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Hong Kong Tax Newsflash

Views exchanged in the 2024 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 2024 were released today. The minutes highlight substantial discussions on a range of topics. This article summarises the views exchanged on certain key issues regarding profits tax and salaries tax.

Profits tax issues

Foreign-sourced income exemption (FSIE) regime

(i) Whether certain gains constitute disposal gains under the FSIE regime

A disposal gain under the FSIE regime refers to any gain or profit derived from the sale of property, including equity interests. The term "sale" is defined as a transfer of property (other than a transfer effected by extinguishing the property) for valuable consideration.

Based on these definitions, the IRD has the following views on disposal gains under the FSIE regime:

- **Distribution from liquidation of an investee entity not regarded as a disposal gain**: Liquidation is not considered a "sale" since any transfer of shares is void upon liquidation. In other words, no transfer of shares occurs. As such, distributions from liquidation are not disposal gains under the FSIE regime. However, if shares are actually transferred and not extinguished, any gain from such a transfer would be a disposal gain for the purposes of the FSIE regime.

- **Capital reduction through share cancellation does not constitute disposal gains**: These transactions involve the extinguishment of shares and do not fall within the definition of "sale". Therefore, any gain from these transactions is not a disposal gain under the FSIE regime.

- **Share redemption by an investee entity does not constitute disposal gains:** For the same reason as capital reduction.

- **Gain from share repurchase regarded as a disposal gain unless the shares are cancelled**: A share repurchase involves transferring shares and qualifies as a "sale". Any gain from a share repurchase would

be regarded as a disposal gain under the FSIE regime. However, if the repurchased shares are deemed cancelled (extinguished), it would not be considered a disposal gain under the FSIE regime.

(ii) Deemed received in Hong Kong

A specified foreign-sourced income would be deemed received in Hong Kong if it is used:

- to satisfy any debt incurred in respect of a business carried on in Hong Kong; or
- to buy movable property brought into Hong Kong.

The IRD explained that satisfying a debt generally involves repaying a sum owed or fulfilling an obligation to pay. In determining whether a debt is related to a business carried on in Hong Kong, the IRD would consider the nature of the business conducted in Hong Kong. Whether movable property is considered as having been brought into Hong Kong depends on the nature and form of the asset.

Capital injecting through the subscription of new shares: Injecting capital into a subsidiary through the subscription of new shares, which is neither a repayment nor an obligation fulfilment, would not be considered as satisfying a debt.

Purchase of shares from a shareholder: Using specified foreign-sourced income by an investment holding company to purchase shares from a shareholder, rather than from the investee entity, involves an obligation to pay and would be regarded as a debt repayment.

Investing in overseas shares: A trading company investing in shares in overseas markets would not be regarded as satisfying a debt in respect of a business carried on in Hong Kong. However, it could be considered the purchase of movable property and trigger deemed receipt in Hong Kong if the property is brought into Hong Kong.

Shares brought into Hong Kong: For shares in an entity with no nexus with Hong Kong (e.g. registered and listed overseas with no operation or assets in Hong Kong), the IRD would regard the shares as located overseas. The mere physical presence of a share certificate in Hong Kong does not automatically deem the shares as brought into Hong Kong.

Continuous tracing of funds: If those shares are later sold and the proceeds are remitted to Hong Kong, the original foreign-sourced income could then be deemed received in Hong Kong. Therefore, taxpayers have to trace the funds if the economic substance requirement is not met in the year of accrual, and there is no time limit for tracing funds.

Intellectual property (IP) brought into Hong Kong: The place where the IP was registered or protected, the place where it was managed, and the place where it is used and generates a financial benefit for its owner are relevant considerations for determining whether the IP is brought into Hong Kong. Each case must be determined on its own facts and there is no hard and fast rule.

Tax credit granted only for tax paid in accordance with a tax treaty and computed according to the IRO

The IRD emphasized that foreign tax credit would only be granted for tax paid in accordance with the Comprehensive Double Taxation Agreements (CDTAs) which generally stipulate that the profits of a Hong Kong enterprise should be taxable only in Hong Kong, unless the enterprise carries on a business in the other

jurisdiction through a permanent establishment (PE) situated there. Additionally, the amount of tax credit should not exceed the Hong Kong tax liability on that income, as calculated in accordance with the provisions of the Inland Revenue Ordinance (IRO), not calculated in accordance with the tax law of the foreign jurisdiction.

For example, when a Hong Kong company receives a service fee from a Mainland entity, the Mainland tax authorities may withhold Enterprise Income Tax based on a deemed profit method.

- If the Hong Kong company does not have a PE in the Mainland, no tax credit will be granted.
- If a PE does exist, the tax credit limit would be calculated based on the assessable profits computed under the IRO. No tax credit will be allowed for any excess deemed profits over the assessable profits computed under the IRO. The portion of Mainland tax paid attributable to such excess will also not be deductible.

Tax Certainty Enhancement Scheme for onshore equity disposal gain: tax treatment of unrealized fair value gain / loss may constitute the exclusion from the Scheme

The Tax Certainty Enhancement Scheme does not apply to equity interests treated as trading stock. Equity interests are considered trading stock if any gain or loss thereon has been "brought into account for tax purposes". The IRD clarified that where taxpayers elect for assessment on fair value basis, any unrealized gain or loss from equity interests, which has been brought into account under a final and conclusive assessment or computation of loss, would be regarded as "brought into account for tax purposes". The specified equity interest would be treated as trading stock and hence would not be eligible to the Scheme. For taxpayers adopting the realization basis of taxation, only realised gains or losses from the actual disposal of equity interests would be regarded as "brought into account for tax purposes".

Court-free amalgamation: "qualifying relationship" covers both direct and indirect ownership

Pre-amalgamation losses of an amalgamating company can be carried forward and offset against the assessable profits of the amalgamated company, provided certain conditions are met. One of these conditions is that the companies must have entered into a "qualifying relationship". A qualifying relationship exists if one company is a wholly owned subsidiary of the other, or both companies are wholly owned subsidiaries of a body corporate.

The IRD clarified that, in determining whether two companies have entered into a qualifying relationship, both direct and indirect ownerships would be considered. For example, if two companies are indirectly wholly owned by the ultimate holding company through various immediate parent companies, they would still be regarded as having entered into a qualifying relationship.

Foreign mergers subject to anti-avoidance tests similar to court-free amalgamation

Currently, there is no specific provision in the IRO that deals with the profits tax treatment of a merger effected under the law of a foreign jurisdiction. The IRD has taken the position that if a foreign merger by way of universal succession[1] is approved under the law of the home jurisdiction, the transfer of assets and liabilities to the surviving entity would not constitute a sale, and the surviving entity would generally be treated as a continuation of the merging entity, provided the merger is not for tax avoidance.

[1] Universal succession provided for the artificial continuance of a person by another, and all the rights and liabilities of the former person were automatically transferred to and vested in the latter.

In determining whether a foreign merger is carried out for tax avoidance, the IRD would consider factors similar to those applied for court-free amalgamations, e.g. the same trade test, trade continuation test, financial resources test and post entry test. Additionally, the IRD would consider the seven factors under the general anti-avoidance provision, including whether the merger has created rights or obligations which would not normally be created between persons dealing at arm's length.

One-off adjustment to the provision of long-service payment (LSP) regarded as specific provision and deductible

Following the abolition of the mandatory provident fund offsetting arrangement for LSP, one-off additional LSP provisions may be recognized by employers. The IRD confirmed that this one-off adjustment to the LSP provision, made in accordance with the Employment Ordinance and fairly accurate, would be accepted as a specific provision and deductible when recognised in the accounts (whether charged to the profit and loss account or other comprehensive income). The IRD reminded that taxpayers should also consider the chargeability of the relevant Government subsidy under Section 15(1)(c) of the IRO.

Salaries tax issues

Domestic rents expense deduction not allowed for serviced apartments under licence agreements

Rents paid under a qualifying tenancy for domestic premises are deductible for salaries tax and tax under personal assessment. A qualifying tenancy must be a written agreement that confers exclusive use of the premises and is stamped according to the Stamp Duty Ordinance. However, some serviced apartments are leased through license agreements, which do not confer exclusive possession and are not subject to stamp duty.

The IRD clarified that these licence agreements do not qualify as qualifying tenancies since they do not create a landlord-and-tenant relationship and are not chargeable to stamp duty. Therefore, rent paid under such license agreements are not deductible. However, if a serviced apartment is leased under a qualifying tenancy that provides for exclusive possession and is stamped, the rents paid would be eligible for deduction.

Revision of assessment upon clawback of share awards

The IRD acknowledged that clawback provisions in share award plans are common. Generally, if the clawback condition occurs and tax avoidance is not involved, the IRD agreed that the employer could file a revised employer's return, and the employee could request to revise the assessment for the year the income was originally taxed.

The IRD clarified that such revisions would not be considered corrections of errors, as no errors are involved. Instead, they would be treated as objections. If the clawback occurs after the statute of limitations, the IRD would accept an objection filed within a reasonable time, say within one month from the clawback.

Our observations

While the views expressed in the meeting minutes between the IRD and the HKICPA are not legally binding, they provide valuable insights into the IRD's stance on various tax issues. These discussions have significant implications for taxpayers and practitioners, and it is essential to be aware of the key points to ensure compliance and optimize tax planning.

Taxpayers should be cautious about the IRD's stance on deemed receipt in Hong Kong under the FSIE regime. The tracing of funds for deemed receipt in Hong Kong highlights the need for meticulous record-keeping and compliance. In particular, if taxpayers use the funds from the foreign-sourced income to purchase overseas shares, subsequently dispose of them, remitting the sale proceeds to Hong Kong, the original foreign-sourced income will be regarded as received in Hong Kong. In addition, the disposal gain of the shares, if foreign-sourced, will also fall into the FSIE regime and be subject to a separate assessment of conditions for exemption and fund tracing.

The IRD's approach in assessing whether a foreign merger is carried out for tax avoidance purpose appears to be broadened. It is a combination of the seven factors under the existing general anti-avoidance rule and the additional tests for court-free amalgamation. Taxpayers should watch out for this practice when structuring foreign mergers.

Overall, the meeting minutes offer a comprehensive overview of the IRD's current thinking on a range of tax issues. Taxpayers and practitioners should review these discussions to ensure their tax strategies are aligned with the IRD's interpretations and to identify any necessary adjustments to their financial and operational structures.

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