KPMG

HONG KONG TAX ALERT

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Key Hong Kong corporate tax issues discussed in the 2021 annual meeting between the IRD and the HKICPA

Summary

The minutes of the 2021 annual meeting between the Hong Kong Institute of Certified Public Accountants (HKICPA) and the Inland Revenue Department (IRD) was recently published. The minutes summarise the IRD's views on various issues related to profits tax, salaries tax, transfer pricing (TP) and double tax agreements that were discussed during the meeting.

This tax alert highlights some of the more important profits tax and cross-border tax issues discussed in the meeting. Hong Kong business groups should take this opportunity to review their group's Hong Kong profits tax profile and level of compliance with the TP rules, taking into account the IRD's views (although they are not legally binding) expressed in the meeting.

The IRD and the HKICPA held their 2021 annual meeting in May last year to discuss and exchange views on various tax issues. The minutes of the 2021 meeting was recently published. The IRD's views and clarifications on the more important profits tax and cross-border tax issues are summarised below. For a full list of tax issues discussed in the meeting, please refer to the meeting minutes in this link.

Hong Kong profits tax issues

1. Application of the source principles to a data center or server permanent establishment (PE)

The IRD reiterated that a "two-step approach" would be adopted to assess whether a data center or server PE of a non-resident enterprise would be chargeable to profits tax in the Hong Kong SAR (Hong Kong). That is, profits would first be attributed to the PE according to the separate enterprises principle and then the source of the profits attributed to the PE would be determined by applying the operation test. Only those Hong Kong sourced profits of the PE would be chargeable to profits tax. However, the IRD also mentioned that in practice, it may be difficult to conclude that the profits attributable to a PE in Hong Kong did not arise in Hong Kong. In determining whether a server or other computer equipment constitutes a PE in Hong Kong, the IRD would generally follow the OECD's Commentary on the PE Article of the OECD Model Tax Convention.

KPMG observations: We welcome the IRD's reiteration that attributing profits to a PE in Hong Kong does not necessarily mean such profits are Hong Kong sourced and taxable. Non-resident enterprises operating their businesses with a server or other computer equipment located in Hong Kong should carefully examine whether such computer hardware would give rise to any Hong Kong profits tax exposure based on the specific facts and circumstances of their cases.

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2. Interaction between the source rules and fair value taxation

For trading in securities, the IRD's established position is when either the purchase or sale contract was effected in Hong Kong, the initial presumption would be the source of the trading profits is in Hong Kong. Accordingly, for trading securities of which the purchase was effected in Hong Kong, the IRD's view is the realised trading profits upon sale of such securities would very unlikely be accepted as offshore shored. Based on this, where a taxpayer has elected for fair value basis of taxation and recognised an unrealised gain on revaluation of trading securities, the IRD's view is the taxpayer should offer the unrealised revaluation gain for tax. Interestingly, the IRD also noted that both the sale and purchase transactions are equally important in determining the source of profits derived from securities trading and that the above is a complicated issue that may warrant further thought.

KPMG observations: Other than fair value gains from revaluation of trading securities, taxpayers with unrealised revaluation gains on other financial instruments should carefully consider whether to offer such unrealised gains for taxation taking into consideration both the source and nature (capital vs revenue) of such gains as well as whether to elect for a fair value basis of taxation.

3. Definition of "fund" under the unified fund exemption (UFE) regime

There was a discussion in the meeting about the three requirements under the definition of "fund" in the Inland Revenue Ordinance (IRO) for the purposes of the UFE. The IRD reaffirmed that, in order to fulfil the definition of "fund", an arrangement must meet: (1) **either** the "managed as a whole" **or** "pooling" requirement, (2) the "no day-to-day control" requirement **and** (3) the "purpose or effect of the arrangement" requirement at all times during the basis period for the year of assessment.

The IRD clarified that the concept of the "pooling" requirement is different from that of the "purpose or effect of the arrangement" requirement and that the former is not a pre-requisite condition of the latter. The "pooling" requirement refers to the combination of capital contributions and profits or income of multiple investors while the "purpose or effect of the arrangement" requirement refers to the participation or receipt of profits, income or returns by the investors via the arrangement.

4. Taxation of ship leasing income

The IRD reiterated that section 23B of the IRO is a specific regime for ascertaining the assessable profits of a **ship operator** who provides services for the carriage by sea of passengers and/or goods as a ship owner or charterer. Section 23B of the IRO would only apply to exempt ship leasing income if such income is arising from **incidental** chartering activities. If the ship leasing income is exempted from tax under section 23B, the IRD would not apply section 15(1)(o) [1] of the IRO to deem such income as taxable.

KPMG observations: As expressed in the 2016 annual meeting, the IRD's interpretation of section 23B is that it only applies to exempt income derived by "ship operators" (including ship leasing income arising from incidental chartering activities of such ship operators) but not ship leasing income derived by business groups that do not carry on a ship operation/transportation business. The IRD has since then challenged and/or denied the section 23B exemption claims of some business groups in Hong Kong. However, the above IRD's interpretation has not been tested in courts and we consider it is not in line with the relevant legislation. In terms of what would be regarded as "incidental" to a ship operation/ transportation business, reference can be made to the OECD's Commentary on the International Shipping and Air Transport Article of the OECD Model Tax Convention. Business groups that are relying on section 23B for tax exemption of their ship leasing income may need to review their exemption claims in light of the IRD's comments and prevailing practice.

5. Substantial activities requirements under the ship leasing tax concessions

In order to qualify for the ship leasing tax concessions, the substantial activity requirements require a qualifying ship lessor or qualifying ship leasing manager to employ an adequate number of qualified full-time employees and incur an adequate amount of operating expenditure for carrying out the core income generating activities (CIGAs) in Hong Kong.

The IRD indicated that complying with the substantial activity threshold requirements is not a simple mathematic or division exercise. It also confirmed that in determining whether the employee threshold requirement is met, the employees of other group companies seconded to the taxpayer's entity and their related staff costs can be taken into account, subject to a number of conditions including (1) the types of activity carried out by the seconded employees, (2) whether the staff costs are fully borne by the taxpayer on an arm's length basis and (3) whether the number of employees and the amount of staff costs are commensurate with and adequate for the carrying out of the CIGAs.

1 Under section 15(1)(o) of the IRO, profits derived by a ship lessor or a ship leasing manager from carrying on a ship leasing business or a ship leasing management business in Hong Kong are chargeable to profits tax, even if the ships concerned are used outside Hong Kong.

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6. Application of the "main purposes test" under tax concession regimes

The tax concession regimes introduced in recent years generally include the "main purposes test" as an anti-avoidance provision.

The IRD clarified in the meeting that the main purposes test would not operate to deny tax concessions for the vast majority of genuine businesses with CIGAs carried out in Hong Kong. The IRD further assured taxpayers that in general, it would not consider obtaining tax concession in a normal course as the main purpose and hinder the potential investors from setting up businesses in Hong Kong.

KPMG observations: We welcome the IRD's assurance on the non-applicability of the main purposes test to genuine business set-ups in Hong Kong that are with real commercial substance. This gives some comfort to potential investors that want to operate a business in Hong Kong and benefit from the tax concessions available on a legitimate basis.

Transfer pricing issue

Issuance of Form IR1475 on TP documentation

The IRD has issued From IR1475 to selected taxpayers since September 2020 to request detailed TP information. The IRD indicated in the meeting that with the enactment of the TP rules and documentation requirements in Hong Kong, it would conduct regular desk-based reviews and TP audits to ensure taxpayers' compliance with the TP rules and documentation requirements. Form 1475 serves as a tool for the IRD to determine whether a taxpayer has prepared and maintained proper master file and local file as required and the information collected can assist the IRD to assess the level of TP risk of a particular taxpayer.

KPMG observations: The IRD's comments above reveal that the main purpose of Form IR1475 is to enable the IRD to enforce compliance with the TP documentation requirements and identify potential high risk cases for a TP audit. Since the issuance of the first batch of Form IR1475 in September 2020, the form has been fine-tuned based on comments received to make it easier to complete. Business groups which have filed Supplementary Form S2 with the IRD should review their group TP policies and compliance level of the TP documentation requirements, and be prepared to handle requests from the IRD for filling in the Form IR1475 or providing further information on the related-party transactions of the groups.

Double Tax Agreements

Status of implementing the BEPS Multilateral Instrument in Hong Kong

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (Multilateral Instrument) was signed by China in June 2017. Its application is to be extended to Hong Kong after completion of the ratification procedures in China (including depositing the approved instrument with the OECD and making the necessary reservations and notifications applicable to Hong Kong) and Hong Kong (including making of an order by the Chief Executive that is subject to negative vetting by the Legislative Council). No further information on the expected timeline of implementation is contained in the minutes.

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