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INTERNET NEWSLETTER- April 2006

Issue 15.

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1. Transfer of Pregnant Employee- Breach of the Employment Ordinance

The Employment Ordinance, Cap 57 ("the Ordinance"), gives a measure of employment protection to employees who become pregnant. Provided that the requirements relating

to continuous employment and the giving of notice of pregnancy are satisfied, such an employee is entitled to a period of maternity leave and may be entitled to four-fifths of her normal pay. In addition, s 15(1)(a) prohibits termination of the employment during the maternity period.

Where an employer dismisses the pregnant employee in contravention of the statutory prohibition, s 15(2) imposes a liability to pay the employee sums which she would have been entitled to under the Maternity Protection provisions of the Ordinance. Moreover, by s 15(4), such an employer also commits an offence punishable by a fine.

In a recent case the Court of Final Appeal found that the Employer had breached the provisions of the Employment Ordinance by attempting to transfer the pregnant employee to another company in the Group.

Brief facts were:

(a) The respondent began working for a state-owned mainland corporation called China Merchants Holding Co Ltd ("CMH") in 1994. In 1998, she was transferred by CMH to work for the applicant, a Hong Kong subsidiary of CMH. After an interlude when she worked for a fellow Hong Kong subsidiary of CMH, she resumed her employment with the applicant in August 2000.

(b) The respondent became pregnant and (after taking advice from the Labour Department) served notice of such pregnancy on the applicant on 17 December 2001. The notice stated that her expected date of confinement was 23 April 2002 and that she intended her maternity leave to commence on 15 February 2002. It was duly supported by a medical certificate and was a valid notice for the purposes of the Ordinance.

(c) The applicant's response was to inform her on the next day, 18 December 2001, that she was to be transferred back to the mainland to work at Shekou for a mainland subsidiary of CMH called Shekou Ming Wah Shipping Co Ltd ("SKMW") with effect from 17 January 2002 (ie, a month later). On 25 December 2001, she received notices from the applicant requiring her to report to SKMW on 17 January 2002 and to return all company effects to the applicant before then. By her letter of 27 December 2001, the respondent informed the applicant that she was unwilling to accept the transfer. She did not in fact appear as instructed at Shekou on 17 January and was consequently treated by the applicant as having left the company.

The Court held that there had been termination on the grounds that:

(1) Section 15(1)(a) stipulated that "the employer shall not terminate her continuous contract of employment otherwise than in accordance with section 9 during the [relevant] period". There was no ambiguity and there was no basis for cutting down this limited protection by pointing to an offer of alternative employment

under a new contract with some other entity, albeit an entity which was a member of the same group of companies;

(2) Even if the order for transfer was not a termination and s 15(1)(a) was not engaged the Court held that it begged the central issue in the case. If it *was* a termination and the section engaged, the order to transfer would obviously not be lawful. The employee's subsequent failure to report for work at Shekou could not thereafter constitute disobedience of a lawful and reasonable order and no dismissal under s 9 could be justified.

Comment: Although it may come as surprise to many employers that a transfer within a group could amount to termination, the court has adopted a strictly literal interpretation of the legislation, which, on the face of it, appears to be correct. It should be noted that the Court was not persuaded to change their decision despite the fact the employee's visa had expired and the Employer risked prosecution by Hong Kong immigration.

2. **Can an Employee ask for Commission to be included in the calculation of holiday pay and annual leave pay ?**

This seems an obvious issue, and yet it seems it is the first time it has been considered by the Court of Appeal in Hong Kong.

The case involved an employee who earnt only some HK$5000.00 per month basic salary but in addition, earnt over 5 times the basic salary from commission. The Employee argued that she was entitled to additional entitlements of holiday and annual leave pay if commission received on a 12 month basis was included in the calculation.

On the basis that commission was calculated on a daily basis, the Court considered the Employee might have a case, but since the commission was accrued and calculated on a monthly basis sections 41 (2) and 41C (2) of the Employment Ordinance could not assist the Employee. No commission therefore was to be included in the calculation of holiday pay and annual leave pay.

Comment: This case serves to demonstrate that for the avoidance of misunderstandings it might be wise to include a term in employment contracts where large amounts of commission are payable that commission does not come into calculations of holiday pay or annual leave pay, and, moreover, is not calculated on a daily basis.

3. **The Test for Interest Deductions on Shareholder Loans advanced to a Company**

Zeta Estates Ltd v IRD was decided in the Court of Appeal on the 6/3/06. This is an important case and has tax implications, especially for any shareholders with disposable capital who may from time to time have to consider funding the company at the time a dividend is declared.

The case also shows that to simply rely on the fact that interest on shareholder loans must be deductible on the basis that any loan to the Company from shareholders is for working

capital can be wrong, and that it seems the court will look further into the use of the additional capital advanced to establish if it really was for the purpose of producing assessable profits, or was an attempt to replace capital used in the distribution of a dividend, or an attempt to obtain deductions when the advance was not used for working capital.

The brief facts were:

(a) On 1 July 1998 the directors of Zeta ("Appellant") declared an interim dividend of $40,000.00 per share in the total amount of $396 million and on 28 February 1999 they declared a final dividend of $60.00 per share, in the total amount of $594,000.00;

(b) The declared dividends were not paid over in cash but, by a series of accounting entries made on the same dates, they were credited to the accounts of the shareholders or their respective associates as loans with interest charged thereon (the new shareholders' loans).

(c) It was the Appellant's case that immediately prior to the declaration of dividends the appellant's business was funded by shareholders' loans of approximately $400 million (the old shareholders' loans), and retained profits of approximately $407 million, and that immediately after the declaration of dividends, the appellant's business was funded by the old shareholders' loans and the new shareholder's loans.

(d) Counsel for the appellant submitted that the new shareholders' loans were required as working capital and that by working capital he referred to circulating capital available which was not invested in fixed assets and therefore available for the day to day business of the company.

One witness for the Appellant said that the purpose of the transactions was to allow the distributions to be made while another witness, somewhat unwisely, said that the purpose was to allow shareholders to earn interest income.

The Court concluded that:

(1) the purpose was not to produce the chargeable profits of the taxpayer but to reduce them;

(2) the Appellant in its submissions had argued that the loans made were to replenish its working capital after distribution of the dividends. The Court did not agree with those submissions. The Court considered that there was no evidential basis to support the argument that fresh working capital was needed in the light of the continuing operations of the Appellant having regard to its financial circumstances and, if such working capital was needed, then the directors should

not have recommended paying a dividend, since the Appellant was not in a position to pay one.

(3) The Board concluded that the loans were obtained for the purpose of paying the dividends and the interest expenses were therefore attributable to the dividend payments - so that they could not be said to have been incurred in the production of the Appellant's profits."

Comment: It is our view the decision is wrong. Advance of the shareholder loans was at the end of the day replacement of circulating capital and to decide that the funds advanced could be separated from that seems to be illogical. Advances of loans used by the Company even for the purpose of paying dividends or replacing earlier loans are nonetheless advanced for the purpose of the company earning assessable profits, and the interest on the loans themselves in the shareholders hands are assessable to tax.

4. **Avoidance of Hong Kong Tax on Income from Services Performed Offshore**

This topic appears again and again in Board of Review cases with similar fact situations and invariably with the same result. Almost always an Employee from a parent company offshore is seconded to Hong Kong or an Employee from a Hong Kong company is seconded to work in China. There is then an argument advanced that the Employee has performed significant services outside Hong Kong, but the Board of Review usually reject the argument on the basis that either the situs of the employment contract was Hong Kong or that services meant to be performed outside Hong Kong were in fact, even in a small way, performed in Hong Kong or had of necessity to be performed in Hong Kong.

Lack of planning in this area can have disastrous results. As an example of what not to do, we mention a tax case we are involved with at the moment where the Vice – President of an offshore parent was seconded to Hong Kong to liase with the HK subsidiary. No services were performed in HK, but payments were made by the HK subsidiary to the Employees offshore BVI service company, and inexplicably, and in error, reported as salaries income to the IRD. The resulting assessment of a large amount of tax has been made by the IRD on the basis that although no services may have been performed in HK(there has been however some minor attendances) salaries were paid by the HK subsidiary and the source of employment is therefore Hong Kong.

It is beyond the scope of this article to discuss all the tax law that is applicable to this much vexed issue, but we would mention the following points:

(a) it must be appreciated that HK tax will be assessed in respect of services rendered in either Hong Kong or offshore if the employment contract is made in Hong Kong or the salary or remuneration is paid by a Hong Kong company. This is the cardinal principle in the leading case on the subject, Goepfert v IRD;

(b) If there is a parent company and a subsidiary and the Employee will work for both inside and outside Hong Kong, there must be two employment contracts;

(c) Remuneration under an offshore contract should not be charged back to the Hong Kong employer;

(d) It must be remembered (and it was confirmed a recent Board of Review case) that even a small attendance or employment related meeting in relation to duties to be performed under the offshore contract may prejudice the whole planning arrangement;

(e) Proper drafting of the two employment contracts is vital; simply throwing together two similar employment or consultancy contracts will not do. Some of the issues to be addressed in each contract include:

1. there must be a careful description of duties to be performed in each contract. Simply saying that some part of the same work is done in different countries will not work;

2. The contracts must provide for the amount of time spent on the employment, and obviously time to be spent on the other employment should be also spelt out;

3. It is vital that the proportion of salary paid offshore be commensurate with the actual time spent working offshore;

4. Who the Employee reports to is vital. Obviously the offshore contract should not nominate a person in Hong Kong;

5. It is quite in order for each contract to refer to the other and in some cases it may be appropriate to provide that one contact has priority over the other in the event of a conflict;

6. There are other important issues that must be addressed, such as provision that the HK duties may be performed overseas, recharge of costs for benefits granted under one contract, but not under the other, and provision of pension rights and stock option;

7. Separate payment of salaries, separate name cards, letterhead etc are all obvious issues that need to be addressed;

8. Where possible, consultancy arrangements are preferable to employment contracts.

9. Make sure that accountancy staff in the Hong Kong office do not do something silly. Proper reporting to the IRD is essential and an incautious salaries tax return filed with the IRD including benefits under an offshore contract may bring about unforeseen tax assessments.

Comments: We offer advice and planning covering the above issues, including preparation of appropriate documentation. Proper planning can offer large tax savings, but as a fundamental principle it must be recognized that simple performance of services outside Hong Kong is no guarantee that tax on the income from these services can be avoided.

5. **China Law**

On the 27/10/05 The National Peoples Congress promulgated a revised company law which made fundamental changes to formation, governance etc.

Of most importance were:

(a) reductions to the registered capital to RM30,000.00, and RM500,000.00 for a joint stock company. These are significant reductions from previous levels;

(b) Payment of the capital in stages, and over a period of two years;

(c) 70% of the capital may be in the form of transfers of intellectual property, tangible assets, property, non patented technology;

(d) A single person limited company may now be established with a minimum capital of RM100,000.00;

It is also possible now for creditors to " pierce the corporate veil" and liability is now thrust upon shareholders and directors where losses occur as a result of shareholder and director defaults.

Comment: These and other significant changes mean that China is increasingly adopting western models and practices in the company law field.

6. **Tax Holiday for Employees working in New Zealand.**

As we are engaged in the associated offshore Trust area, we mention briefly legislation passed in New Zealand recently which would grant a tax holiday to employees going to work in New Zealand for a period of years, or migrating with a business permanently.

In summary:

(a) The legislation sets up a two tier system;

(b) The first tier exempts employees for 5 years;

(c) The second tier is a three year exemption for all migrants for 3 years;

(d) The exemption is calculated on tax years, not 12 month periods;

(e) The exemption extends to all dividends and income, and harmonises with a similar regime in Australia;

(f) Tax residency will be re- defined so as not to catch a person making a preliminary visit to New Zealand and being caught in a back dating of residency when arriving permanently;

(g) Bonus payments paid before coming to New Zealand are exempt;

(h) A period of time (54 days) is given for an employee to locate full time work;

(i) The exemption is not available to a former NZ resident unless they have lived outside NZ over 10 years, as new and returning residents must not have been tax resident for 10 years;

The question for some employees, new migrants and returning new Zealanders is whether there is still place for a foreign trust set up before they become resident in New Zealand.

The answer is our view is yes because:

(a) once you are tax resident the opportunity to establish a foreign Trust may be lost;

(b) the bill is in draft form as yet and it is not clear if a trust was established while a person was tax resident whether it would have exempt status as far as distributions were concerned. The legislation only covers dividends and interest;

(c) Receipt of dividends, interest etc would mean the IRD may gain access to assets held offshore and future planning may be difficult, although there is no certification process through the IRD to obtain exempt status, and self assessment is allowed;

(d) Election to treat the offshore trust as a resident trust is specifically referred to, and the election it seems may take place at the end of the exemption period.

Comment: The temporary exemption regime will be of most interest to employees without substantial assets offshore, and we still recommend pre- migration and trust planning for those with businesses and other significant assets.

7. **Amendments to New Zealand's Offshore Trust Regime**

Those familiar with the New Zealand's offshore trust regime will know that there is an exemption from tax on offshore income earnt outside new Zealand and no requirement for the NZ trustee to file any returns of income with the IRD in New Zealand.

As from the 1/10/06 there will be a change to the non- reporting requirement. Ostensibly it says because of obligations it has under double tax treaties to co- operate with UK, Australia in the detection of tax evasion , money laundering etc, the NZ Government has amended the international tax rules to provide for:

1. Disclosure to the IRD in NZ of foreign trust particulars;

2. the name and other identifying particulars (eg date of settlement) of the Trust must be provided. There are as yet no forms and it is uncertain what other particulars must be provided.

3. The name and contact details of the NZ Trustee must be provided;

4. Whether the settlor is a resident of Australia or not. This requirement reveals that the intention of the legislation is primarily aimed at Australian settlors, many of whom have taken advantage of the NZ legislation. Where the settlor resides say in Hong Kong or a country where NZ has no double tax treaty it may be that enforcement of the legislation and follow up on assets of the Trust may be less likely. The legislation does not specifically refer to the name of the Settlor being revealed, but that seems inevitable if requests for asset information etc are ever made;

5. Keeping of some financial records of the Trust in New Zealand which must be made available to the IRD upon request. It is to be noted that it is an offence for the Trustee not to maintain records, although the nature and standard of the records is not defined.

6. Other advantages of the foreign trust regime continue and there is no requirement to file tax returns or pay tax on overseas income.

Our firm provides Trustee services to a number of foreign settlors. We will be writing to each about the changes. If we are to continue to provide the service, we will require additional records, including a balance sheet for each trust. We have mentioned this requirement before, and it is generally desirable in any event to prove there is a valid trust and separate assets administered by the Trustee. Our charges for providing a Trustee will have to rise due to the additional responsibilities and risk of prosecution if information was not provided.

Comment: For those settlors requiring a degree of confidentiality the changes proposed are unwelcome, and may require re- domicile of the Trust and appointment of a new offshore trustee. For others prepared to maintain some records and no concerns about disclosure, utilization of a respectable trust jurisdiction may still be a priority.

7. **Copyright Infringement- what needs to be proved** ?

For those in the service industry providing written material and methodology to clients, copying by competitors and clients is a constant threat. If a person holds the original copyright in literary material there is usually no difficulty in proving a breach of copyright (which does not require registration as with a trade mark) when the material is copied word for word, but real difficulties arise when the material is partially copied and dressed up to look like something different, and when the idea or methodology behind a business is also being used in the competing business.

The following are a summary of the basic principles considered by the courts when examining possible infringements of copyright.

1. It is obvious that someone may subconsciously copy material, such as a song, and claim that they have never copied a similar work. That person is entitled to protection if he developed a work through his own skill and labour. In those cases, factual evidence is needed to show the offender had either not seen the material or work, or had no opportunity to copy it;

2. There can be indirect copying- where the work copied is itself a copy of a copyrighted work;

3. The courts will generally look at the likelihood of the offender deliberately setting out to cut corners and appropriate the claimants original material;

4. A key issue always is whether there has been a **substantial** copying of the claimants work. This concept is best illustrated by a leading copyright case where a court was prepared to hold there was a breach of copyright of a song, even though the notes were not the same. It was because the overall sound was the same, and this shows that the test is whether there is strong overall resemblance to the claimant's work. Accordingly, copying of only a small part of a work might still mean the overall affect was a copy of the original material. As another example, copying of the scenario and characters of a work without the exact dialogue was still copying;

5. Finally, it has to be recognized that although copyright does not protect ideas but their form of expression, that is an over simplification. What is protected is the work, skill and effort that goes into a work or methodology, and imagination, and the essence of an idea will be synonymous with skill, labour and effort. In reality, the idea can sometimes effectively be protected. An example is performance of a copyrighted cartoon on stage. Although not copying in the literal sense, using it in another medium was in reality use of the same idea and copying of the skill and

effort put into producing it. The same may apply to reproductions of materials and methodology where it appears that the overall substance of what has been produced has been put into a different form without skill or effort by the offender.

6. An up todate summary of Copyright principles can be expected on release of the decision in London involving Dan Brown, the Author of " The Da Vinci Code", who is being sued by third party authors claiming their work has been copied as well as the ideas and plot in their original research material.

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