement with overseas entities.

Simultaneously, a secondment agreement was entered into between CIO and overseas entities for secondment of CIO employees. CIO was to bear all costs of the monthly remuneration of secondees, which overseas entities would recharge to CIO on a monthly basis.

Ruling of the AAR – The Authority for Advance Rulings (AAR), on an application by CIO, ruled against it and held that reimbursement of salary costs to overseas entities was income

accrued in their hands, and tax was liable to be deducted at source on the same. Further, the AAR also held that services provided by employees were outside of the scope of 'fees for technical services' under the relevant articles of the India-UK/India-Canada Double Taxation Avoidance Agreements. Hence, considerations paid to overseas entities were not fees for technical services. However, Service Permanent Establishment (PE) was constituted on account of the employee deputation.

Order of the High Court – Aggrieved by this ruling, CIO approached the Delhi High Court (the "High Court"). The High Court reversed the AAR ruling on fees for technical services and held that there is no distinction between the provision of services by overseas entities and the mere secondment of employees, since the services provided by overseas entities are the provision of technical services through the secondees. The High Court also rejected the arguments put forth by CIO against PE basing its decision, amongst others, on the fact that CIO did not have the obligation to pay remuneration or the right to terminate the subsisting employment with overseas entities. The High Court had placed significant weightage on overseas employment despite CIO having operational control over these persons. Thereby, it appears that the High Court indirectly held that there would be a service PE constituted in case of secondment of employees. However, while deciding on the above lines, the High Court had not independently analysed Article 5 on PE, which specifically provides that where services are taxable under Article 12/13 (fees for technical services), they would not create a service PE.

Issue and Decision

CIO filed a Special Leave Petition (SLP) before the Supreme Court against the above order of the High Court. After hearing the arguments put forth by CIO, the Supreme Court has dismissed the SLP.

Deloitte's view

The order of the Supreme Court does not contain the reasons considered by it in dismissing the SLP filed by CIO. As such, the principles of 'economic employment' as recognized by Indian courts in the past, or the OECD Commentary, have not been deliberated in the instant case. The dismissal of the SLP by the Supreme Court reiterates the need for companies to review their deployment models to determine the true nature of the arrangement. Companies may have to ensure that their documentation is robust and clearly brings out the true intent of the arrangement in order to minimize the tax exposure and probability of litigation.

Source: Order of the Supreme Court dated 10 October 2014

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United Kingdom:
Immigration Update – Changes to immigration rules

Overview

The UK Government published its statement of changes in the immigration rules. The most notable changes are summarized below, including the amendments in the following immigration categories:

- Tier 1 Investor;
- Tier 1 Entrepreneur;
- Tier 2; and
- Business visitors

The changes to the above-mentioned immigration categories will take effect from 6 November 2014 and any applications submitted by 5th November 2014 will be considered under the current rules.

Changes

Tier 1 Investor – The long anticipated change in minimum funds required to apply for a Tier 1 Investor visa is now coming into force and from 6 November 2014, the minimum investment threshold increases to £2 million.

Other significant changes to this category are:

- Removing the need to 'top up' investment if its market value falls below the minimum threshold.
- Removing the option to use loaned money; investors will now need to show cash funds only;
- Changing the way funds can be invested. From 6 November, investors will need to invest the full £2 million by way of UK Government bonds, share capital, or loan capital in active and trading UK registered companies. It will no longer be possible to use 25% of the funds to buy an asset or hold as cash.

No changes have been made to the prescribed method of investment. The Migration Advisory Committee (MAC) previously included recommendations in their report and it is expected that further consultations in this respect and changes may follow in due course.

Tier 1 Entrepreneur – A number of small changes are also being implemented for the Tier 1 Entrepreneur category from 6 November. These include:

- Where an individual is applying in the UK, the required money must be held in the UK;
- A requirement to show that entrepreneurs have invested their funds is being introduced for indefinite leave to remain applications, if applicants have not been required to do so in a previous application;

- A number of clarifications are being made to evidential requirements as well as definitions, such as what constitutes a new business, etc.
- Full details of the clarifications made can be found in the statement of changes **URL:** https://www.gov.uk/government/publications/statement-of-changes-to-the-immigration-rules-hc693-16-october-2014

Tier 2 – Whilst there are no major changes to the Tier 2 categories, the changes will give more power to immigration officers to refuse applications if they have reasonable grounds to believe that the requirements are not met.

Genuine vacancy requirement, this applies to both Tier 2 Intracompany Transfer and Tier 2 General:

- No points will be given for Sponsorship if the job as recorded in the Certificates of Sponsorship is not a genuine vacancy;
- No points will be given for Sponsorship if the applicant is not appropriately qualified for the role;
- Tier 2 General only – no points will be given for Sponsorship if any advertisements are inappropriate for the job on offer and/or have been tailored to exclude the resident workers from being recruited.

Third party and contract workers:

- The existing requirement prohibiting hire of an applicant to fill a position with a third party and prohibiting contractors to undertake an ongoing routine work is now being included in the Immigration rules.

Tier 2 Intracompany Transfer

- Clarification is included to correct a previous drafting error to explain that time spent in the Tier 2 Intracompany Transfer category does not count towards the six-year limit on Tier 2 General when switching from the Tier 2 Intracompany Transfer category to Tier 2 General in the UK.

Tier 2 General

- Extension of the exemption from the resident labor market test for extension applications where the migrant submits the application within 28 days following expiry of current leave.

Business Visitors – Additional activities are being added to the permitted business visitors' activities, these include:

- Allowing scientists and researchers to share knowledge, expertise, and advice on an international project which is being led by the UK, provided the visitor is paid and employed overseas, and not carrying out research in the UK; and
- Creating a provision for overseas lawyers, to advise a UK client on litigation and/or international transactions as employees of international law firms, provided they remain paid and employed overseas.

Knowledge of Life in the UK and Indefinite leave to remain – Applicants may be required to attend an interview as part of their indefinite leave to remain application.

If reasonable doubt exists, immigration decision makers may require applicants to provide additional evidence of knowledge of the English language and/or knowledge of life in the UK.

Deloitte's view

The changes come as no surprise as the majority of Tier 1 changes have been recommended in the MAC report. The report was published in February 2014, giving potential applicants enough time to submit their applications under the current rules.

Tier 1 applicants still have two and half weeks to apply under the current rules, but from 6 November, they will need to meet the new rules, including demonstrating that they have £2 million of cash for a Tier 1 Investor visa. There could be delays in processing applications if an unexpected number of applications are submitted prior to 6 November. Applicants are advised to seek specialist advice to see if they can make their application before the rule changes.

The changes on Tier 2 should not have an effect on sponsors as they merely seem to clarify what has been an established practice previously put in place to ensure immigration compliance.

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Global Rewards Updates:
Bermuda: Change in payroll tax treatment

Background

Payroll tax is charged in Bermuda on employers with employees that are wholly or mainly employed in Bermuda and who provide services during any tax period. Payroll tax is currently payable at 14% on employee remuneration, which includes benefits derived by the employee as a result of his/her employment, whether paid in cash or in kind. Therefore, although share-based awards are not subject to income tax or social security in Bermuda, they are subject to payroll tax.

Although payroll tax is an employer liability, employers can (but are not required to) recover 5.25% of the 14% payroll tax rate from employees.

Change in payroll tax treatment of share options

The Office of the Tax Commissioner ('OTC') of Bermuda has previously generally taken the position of treating share options granted to employees as subject to payroll tax on the difference between the fair market value and the exercise price of the share options at the date of grant. This meant that there would be no tax on any market value options (i.e. share options with an exercise price equal to the fair market value at grant).

Recently, the OTC revised this policy on the point of taxation for share options. This has occurred without any corresponding changes or amendments to current legislation. The OTC's revised position is that, effective for reporting tax periods beginning on or after 1 July 2014, share options granted to employees on or after 1 July 2014 will now be subject to payroll tax on the difference between the fair market value and the exercise price only when the options have vested/become exercisable.

Application to other equity awards

The OTC has confirmed that the change in the tax point for payroll tax purposes can be applied to other share-based awards similar to share options. For typical PSP/RSU plans, payroll tax should now also be payable at vesting (on the fair market value at vesting), rather than at grant (on the fair market value at grant).

Transitional provisions

New share option plans or similar benefits granted to employees on or after 1 July 2014 will be eligible for the revised treatment. However, no refund claims will be accepted for payroll taxes that have already been reported and paid under the previous policy.

The OTC will consider refunds for payroll taxes already paid at the date of grant on share option rights and conditional share awards that were subsequently forfeited due to employment termination/failure to meet performance conditions before the end of the vesting period. This remains consistent with prior OTC policy.

Action

Companies should revise their processes, to ensure that they are making payroll tax payments according to the revised policy:

- For awards granted prior to 1 July 2014 – payroll tax is payable at grant on any positive difference between the fair market value at grant and the exercise price (if any);
- For awards granted post 1 July 2014 – payroll tax is payable at vesting on any positive difference between the fair market value at vesting and the exercise price (if any).

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Have a question?
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