KPMG

Hong Kong (SAR) Tax Alert

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Key Hong Kong profits tax and salaries tax issues discussed in the 2023 annual meeting between the IRD and the HKICPA

Summary

The minutes of the 2023 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 (including the foreign-sourced income exemption (FSIE) regime) and salaries tax that were discussed during the meeting.

This tax alert highlights the more important Hong Kong profits tax and salaries tax issues discussed in the meeting. Hong Kong business groups, employers and employees should take note of the IRD's views expressed in the minutes and evaluate whether their tax profiles would be impacted, although such views are not legally binding.

The IRD and the HKICPA held their 2023 annual meeting in May last year to discuss and exchange views on various tax issues. The minutes of the 2023 meeting is now available[1]. The IRD's views and clarifications on the more important tax issues are summarised below.

Hong Kong profits tax issues

1. Source of interest income

Whether the "provision of credit" test or the operation test should be applied to determine the source of interest income is a common issue for taxpayers. In the meeting, the IRD expressed the following views:

- The operation test should apply when the loan is not a "simple loan of money".
- In general, the IRD would only accept **mere lending of its own surplus funds** by a company (which is not carrying on a business of a financial institution, money lending or intra-group financing) as a "simple loan of money".
- The fact that a loan is one-off does not necessarily mean it is a "simple loan of money" or that the operation test could not be applied.
- Where a one-off loan involves borrowing and on-lending of funds, it would be surprising to solely consider the place of lending, to the exclusion of the place of borrowing, in determining the source of the interest income.

[1] The 2023 annual meeting minutes can be accessed via this link: https://www.hkicpa.org.hk/-/media/Document/APD/TF/Tax-bulletin/034_April-2024.pdf

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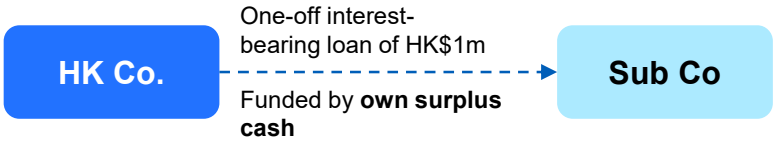
Based on the above views, the IRD commented on the below three scenarios:

Scenario 1



The IRD's position:

- Simple loan of money => Provision of credit test applies

Scenario 2

- Simple loan of money => Provision of credit test applies (assuming no borrowing / complex financing arrangement behind)

Scenario 3

- **NOT** simple loan of money => Operation test applies
- Whether the parent company funded the loan with its own surplus cash is irrelevant

KPMG observations: Hong Kong business groups with significant intra-group loan arrangements should review those arrangements in view of the above IRD positions and consider whether any restructuring of the loan arrangements are desirable.

2. Clarifications on practical application of the FSIE regime

The IRD provided the following clarifications on the practical application of the FSIE regime during the meeting:

Economic substance requirement

- There is no specified frequency for review and audit of FSIE claims. The IRD would select some (but not all) FSIE claims for desk-based review every year.
- **Board minutes recording the discussion on making and managing investments in Hong Kong** are accepted as sufficient proof that the MNE entity has made strategic decisions, managed and borne principal risks with respect to the relevant asset in Hong Kong.
- For an outsourced entity performing the specified economic activities for various outsourcing entities within a group, whether the adequacy test is met with no double counting of qualifying employees / human resources is **not a pure arithmetic question**.

The subject to tax condition

- For the purpose of the "subject to tax" condition under the participation exemption, where a specified foreign-sourced income (SFSI) is taxed at both federal and state/regional levels in a foreign jurisdiction, the "applicable rate" would be the aggregate of the respective **headline tax rates at the federal level and state/regional level** provided that the taxes levied at both levels are of substantially the same nature as Hong Kong profits tax.

Interpretation of "received / deemed received in Hong Kong"

- Where an MNE entity maintains a mixed pool of funds in an overseas bank account comprising SFSI and non-SFSI and has practical difficulties in tracking the SFSI funds kept in the bank account, the IRD would take the below pragmatic approach to determine whether a fund remittance to Hong Kong from a mixed pool of funds includes any SFSI:

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- The IRD would regard any withdrawn funds used to (1) satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong or (2) buy any moveable property outside Hong Kong which is intended to be brought into Hong Kong as **first sourced from the non-SFSI funds**. Any excess portion of the withdrawn funds over the non-SFSI fund balance in the bank account would be considered as sourced from the SFSI funds.

- Any withdrawn funds used for purposes other than the above would be regarded as **first sourced from the SFSI funds**. Any excess portion of the withdrawn funds over the SFSI fund balance in the bank account would be considered as sourced from the non-SFSI funds.

- No SFSI would be regarded as remitted to Hong Kong if the amount of remitted funds is no more than the non-SFSI fund balance in the bank account. Only the **excess portion of the remitted funds over the non-SFSI fund balance** would be regarded as SFSI remitted to Hong Kong.

- Based on case law, it would be difficult to regard an investment holding company as not carrying on a trade or business in Hong Kong for the purpose of the FSIE regime given its activities of acquiring, holding and selling of assets would constitute a gainful use of assets. As such, the use of SFSI (e.g. foreign sourced dividends) by such company to settle its overseas expenses may be regarded as settling a debt in relation to a trade or business in Hong Kong.

KPMG observations: We welcome the IRD's further clarifications on the practical application of the FSIE regime. In particular, it is encouraging to see that the IRD adopts a favorable approach to dealing with a mixed pool of SFSI and non-SFSI funds kept in an overseas bank account. The IRD's approach is similar to the one adopted by Singapore. However, taxpayers should bear in mind that they would need to keep track of the balances of SFSI and non-SFSI funds in the overseas bank account even under the IRD's pragmatic approach.

3. Taxation of e-commerce business models

There was a discussion on the tax treatment of four digital business models (i.e. online intermediary, search engine, social network platform and online gaming) in the meeting.

The IRD indicated that the location of the server is not the sole determining factor for the locality of the profits of e-commerce businesses and the proper approach is to focus on (1) the core operations that have effected the e-commerce transactions to earn profits and (2) the place where those core operations have been carried out. If all the core operations and support activities of a platform-based operator are performed in Hong Kong, the e-commerce profits should be fully chargeable to Hong Kong profits tax even though the server is located outside Hong Kong.

The IRD considered that the core operations of e-commerce business models may include (1) user network promotion (e.g. developing network relationships between suppliers and consumers or viewers and advertisers) and customer contract management, (2) provision of services associated with establishing, maintaining and terminating links between users and (3) network infrastructure operations associated with maintaining and running a physical and information infrastructure.

The IRD also mentioned it would consider updating DIPN 39 on taxation of e-commerce after any implementation of Pillar One of BEPS 2.0 in Hong Kong.

4. Tax treatment of founder/promoter shares of Special Purpose Acquisition Companies (SPACs)

The IRD indicated that the tax treatment of founder/promoter shares of SPACs would depend on the circumstances under which the shares were granted, in particular the terms and conditions governing the grant and the obligations performed by the founders/promoters. If the shares are regarded as a capital investment, any gains arising from the shares would be capital in nature and non-taxable. If the shares are regarded as payments for services rendered by the sponsors/promoters, the relevant gains would be regarded as service income for salaries tax or profits tax purposes (depending on whether the remuneration was derived from an employment or a business).

KPMG observations: While the gains derived from the automatic conversion of the founder shares to public shares upon completion of the target acquisition may be regarded as service income and taxable (if the shares were granted for services rendered), there could be basis to argue that further gains derived from the subsequent disposal of the shares (say after holding the shares for a period of time) are gains from a capital investment and not taxable, subject to any terms and conditions imposed on the founders/promoters in respect of the shares.

5. Dividends or profits distributions received from a tax-exempt fund

The IRD confirmed that dividends or profits distribution from a tax-exempt fund under the unified fund exemption regime would be regarded as tax-exempt income in the hands of the recipients. This is because the fund is regarded as chargeable to Hong Kong profits despite not having any assessable profits.

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6. Tax deduction of lease reinstatement costs

The IRD reiterated that it has no room to provide a concessionary deduction of lease reinstatement costs given that they are capital in nature. In this regard, the Financial Secretary announced in the 2024/25 Budget that a tax deduction will be granted for reinstatement costs incurred for lease premises starting from the **year of assessment 2024/25**.

KPMG observations: We welcome the policy move of providing a tax deduction for lease reinstatement costs, which represent costs necessarily incurred by taxpayers to earn their chargeable profits. Similar tax deduction is available in Singapore, subject to the following three conditions[2] : (1) the costs claimed are actual expenses incurred rather than provisions made under the accounting standard on leases; (2) the costs claimed are contractually provided for in the tenancy agreement and (3) the premises are not vacated due to any cessation of business. However, we suggest allowing taxpayers to claim a deduction based on the accounting treatments under HKFRS 16 (similar to the IRD's current assessing practice for lease payments). We also consider that condition (2) is not necessary as the tenants would not incur such reinstatement costs if they were not obliged / required to do so and that condition (3) should not be imposed since according to the principle established in CIR v Cosmotron Manufacturing Co Ltd, payments made upon cessation of a business are deductible if they represent expenses incurred to meet existing obligations in running the business despite they only crystalise upon cessation of the business.

Hong Kong salaries tax issues

1. Employees working remotely overseas or in the Mainland of China (the Mainland) – tax treatment

There was discussion on the salaries tax implications to individuals who are employed by a Hong Kong employer but work remotely.

The example discussed is as follows:

- The individual is a tax resident of the Mainland and subject to tax in the Mainland in accordance with the comprehensive avoidance of double taxation arrangement (DTA) between the Mainland and Hong Kong (Mainland-HK DTA);
- the individual is employed and paid by a Hong Kong resident employer; and
- the individual works primarily remotely but will travel to Hong Kong for work and spend 80 days a year in Hong Kong.

In summary, the individual would not qualify for full exemption or relief from salaries tax under the provisions in the Inland Revenue Ordinance or articles in the Mainland-HK DTA. However, the IRD broadly agrees that the individual should be subject to salaries tax on a "time apportionment" basis under Article 14 of the Mainland-HK DTA, i.e., only to the extent that the remuneration was derived from the exercise of employment in Hong Kong (80 days in this scenario).

KPMG observations: We welcome the IRD's response that time apportionment of income is available under a comprehensive DTA. This is helpful to mitigate double taxation as in many jurisdictions, tax residents are taxed on worldwide income , and in the absence of time apportionment under a comprehensive DTA, individuals who hold a Hong Kong employment may also be subject to salaries tax on their employment income in full. Individuals who work remotely should consider the salaries tax treatment of their income, whether relief or time-apportionment of income is available.

2. Reimbursement of relocation expenses

The HKICPA asked the IRD to clarify the salaries tax treatment of a reimbursement of relocation expenses from the employer to the employee for the purposes of relocating the employee and his family members to or out of Hong Kong upon assumption of a new post or termination of an existing post in Hong Kong.

The IRD explained that if the employer pays a third-party (e.g., airline or travel agent) in discharge of the employer's own liability (e.g., amounts charged to the employer for air tickets to relocate the employee to Hong Kong), the amount paid by the employer should be excluded from the charge to salaries tax. However, if the employee incurs relocation expenses and the employer reimburses the employee, this would be regarded as a discharge of the employee's personal liability and the amount reimbursed would be a taxable perquisite for salaries tax purposes.

KPMG observations: Employers should consider how services or benefits are provided to employees, e.g., whether the employer contracts the service provider and is liable to pay for the services, or via reimbursement, as the method may impact the tax treatment.

[2] For more details, please refer to the IRAS guidance via this link: https://www.iras.gov.sg/taxes/corporate-income-tax/income-deductions-for-companies/business-expenses/tax-treatment-of-business-expenses-(m-r)

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3. Tax obligations for foreign talents with non-Hong Kong employment working in Hong Kong

There was discussion on the tax obligations for foreign talents who are employed by overseas employers working in Hong Kong, e.g., foreign talents holding a visa issued under the Top Talent Pass Scheme who may work in Hong Kong without a local sponsor.

Broadly, an employer who employs in Hong Kong an individual who is, or is likely, chargeable to salaries tax would be required to file Employer's Returns in respect of the employee. This is irrespective of whether the employer has business presence in Hong Kong and there is no waiver of filing requirements for overseas employers. Employers may file paper Employer's Returns or e-file via the IRD's e-Tax system. Separately, individuals who are chargeable to tax have individual tax obligations, e.g., notifying the Commissioner of Inland Revenue their chargeability to tax.

KPMG observations: Whether an overseas employer would be required to file Employer's Returns for such foreign talents will depend on individual facts and circumstances and whether they are "employed in Hong Kong", as it may be the individual's personal choice to spend time working in Hong Kong. Similar considerations apply to frequent business travellers to Hong Kong. Separately, such individuals should consider whether they are chargeable to tax. Employers and individuals should review their tax obligations and whether their activities in Hong Kong may create a taxable presence for the employer in Hong Kong (e.g., a permanent establishment in Hong Kong).

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