Deloitte.
德勤

Tax
Issue H53/2013 – 20 December 2013

Tax Analysis

Authors:

Hong Kong

Raymond Tang, Partner
Tel: +852 2852 6661
Email: raytang@deloitte.com.hk

Silent Li, Senior Tax Manager
Tel: +852 2852 6399
Email: silli@deloitte.com.hk

Update on Inland Revenue Department's Views on Tax Treatment of Share-Based Payment Transactions: Opportunities and Uncertainties

Background

Companies have been required to recognize share-based payment transactions in their financial statements since 1 January 2005, the date the Hong Kong Financial Reporting Standard 2: Share-based payments became effective. However, neither the Inland Revenue Ordinance (IRO) nor any Departmental Interpretations and Practice Notes (DIPN) contains specific provisions or guidelines addressing the tax treatment of share-based payment transactions. The Inland Revenue Department (IRD) has expressed its position on the tax treatment of such transactions by way of frequently asked questions (FAQs) and tax information for tax representatives published on its website (Website Information).

According to the Website Information, it has been the IRD's position that share-based payments recognized in respect of stock option or share award obligations fulfilled by issuing new shares (i.e. equity-settled share-based payment transaction) are not deductible because no outgoing or expense is incurred for purposes of section 16(1) of the IRO. If the stock option or share award obligations are met by acquiring shares from the market, the costs incurred in the acquisition are tax deductible at the time the stock options are exercised or the conditions for the vesting of the share awards are satisfied.

Stock option/share award obligations often are discharged by way of "recharge arrangements" between group companies. In other words, the employing entities (usually the operating subsidiaries) are recharged for the monetary value of the shares issued or acquired by another group entity (usually the listed parent company), with or without a mark-up. According to the Website Information, the IRD's positions on the deductibility of the share-based payment recharge expenses are as follows:

- There should be a written recharge agreement;
- A recharge is deductible for both a new issue of shares and an acquisition of shares on the market by a group entity (the IRD previously took the position that a recharge in relation to a new issue of shares would not be deductible);

- The deduction may be taken at the time the stock options are exercised/when the share awards vest;
- The amount of the deduction claimed may not be "excessive";
- If option shares/award shares are subsequently forfeited or cancelled, any deduction previously allowed must be written back as a trading receipt and offered for assessment; and
- Share-based payment transactions that are entered into for tax avoidance purposes may be challenged by the IRD and the IRD can invoke anti-avoidance provisions to counteract the tax benefits obtained.

During the 2013 annual meeting of the IRD and the Hong Kong Institute of Certified Public Accountants (HKICPA) (2013 Annual Meeting), the IRD further explained its views on share-based payment recharge arrangements. This Tax Analysis recaps the issues discussed during the 2013 Annual Meeting.

Timing of deduction

The IRD maintains its position that a tax deduction for share-based payment recharge is allowable only for the employing entity at the time stock options are exercised/when the share awards vest. This treatment is debatable. In *Lo & Lo v. Commissioner of Inland Revenue [1984] 2 HKTC 34* (*Lo & Lo case*), Hong Kong's High Court held that an expense is incurred at the time it is paid or when the liability to pay arises (i.e. when the employing entity becomes unconditionally liable to the recharge). Accordingly, subject to the terms and conditions of the recharge arrangement, the timing of the exercise of stock options/vesting of share awards arguably should not directly affect the timing of a deduction for the recharge because it may contradict the principles articulated in the *Lo & Lo* decision.

Deduction must not be excessive

During the 2013 Annual Meeting, the IRD confirmed that, where a recharge arrangement is used in a group employee share-based incentive scheme, the employing entity would incur an expense at the time the stock options are exercised/share awards vest. The recharge incurred by the employing entity will be deductible provided the amount is not excessive and the conditions mentioned above are satisfied.

The amount of the deduction allowable to the employing entity will be the actual amount of the recharge incurred under the recharge agreement. If the costs of shares acquired by the listed parent company on the market are less than the actual amount of the recharge, the amount of the recharge may be regarded as excessive, since the IRD would expect that there should be terms in a commercial realistic recharge agreement allowing for an adjustment of the amount of the recharge having regard to the market circumstances. On the other hand, if the actual costs incurred by the listed parent company for acquiring its own shares from the market are greater than the amount of the recharge, the IRD's view is that the deduction allowable is the actual amount of the recharge incurred under the recharge agreement. The IRD has not weighed in on whether an additional deduction would be available if the recharge agreement includes an upward adjustment on the pre-determined amount.

Chargeability of the recharge received

The IRD stated that a recharge payment received by the listed parent company normally will be considered a capital receipt and non-taxable if the stock option obligation of the employing entity is discharged by the listed parent company by issuing new shares. However, if the listed parent company acquired the shares from the market, the taxability of the recharge payment will depend on whether the listed parent company intended to trade the shares or only discharge the stock option obligation. The IRD also clarified that it would not normally regard the acquisition of shares for discharging the stock option obligation as trading in shares unless the facts of the case indicated otherwise. However, the IRD pointed out that it may be necessary to look into the facts if the recharge payment includes a service fee for intra-group services rendered by the listed parent company. Such a fee would be subject to Hong Kong profits tax.

The IRD's comments presumably apply only to listed parent companies that carry on a business in Hong Kong; overseas listed parent companies not carrying on a business in Hong Kong should not be affected, but any overseas tax implications should be considered.

Transfer of employee between subsidiaries

If employees who have received share-based payments from one employing group entity are transferred to another entity and the listed parent company recharges each employing group entity, the IRD stated that the deductibility of the recharge for the employing group entities involved depends on the terms and conditions of the recharge agreement.

IRD guidelines

The IRD stated that it does not intend to issue a DIPN on the tax treatment of share-based payment transactions since share-based incentive scheme arrangements vary and it may not be feasible to provide examples in the form of a DIPN that would apply to all situations. Nevertheless, the IRD will continue to update its website to provide general insight to taxpayers. The IRD also suggested that taxpayers apply for advance rulings for individual cases or discuss their cases with the tax authorities if uncertainty prevails.

Observations and recommendations

Although the Website Information and the IRD's statements during the 2013 meeting are not law and have no legal binding effect, the IRD's further clarifications of its views on the tax implications of share-based payments through different channels are welcomed. Certain issues, however, remain unresolved and controversial:

- *Timing for the deduction of share-based payment recharge expenses*: The legal basis of the requirement that stock options must have been exercised/share awards vested in order to claim a deduction on the recharge is not fully explained and as mentioned above, such treatment seems to conflict with the decision in the *Lo & Lo* case.

- *Amount of the deduction*: It seems the IRD will allow a deduction only if the amount of the recharge is less than or equal to the acquisition costs incurred by the listed parent company from the market since the IRD is of the view that a commercial realistic recharge agreement would allow for a downward adjustment of the amount of the recharge. This view is also debatable.

  There was no discussion at the 2013 Annual Meeting on the factors that would go into determining whether a recharge agreement is commercially realistic. If a recharge agreement follows the market practice where an adjustment clause is not commonly used, would it be possible to conclude that a recharge agreement without an adjustment clause is not commercially realistic? On the other hand, what would be the consequences if the recharge agreement allowed for an upward adjustment of the amount of recharge if the actual acquisition costs incurred by the listed parent company were greater than the pre-determined amount of recharge? Would the upward adjustment on the amount of the recharge be allowed as a tax deduction?

  The IRD also did not express its view on a recharge case involving a mark-up. If a mark-up is commercially determined (for example, to cover the administrative costs of the listed parent company), would a recharge be regarded as excessive?

- *Forfeiture or cancellation of stock options/share awards*: Issues relating to forfeiture or cancellation of stock options/share awards were not raised for discussion during the 2013 Annual Meeting. According to the IRD's viewpoints stated in the Website Information, any deduction previously allowed should be written back as a trading receipt and offered for assessment if the stock options/share awards are subsequently forfeited or cancelled. It is unclear whether such treatment would cover all situations. For example, if the recharge agreement does not allow for a refund of a recharged amount to the employing entity even upon forfeiture or cancellation of stock options/share awards, there will not be any income recognized by the employing entity upon forfeiture or cancellation. The employing entity in such as case has incurred the recharge expense according to the agreed terms and conditions of the recharge agreement, notwithstanding that the share options/share awards are subsequently forfeited or cancelled. Would it still be reasonable to write back the deduction as a trading receipt and offer that amount for tax assessment?

As mentioned above, there are many kinds of share-based incentive arrangements and varying terms of such schemes and, thus, the tax treatment can differ from case to case. There are no authoritative court decisions or comprehensive guidelines from the IRD concerning the tax treatment of share-based payment transactions. Taxpayers should seek advice and assistance from legal and tax professionals, particularly if a recharge arrangement is in place. The terms and conditions of a recharge arrangement may have implications on the taxability of the recharge income and deductibility of the recharge expense.

Furthermore, a share-based incentive scheme that involves group entities in overseas jurisdictions may pose further uncertainties since the tax rules and accounting standards for share-based payment transactions can vary among jurisdictions. Affected entities should monitor the overall tax implications for group companies in various jurisdictions. In addition, issues other than tax (e.g. foreign exchange control) may need to be considered if the recharge scheme involves group entities in different jurisdictions.

Closing remarks

Legal, regulatory, human resources, financial and corporate tax implications all need to be taken into account when designing an effective share-based incentive scheme. Given that a slight difference in arrangements, terms and conditions may result in different tax implications for the group companies involved, companies should obtain professional advice on their proposed or existing schemes.

We also look forward to the IRD's further explanation on the controversial issues to ease the concerns of taxpayers and tax practitioners.

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte China. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

Beijing
Kevin Ng
Partner
Tel: +86 10 8520 7501
Fax: +86 10 8518 7501
Email: kevng@deloitte.com.cn

Hong Kong
Sarah Chin
Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@deloitte.com.hk

Shenzhen
Constant Tse
Partner
Tel: +86 755 3353 8777
Fax: +86 755 8246 3222
Email: contse@deloitte.com.cn

Chongqing
Claude Gong
Partner
Tel: +86 23 6310 6206
Fax: +86 23 6310 6170
Email: clgong@deloitte.com.cn

Jinan
Eunice Kuo
Partner
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: eunicekuo@deloitte.com.cn

Suzhou
Frank Xu / Maria Liang
Partner
Tel: +86 512 6289 1318 / 1328
Fax: +86 512 6762 3338
Email: frakxu@deloitte.com.cn
mliang@deloitte.com.cn

Dalian
Frank Tang
Partner
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297
Email: ftang@deloitte.com.cn

Macau
Quin Va
Partner
Tel: +853 8898 8833
Fax: +853 2871 3033
Email: quiva@deloitte.com.hk

Tianjin
Jason Su
Partner
Tel: +86 22 2320 6680
Fax: +86 22 2320 6699
Email: jassu@deloitte.com.cn

Guangzhou
Constant Tse
Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: contse@deloitte.com.cn

Nanjing
Frank Xu
Partner
Tel: +86 25 5791 5208
Fax: +86 25 8691 8776
Email: frakxu@deloitte.com.cn

Wuhan
Justin Zhu
Partner
Tel: +86 27 8526 6618
Fax: +86 27 8526 7032
Email: juszhu@deloitte.com.cn

Hangzhou
Qiang Lu
Partner
Tel: +86 571 2811 1901
Fax: +86 571 2811 1904
Email: qilu@deloitte.com.cn

Shanghai
Eunice Kuo
Partner
Tel: +86 21 6141 1308
Fax: +86 21 6335 0003
Email: eunicekuo@deloitte.com.cn

Xiamen
Lynch Jiang
Partner
Tel: +86 592 2107 298
Fax: +86 592 2107 259
Email: lijiang@deloitte.com.cn

About the Deloitte China National Tax Technical Centre

The Deloitte China National Tax Technical Centre ("NTC") was established in 2006 to continuously improve the quality of Deloitte China's tax services, to better serve the clients, and to help Deloitte China's tax team excel. The Deloitte China NTC prepares and publishes "Tax Analysis", "Tax News", etc. These publications include introduction and commentaries on newly issued tax legislations, regulations and circulars from technical perspectives. The Deloitte China NTC also conducts research studies and analysis and provides professional opinions on ambiguous and complex issues. For more information, please contact:

National Tax Technical Centre
Email: ntc@deloitte.com.cn

National Leader
Leonard Khaw
Partner
Tel: +86 21 6141 1498
Fax: +86 21 6335 0003
Email: lkhaw@deloitte.com.cn

Eastern China
Bill Ye
Partner
Tel: +86 21 6141 1261
Fax: +86 21 6335 0003
Email: bye@deloitte.com.cn

Northern China
Julie Zhang
Partner
Tel: +86 10 8520 7511
Fax: +86 10 8518 1326
Email: juliezhang@deloitte.com.cn

Southern China (Mainland/Macau)
German Cheung
Director
Tel: +86 20 2831 1369
Fax: +86 20 3888 0121
Email: gercheung@deloitte.com.cn

Southern China (Hong Kong)
Davy Yun
Partner
Tel: +852 2852 6538
Fax: +852 2520 6205
Email: dyun@deloitte.com.hk

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.