KPMG

Hong Kong (SAR) Tax Alert

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Key Hong Kong corporate tax issues discussed in the 2022 annual meeting between the IRD and the HKICPA

Summary

The minutes of the 2022 annual meeting between the Hong Kong Institute of Certified Public Accountants (HKICPA) and the Inland Revenue Department (IRD) were recently published. The minutes summarise the IRD's views on various issues related to profits tax, salaries tax, stamp duty, double tax agreements, the OECD's BEPS 2.0 initiative and electronic tax filing (e-filing) that were discussed during the meeting.

This tax alert highlights some of the more important Hong Kong profits tax and international tax issues discussed in the meeting. Hong Kong business groups should take note of the IRD's views expressed in the minutes and evaluate whether they have any impact on the groups' Hong Kong profits tax profile, although such views are not legally binding.

The key salaries tax issues included in the meeting notes will be discussed in a separate Hong Kong tax alert to be issued in due course.

The IRD and the HKICPA held their 2022 annual meeting in May last year to discuss and exchange views on various tax issues. The minutes of the 2022 meeting was recently published. The IRD's views and clarifications on the more important issues from the Hong Kong profits tax, BEPS 2.0 and e-filing perspectives 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. CBA on second-hand pre-1998/99 commercial buildings

The IRD reiterated that since there is no provision in the Inland Revenue Ordinance (IRO) which grants commercial building allowance (CBA) in respect of commercial buildings that are still in use after the 25-year period, it has no authority to grant any CBA or provide any concession to the buyer of such buildings even though a balancing charge may have been made to the seller. The IRD also confirmed that for commercial buildings that have been in use prior to year of assessment (YOA) 1998/99, YOA 2023/24 will be the last year in which CBA on such buildings can be claimed.

KPMG observations: While we agree that the IRD does not have any legal basis to grant any CBA to commercial buildings over the 25-year period under the IRO, we urge the government policy bureau to consider the possible options (including those proposed in KPMG's submission to the government in June 2022[1]) of dealing with this issue to promote greater fairness of Hong Kong's tax system. As the end of the 25-year period for pre-1998/99 commercial buildings is fast approaching, this has become an imminent issue that needs to be dealt with without further delay.

[1] For a more detailed discussion of the issue and our submission, please refer to our Hong Kong Tax Alert - Issue 12, August 2022.

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2. Hong Kong certificate of resident status for non-Hong Kong incorporated companies

The IRD reiterated that in considering whether a Hong Kong certificate of resident status (HK CoR) can be issued to a non-Hong Kong incorporated company, it will examine all the relevant facts and circumstances (e.g. its nature of business, place of business, mode of operations and place of board meetings, etc.) to determine whether the company exercises its management and/or control (M&C) in the Hong Kong SAR (Hong Kong).

The IRD clarified that whether the company has applied for a **business registration** in Hong Kong is only one of the relevant factors for consideration but **not a conclusive factor** to consider. However, in the absence of a business registration in Hong Kong, the HK CoR applicant will need to provide further concrete evidence to establish that it has commercial substance and exercises its M&C in Hong Kong.

KPMG observations: Despite the IRD's response above, based on our experience, it would be difficult in practice for a non-Hong Kong incorporated company without a business registration in Hong Kong to obtain a HK CoR from the IRD. Obtaining a business registration in Hong Kong may also serve as an indication of having certain commercial substance in Hong Kong.

3. Permanent establishment of non-Hong Kong resident persons

Schedule 17G of the IRO set out the definitions of "permanent establishment" (PE) of a non-Hong Kong resident person in Hong Kong in tax treaty and non-tax treaty context for the purposes of applying the transfer pricing rules and double tax relief in Hong Kong. Under Schedule 17G, a "non-DTA territory resident person" means "*a person who, under the laws of the territory, is liable to tax in the territory by reason of the person's domicile, residence, place of management or any other criterion of a similar nature ……*".

The HKICPA raised the issue that the above definition cannot be applied to non-resident persons in jurisdictions that (i) do not impose corporate income tax (such as the British Virgin Islands and the Cayman Islands) or (ii) levy tax on a quasi-territorial basis (such as Singapore) and (iii) in the US where tax is levied on corporations **formed** in the US.

The IRD clarified that the definition of "non-DTA territory resident person" under Schedule 17G is modelled on Article 4 (the Resident Article) of the 2017 OECD Model Tax Convention but with an adjustment such that persons who are only subject to tax in a jurisdiction in respect of income from sources in that jurisdiction are not excluded from the definition. This ensure that the residents of jurisdictions adopting a territorial principle (e.g. Singapore) would not be excluded from the definition. For companies incorporated in jurisdictions that do not impose corporate income tax, the IRD considered that these companies are usually managed or controlled in another jurisdiction and subject to tax in that other jurisdiction.

The IRD also referred to the OECD Commentary on Article 4 and pointed out that in constructing the definition of "resident for tax purposes" in relation to a non-DTA territory, it has adopted the approach of regarding a person as being liable to taxation in a jurisdiction even if the jurisdiction does not in fact impose tax on the person as certain requirements in the tax law are met.

4. Application of anti-round tripping provisions under the unified fund exemption regime

There was a discussion in the meeting on whether a Hong Kong resident Fund A holding a more than 30% beneficial interest in another Hong Kong resident Fund B (which in turn holds a special purpose vehicle) would trigger the anti-round tripping provisions under the unified fund exemption (UFE) regime, provided that both funds are tax-exempted funds under the UFE regime.

The IRD clarified that a look-through approach would be adopted to identify the **beneficial owner** of a tax-exempted fund in applying the anti-round tripping provisions under the UFE regime. In the above case, the IRD held that **the participating persons of Fund A**, rather than Fund A, should be regarded as the **beneficial owners of Fund B**. In this regard, the participating persons would be the **limited partners** (for a fund in the form of a limited partnership) and the **shareholders** (for a fund in the form of an Open-ended Fund Company) respectively.

KPMG observations: We welcome the IRD's look-through approach and clarification on the non-applicability of the anti-round tripping provisions to investment structures involving "fund of fund". In particular, we are pleased to see that the IRD is willing to adopt a purposive interpretation that reflects the legislative intent of the UFE regime and avoids an absurd outcome.

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5. Tax deduction of purchase costs of renewable energy credits/certificates or carbon credits

The IRD indicated that, to qualify for a tax deduction, the acquisition costs of renewable energy credits/certificates (RECs) or carbon credits have to be a **revenue** expenditure incurred in the **production of chargeable profits** (i.e. deductible under section 16(1) of the IRO and not disallowable under section 17(1) of the IRO). The IRD further emphasised that the **degree of connection** between the acquisition costs and the profit-earning process of the taxpayer's trade, profession or business is an important factor to determine whether the acquisition costs are incurred in the production of chargeable profits.

KPMG observations: Nowadays, a company's ESG performance could be an important factor to be considered by suppliers and/or customers in deciding whether they would like to do business with the company. In some cases, the expenses in connection with REC or carbon credits could be considered as branding or marketing expenses incurred in building up the corporate image. All these should provide certain support to the close/direct nexus between the expenses and the production of chargeable profits and thus the deductibility of the expenses.

Issues on the BEPS 2.0 initiative

1. Definition of "Hong Kong resident person" for the purpose of the Global Anti-Base Erosion (GloBE) Rules

The IRD indicated that currently there is no definition of "Hong Kong resident person" for the general application of the IRO. The definition of "Hong Kong resident person" is currently included in Part 8AA of the IRO, which only applies for the purposes of transfer pricing and double tax relief, etc. To facilitate the future implementation of GloBE rules under Pillar 2 of BEPS 2.0 in Hong Kong, the IRD is considering introducing a definition of "Hong Kong resident person" under the IRO for determining residence under the GloBE rules.

2. Mismatch between PE definition under the GloBE rules and Hong Kong's territorial tax system

There was also discussion in the meeting that the current definition of PE under the GloBE rules (where there is no applicable tax treaty)[2] does not work under Hong Kong's territorial tax system since Hong Kong only taxes profits attributable to a PE in Hong Kong that are with a Hong Kong source. The IRD considered that it would be difficult for a person to establish that the profits attributable to a PE in Hong Kong do not arise from its profit-producing activities in Hong Kong. Nevertheless, the IRD indicated that this issue would need to be considered further as the OECD guidance in this area is not available and noted that some other jurisdictions have already raised this issue with the OECD.

Electronic tax filing

Consistent with the IRD's original plan, the IRD indicated that it would consider extending the scope of e-filing of profits tax returns gradually to cover other classes of businesses or entities at a later stage after the roll-out of voluntary e-filing in 2023 and the ultimate goal is to achieve full-scale implementation of mandatory e-filing by 2030. The IRD further clarified that even with the implementation of e-filing of profits tax returns in Hong Kong, currently it has no plan to issue notices of assessment or statements of loss to all "inactive" or dormant corporations and partnership businesses annually given the limited resources available.

[2] The GloBE rules define PE (where there is no applicable tax treaty) as "a place of business in respect of which a jurisdiction taxes under its domestic law the income attributable to such place of business on a net basis similar to the manner in which it taxes its own tax residents".

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