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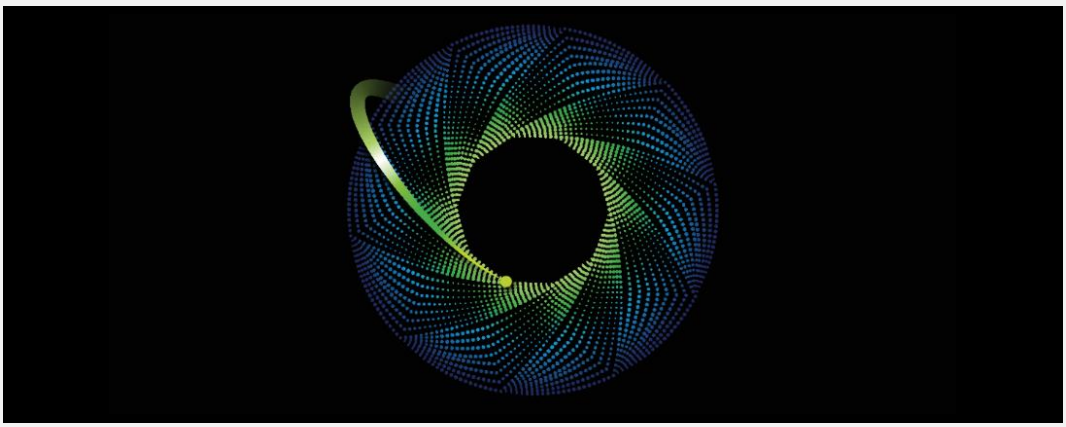

Hong Kong Tax Newsflash

Profits Tax matters discussed in the 2023 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 2023 were recently released. The discussions covered a wide range of tax topics. This article highlights the views exchanged on certain key issues.

Taxation of interest income

In determining the source of interest income, the IRD clarified that the operation test[1] would be the default test. The "provision of credit"[2] test would only apply where the interest income was derived from a "simple loan of money".

To consider whether the loan is a "simple loan of money", the IRD will take into account all the relevant facts. In general, if the company is not a financial institution nor carrying on the money lending or intra-group financing business, the mere lending of its own surplus fund would be accepted as a "simple loan of money". In contrast, if money had to be borrowed before it could be lent, even the loan was one-off, it would not be accepted as a "simple loan of money".

Based on the above, the IRD provided its comments on the following scenarios:

Scenario 1 - A Hong Kong company lends a one-off interest-bearing loan of HKD1 million to its subsidiary that is funded by its own surplus cash.
IRD's view: The one-off interest-bearing loan would be accepted as a "simple loan of money" and the "provision of credit test" would be applicable.

Scenario 2 - A Hong Kong company lends a one-off interest-bearing loan of HKD1 million to its subsidiary that is funded by an equity injection from its parent company.
IRD's view: Provided that the equity injection did not involve any borrowing of money or any complex financing arrangement, the injected equity would be considered as the company's own funds and the one-off interest-bearing loan would be accepted as a "simple loan of money". Thus, the "provision of credit test" would be applicable.

Scenario 3 - A Hong Kong company lends a one-off interest-bearing loan of HKD1 million to its subsidiary that is funded by an interest-free loan borrowed from its parent company.
IRD's view: The Hong Kong company's borrowing and on-lending of money to its subsidiary would generally not be accepted as a "simple loan of money". Thus, the operation test would be applicable.

Foreign-sourced income exemption (FSIE) regime

(i) Economic substance requirements[3] (ESR)

Specified economic activities

In general, specified economic activities of a pure equity holding entity[4] (PEHE) included exploring investment opportunities, evaluating feasibility of investments, making decisions on the holding and selling of equity interests, monitoring investment performance, calculating risks, and reviewing or revising financing arrangement for acquiring equity interests.

Whereas a non-PEHE could acquire, hold, manage or dispose of any assets (not just equity interests). For example, specified economic activities of a non-PEHE engaged in lending of loans include analysing the creditability of the borrower, monitoring the borrower's fulfilment of obligations to pay interest and make repayment of principal, and taking enforcement actions against the borrower in case of default.

Proof of ESR

The IRD accepted the minutes of the board meetings recording the discussion on making and managing investments in Hong Kong as a sufficient proof that the specified economic activities were carried out in Hong Kong. However, the entity also needs to provide other supporting evidence to substantiate that the adequacy test was satisfied.

Adequacy test for a shared outsourced entity

In case the specified economic activities were outsourced to an outsourced entity whose qualifying employees were shared among outsourcing entities within the group, the IRD indicated that in determining the adequate test, the average number of employees per outsourcing entity could be a good starting point. It would also consider the size and nature of assets held by each outsourcing entity, the amount of specified foreign sourced income (SFSI) earned by the entity and the complexity of specified economic activities required to be performed for each entity.

(ii) Headline tax rate for participation exemption

For the purposes of the "subject to tax" condition[5] under the participation exemption, in cases where an income or profits of an entity was or were taxed at both federal and state/regional levels, the IRD clarified that they would take the applicable rate as the aggregate of respective headline tax rates at the federal level and the state/regional level provided that both taxes levied at different levels were of substantially the same nature as Hong Kong profits tax.

(iii) "Received in Hong Kong" from mixed pool of funds

The IRD would adopt a pragmatic approach to determine whether a remittance from a mixed pool of funds kept in an overseas bank account comprising SFSI and non-SFSI funds included any SFSI.

The multinational enterprise (MNE) entity should first ascertain the balance of SFSI funds (Balance A) and the balance of non-SFSI funds (Balance B) kept in the overseas bank account immediately before the remittance was made.

<u>Fund withdrawal for debt settlement / purchase of movable property</u>

If the fund was used to satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong, or to buy outside Hong Kong any movable property which was intended to be brought into Hong Kong, the IRD would presume that the fund was first sourced from the non-SFSI funds (i.e. Balance B). If Balance B was not adequate to cover the fund, the excess of the fund over Balance B would be regarded as sourced from the SFSI funds (i.e. Balance A).

If the fund was used for purposes other than those mentioned above, the IRD would presume that the fund was first sourced from the SFSI funds (i.e. Balance A). If Balance A was not adequate to cover the fund, the excess of the fund over Balance A would be regarded as sourced from the non-SFSI funds (i.e. Balance B).

<u>Remittance</u>

If the amount of the remittance was no more than Balance B, no SFSI would be regarded as remitted to Hong Kong.

If the amount of the remittance was more than Balance B, the excess of the remittance over the amount of Balance B would be regarded as SFSI remitted to Hong Kong.

An example is provided in the meeting minutes.

E-commerce

The IRD reiterated that the proper approach for determining the locality of the profits from e-commerce transaction is to focus on the core operations that had effected the e-commerce transaction and the place where those operations had been carried out. If all the core operations and support activities were performed in Hong Kong, the e-commerce profits should be fully chargeable to profits tax even though the server was located outside Hong Kong. The views are in line with Departmental Interpretation and Practice Notes No. 39 (DIPN 39).

Based on the above, the IRD set out its views on how the source rules apply to the following examples:

Online intermediaries

- A non-Hong Kong resident company develops, maintains and operates a global travel shopping website outside Hong Kong. The website is hosted on a server outside Hong Kong. The partner hotels from all over the world (including Hong Kong) sign the standard e-contracts through the website. Commission will be received from the hotel when a user books a hotel room through the website. The company maintains a customer service centre in Hong Kong with staff to answer customers' enquiries.

- IRD's view: Assuming the company did not have any core operations or support activities performed in Hong Kong, it would not be chargeable to profits tax. However, if the staff of the customer service centre in Hong Kong had the authority to conclude contracts with the partner hotels on behalf of the company and performed core operations or support activities in Hong Kong, the commission income received by the company would be regarded as derived from Hong Kong and chargeable to profits tax.

Search engine

- A non-Hong Kong company develops and maintains an informational website outside Hong Kong and hosts the website on the server of an internet service provider (not at the company's disposal) in Hong Kong. The company has staff in Hong Kong to prepare and post information on the website which is free of charge to viewers. The company derives advertising fee income from customers who place advertisements through the website from all over the world (including Hong Kong).

- IRD's view: The activities of preparing and posting information on the website, though free of charge to viewers, would attract more viewers to the site which in turn would generate advertising revenue through the use of data from viewers. Such activities might arguably

be a significant part of the company's search engine business, which would constitute the profit-generating operation of the company.

Social network site

- A Hong Kong company hosts an app / website on a server at its disposal in Hong Kong. The app / website was developed and maintained by its group company outside Hong Kong. The company does not have any physical operations in Hong Kong. It derives advertising fee income from customers who places advertisements through the website from all over the world and the payments are made online.

- IRD's view: If the core functions and support activities (e.g. conducting marketing activities to generate demand for the advertising services, providing technical consultancy services to potential advertising clients) were not performed in Hong Kong, the Hong Kong company would not be chargeable to profits tax.

Online gaming

- A Hong Kong company holds a licence for an e-game from its overseas group company, which developed the game and the relevant virtual goods outside Hong Kong. The game is promoted in Hong Kong by online advertisements. The game is free of charge to the players. The company derives income from the Hong Kong players who purchases virtual goods through the app / website. No physical operations are required in Hong Kong.

  IRD's view: The IRD did not draw a conclusion based on the above information. It would need to examine what kinds of activities were carried out in Hong Kong or through the server in Hong Kong (if any) by the Hong Kong company and whether those activities were the core operations of the Hong Kong company's business when considering the source of its e-commerce profits.

If the activities for core operations were performed partly in Hong Kong and partly outside Hong Kong, whether apportionment of onshore / offshore income would be allowed depends on the nature of trade, i.e. trading or service. The IRD indicated that apportionment would not apply to trading of goods.

The IRD also mentioned that it would consider updating DIPN 39 on digital economy, electronic commerce and digital assets and adding more examples in future.

Dividends or profit distributions made by a tax-exempt fund

The IRD confirmed that dividends paid by a tax-exempt fund in Hong Kong would be treated as exempt income in the hands of the recipients pursuant to Section 26 of the Inland Revenue Ordinance. Yet, it reserved the rights to invoke the general anti-avoidance provisions to tackle any arrangement which aimed to obtain a tax benefit by exploiting the exemption.

Electronic filing (e-filing) of profits tax returns

The IRD proposed to implement the mandatory e-filing of profits tax return for MNE group starting from the year of assessment 2025/26. An MNE group whose annual consolidated group revenue for the preceding accounting period reached at least EUR 750 million (same as the threshold requirement for filing a Country-by-Country Return and similar to Pillar Two) would be in-scope for the first phase of mandatory e-filing.

Note: The above was discussed in May 2023. The final rules are subject to the announcement by the IRD subsequent to the consultation exercise on Pillar Two.

Our comments

Although the views expressed in the meeting minutes are not legally binding, they are good references of the IRD's stance on various tax issues. In particular, the IRD's comments on taxation of interest income are far-reaching. It is expected that the IRD would adopt "operation test" more often in determining the source of interest income and the "provision of credit" test would be of limited application. Even if all the profit-generating activities related to the loan interest are carried out outside Hong Kong, the offshore interest income is still subject to the FSIE regime, i.e. it would only be exempt from profits tax provided that the ESR is met. However, it is not easy to draw a line between the operations that determine the source of profits (which should be done outside Hong Kong) and the economic activities for FSIE purpose (which should be done in Hong Kong). Taxpayers should seek professional advice and need to be careful in arranging the loan transactions so that the offshore claim will not be tainted while the ESR can be met.

[1] One looks to see what the taxpayer has done to earn the profit in question and where he has done it.

[2] The place where the funds from which the interest is derived were provided to the borrower.

[3] It requires the entity to carry out the specified economic activities (i.e. making necessary strategic decisions, and managing and bearing principal risks in respect of any assets it acquires, holds, or disposes of) in Hong Kong and satisfy the adequacy test (i.e. employ an adequate number of qualified employees and incur an adequate amount of operating expenditure in Hong Kong).

[4] An entity that only holds equity interests in other entities, and only earns dividends, equity interest disposal gains and income incidental to the acquisition, holding or sale of such equity interests.

[5] It requires the foreign-sourced income to be subject to tax in foreign jurisdiction at the applicable rate of at least 15%.

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