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Issue 23

In this Issue:

*1. **TAX**:*

(a) A summary of termination and severance payments that are exempt from HK tax;

(b) New Zealand- Hong Kong Double tax Agreement- a brief pre- view of the intended treaty and the reasons for it.

2. TRUSTS:

(a) Vista Trusts in BVI- advantages and disadvantages;

*3. **PLANNING FOR AUSTRALIAN AND NEW ZEALAND EXPATRIATES***

(a) A comparison of the Australian and NZ temporary resident exclusion from tax regimes for migrants and returning expatriates who qualify;

(b) A comparison of an Australian Offshore Superannuation Fund with an offshore trust;

(c) A summary of NZ planning opportunities;

4. SETTING UP JOINT VENTURES IN HONG KONG

(a) Essential issues to consider at the initial stages;

(b) Tax issues for HK directors of JV company.

(1) ***A summary of Termination and Severance payments that are exempt from HK Tax;***

The harsh economic times have unfortunately meant some employees have been made redundant. Structuring of a severance payment in the most tax effective way has become important. The following notes summarise the general tax position although not all situations are straightforward and advice should be taken where the severance payments are significant.

1.1. Payment in Lieu of Notice:

Any payment paid to an employee in lieu of notice by an employee within the terms of his or her employment contract or the provisions of the Employment Ordinance is not income relating to a service provided by an employee and is thus not taxable;

As payment in lieu of notice is not taxable, an employer need not report it on Form IR56F or 56G and the employee need not report it in his tax return. However, an employee given sufficient notice of termination and who is required to work during the notice period, would be taxed as the salary is normal work for services rendered;

On the other hand, the salary as substitute of the payment in lieu of notice by the employee to the employer is still regarded as assessable income of the employee. As such, the employer is required to include that salary as income of the employee.

1.2 Payment in Lieu of Leave

Any salary an employee receives while he or she on leave is part of his or her income and is taxable. This is called "leave pay". However, if an employee’s employment is terminated and the employee has earned but not taken leave, the employer may wish to make a cash payment in lieu of leave to eliminate the accumulated leave balance. Cash in lieu of leave is similar to the salary paid when an employee takes leave, and is thus taxable. An employer must report it.

Sometimes for business reasons an employee may wish to defer annual leave. If an employee’s employment is terminated the employee may take the entitled leave before the cessation date. However, if an employer asks an employee to forego this option and tops up the payment for this earned but untaken leave with a cash payment as compensation, the topped-up payment is in nature similar to leave pay and should be reported by both employee and employer.

1.3 Employee Compensation Arising from Injury

If an employee suffers personal injury through an accident arising out of and in the course of his employment, the payments he receives under the Employees' Compensation Ordinance are not considered as income an employer does need to report them.

1.4 Severance Payments and Long Service Payments

Sums paid to an employee as severance payments or long service payments strictly in accordance with the provisions of the Employment Ordinance are not assessable to salaries tax. The amount not assessable to salaries tax should be computed after deduction of:

(a) contract gratuities based on length of service;

(b) benefits attributable to employer's contributions paid under an occupational retirement (OR) scheme; and

(c) accrued benefits attributable to employer's contributions held in a mandatory provident fund (MPF) scheme or which have been paid.

An employer need not report the sums computed as above and an employee need not report them. However, an employee and an employer have to report sums that were paid in excess of any statutory entitlement.

1.5 Structuring severance payments to the advantage of the Employee:

While the HK IRD will view any artificial planning with suspicion, there are circumstances where the departure of an employee can be negotiated on certain terms, leaving parts of a severance payment exempt from salaries tax.

An example would be a situation where an employee was subject to restraint of trade restrictions. An Employer may wish to consider preparation of a separation agreement which, in consideration of a payment in excess of statutory requirements, may contain a waiver by the employee of any future action or direct competition. Such an agreement can contain a breakdown of all benefits due, and include post termination restrictions, confidentiality provisions, etc. Payment to the employee of an excess amount would not normally be taxable and may be an incentive to the employee. Needless to say, extreme care is needed in the negotiation of terms and the form of agreement.

2 New Zealand- Hong Kong Double tax Agreement- a brief pre- view of the intended treaty and the reasons for it.

New Zealand (NZ) and Hong Kong have signed a free trade agreement on the 29th March 2010 (FTA) on the back of recently concluded trade talks. A double tax treaty is to be signed in the latter part of this year to complement not only the FTA but also the NZ-China FTA, the first with an OECD country.

Although Hong Kong's status as an open port meant that zero tariffs applied to any imported goods – agricultural or otherwise, the benefit of the agreement is said to lie in the fact that it guarantees the security of access to the market for NZ. It also complements the NZ-China FTA concluded a year ago, and may help to speed up the process of tariff's being phased out in that market (Meat & Wool New Zealand).

Although the FTA may not give significant benefits to sectors like manufacturing in NZ, a tax treaty with HK, together with the existing treaty with China, may offer planning opportunities to entities from Hong Kong who could establish a company in NZ to sell into China and take advantage of not only both treaties, but also the new offshore tax regime in NZ which has adopted the Australian system of exemption of tax on trading profits not remitted back to a NZ holding entity.

We will report on the new treaty as soon as details become available.

3 ***Vista Trusts in BVI- advantages and disadvantages;***

Much promotion has taken place in HK regarding vista trusts and the advantages they offer to individuals wishing to establish a company entity with the characteristics of a trust.

The structure is known as a BVI Share Trust under the British Virgin Islands Special Trusts Act (" Vista") which comprises a Trustee (licensed as a trustee under BVI laws) and another BVI company acting as a holding company (owning the underlying assets), itself own by the Vista trustee.

The purpose of the structure is to remove succession problems for an individual, allowing him as the settlor to effectively control the assets of the underlying BVI holding company as a director and, at the same time, settling the assets of the company on named beneficiaries in fixed shares. At any time the settlor can get the shares in the BVI holding company back under a call option or the Trustee, in a time of trouble, can force the settlor to take them back under a put option.

While it is true that a settlor of a trust can be comforted by structure that allows him to trade a business with a BVI company during his lifetime and know that on his death the company will devolve on named beneficiaries, there are some disadvantages inherent in the structure.

In our view the disadvantages are as follow:

(a) They offer little asset protection, as if the settlor goes bankrupt, the trust must transfer the shares in the underlying BVI holding company back to the settlor. The assets are then at the mercy of creditors;

(b) Beneficiaries and shares are fixed and cannot be changed later- not like the normal discretionary trust;

(c) The Vista trust, in some jurisdictions, would be treated as ineffective for tax purposes as the settlor still controls everything;

(d) There may be better planning structures available. As an example:

   (i) the settlor can set up a revocable trust and take the assets back at any time as in a Vista Trust;

(ii) if the settlor establishes a PTC(private trust company) he can be a director and control the Trust assets through an underlying holding company;

(iii) a friend or family member owning the PTC avoids succession problems;

(iv) shares in a BVI can be owned jointly- on death of one shareholder the shares go to the survivor without probate;

(v) the discretionary family trust is far more flexible- beneficiaries can be changed at any time unlike a Vista trust;

(vi) asset protection is better with the usual discretionary trust;

(vii) costs to establish a simple PTC may not greatly exceed a Vista Trust- say HK$25,000.00 to HK$35,000.00 depending on the circumstances.

This is not to say that where the circumstances of the individual warrant it a Vista Trust may not suit some individuals. However, we do not believe any person can or should set up a Vista Trust without advice on how its impacts on their domestic tax situation, asset protection planning and family succession.

4 ***A Comparison of the Australian and NZ temporary resident exclusion from tax regimes for migrants and returning expatriates who qualify;***

Both Australia and New Zealand have implemented temporary resident rules allowing exemptions on offshore income for new migrants and returning expatriates who come to live in Australia or New Zealand. The schemes are designed to attract persons with skills.

So far as Australia is concerned, with effect from 1 July 2006 individuals who qualify as "temporary residents" will be exempt from Australian tax on certain foreign source income or capital gains. In this respect they will be treated similarly to non- residents, even though in many cases they will be taxed as residents under the normal tax rules. With effect from 6 April 2006 there is also an exemption from interest with-holding tax, and special rules apply to employee shares and rights.

A temporary resident is a person who holds a temporary visa. A temporary visa is one that enables a person to remain in Australia during a specified period, or until a specified event occurs, or while the holder has a special status.

A person may be temporary resident irrespective of whether they are resident or non - resident under the normal tax rules. However, a person will not be a temporary resident if they or their spouse are residents under the separate test laid down in the Social Security Act. In effect, this means that they cannot be an Australian-resident citizen, permanent resident, or person who holds a protected special category visa holders.

Provided temporary residency is able to be maintained, there is, unlike New Zealand, no time limit on the benefits available under the scheme.

The New Zealand temporary tax exemption scheme for foreign income is for four calendar years (up to 49 months). The tax exemption is granted automatically.

Types of income that are temporarily exempt from tax in Australia and New Zealand are broadly the same and include:

- Dividends
- Interest
- Bonuses from a previous job overseas
- Controlled foreign company income
- Foreign Investment fund income (FIF), including foreign superannuation
- Non- resident withholding tax on foreign mortgages
- Taxation arising from employee share options
- Accrual income from foreign financial arrangements
- Certain trust income
- Rental income derived offshore
- Royalties derived offshore
- Gains on sale of property derived offshore
- Offshore business income not related to personal services

The following income is not exempt:

(a) Income derived from overseas employment while receiving the exemption;
(b) Business income relating to services performed offshore.

From our research, New Zealand citizens who arrive in Australia after 26/2/2001 are classified as temporary residents, because they are a " Special Category Visa Holder", but those who resided in Australia as at 26/2/2001 or who were present in Australia for 12 month or more during a period 26/2/1999 to 26/2/2001 and then subsequently returned to Australia, are not temporary residents;

Given the exemption scheme under the Australian and New Zealand regimes, several approaches to future planning in relation to funds and assets held outside Australia or New Zealand after taking temporary residence seem possible;

The most obvious option is to do nothing and rely on the schemes to shield income from bank deposits, dividends and other passive income. However, bearing in mind that the Australian scheme will come to an end if you become a permanent resident (or legislative change may cancel it) and the New Zealand scheme only lasts 4 years, some future planning for income and asset protection is perhaps best carried out while the individual is not currently tax resident in Australia or New Zealand and are free to establish structures and business entities when there are no reporting requirements. Structures can be retained post temporary visa or resident status.

5. ***Australian Employer- Sponsored Foreign Superannuation Fund***

One of the most interesting investment opportunities open expatriates or migrants may be an Employer Sponsored Foreign Superannuation Fund(ESFS). If such a fund complies with

certain conditions, it benefits from considerable investment and tax advantages. The key conditions include the following:

- the fund must be established and/or maintained by an employer and must be genuinely for retirement provision;
- it must be established and have residency outside Australia;
- it must not benefit from from concessional tax treatment in Australia;
- it must not invest in Australia

An approved fund may invest funds in offshore capital markets. While the expatriate is non-resident, participation in such a fund will not be subject to tax in Australia under FIF, CGT, FLP, or any other rules. Importantly, when returning to Australia, the expatriate may bring all or any part of their accumulated entitlement into Australia, within 6 months, completely tax free. This can then be rolled over into a complying fund or approved deposit fund in Australia, with the accompanying tax benefits.

Any accrued benefits which are not brought back into Australia within 6 months of the expatriate's return will be subject to tax in Australia, but only on the difference between the benefits the expatriate finally receives and the value of the accrued entitlement on the day that the expatriate returns to Australia. In some cases this could give rise to significant tax benefits.

While both an Employer-sponsored Foreign Superannuation Fund (EFSF) and an offshore Trust (Trust) are trusts with trustees owning and holding the assets transferred to them, there are a number of major differences in the way assets can be dealt with.

It is beyond the scope of this Newsletter to comment on detailed planning issues or possible structures and comparing the relative merits of an EFSF and Trust, but a few brief points may be made:

- An important factor to consider is that the beneficiary of an EFSF is the original settlor alone or other designated employees; wives and children cannot be beneficiaries unless taking on your death;

- Assets held in an EFSF will only be able to be withdrawn upon a member satisfying certain retirement and termination events. As an example, attaining normal retirement age, retiring from the work force, cessation of employment with the employer. Accordingly, there is less flexibility than with the Trust where wife and children along with the settlor if required can be named as beneficiaries and receive distributions of income and capital at any time both before and after your death;

- The EFSF will have a taxation advantage over a Trust, as in most cases, the transferor and attribution tax rules in Australia will operate to catch and tax distributions from an offshore trust unless the temporary residents exemption applies.(although distributions from a listed country such as New Zealand may not be caught- say capital gains from property). However, and by comparison, so long as the EFSF is employer maintained (its contributions come from a trading offshore) then income earnt from it should not be attributable to the settlor personally;

- Distributions from the EFSF to a settlor as employee on retirement of the earnings component will attract Australian income tax at the marginal rate whereas if it were possible to structure payments from a trust as repayments of a loan owing no tax should be levied provided the Trust was able to be formed in such a way as make it a non -assessable entity under the Australian transferor and trust control rules;

- In the case of the EFSF the initial funds will have to come from the settlor and be contributed directly as employee and/or employer contributions with ongoing contributions from an Employer. It will be necessary to show that the ESFS is employer maintained. In other words, to establish and maintain the necessary records may add a layer of extra administration costs;

- Costs to establish and maintain an EFSF may be considerably higher than a Trust;

- An ESFS established perhaps in Hong Kong using local service companies would be considerably cheaper to set up and run as compared with those schemes promoted by some professional trustees, notably in Singapore.

6. A Summary of NZ Planning Opportunities;

We intend in this Newsletter to briefly highlight some of the planning opportunities offered through New Zealand and intend to deal with such planning opportunities in later Newsletters.

Although a relatively highly taxed OECD country it is surprising that for the migrant, returning expatriate or offshore investor New Zealand offers planning opportunities on a par with some offshore tax havens and without some of the stigmas.

For the migrant, expatriate and investor the following planning structures can be considered:

- An offshore trust with an offshore Trustee allows deferment of tax indefinitely on the Trust's income, notwithstanding that the original settlor becomes a tax resident in New Zealand following formation of the Trust;

- A trust settled by a foreign settlor (who will never live in NZ) with a NZ trustee enjoys complete exemption from NZ tax on all income earnt outside NZ, and is not required to file a tax return in NZ;

- NZ corporate and securities law allows formation of a NZ company as an offshore finance company ("Ofco"). Although use of the word " bank" in the name is not allowed, similar names such as " Bankcorp" are permissible. Ofco can operate with a NZ bank account and must comply with NZ company and securities laws. Tax concessions are given. Providing it is independent of depositors Ofco can accept global deposits, earn high interest in the range of 4.5% on call, to 3.75% for one month term deposit) and pay the depositors a lesser interest rate. Instead of the non- resident withholding tax rate, only 2% tax is deducted on interest paid to non-residents. This is the "Approved Issuer Levy" scheme where the independent finance company (or any taxpayer) who has

complied with their tax obligations, can register as an approved issuer. The financial arrangement must be a security which is registered with the New Zealand Revenue.

- Conduit NZ companies can be formed for trading outside NZ, which pay little tax in NZ;

- As NZ has no licensing for forex dealers in the spot market, a NZ company can trade forex offshore with minimum regulation;

- The existing double tax treaty between NZ and China and the contemplated NZ/HK double tax treaty, along with the free trade agreements that NZ has with both HK and China, offer planning opportunities.

7. ***Essential issues to consider when setting up Joint Ventures using a Hong Kong Company:***

7.3 Initial Negotiations and Documentation:

A typical joint venture in Hong Kong involves a Hong Kong Company, and two or more parties either in Hong Kong or from the USA, Europe, or other countries. While it is common for parties to meet and discuss terms which are later produced in a terms sheet, there may be advantages, depending on the circumstances, in producing the initial terms of the Joint Venture in a Heads of Agreement or Memorandum of Understanding (HOA, MOU). The HOA and MOU can be signed by all parties prior to preparation and signature of a joint venture agreement, shareholders agreement or investment agreement. Advantages of using a HOA or MOU are as follows:

- The contracting parties, addresses etc, are clearly identified and have signed an agreement indicating a commitment to the deal, albeit the HOA, MOU is not entirely legally binding;

- it may be important for IP rights and confidential information to be protected when information is exchanged and the HOA or MOU will have binding commitments to protect proprietary information and provide penalties for failure to do so. These provisions will continue to apply even if the negotiations ultimately fail;

- it may be important that the parties agree there be no negotiations with 3rd parties while the deal is being negotiated. Again, this covenant will be legally binding;

- costs can be an issue, and again, the HOA or MOU may provide that all parties bear their own costs, or cover details such as how the costs of the set up of the JV company are met;

- an initial structure plan is ideally annexed to an HOA or MOU so as to establish whether there will be subsidiaries offshore trading companies etc;

- persons who are entitled to represent each of the parties in negotiations can be named;

- the HOA and MOU can provide time milestones setting out what documents will be needed to form the JV and when they will be signed. If not signed by a certain date the JV may not proceed;

- as the HOA and MOU will provide that its contents are not legally binding (other than the IP right provision and other issues mentioned above) no party should have any hesitation in signing it.

7.2 Other Essential Issues;

Leaving aside the usual issues covered by a JV or shareholders agreement, essential matters concerning structure would include:

- Is it a joint venture or a simple shareholders agreement- a JV may mean parties share losses;

- Capital structure- equity funded or is there an advantage in financing on loan account.HK imposes capital duty of HK$1.00 per HK1000.00 (after the initial fee of HK$1720.00) to a maximum of HK$30,000.00;

- How will shares be held by the parties ? As HK imposes stamp duty on a transfer of shares at 0.20% there may be substantial savings if share are held through an offshore company thus allowing sale of the company rather than the shares;

- If one party is contributing IP rights to the JV company, how will these be inserted into the JV company ? Those owning IP rights and wishing to retain them in the event of the failure or termination of the joint venture may prefer to license (and not transfer) the IP rights for a nominal sum to the JV company;

- If the investment is in an existing company which is issuing new shares, will the new shares be issued at a premium ? Valuation of the existing shares may be desirable;

- Will the structure be better served by having the HK company as a wholly owned subsidiary of say an offshore BVI company, which will be the JV company where the investment takes place ? There may be tax and other advantages in doing this;

- The tax implications of the structure should be examined. If it is desired that the HK JV company act as mere invoicing company with its operations wholly outside HK for tax purposes, careful thought needs to be given to management and operating issues and whether there is need for an affiliated offshore company where the actual trading may take place. The HK IRD have become increasingly active in examining and trying to assess the offshore profits of HK companies.

7.3 Tax issues for offshore HK directors of JV company.

As part of the planning by offshore parties setting up a JV company some consideration should be given to how a director say in the USA or Europe can access directors fees or say consulting fees to the maximum tax advantage. Generally, HK law imposes salaries tax on directors fees payable by a HK company irrespective of the place services are rendered.

There have been many cases where directors of a HK JV company have been paid quite substantial fees and never thought that, as they were offshore, there was any tax liability.

This area of tax law is quite complicated. The following notes may offer some assistance:

1. *Director salary or salary to an office holder of a HK company*:

1.1 Notwithstanding that a Director does not live in HK or performs no services there, salaries paid from a HK company to a Director or office holder will be taxable in Hong Kong;

1.2 This is because the source of the income is regarded as being in Hong Kong where the control of the Company is exercised.

1.3 However, there is a difference between holding an office and simple employment and it is possible for a Director or office holder to be employed in a different capacity which will affect the taxability of the income.

2. *Duality of Employment*:

2.1 Despite the existence of Hong Kong employment (excepting Director or office holder employment) it is possible for income to be totally exempt from HK salaries tax if no services are performed in Hong Kong or services are performed during visits of less than 60 days;

2.2 If the 60 day rule does not apply, even minor administrative duties in Hong Kong may trigger salaries tax on the income;

2.3 If a HK director is employed not as a Director but rather as a consultant, is not a resident of Hong Kong and renders all services outside Hong Kong (subject to the 60 day rule) then there should be no tax on the consultancy income;

2.4 However, reporting of the income paid in the Employer's Return to the IRD as salary is likely to trigger a long and possibly expensive investigation by the IRD who will likely claim that salaries tax should be paid especially if the tax payer is named as a director and has performed some work in Hong Kong. The IRD will look at visitor records in its investigation and ask for information on the duties performed in Hong Kong;

2.5 A consultancy agreement should be carefully prepared setting out that all duties are performed outside Hong Kong;

*3. **Resignation as a Director**:*

3.1 If you resign as a Director, sign a consultancy agreement, do all work outside Hong Kong, and do not spend more than 60 days in HK in a financial year, then you should not be assessable to HK tax, assuming you do not have base in HK and continue to live outside HK.

4. ***Dual Employment Contracts***:

4.1 Ideally, there might well be two employment agreements; the first covering salary paid for say 10% of the total income paid for director services in Hong Kong and the second covering 90% of the income for services as a consultant outside Hong Kong;

4.2 This dual employment is technically possible but given any previous employment history with the IRD it would be a risky strategy. It would work better if you were employed by as a consultant by a non- HK company;

5. ***Employment by a non - HK Company***: If you are employed under a consultancy contract by a non -HK company and paid for services rendered outside HK and do work in HK for less than 60 days in a financial year, there is no HK tax at all on your income. In that situation, you could remain a director of the HK company, and as mentioned above, be paid a small salary on which some tax might be paid unless the income was below the personal exemption;

6. ***Tax paid on Income in other Countries***: If you declare and pay tax in another country of the same nature on HK income, or in some other jurisdiction, there is an exemption from HK tax. However, this exemption is complex and can be difficult to claim, especially as you have to prove you actually paid the tax;

7. ***Status or the Hong Kong Company paying the Income*** - ***Trading Trusts***

7.1 Some more sophisticated planning to avoid salaries or profits tax on consultancy income may be embarked on using a trading trust. This planning is beyond the scope of this article.

Summary:

Care is needed in planning when using Hong Kong entities which are to trade internationally. The IRD in Hong Kong are now treating any claim of offshore income with suspicion. The twin issues of taxability of the income of the Hong Kong entity and the taxability of the income paid out from it must be addressed in any planning. Whatever is done, it must be documented by proper signed consultancy agreements or employment contracts as these are heavily relied on by the HK IRD. In addition, correct reporting of director or consultancy income by the HK company is obviously vital to avoid problems.

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