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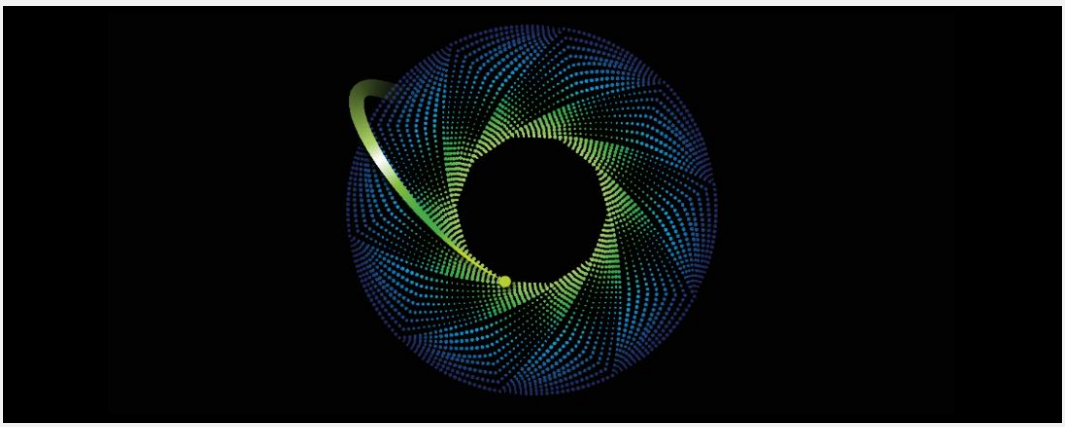

Hong Kong Tax Newsflash

Views exchanged during the 2021 annual meeting between the Inland Revenue Department and HKICPA

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The minutes of the annual meeting between the Inland Revenue Department (IRD) and the Hong Kong Institute of Certified Public Accountants (HKICPA) held in 2021 were recently released. The discussions covered a wide range of tax topics. This article highlights the views exchanged on certain key issues.

Impairment loss on leased asset under Hong Kong Financial Reporting Standard (HKFRS) 16

Question:

As indicated in the IRD's website on *Profits Tax Treatment of Leases Where HKFRS 16 Applies*, impairment loss of leased asset would be allowed for deduction over the remaining term of the lease on a straight-line basis. When can the taxpayer start claiming a deduction of the impairment loss?

Answer:

If it was proved to the satisfaction of the IRD that the recognition of impairment loss was in compliance with HKFRS 16 and Hong Kong Accounting Standard 36 *Impairment of Assets*[NB1] and that the recognition was made on a specific date as claimed, the taxpayer can

claim a deduction of the impairment loss starting from the month following the month in which the impairment loss was made. For example, if the impairment loss was made on 30 June 2020, the taxpayer can claim a deduction starting from July 2020. The same basis should be adopted where there was a subsequent reversal of the impairment loss.

NB1 *HKAS 36 requires an entity to assess at the end of each reporting period whether there is any indication that an asset may be impaired.*

Valuation of trading stock

Question:

If trading stock was transferred at below market value from one Hong Kong taxpayer to another related Hong Kong taxpayer with the conditions of exempted domestic transactions [NB2] satisfied, would the IRD adjust the transaction price by invoking transfer pricing provisions?

If trading stock was transferred upon cessation of business with the conditions under section 15C(a)[NB3] of the Inland Revenue Ordinance (IRO) satisfied, would the IRD disturb the actual transaction price by invoking transfer pricing provisions or anti-avoidance provisions of the IRO?

Answer:

- Where trading stock was transferred in the course of trade, the arm's length provision (section 50AAF) would come into play unless the conditions of exempted domestic transactions [NB2] were satisfied.

- Where trading stock was transferred upon cessation of business (where conditions under section 15C(a) [NB3] were satisfied), the transaction price should be taken as the consideration for the transfer without the arm's length requirement.

- Where trading stock was transferred otherwise than in the course of trade nor cessation of business, the trading stock would be deemed to be transferred at open market value pursuant to section 15BA(4)/(5). The arm's length provision (section 50AAF) would not apply regardless of whether the conditions of exempted domestic transactions [NB2] were satisfied.

- In any case, the IRD might invoke the anti-avoidance provisions (sections 61 and/or 61A) to counteract a blatant tax avoidance arrangement involving non-arm's length transactions between related parties.

NB2 *The trading stock was transferred to a Hong Kong taxpayer and there was no actual tax difference (Section 50AAJ(2) of the IRO).*

NB3 *The trading stock was sold or transferred for valuable consideration to a person who carried on or intended to carry on a trade or business in Hong Kong; and the cost whereof might be deducted by the purchaser as an expense in computing its assessable profits.*

Taxation of datacenter or server permanent establishment (PE)

Question:

In the Departmental Interpretation and Practice Notes (DIPN) No. 39 (Revised), the IRD seems adopting different approaches in taxing e-commerce business under two different models.

- A non-Hong Kong resident enterprise merely locating a datacenter (which was an essential and significant part of its business activity) in Hong Kong is chargeable to tax in Hong Kong for the profits attributable to the server PE (example 5 of DIPN 39).

- A Hong Kong resident enterprise performs all the core operations and support activities in Hong Kong is fully chargeable to tax in Hong Kong, notwithstanding that the server is located outside Hong Kong. Effectively, the location of the server outside Hong Kong is disregarded (paragraph 19(a) of DIPN 39).

Can the IRD clarify its approach in taxing e-commerce business? Would the IRD accept apportionment of onshore / offshore profits for a Hong Kong resident enterprise which has operations in Hong Kong but the server is located outside Hong Kong?

Answer:
The IRD clarified that it would adopt a two-step approach when ascertaining whether a PE of a non-resident person would be chargeable to profits tax in Hong Kong.

- First, profits would be attributed to the PE in accordance with the separate enterprises principle. Example 5 of DIPN 39 illustrated the concept of server PE, i.e. whether the datacentre / server would constitute a PE in Hong Kong.

- Then, the source of the profits would be determined in accordance with the operation test. Paragraph 19(a) of DIPN 39 illustrated the principles applied in determining the locality of e-commerce profits.

It did not necessarily mean that profits attributable to a PE had to be chargeable to tax in Hong Kong. In determining the locality of profits, the IRD would examine what constituted the core business activities of the enterprise and the place where these activities were carried out. However, the IRD mentioned that, in practice, it might be difficult to conclude that the profits attributable to a PE in Hong Kong did not arise in Hong Kong.

Provisional tax payable on royalties

Question:
If a taxpayer's final tax payable on royalty for non-resident will be lower when computed according to section 15(1)(b) of the IRO, less tax reduction, while the treaty rate will result in lower tax for provisional payment, will the IRD accept different ways to compute the final tax and the provisional payment?

Answer:
Yes, the final tax, in practice, could be charged at the normal rate with the tax reduction while the provisional tax could be charged at the treaty rate.

Deeming provision for shipping business

Question:

Where a ship operator carries on its business in Hong Kong and derives charter hire income from ships mainly navigate outside the waters of Hong Kong, such income would neither be chargeable under the ship-owner provision (section 23B) nor eligible for the ship leasing tax concession (section 14O). Would such income be then deemed taxable under section 15(1)(o) which stipulates that income from carrying on a business in Hong Kong of granting a right to use a ship is deemed to be taxable if not otherwise chargeable under any profits tax provisions of the IRO?

Answer:
No, whilst charter hire derived by a ship operator from ships navigating outside the waters of Hong Kong was not chargeable to tax under section 23B, such income would not be deemed taxable under section 15(1)(o).

Threshold requirements for ship leasing tax concession

Question:
In DIPN 62, the IRD states that the number of full-time employees of a group company can be taken into account, subject to certain conditions, in determining whether the thresholds (i.e. the number of employees and the amount of operating expenditure) for the ship leasing and ship leasing management provisions have been met. Does the IRD agree that the thresholds should be applied on a group basis?

Answer:

- The threshold requirements should be applied on an entity basis (i.e. per each ship lessor or ship leasing manager) instead of a group basis. The thresholds could not be applied on a group basis by taking into account the employees of other group companies who had not carried out the core income generating activities for the qualifying ship lessor / leasing manager.

- If an employee of a group company works for different qualifying ship lessors / leasing managers within the group, the employee and the related staff costs could be taken into account in determining the threshold requirements for each of the qualifying ship lessors / leasing managers provided that certain conditions [NB4] are met.

- If the qualifying ship lessors / leasing managers within a group outsource the core income generating activities to a group company, in determining whether the threshold requirements are satisfied, the IRD would consider all the relevant factors, including what kind of activities were carried out by the outsourced company; the number of ship owners that it served; whether the number of the full-time employees and the amount of operating expenditure incurred in Hong Kong were commensurate with and adequate for the carrying out of the core income generating activities. The approach should be consistent with the Forum on Harmful Tax Practices of the OECD.

[NB4] *The conditions for taking into account employees of a group company include (a) whether the core income generating activities were carried out by staff secondment or outsourcing arrangement (b) whether the staff costs were fully borne by the qualifying ship lessor / leasing manager on an arm's length basis (c) whether the number of employees and the amount of staff costs were commensurate with the level of core income generating activities (d) whether the qualifying ship lessor / leasing manager exercised adequate monitoring. See examples 22 and 23 and paragraph 96 of DIPN 62.*

Main purpose tests for tax concession regimes

Question:
There are "main purpose tests" to prevent tax avoidance in some of the preferential tax regimes. Where the main purpose, or one of the main purposes, of entering into the arrangement is to obtain a tax benefit, no profits tax concessions will be granted. Meanwhile, tax concessions are expected to help attract setup of related business establishments in Hong Kong. Would the fact that Hong Kong tax incentive or access to Hong Kong tax treaties formed a significant part of the decision to set up business in Hong Kong in itself be regarded as tax avoidance so that the preferential tax treatment would be denied under the main purpose tests?

Answer:

- The main purpose tests targeted at taxpayers who sought to abuse the tax concessions or achieve treaty shopping by artificial means and siphon the profits into Hong Kong simply to take advantage of the tax concessions or treaty benefits without any commercial reasons and business substance established in Hong Kong.

- The main purpose test would not operate to deny tax concessions for the vast majority of genuine businesses with core income generating activities carried out in Hong Kong.

- When applying the main purpose tests, the IRD would consider the facts and circumstances of each case, including the aims and objects of all persons involved in putting the arrangement or transaction in place.

Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Multilateral Instrument)

Question:
Can the IRD provide an update on the progress of giving effect to the Multilateral Instrument in Hong Kong?

Answer:
China (which signed on the Multilateral Instrument and extended its application to Hong Kong) was taking steps to approve the Multilateral Instrument.

If you have any questions, please contact our professionals:

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