Hong Kong (SAR) Tax Alert

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The IRD's views on tax issues discussed in the 2024 annual meeting between the IRD and the HKICPA

Summary

The minutes of the 2024 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 profits tax, salaries tax, stamp duty and BEPS 2.0 issues discussed during the meeting.

This tax alert discusses the more important views expressed by the IRD in the meeting and our observations on those views. Taxpayers should take note of the IRD's views expressed in the minutes as they serve as a good reference of the positions taken by the IRD, though they are not legally binding.

The IRD and the HKICPA held their 2024 annual meeting in May last year to discuss and exchange views on various tax issues. The minutes of the 2024 meeting is now available online[1]. The IRD's views and clarifications on the more important tax issues are summarised below.

Hong Kong profits tax issues

1. Profits tax treatment of foreign mergers

In the meeting, the IRD expressed the following views on the profits tax implications of a foreign merger:

- The current provisions in the Inland Revenue Ordinance (IRO) related to court-free amalgamation of companies in the Hong Kong SAR (Hong Kong) do not apply to foreign mergers effected by way of universal succession.
- If two overseas incorporated entities merged by universal succession under the law of their home jurisdiction and the assets and liabilities of the merging entity become the assets and liabilities of the surviving entity as part of the process, those assets and liabilities would generally be regarded as being transferred to the surviving entity by operation of law rather than by sale.
- In determining whether the pre-merger losses of the merging and surviving entities (if any) can be used to offset against the assessable profits of the surviving entity after the merger, the IRD would consider whether the foreign merger was carried out for the purpose of obtaining a tax benefit and the applicability of section 61A or 61B of the IRO. In particular, the same trade test, trade continuation test, financial resources test and the post entry test under Hong Kong's company amalgamation regime would be regarded by the IRD as relevant factors to consider under section 61A.

1 The 2024 annual meeting minutes can be accessed via this link: https://www.hkicpa.org.hk/-/media/Document/APD/TF/Tax-bulletin/035_May-2025.pdf

2. Foreign tax credit claims

In the situation where (i) Chinese enterprise income tax has been withheld upon remittance of service fees from a Mainland entity to a Hong Kong company for services rendered in Hong Kong, (ii) the Chinese withholding tax (WHT) is calculated based on the deemed profits method rather than the actual profits derived by the Hong Kong company and (iii) the service fees are fully taxable in Hong Kong, the IRD's positions on foreign tax credit (FTC) claim in respect of the Chinese WHT are as follows:

- if the Hong Kong company does not have a permanent establishment (PE) in the Mainland, no FTC will be allowed since the Chinese WHT is not paid in accordance with the provisions of the double tax arrangement between the Mainland and Hong Kong;
- if the Hong Kong company has a PE in the Mainland, FTC will be allowed but it will be limited to the amount as computed based on the assessable profits ascertained according to the IRO rather than on the deemed profits; and
- while the Chinese WHT paid in respect of the assessable profits computed in accordance with the IRO that exceeds the credit limit can be deducted under section 50(5) of the IRO, the portion of the Chinese WHT paid attributable to the excessive deeming profits will not be deductible.

KPMG observations: While we agree that the IRD's positions above are correct from a technical perspective, business groups in such situations will suffer from double taxation as the service fee income is taxed in both Hong Kong and the Mainland with no or only a partial FTC. It would be helpful from a practical perspective if the HKSAR Government can liaise with the Mainland Government to work out a mutually agreed solution to this issue to eliminate the double taxation.

3. Clarification on the tax certainty scheme for onshore equity disposal gains

Under the tax certainty scheme for onshore equity disposal gains, equity interests held by an entity (the holding entity) will be regarded as trading stock (and therefore not eligible for the scheme) if any realised / unrealised profit or loss in respect of the equity interests (or other equity interests acquired by the holding entity on the same occasion) has been "brought into account for tax purposes". The term " brought into account for tax purposes" means the amount has been brought into account for computing the holding entity's assessable profits or losses in a final and conclusive assessment made on it or a computation of losses in respect of the entity.

The IRD clarified that for taxpayers adopting the realisation basis of taxation, any unrealised gains or losses from revaluation of equity interests that are excluded for profits tax filing purposes would not be regarded as "brought into account for tax purposes" under the tax certainty scheme. In such cases, only gains or losses that are realised from the disposal of the equity instruments will be regarded as "brought into account for tax purposes".

4. Clarifications on practical application of the FSIE regime

The IRD provided the following clarifications on the practical application of the foreign-sourced income exemption (FSIE) regime during the meeting:

(i) Equity interest disposal gains

The IRD clarified whether the gains recognised by an investor entity from the following transactions will be regarded as "equity interest disposal gains" for the purposes of the FSIE regime:

<table>
<tr><th>Type of transaction</th><th>Equity interest disposal gain?</th><th>Basis of conclusion</th></tr>
<tr><td>1. Liquidation of the investee entity</td><td>No</td><td>Does not fall within the definition of "sale" as no transfer of shares is involved.</td></tr>
<tr><td>2. Reduction of capital through cancellation of shares</td><td>No</td><td rowspan="2">Does not fall within the definition of "sale" as the transfer of shares is effected by extinguishing the shares.</td></tr>
<tr><td>3. Redemption of shares</td><td>No</td></tr>
<tr><td>4. Reduction of capital through repurchase of shares</td><td>It depends</td><td>Same as (2) & (3) above if the repurchased shares are cancelled or deemed to be cancelled upon repurchase. Otherwise, it is a transfer for valuable consideration and thus a "sale" for the FSIE purposes.</td></tr>
</table>

(ii) Received in Hong Kong

The IRD expressed the following views on the interpretation of "received in Hong Kong" at the meeting:

- The act of injecting capital into a foreign subsidiary through subscription of new shares (say using foreign-sourced dividends received) is neither repayment of a sum owed nor fulfilment of a paying obligation. As such, it will not be regarded as satisfaction of a debt incurred in respect of a trade or business in Hong Kong and the foreign-sourced dividends will not be regarded as "received in Hong Kong".
- However, if an **investment holding company** in Hong Kong uses the specified foreign-sourced income (FSI) received to purchase shares of the investee entity from its shareholder, rather than from the investee entity as the issuer, the specified FSI used to settle the share purchase costs will be regarded as being used to satisfy a debt in respect of a trade or business in Hong Kong and therefore "received in Hong Kong".
- Passive investment holding could amount to "carrying on a business" as case law has established that for a company incorporated for the purposes of making profits for its shareholders, any gainful use of any of its assets will, *prima facie*, amount to the carrying on of a business.
- If the specified FSI is used to acquire **shares** of an investee entity which has no nexus with Hong Kong (e.g. it is registered / listed overseas and having no operation or assets in Hong Kong), the shares are regarded as located at overseas and not being "brought into Hong Kong". In the IRD's view, shares purchased outside Hong Kong could hardly be considered as being "brought into Hong Kong".
- If the specified FSI is used to acquire an **intellectual property** (IP), the places where the IP was registered or protected, managed, and used (and thereby created a financial benefit to its owner) **may** be relevant in determining the location of the IP.

KPMG observations:

Based on the above IRD responses, it is not absolutely clear whether the shares of a company incorporated outside Hong Kong or having its share register kept outside Hong Kong but having a nexus with Hong Kong (e.g. with a branch operating in Hong Kong or holding an immovable property in Hong Kong) will be regarded as located in Hong Kong. It also seems that there are no definite rules on determining the location of an IP.

Like Hong Kong, under the revised FSIE regime in Singapore which took effect from 1 January 2024, gains derived by MNE groups from disposal of foreign assets are taxable if they are received or deemed to be received in Singapore, unless certain specified conditions are met.

In the updated e-Tax Guide on Tax Treatment of Gains or Losses from Sale of Foreign Assets issued by the Inland Revenue Authority of Singapore (IRAS) in late December 2024[2], the IRAS has set out clear rules for different types of assets as to when the assets will be regarded as situated outside Singapore (i.e. being a foreign asset). For example, (i) any shares in or securities issued by a company are situated outside Singapore if the company is incorporated outside Singapore and (ii) an IP right or a licence is situated outside Singapore if the owner of the IP right or licence is resident in a jurisdiction outside Singapore.

To provide greater clarity and certainty to taxpayers, we recommend that the IRD consider setting out clear rules on determining the location of different types of property for the purposes of the FSIE regime.

5. The BEPS 2.0 initiative

i. Tax residency under the GloBE Rules – When being asked whether a Hong Kong tax resident can obtain a Hong Kong Certificate of Resident Status (HK CoR) for Pillar Two purposes, the IRD mentioned that it was not aware of any jurisdictions requiring provision of CoR as a proof of tax residency for Pillar Two purposes but will closely monitor any further development in this area.

ii. Other issues relating to the Pillar Two implementation in Hong Kong – The issues discussed in the meeting have now been largely addressed by the draft Pillar Two legislation published in December 2024 and the government's responses to the submissions on the draft legislation.

iii. The Subject-to-Tax Rule (STTR) – The STTR can only be implemented in Hong Kong if the Mainland Government signs the Multilateral Instrument for the STTR and extends its application to Hong Kong. In addition, Hong Kong will only incorporate the STTR into the existing double tax agreements with the developing jurisdictions upon their request.

2 The IRAS e-Tax Guide can be accessed via this link: https://www.iras.gov.sg/media/docs/default-source/e-tax/tax-treatment-of-gains-or-losses-from-the-sale-of-foreign-assets.pdf

iv. Amount B of Pillar One – The IRD indicated that it did not intend to implement the "taxpayer safe harbour approach"[3] under Amount B at present but did not rule out the possibility of doing so in the future, provided that the approach is appropriately defined and scoped.

Hong Kong salaries tax issues

1. Domestic rents expense deduction

The IRD has clarified that leases for certain serviced apartments, which are arranged as license agreements rather than traditional tenancy agreements, do not qualify as "qualifying tenancy." Consequently, rents paid under such a license for a serviced apartment are not eligible for deduction as domestic rent expenses. However, if a serviced apartment is leased under a qualifying tenancy for residential purposes, the rents paid under that tenancy can be deducted.

KPMG observations: Taxpayers renting serviced apartments should carefully consider the structure of their lease agreements to determine eligibility for domestic rent deductions. Although rents for serviced apartments may not be deductible as domestic rent expenses, they may be reimbursable under rental reimbursement arrangements operated by employers. A reimbursement of rent is afforded preferential Salaries Tax treatment. Taxpayers should evaluate the availability of the deduction versus participation in an employer's rental reimbursement arrangement. Employers should consider reviewing their rental reimbursement policies to determine if any adjustments required.

2. Claw-back of share awards

The IRD clarified that if the employer clawed back all or part of the share award granted or vested to an employee, and the value of these awards had been previously assessed to tax, the employer can amend the employer's return for the year in which taxation occurred to revise the amount of income accrued to the employee. Furthermore, the employee can request a revision of their tax assessment through a late objection, rather than reopening the case under section 70A of the IRO. The IRD advised that the taxpayer should submit a notice of objection within a reasonable timeframe, such as one month from the claw-back, and may ask the Commissioner for an extension of the notice period if there is a reasonable cause.

KPMG Observations: Both employers and employees should pay attention to the suggested procedures and timeframes for seeking revision when a claw-back of share awards occurs.

3. Basis of time apportionment for dual employments

The IRD traditionally uses the day-in-day-out (DIDO) calculation method to determine the amount of income attributable to services performed in Hong Kong when an individual holds non-Hong Kong employment. In a recent Board of Review (BOR) case, D18/22 (refer to our Hong Kong (SAR) Alert – Issue 8, April 2023), the BOR proposed an adjusted DIDO approach to reflect the value of the taxpayer's work to the non-Hong Kong employment while in Hong Kong, essentially providing a discount. The HKICPA requested clarification from the IRD on whether this discount would generally be applicable in other situations.

The IRD emphasised that it will assess whether the dual employment constitutes two separate employments, or a single employment. Where there are two separate employments, the IRD will generally adopt the traditional DIDO approach and may consider alternative apportionment bases depending on the specific facts and circumstances.

KPMG Observations: There is an increasing trend to adopt dual employment arrangements to accurately reflect the services performed by employees for each employer and to manage permanent establishment exposure. It is important to note that, despite the publication of the Board of Review Case D18/22, the IRD may not necessarily follow the approach and calculation method used in this case, but will assess each case based on its individual merits to determine their stance. Employers looking to implement such arrangements should proceed with caution and seek professional advice.

4. Filing Form IR56M for "local persons"

The HKICPA sought clarification from the IRD on the interpretation of the terms "local person" and "non-resident individuals" in the context of making payments to consultants and filing forms IR56M and IR623P, respectively.

The IRD explained that determining whether an individual is a "local person" or a "non-resident individual" is a question of fact. An individual is considered a non-resident if they do not have **a home or habitual abode** in Hong Kong, and a local person if they do. While the IRD reiterated that possessing a Hong Kong Identity Card (HKID) is not conclusive in determining whether an individual is a local person, they acknowledged that a simple approach, such as checking whether the recipient holds an HKID card, is commonly used.

3 Under this approach, a jurisdiction allows taxpayers to elect to apply the simplified and streamlined approach to the application of the arm's length principle to certain baseline marketing and distribution activities but does not make the approach mandatory even when the scoping criteria are met.

KPMG observations: Employers should review their current filing practices in view of the commentary to determine if any updates are needed.

Stamp duty issue

The IRD confirmed that partnership properties (e.g. Hong Kong stocks or immovable properties) distributed upon termination of a limited or general partnership **strictly on a pro-rata basis** to the partners involved **with reference to their respective capital accounts** would not attract stamp duty given that no beneficial interest in the properties is passed upon the distribution.

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