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Tax Newsflash

Hong Kong Tax News

Tax issues discussed in the Annual Meeting between the IRD and HKICPA

The 2014 Annual Meeting between the Inland Revenue Department (IRD) and the Hong Kong Institute of Certified Public Accountants (HKICPA) was held in February 2014. The minutes of the meeting are reproduced as Tax Bulletin published by the HKICPA recently (see attached). There were important issues discussed, covering profits tax, salaries tax, cross-border tax, Double Tax Agreements (DTAs), and policy and administrative matters.

The key issues are summarized below. Please note that the views are those of the IRD only. Clients should seek professional advice before acting on the information contained in the minutes.

Source rule for determining dividend income [item A1(a)]

Under section 26, dividends received from a company which is chargeable to profits tax in Hong Kong are exempt from tax. Such exemption does not apply to dividends received from corporations which are not chargeable to tax in Hong Kong. If the investor company does not actively take part in the operation of the investee company, the taxability of dividend income may depend on the place of operation of the investee company. If the investor company is an asset management company which derives dividends from asset management services rendered in Hong Kong, the dividends would be sourced in Hong Kong and taxable, if section 26 exemption does not apply. Hence where the remuneration of an asset management company is structured as dividends or distributions, the IRD could treat such dividends or

Share-based payments in a single company situation [item A1(g)]

An overseas listed company with a Hong Kong branch incurred costs in acquiring its own shares from the market as treasury stock, and used the acquired treasury stock to grant the stock option or share award to its employees. The expense incurred by the Hong Kong branch would be deductible. However, if the company is a Hong Kong incorporated company, the shares it bought back would be treated as cancelled under the Companies Ordinance. The subsequent issue to its employees is a new issue of shares. Therefore, the expense would not be deductible because it is not an "outgoing" or "expense".

Tax implications on amalgamation under the new Companies Ordinance [item A1(h)]

The IRD has been studying the relevant tax issues relating to the new court-free regime for corporate amalgamation. The IRD considered that change in law might be required to provide tax certainty. Taxpayers may in the interim seek an advance ruling. In addition, the abolition of par value of shares under the new Companies Ordinance would have implications on the exemption under section 45 of the Stamp Duty Ordinance for intra-group transfer of stock.

Utilization of tax loss under section 61B [item A1(j)]

Section 61B would be invoked to disallow the set off of tax loss where there is a change in the shareholding in a corporation, and as a direct or indirect result of the change, profits have been received by that corporation and the sole or dominant purpose of the change was for the purpose of utilization of losses in order to avoid tax liability. The IRD explained that the words "any change in the shareholding in any corporation" were potentially very wide in scope (e.g. changes in beneficial interest could be included). Nevertheless, the IRD will normally regard it as a change in shareholding if shares are transferred from one person to another person. In other words, the IRD will normally consider that there is no change in a company's shareholding if there is only a change of shareholding in its parent company, and hence will not invoke section 61B.

Residence of an overseas company with a branch in Hong Kong [item A4(b)]

As discussed in last year's annual meeting, the IRD would consider the management or control of the bank as a whole in deciding whether an overseas bank is "normally managed or controlled in Hong Kong". The same principle applies when determining the residence of an enterprise (other than a bank) incorporated or established overseas. In addition, these apply not only to the Mainland-Hong Kong DTA, but all other comprehensive DTAs with the same or similar definition for Hong Kong resident. This would have implications where the Hong Kong branch of an overseas company (whether or not it is a bank) wishes to claim tax credit in Hong Kong for any overseas tax paid or apply for a tax resident certificate in Hong Kong.

Tax resident certificates issued by the IRD [items A5(e) & B3]

If a non-Hong Kong incorporated company does not apply for a business registration in Hong Kong, it may fail to establish that it carries on a business in Hong Kong and therefore the IRD may decline to issue the tax resident certificate. Nevertheless, business registration is not a conclusive factor in determining the residence status. Even if a company has business registration, the IRD may decline issuing the tax resident certificate if the evidence indicated that the overseas incorporated company is a conduit or is actually managed or controlled

registration, the IRD may issue the tax resident certificate.

When determining whether to issue a tax resident certificate to a company (no matter incorporated in Hong Kong or overseas), in addition to meeting the definition of tax resident, the IRD would consider whether the person would not be entitled to those treaty benefits. If the IRD has reason to believe that a person would not be entitled to benefits, the IRD may request further information or exchange information with the other treaty partner before deciding whether a tax resident certificate could be issued. The IRD would consider the beneficial ownership, whether there is an abuse of the DTA and whether it is a conduit company. The IRD would refuse to issue a tax resident certificate to a paper company which was incorporated in Hong Kong merely to obtain treaty benefits. This would mean that the process of applying for a tax resident certificate in Hong Kong will likely be lengthened. The IRD will likely request more information and documents in the process, where in the past, such information and documents were only be required at the later stage when the overseas tax authority considers the granting of tax treaty benefits.

Taxation of Hong Kong Investment Managers / Advisors [item B2]

While the IRD accepts the hedge funds and private equity funds established outside Hong Kong fell within the offshore fund regime, the IRD takes the view that the Hong Kong investment managers or advisors should be remunerated on an arm's length basis. The IRD considered that the compensation structures for the investment managers or advisors may vary from fund to fund, but the standard pay formula is called "2 and 20" (i.e. the lead fund managers took 2% of the fund's assets each year as a management fee, and 20% of the total profits as a kind of performance bonus). However, the IRD found that, in few cases, the management and performance fees paid to the investment managers or advisors were computed on a cost-plus formula, far below the arm's length rate, even though the investment managers or advisors performed significant functions and bore significant risks in generating the profits of the funds. The IRD expects that the investment managers or advisors in Hong Kong should be adequately remunerated after taking into account the functions, assets and risks attributed to the Hong Kong operation. This indicates that the IRD will likely be looking at the remuneration structures of fund management groups more closely.

If you have any questions please contact:

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