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IN THIS ISSUE:

Employment law- can an Employer vary the terms of an employment contract without the consent of the Employee ?

Re- invoicing-source of profits in Hong Kong- latest IRD approach- a need to review method of operation of re- invoicing companies ?

Trusts- wealthy husband and wealthy wife- creation of joint, parallel or mirror trusts

Self dealing by Directors- can a resigning Director seize a corporate opportunity afforded to his previous employers ?

Offshore trusts- how to extract tax effective profits from them- two UK cases where benefit conferred escaped the tax net.

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Employment Law in HK

1. Right for the Employer to vary the terms of an employment contract

It has been all too common in tough economic times in HK for there to be a renegotiation of the terms of an employment contract, but are their any limitations on what an Employer might do, and are there remedies for the Employee if the Employer simply dismisses the Employee if he or she fails to accept the new terms ?

The following general principles apply to a situation where an Employer insists on a wage reduction or other variation of the employment contract:

(a) If there is a term in the Employment Contract with allows an Employer to vary the terms of the contract, the Employee may have to accept the variations. However, such a term in a contract would be unusual.

(b) Where an Employer has no contractual right to vary a contract, an Employee may be protected by the provisions of Part VIA of the Employment Ordinance, which provides the Employee with a right of compensation where there is an unauthorized variation.

(c) Part VIA however is only available to the Employee if he or she can establish that the variation has been undertaken

Employment Law in HK (contin)

without the consent of the Employee, and is unreasonable.

(d) A variation will not be regarded as being unreasonable where it is undertaken for any of the following reasons:

(i) the unacceptable conduct of the Employee;

(ii) the redundancy of the Employee or other genuine operational needs of the Employer;

(iii) capability of the Employee to perform different work;

(iv) in order not to breach the law;

(v) any other reason of substance.

Comment: Obviously there may well be difficult issues arising when the general conduct of an Employee is advanced as the reason for variation. Obviously race, religion and age are not valid reasons, as discrimination legislation may apply, but where say staff are asked to go to a part time employment basis, and benefits will be lost, does Part VIA apply ? The answer is that where statutory rights may be lost, the legislation gives the Employee three remedies, which are re- engagement, re-instatement or a termination payment.

In general, where Employers wish to vary employment contracts, they would be well advised to pay out any statutory benefits to staff, and then re- employ them on new terms, which may technically involve a termination.

.**Source of Profits**

The following set of facts were taken from the IRD advance rulings Web Site, and are a typical example of the "re-invoicing" arrangements so common in Hong Kong. However, as mentioned below, it is instructive to compare this case, where the IRD ruled that the profits of the HK Company were subject to profits tax, with another case where the profits were ruled not assessable.

(a) A HK Company maintains a registered office in Hong Kong through a local accounting firm (the Hong Kong Office).

(b) The beneficial owner of the Company is Mr. A, living in Australia, who is the sales manager of Company B, which is a company incorporated in Australia and is a major supplier of the Company.

(c) Mr. A is responsible for negotiation and conclusion of sales and purchase contracts, for both Hong Kong and overseas sales.

(c) The local accounting firm will perform documentation and other administrative works, such as preparing purchase and sales orders, invoices, operating bank accounts and maintaining accounting records, under instructions from Mr A.

(d) The goods are mainly sourced from overseas suppliers. The local accounting firm places the purchase orders to the suppliers and accepts sales orders from customers in Hong Kong under Mr. A's instructions. The suppliers then send the invoices, packing lists and other documents to the Hong Kong Office.

(e) The suppliers deliver the goods to the HK. Company for sales to local and other overseas customers and the goods are kept in warehouses in Hong Kong.

(f) The Company pays the suppliers by

The arrangement

(a) A PRC agent is appointed by Company B to act as its agent for the sales of accessories to a customer in PRC.

(b) Mr. A negotiates with the PRC customer and the said PRC agent directly for price, quantity, quality and shipment of the sales and at the same time negotiates with the supplier in Italy for price, quantity, production schedule and delivering of the goods.

(c) Upon confirmation of sales, Mr. A will ask the PRC customer to issue purchase orders to the Hong Kong Office directly and at the same time inform the local accounting firm of the details of the transactions. Then the local accounting firm will place purchase orders to the Italian supplier in accordance with Mr. A 's instructions. The goods are shipped to the PRC customer directly.

(d) The settlement from the customer and to the supplier are by L/C on a back-to-back basis arranged by the local accounting firm.

The above case may be contrasted with a second case where the facts were broadly similar, except that there was an Indonesian supplier, and a US buyer, all contracts were signed outside HK, and no goods were warehoused in HK. The IRD ruling was that no profits arose in HK.

Comment: The second ruling was no doubt based on the IRD practice note DIPN21 which exempts profits where the sole function of the HK company is to issue or accept an invoice, arrange L/Cs, operate a bank account etc, whereas in the first ruling it seems significant that there was a **purchase order** with the Italian firm (only invoices issued as a result of a contract already entered into outside

(**Source of Pofits- contin.)**

HK qualify for exempt treatment under the practice note) and there was a stock of goods in HK thus re-enforcing the position of the IRD that the real operations of the HK company were carried out in HK.

Although the intention of the IRD to exempt the true invoicing company (one that carries on no real business in HK but simply transacts with overseas group companies to shift profits from another jurisdiction) is manifested in PIPN21 and will no doubt continue to be observed, the requirement that orders issued or accepted in HK will give rise to a taxable transaction or imply that real operations are carried out in HK seems illogical, and if enforced, will hit a number of re- invoicing companies.

It would be as well for those operating re- invoicing companies to review their mode of operations to ensure that overt orders and other indicia of operations in HK are perhaps avoided so as to fall squarely within paragraph 9 of DIPN21, which sets out the exemption in full.

Self Dealing- Corporate Opportunity

This may be briefly mentioned and applies where a Director identifies a business opportunity but then appropriates it himself after leaving the Company. This is allowed so long as the Board, with all the facts, has declined it, and offered no objection to a Director proceeding personally. However, where there is a 'maturing opportunity' only available through the Directors connection with the Company, the courts will award damages to the Company for the loss.

Comment: This is particularly so where there is evidence that the desire to leave the Company was motivated by a desire to seize the maturing opportunity which might not have been available solely on the basis of a fresh initiative by the Director.

Joint, Parallel and Mirror Trusts

While it is more common in HK for the husband as Settlor of a Trust to be possessed of most of the family wealth, there are occasions where the wife herself is possessed of equal or substantial assets and there may be a desire on the part of both parties to leave their estates to their surviving spouse and the children or remoter issue. In this situation the use of a joint trust or separate mirror or parallel trusts may offer some advantages.

We may define these different trusts as follows:

(a) **Joint Trusts:** As the name implies, this involves both husband and wife establishing one trust together and appointing themselves, children, grandchildren and remoter issue as beneficiaries. The power to remove beneficiaries may be vested on both husband and wife as appointors, but difficulties may arise if there is death of one spouse or a matrimonial break up where there may then be doubt as to whether the two spouses while alive, but separated, or the surviving spouse, can agree on amendments or exclusion of assets or beneficiaries. In this type of trust the home should be excluded.

(b) Mirror Trusts: This was an estate duty planning device where each spouse establishes a trust, transfers their assets to it, and makes the beneficiaries the other spouse and the children. The disadvantage in a matrimonial dispute, where each spouse is also a trustee of each trust, can be imagined, as the spouses will not wish to give their property to the other, but each as Trustee may not be prepared to change the provisions.

(Trusts- contin.)

(c) **Parallel Trusts:** This is the same as a mirror trust except that under each trust each Settlor is a beneficiary and each spouse has some degree of control over the trust's assets.

Although use of the above structures in estate planning to avoid HK estate duty may not be appropriate in all cases, uses of these trusts in the offshore arena, and not purely domestically, may well offer advantages and allow both spouses to settle their own assets and benefit their surviving spouse and children, while at the same time safeguarding their respective assets from a marriage break up or other dispute.

To avoid potential difficulties:

(a) there be two trusts, each settled by husband and wife respectively, with each transferring selected income and capital appreciating assets to their respective trusts;
(b) the trustee be an independent trust company or an offshore trust company owned by both spouses;
(c) the beneficiaries of each trust be the other spouse and the children, remoter issue;
(d) each spouse be the Protector of his/her respective trusts with power to the Protector to approve distributions, change or exclude beneficiaries, change the Trustee etc. This power of the Protector may be given to a trusted friend instead, and a replacement Protector may be appointed by the existing Protector or named either in the Trust Deed or in a will.

Trusts (contin)

The advantage of this arrangement is that in the event of any disagreement, death or marriage breakup, each settlor spouse can then decide to exclude the other spouse from their respective trusts if they wish to, and can also change trustees, appoint or exclude beneficiaries etc.

(d) That only income producing and capital appreciating assets be transferred to the trusts, with the matrimonial home being vested in husband and wife as joint tenants, with rights of survivorship, or, if there is doubt about that, as tenants in common in equal shares, with no rights of survivorship.

Comment:

It is all too easy to forget the possibility of matrimonial break up when forming trusts, and although " trust busting'' through robust matrimonial property laws is not a feature of the law in Hong Kong, it is in other commonwealth countries. In some cases courts have not been slow to trace assets transferred to a Trust which has the effect of putting what might have been matrimonial property beyond the reach of the wife. However, given that HK does not at the moment have matrimonial laws that allow a classification and automatic sharing of matrimonial property, spouses would be wise to set up their own trusts with their own assets on the basis suggested so as to allow a measure of control should matrimonial difficulties emerge.

Loan from Offshore Trust- legitimate tax avoidance ?

A case from the UK tax tribunal deserves attention because it demonstrates the legitimate use of an offshore trust and the provision of a tax effective benefit to a beneficiary who was a tax resident in the UK at the time a loan was made by the offshore Trust.

G who was Japanese transferred a large amount of money to a Bank in London. He later transferred the money to another Bank in Jersey on advice that the UK deposit would be subject to 40% UK Inheritance Tax in the event of his death. Subsequently G set up a trust in Jersey of which his granddaughter B was a discretionary beneficiary. B was UK ordinarily resident.

The trustees made a payment to B to help her buy a house. She was assessed to income tax on the payment under sec. 740 of the UK Tax Act (a tax avoidance provision) and appealed on the grounds that neither the transfer by G nor any associated operation were effected for tax avoidance purposes.

As an initial point the Special Commissioners decided that the test of purpose under sec. 741 was a subjective rather than an objective test and that it was therefore appropriate to look at G's motive and purpose. They then noted that a distinction was to be made between tax avoidance and legitimate tax mitigation. A taxpayer had always been free to arrange his affairs to mitigate tax. It was perfectly legitimate, for example, for a non-UK domiciled taxpayer to open an account with a London Bank in a foreign currency rather than sterling to prevent the balance being subject to Inheritance Tax in the event of his or her death.

(Loan from Offshore Trust (contin)

It was equally legitimate to transfer a sterling balance to a Bank in Jersey to prevent an Inheritance Tax charge. The Special Commissioners decided that the sec. 741 defence was available to B and quashed the assessment.

Comment: It is not clear from the facts given in the report whether the funds paid to B were in the form of a loan or a cash advance, but certainly under HK law it would not matter, as such an advance would not, it is submitted, be caught under any category of income in HK, nor would the anti-avoidance provisions in HK be deemed to apply.

However where such advance was made in other commonwealth jurisdictions it might well be caught under legislation that attempts to tax distributions from trusts, and there is always the possibility that the case quoted might be appealed by the IRD in the UK.

It is also interesting to compare this case with the other UK case quoted in this Newsletter, where the form of a loan from the offshore trust was of some importance in the classification of the benefit taken be the beneficiary.

Offshore Trust- interest free loan to beneficiary- whether taxable benefit arising

Although not so much of an issue in HK, the method of extraction of funds from an offshore trust by the Settlor, who may have made loans to the Trust, or a beneficiary, is a vital issue in commonwealth countries and the USA whose legislation seeks not only to tax income accrued by offshore trusts set up by resident or returning settlors, but also seeks to tax distributions to tax resident settlors and beneficiaries either on the basis that such distributions are income, capital gains, or are perhaps loans which indirectly confer taxable benefits on the beneficiary.

The following case which occurred before the UK tax tribunal gives a good illustration of the tax issues involved where there has been a loan from an offshore trust to a tax resident, who was in fact the settlor of the Trust. Although UK tax legislation involved, analagous legislation exists in many countries.

The Chargeable Gains Act 1992, sec. 86 in UK contains rules which attribute the capital gains of non-UK resident trusts to beneficiaries who receive "capital payments" from the trusts. The beneficiaries (provided they are UK domiciled and UK- resident or UK-ordinarily resident) are then, in broad terms, charged with UK capital gains tax on those attributed gains. Sec. 97(4) of the Act provides that for the purposes of sec. 87 "the amount of a capital payment made by way of loan ….. shall be taken to be equal to the value of the benefit conferred by it."

Offshore Trust – interest free loan(contin)

Facts: C, was domiciled and resident in the UK, and received interest free, upon demand, loans from trustees of a non-UK resident trust of which he was settlor. He was assessed to tax on attributed capital gains on the basis that the benefit conferred by the loans was an amount equal to interest which a commercial lender would have charged on those loans.

The Special Commissioners noted, inter alia, that the legislation assumed that the making of a capital payment would be a single identifiable event. The date of this single event was relevant to the rules which matched gains and payments. At the time of the making of the loans however, the value of the benefit conferred was very small because the loans were repayable on demand. The Special Commissioners decided that the only relevant benefit C received was this negligible benefit at the time of making the loans. There was no continuing benefit to be ascribed to C in respect of any notional interest.

Comment: This case represents an interesting technical win for the taxpayer and prima facie opens up planning possibilities for not only UK-beneficiaries of offshore trusts, but possibly other jurisdictions. However, it cannot be ruled out that the case will be taken to the High Court and perhaps beyond.

Offshore Trust – interest free loan(contin)

A vital point in the case was the confirmation by the Tribunal that the fact the loan was " upon demand" mitigated any supposed interest free benefit, and this principle has been confirmed in other jurisdictions.

Just how loans are structured will depend on a number of factors, and our own view is that this a vital consideration to the Settlor of a trust, and not enough attention is paid to the preparation of Promissory Notes and other loan instruments. In certain cases, other terms may have to be included so as to not only make the loan commercial, but also, in estate planning , to convert the loan into a specialty and perhaps secured debt. The terms may also depend whether the loan was the result of a sale of assets to the Trust or a fresh advance, the latter in our view being very risky and subject to scrutiny by the IRD in many jurisdictions. In all cases, close scrutiny of the applicable tax legislation that may apply is vital.