Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Tax Bulletin

2024 Annual Meeting

The Inland Revenue Department

and

The Hong Kong Institute of Certified Public Accountants

2024
ANNUAL MEETING BETWEEN
THE INLAND REVENUE DEPARTMENT AND
THE HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Preamble

As part of the Institute's regular dialogue with the government to facilitate tax compliance, improve procedural arrangements and clarify areas of interpretation, representatives of the Institute's Taxation Faculty Executive Committee (TFEC) met the Commissioner of Inland Revenue (CIR) and members of his staff in May 2024.

An agenda was proposed by the TFEC, taking account also of questions suggested by other members. The minutes of the meeting, prepared by the Inland Revenue Department (IRD), having considered comments from the Institute, are reproduced in full in this Tax Bulletin and should be of assistance in members' future dealings with the IRD. Part A contains items raised by the Institute and Part B, items raised by IRD.

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2024
ANNUAL MEETING BETWEEN
THE INLAND REVENUE DEPARTMENT AND
THE HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Full Minutes

The 2023/24 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department was held on 17 May 2024 at the Inland Revenue Department.

In Attendance

Hong Kong Institute of Certified Public Accountants (the Institute)

Ms Sarah Chan	Chair, Taxation Faculty Executive Committee
Mr Eugene Yeung	Deputy Chair, Taxation Faculty Executive Committee
Ms Agnes Cheung	Member, Taxation Faculty Executive Committee
Mr Anthony Chan	Member, Taxation Faculty Executive Committee
Ms Grace Tang	Member, Taxation Faculty Executive Committee
Mr Jack Fernandes	Member, Taxation Faculty Executive Committee
Mr Louis Lam	Member, Taxation Faculty Executive Committee
Ms Sophia Chan	Member, Taxation Faculty Executive Committee
Ms Vicky Wong	Member, Taxation Faculty Executive Committee
Ms Doris Chik	Member, Taxation Faculty Executive Committee
Ms Carmen Cheung	Member, the Institute
Mr Peter Tisman	Director, Advocacy and Practice Development
Ms Selraniy Chow	Associate Director, Advocacy and Practice Development

Inland Revenue Department (IRD)

Mr Tam Tai-pang, Ashley	Commissioner of Inland Revenue
Mr Chan Sze-wai, Benjamin	Deputy Commissioner of Inland Revenue (Technical)
Mr Leung Kin-wa, Wesley	Deputy Commissioner of Inland Revenue (Operations)
Ms Lam Pui-kuen, Florence	Assistant Commissioner of Inland Revenue, International and Taxation Development Unit
Ms Chan Shun-mei, Michelle	Assistant Commissioner of Inland Revenue, Unit 1
Ms Tang Hing-kwan, Marina	Assistant Commissioner of Inland Revenue, Unit 2
Ms Leung Wing-chi, Wings	Assistant Commissioner of Inland Revenue, Unit 3
Mr Ng Man-kwan, Raymond	Assistant Commissioner of Inland Revenue, Unit 4
Ms Pan Hiu-yan, Sabrina	Senior Assessor (Research)

Mr Tam Tai-pang (CIR) welcomed the representatives of the Institute to the annual meeting and thanked the Institute's support for the past year. CIR introduced the IRD officers in attendance. He appreciated the efforts made by the members of the Taxation Faculty Executive Committee in preparing the agenda for this year's meeting. He expressed that the IRD always treasured the annual meeting as a platform for maintaining an active dialogue with the profession to resolve issues of common interest.

Ms Sarah Chan on behalf of the Institute's Taxation Faculty thanked CIR for arranging the annual meeting. She said that the Institute also viewed the annual meeting as an important event which offered a valuable opportunity to clarify technical issues which were useful and important to its members. She thanked the IRD for allowing the Institute to read through the draft responses before the meeting, and looked forward to continuing the cooperation between the Institute and the IRD in future.

The meeting then proceeded to discussion of the agenda items raised by both sides.

PART A - MATTERS RAISED BY THE INSTITUTE

Agenda Item A1 - Profits Tax Issues

(a) Tax treatment of sale and leaseback transactions recognised under HKFRS 16

Under HKFRS 16, for the initial measurement of a sale and leaseback transaction where the transfer of the asset is a sale under HKFRS 15, the seller-lessee shall account for the transaction as follows:

(i) The right-of-use (ROU) asset arising from the leaseback is measured at the proportion of the previous carrying amount of the asset that relates to the ROU retained by the seller-lessee;
(ii) Any gain or loss recognised should be limited to the proportion that relates to the rights transferred to the buyer-lessor; and
(iii) The lease liability is generally measured at the present value of the lease payments. For leasebacks with variable lease payments that do not depend on an index or rate, the lease liability can be determined as a balancing figure once the value of the ROU asset and the amount of gain or loss on the rights transferred have been determined.

The application of these principles is demonstrated in Illustrative Example 24 in HKFRS 16 (Revised September 2022). An amended Illustrative Example 24 and a new Illustrative Example 25 are set out in the amendments to HKFRS 16 issued in November 2022.

Based on the IRD's assessing practice, lessees are generally allowed deduction of expenditures (i.e. interest on lease liability and depreciation of ROU asset charged to the profit and loss account (P&L)) in respect of leased assets recognised under HKFRS 16, subject to certain conditions. The Institute would like to seek the IRD's view on the following:

(a) In the case of a sale and leaseback transaction, the initial measurement of the ROU asset does not reflect the present value of the lease payments, and thus the total amount of interest on lease liability and depreciation of ROU asset charged to the P&L may be significantly different from the total lease payment over the lease term. The Institute would like to seek the IRD's view on the tax treatment in such cases. Specifically, for taxpayers that have elected to deduct their rental payments based on the P&L charge, would they be allowed to include the gains/losses not permitted to be recognised under HKFRS 16 to truly reflect the value of the ROU asset?

(b) The amendments to HKFRS 16 issued in November 2022 add subsequent measurement requirements for a sale and leaseback transaction where the transfer of the asset is a sale under HKFRS 15. The amendments are expected to mainly affect sale and leaseback transactions with variable lease payments that do not depend on an index or rate. In particular, as demonstrated in the new Illustrative Example 25, the seller-lessee shall recognise in the P&L the difference between the payments made for the lease and the lease payments that reduce the carrying amount of the lease liability. The Institute would like to confirm that such differences recognised in the P&L are generally taxable/deductible for profits tax purposes.

The IRD responded as follows –

(a) As advised in the previous annual meetings, the implementation of HKFRS 16 should have no effect on the operation of sections 16 and 17 of the IRO. Subject to certain conditions, expenditures in respect of a leased asset recognised in accordance with HKFRS 16 (i.e. interest on lease liability and depreciation of ROU asset charged to the profit and loss account) were generally deductible under profits tax insofar as they were in compliance with sections 16 and 17 of the IRO.

In the case of a sale and leaseback transaction, paragraph 100(a) of HKFRS 16 required that if the transfer of an asset by the seller-lessee satisfied the requirements of HKFRS 15 to be accounted for as a sale of the asset, the seller-lessee should measure the ROU asset arising from the leaseback at the proportion of the previous carrying amount of the asset that related to the right of use retained by the seller-lessee. Accordingly, the seller-lessee should recognise only the amount of any gain or loss that related to the rights transferred to the buyer-lessor. The basis for conclusions on this accounting treatment was explained at BC266 as follows:

"The IASB decided that the gain or loss recognised by a seller-lessee on a completed sale in a sale and leaseback transaction should reflect the amount that relates to the rights transferred to the buyer-lessor. In reaching this decision, the IASB considered requiring the sale element of the transaction (ie the sale of the underlying asset) to be accounted for applying IFRS 15 because, from a legal standpoint, the seller-lessee will often have sold the entire underlying asset to the buyer-lessor. However, from an economic standpoint, the seller-lessee has sold only its interest in the value of the underlying asset at the end of the leaseback–it has retained its right to use the asset for the duration of the leaseback. The seller-lessee had already obtained that right to use the asset at the time that it purchased the asset–the right of use is an embedded part of the rights that an entity obtains when it purchases, for example, an item of property, plant and equipment. Accordingly, in the IASB's view, recognising the gain that relates to the rights transferred to

the buyer-lessor appropriately reflects the economics of the transaction."

Since the seller-lessee would not recognise any gain or loss that related to the rights it retained, the initial measurement of the ROU asset would not be the same as the present value of the lease payments and normally, the difference was the "unrecognised gain or loss" that related to the rights retained by the seller-lessee. As demonstrated in Illustrative Examples 24 and 25 in HKFRS 16, the amount of the "unrecognised gain" that related to the rights retained by the seller-lessee was equal to the difference between the initial measurement of the ROU asset and the amount of the lease liability.

For tax purposes, a sale and leaseback transaction involved two tax issues – (i) taxation of the gain on sale of the asset, and (ii) deduction of expenditures in respect of the leased asset. While deduction of expenditures in respect of the leased asset would be governed by sections 16 and 17 of the IRO, whether the gain on sale of the asset was chargeable to tax would depend on the nature of the transaction. If it was capital in nature, the gain would not be taxable. Otherwise, the gain would be subject to tax. Referring back to Illustrative Examples 24 and 25, the IRD considered that the "unrecognised gain or loss" had been effectively factored into the initial measurement of the ROU asset which would be amortised over the term of the lease when depreciation of the ROU asset was charged to the profit and loss account. If the gain or loss on sale of the asset was of capital nature, the "unrecognised gain or loss" would not be taxable or deductible under profits tax. Accordingly, tax adjustments should be made to the depreciation of the ROU asset charged to the profit and loss account to include the amount of the "unrecognised gain or loss" spread over the term of the lease. Similar tax treatment would be applied in case of unrecognised loss. In any event, the overall tax position of the seller-lessee would remain the same despite the change in accounting treatment following the implementation of HKFRS 16.

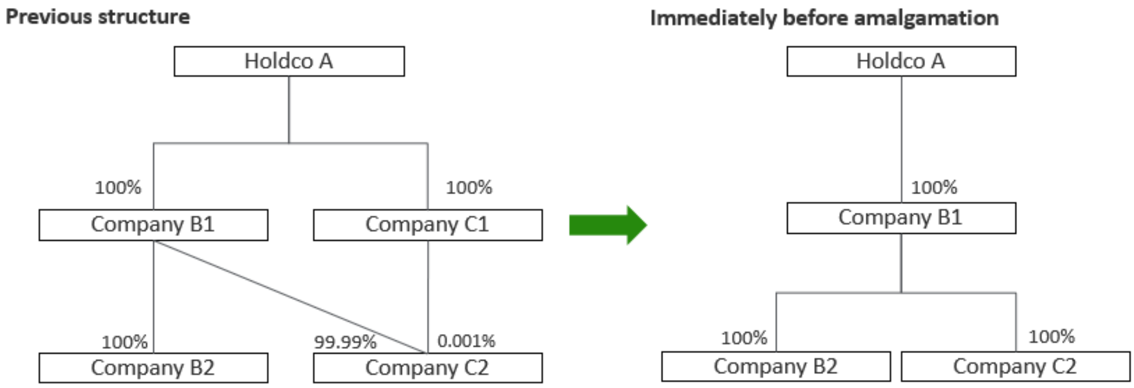
(b) Illustrative Example 25 in HKFRS 16 demonstrated the subsequent measurement of an ROU asset and a lease liability in a sale and leaseback transaction with variable lease payments that did not depend on an index or rate. In the example, "lease payments" were determined to reflect the expected lease payments at the commencement date (Approach 1) or equal periodic payments over the term (Approach 2), and any differences between the actual payments made for the lease and the "lease payments" that reduced the carrying amount of the lease liability were recognised in the profit and loss account. The IRD considered that such "differences" were expenditures incurred in respect of the leased asset, which had not been or would never be covered by the depreciation of the ROU asset and the interest on the lease liability charged to the profit and loss account. Similar to the tax treatment of depreciation of ROU asset and interest on lease liability, such "differences" were generally taxable or deductible under profits tax insofar as they were in compliance with sections 16 and 17 of the IRO.

(b) Court-free amalgamation

Under section 24 in Schedule 17J of the IRO, any qualifying loss of the amalgamating company can be carried forward and set off against the assessable profits of the amalgamated company, subject to certain conditions. Qualifying loss means pre-amalgamation loss of the amalgamating company incurred after the amalgamating company and the amalgamated company entered into a "qualifying relationship", i.e. one of the companies is a wholly owned subsidiary of the other company, or both companies are wholly owned subsidiaries of a body corporate.

It is not explicitly mentioned in the IRO nor DIPN63 whether the "qualifying relationship" refers to direct ownership or both direct and indirect ownership.

See an example below:



First, Company B1 and Company C1 amalgamated in accordance with section 681 of the Companies Ordinance. Following this, Company B2 and Company C2 amalgamated in accordance with section 681 of the Companies Ordinance.

Assuming Company C2 has pre-amalgamation losses, we would like to seek the IRD's clarification on whether or not Company B2 and Company C2 are considered as having a "qualifying relationship" under the previous structure so that the pre-amalgamation losses accrued under the previous structure can be carried forward.

Under the previous structure, although Company C2 is not a wholly owned subsidiary of Company B1 (direct), both Company B2 and Company C2 are wholly owned subsidiaries of the ultimate parent Holdco A (indirect). We consider that they should have entered into a "qualifying relationship" based on the definition under Section 24(7) in Schedule 17J of the IRO as both Company B2 and Company C2 are wholly owned subsidiaries of Holdco A.

We also note that some advance ruling cases (e.g. case no. 64) granted before codifying the relevant rules allowed pre-amalgamation loss between wholly owned subsidiaries under the same group (i.e. the same ultimate parent entity), but not necessarily the same direct immediate parent entity. We would like to confirm that the same practice continues to be applied.

The IRD responded as follows –

- Section 24(7) of Schedule 17J to the IRO provided that for the purposes of the definition of qualifying loss in subsection (6), 2 companies had a qualifying relationship if —

  (a) one of the companies was a wholly owned subsidiary of the other company; or

  (b) both companies were wholly owned subsidiaries of a body corporate.

- A similar definition was provided in section 25(6) of Schedule 17J.

- Schedule 17J applied to a qualifying amalgamation, which was defined in section 40AE of the IRO to mean an amalgamation of companies under section 680 or 681 of the Companies Ordinance (Cap. 622) (CO); and for which a certificate of amalgamation had been issued by the Registrar of Companies under section 684(3) of the CO. While the term "wholly owned subsidiary" was not defined in Schedule 17J, its definition was provided in section 678(1) of the CO as follows:

  "In this Division, a company is a wholly owned subsidiary of another body corporate if it has no members except —

  (a) that other body corporate;

  (b) a nominee of that other body corporate;

  (c) a wholly owned subsidiary of that other body corporate; or

  (d) a nominee of that subsidiary."

- In determining whether two companies had entered into a "qualifying relationship", reference would be made to the definition of "wholly owned subsidiary" in section 678(1) of the CO. Accordingly, both direct and indirect ownership would be counted.

- In the example given above, Company B2 and Company C2 would be regarded as having entered into a qualifying relationship under the previous structure from the date when both companies became wholly owned subsidiaries of Holdco A (indirectly owned through Company B1 and Company C1 which were also wholly-owned subsidiaries of Holdco A). Subject to other specified conditions, any qualifying loss of Company C2 could be carried forward for setting off against the assessable profits of Company B2 derived from the same trade, profession or business that was carried on by Company C2 immediately before the date of amalgamation and succession by Company B2.

(c) Profits tax treatment of foreign mergers

The profits tax treatment of court-free amalgamation of companies under Division 3 of Part 13 of the Companies Ordinance (i.e. qualifying amalgamation) carried out on or after 11 June 2021 is specified in Part 6C and Schedule 17J of the IRO. However, 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.

We are of the view that in the absence of any specific provisions in the IRO, one has to look into the relevant foreign company law governing the merger to determine its profits tax treatment. This is in line with the principles laid down in *Nomura Funds Ireland Plc v The Collector of Stamp Duty* although the case dealt with the stamp duty (instead of profits tax) implications of a foreign merger. In this regard, we would like to:

(i) confirm whether the following treatment would apply for HK profits tax purpose in cases where a foreign merger (say between two foreign entities) is effected by way of universal succession under the merger law of the foreign jurisdiction concerned:

  (a) all rights, businesses, assets and liabilities of one merging entity (i.e. the ceased entity) are regarded as being succeeded by (and fully vested to) the other merging entity (i.e. the surviving entity) by operation of law (i.e. without any sale or transfer of assets/property);
  (b) the surviving entity is treated as if it were the continuation of and the same person as the ceased entity after the merger; and
  (c) the surviving entity is treated as having continued to carry on the trade or business of the ceased entity by way of succession.

(ii) seek clarification on whether the ceased entity is regarded as having ceased business on the day immediately before the effective date of the merger and the applicability of section 15C(b) of the IRO on trading stock; and

(iii) seek clarification on the profits tax treatment of the pre-merger tax losses - i.e.,

Given that a foreign merger is not regarded as a "qualifying amalgamation" as defined in section 40AE of the IRO, we would like to seek confirmation from the IRD that:

  (a) the loss-setting-off conditions set out in sections 24 and 25 of Schedule 17J are not applicable to the pre-merger tax losses of the ceased entity/ surviving entity, as these conditions are only applicable to "qualifying amalgamation" as defined in the IRO;

  (b) the pre-merger tax losses brought forward from the ceased entity could be used to set off against the assessable profits derived by the surviving entity after the merger; and

  (c) the pre-merger tax losses brought forward by the surviving entity could be used to set off against the assessable profits derived by it from the trade or business succeeded from the ceased entity.

The IRD responded as follows –

- Universal succession was a legal concept under civil law systems. It 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. Though the common law system followed by Hong Kong did not have a concept of universal succession, Hong Kong laws did recognise and accept mergers effected by way of universal succession if the merger was allowed under the law of the jurisdiction of the merging entities.

- Therefore, if two overseas incorporated entities were approved to merge by the process of universal succession in their home jurisdiction and it was part of that process that all the assets and liabilities of one (the merging entity) would become the assets and liabilities of the other (the surviving entity), then those assets and liabilities would be regarded as being transferred to the surviving entity by operation of law. For the purposes of the IRO, if the IRD was satisfied that the merger was not carried out for the purpose of obtaining tax benefits, the transfer of those assets and liabilities to the surviving entity would not constitute a sale, and the surviving entity would generally be treated as far as possible as if it were the continuation of and the same person in law as the merging entity.

- Schedule 17J to the IRO only applied to qualifying amalgamations under section 680 or 681 of the Companies Ordinance and therefore was not applicable to foreign mergers effected by way of universal succession. However, in considering whether a foreign merger was carried out for the purpose of obtaining tax benefits and hence section 61A or 61B of the IRO had to be invoked, the factors to be considered were similar to those set out in Schedule 17J. In fact, the IRD all along took into account those factors when determining the tax treatments for court-free amalgamations and foreign mergers prior to the enactment of Schedule 17J. For example, in the case where the merging entity's trading stock was transferred to the surviving entity upon the merger, the IRD would consider whether the surviving entity used the trading stock as its trading stock for carrying on a trade or business in Hong Kong. If the merging entity or the surviving entity had any pre-merger losses, issues similar to the same trade test, trade continuation test, financial resources test and post entry test would be considered.

Mr Eugene Yeung (Mr Yeung) noted that the factors to be taken into account under sections 61A and 61B of the IRO were not merely "similar to those set out in Schedule 17J" and sought for clarification from the IRD. CIR explained that there were seven factors to be considered under section 61A of the IRO, which would encompass taking into account the facts and circumstances of each case. The factors under Schedule 17J would be relevant, and additional considerations might come into play if the IRD wished to apply section 61A. In particular, the IRD would consider the same trade test, trade continuation test, financial resources test and post entry test when ascertaining whether the merger had created rights or obligations which would not normally be created between persons dealing with each other at arm's length. Failure to satisfy those tests would strongly indicate the unusual nature of the merger which might trigger the application of section 61A.

(d) Provision of long-service payment

In June 2022, the HKSAR Government gazetted the Employment and Retirement Schemes Legislation (Offsetting Arrangement) (Amendment) Ordinance 2022 (the Amendment Ordinance). The Amendment Ordinance abolishes the use of the accrued benefits derived from employers' mandatory MPF contributions to offset against the long-service payment (LSP) of the relevant employees (the Abolition). The Abolition will take effect on 1 May 2025.

In this regard, taxpayers will need to recognise a one-off adjustment regarding their additional obligations for LSP to their employees under the Abolition in the 2023 financial statements. The relevant accounting entries are set out as follows:

Dr Past services cost
  Cr Provision for LSP

Assuming the LSP provision is calculated based on the requirement of the Employment Ordinance and a reasoned estimate of the number of employees eligible for the LSP, and by reference to the wages and service years of each employee, we would like to seek clarification from the IRD as to whether the above additional LSP provision would be regarded as a specific provision and deductible under section 16(1) of the IRO.

The IRD responded as follows –

- While the Amendment Ordinance was gazetted on 17 June 2022, the Abolition would officially take effect on 1 May 2025 (the Transition Date). Before the Abolition took effect, employers were allowed to use the accrued benefits derived from their mandatory contributions (ERMC) under a mandatory provident fund (MPF) scheme to offset the LSP payable under the Employment Ordinance (Cap. 57) (EO) (the Offsetting Arrangement). Starting from the Transition Date, the Offsetting Arrangement would be abolished and thereafter, employers could no longer use the accrued benefits derived from ERMC to offset an employee's LSP.

- The Abolition would have no retrospective effect. A "grandfathering" arrangement (the Grandfathering Offsetting Arrangement) was put in place under which employers might continue to use the accrued benefits derived from ERMC to offset an employee's LSP entitlement in respect of the employment period before the Transition Date. An employee's LSP would be divided into (i) pre-transition portion (i.e. for the employment period before the Transition Date) and (ii) post-transition portion (i.e. for the employment period starting from the Transition Date). The pre-transition portion would be calculated on the basis of the monthly wages immediately preceding the Transition Date and the years of service before the Transition Date, whereas the post-transition portion would be calculated on the basis of the last monthly wages before termination of employment and the years of service starting from the Transition Date.

- For accounting purposes, according to the HKICPA, many entities used to account for the expected offset arising from the Offsetting Arrangement as a reduction of the LSP liability and the net LSP position might have been immaterial for their financial statements. Hence, many entities usually did not have disclosures about their LSP liability in their financial statements prior to the Abolition. In light of the Amendment Ordinance, the HKICPA published Financial Reporting Alert 44 in February 2023 to highlight the potential accounting impact of the Abolition. On 4 July 2023, the HKICPA further issued an educational guidance (the Guidance) which provided comprehensive guidance for the accounting for the impact arising from the Abolition. The Guidance focused on the interaction of the MPF and LSP and set out two acceptable accounting approaches to account for the offsetting mechanism and hence the impact arising from the Abolition. It was acknowledged that given the highly complex nature of the issue and the lack of specific guidance in extant literature, an entity should be entitled to sufficient time to determine its accounting policy and implement any necessary policy change. There was no specific time frame for implementing the change. However, entities were expected to consider the Guidance and implement any necessary accounting policy change on a timely basis.

- For tax purposes, deduction of LSP under Profits Tax was governed by sections 16(1) and 17 of the IRO. In general, LSP made in accordance with the provisions of the EO, or any provision made for the purpose of meeting the liability to pay such LSP, would be allowed for deduction under section 16(1) so long as the provision was fairly accurate and incurred in the production of assessable profits. For any one-off adjustment made in respect of an entity's liability to pay LSP arising from the Abolition, it would be accepted as a specific provision for the entity's LSP obligation and would be allowable for deduction under section 16(1) of the IRO when it was recognised in the entity's accounts, provided that it was made in accordance with the provisions of the EO (including the Grandfathering Offsetting Arrangement) and was fairly accurate (i.e. based on valid actuarial assumptions and reasonable estimates by reference to the wages and service years of each employee).

- That said, given that the Government would put in place a 25-year subsidy scheme (Government Subsidy Scheme) to share out employers' expenses on the post-transition portion of LSP, any deduction of provision for the LSP obligation should be considered together with the taxation of the subsidies from the Government Subsidy Scheme under section 15(1)(c) of the IRO.

Mr Anthony Chan asked whether adjustments charged to other comprehensive income (OCI) in accordance with the accounting standards were also tax deductible. Ms Michelle Chan responded that if the LSP provision was made to fulfill the employer's liability for paying the LSP under the EO, such a provision was deductible for profits tax purposes. She appreciated that certain re-measurements, gains or losses might be charged to OCI but clarified that the underlying principle should remain unchanged, regardless of whether the amount was charged to OCI or the profit and loss account.

(e) Calculation of foreign tax credit

When a HK company receives a service fee remitted from a group entity in the Mainland, the Mainland tax authorities will generally withhold Enterprise Income Tax (EIT) based on a deemed profit method, as if the HK company had a permanent establishment in the Mainland. While the taxpayer will take foreign tax minimization steps, in accordance with sections 50AA(2)&(3) of the IRO, the Mainland tax authorities will assess the EIT based on the deemed profit method, which is higher than its actual profit. The same service fee income will also be fully chargeable to profits tax in HK as the services were rendered in HK.

In order to relieve double taxation, the HK company will claim a foreign tax credit on the EIT paid, according to section 50 of the IRO and the Mainland-HK comprehensive avoidance of double taxation agreement (CDTA). In calculating the foreign tax credit limit, will the IRD accept the deemed profit assessed for EIT purposes, instead of the actual profit, as the income?

The IRD responded as follows –

- Under Article 5 of the Comprehensive Avoidance of Double Taxation Arrangement between the Mainland of China and the Hong Kong Special Administrative Region (the Mainland-HK CDTA), an enterprise of Hong Kong would be considered as having a permanent establishment (PE) in the Mainland if, among others, the enterprise had a fixed place of business in the Mainland through which its business activities were carried on, or furnished services, including consultancy services, in the Mainland, directly or through employees or other personnel engaged, for a period or periods aggregating more than 183 days within any 12-month period.

- Pursuant to Article 7 of the Mainland-HK CDTA, the profits of an enterprise of Hong Kong should be taxable only in Hong Kong unless the enterprise carried on business in the Mainland through a PE situated in the Mainland. In the latter case, the enterprise's profits might be taxed in the Mainland, but only so much of them as was attributable to that PE.

- Article 21(2) of the Mainland-HK CDTA provided that tax paid in the Mainland in accordance with the provisions of the CDTA in respect of any item of income derived from sources in the Mainland by a resident of Hong Kong should be allowed as a credit against Hong Kong tax imposed on that resident. However, the amount of the credit should not exceed the amount of Hong Kong tax in respect of that item of income computed in accordance with the tax laws and regulations of Hong Kong.

- Section 50 of the IRO provided for the basis of granting a tax credit in relation to an item of income under double taxation arrangements (DTA). Section 50(3) provided that the credit should not exceed the amount which would be produced by computing the amount of the income in accordance with the provisions of the IRO. In gist, the operation of section 50 was to eliminate double taxation in respect of the assessable profits computed in accordance with the provisions of the IRO, to the extent to which the profits were taxed both in Hong Kong and in a DTA territory by allowing a tax credit in respect of the foreign tax paid in the DTA territory against tax payable in respect of those profits in Hong Kong.

- According to the information provided in this question, HK Company rendered in Hong Kong the services from which the service fee was derived. There was no evidence suggesting that HK Company had a place of business in the Mainland and the service fee was attributable to such place of business. As such, it was doubtful whether HK Company had a PE in the Mainland within the meaning of Article 5 of the Mainland-HK CDTA. In the absence of a PE in the Mainland, no tax credit could be granted to HK Company as the double taxation relief allowable under Article 21 of the Mainland-HK CDTA was only available to the tax paid in the Mainland in accordance with the provisions of the CDTA in respect of the service fee.

- However, if HK Company did have a PE in the Mainland, the tax credit allowed would be subject to the provisions in Article 21(2) of the CDTA and section 50 of the IRO. In this regard, HK Company was chargeable to profits tax in Hong Kong and EIT in the Mainland in respect of its service fee derived from a group entity in the Mainland, and the deeming profits subject to EIT would be higher than the assessable profits computed in accordance with the provisions of the IRO. As such, only the amount of assessable profits computed in accordance with the provisions of the IRO would be subject to tax both in Hong Kong and the Mainland. No tax credit would be allowed in respect of the excess of the deeming profits over the assessable profits computed in accordance with the provisions of the IRO as the question of double taxation did not arise. Under such circumstance, the amount of the profits to be taken for calculating the tax credit limit should be the assessable profits computed under the IRO.

Ms Doris Chik (Ms Chik) asked how the IRD would approach a case in which it had different views from the foreign tax authority on the nature of income which might lead to a different tax treatment. For example, there might be circumstances whereby the foreign tax authority regarded the payment as royalty and imposed withholding tax of 10% but the IRD regarded the income as service income.

Ms Michelle Chan said that before granting the tax relief to a taxpayer, it had to be ensured that the foreign tax paid in the Mainland was made in accordance with the provisions of the CDTA. If there were different views on the nature of income, the taxpayer might have to resort to the mutual agreement procedures (MAP). Mr Benjamin Chan considered that different views held by tax authorities on the nature of income should not give rise to significant issues. In essence, this was a matter relating to the amount of tax credit limit. The Hong Kong tax payable would be reduced by the foreign tax credit limited to the amount of the assessable profits of the relevant income calculated according to the IRO.

[**Post-meeting notes**:

In response to a further question raised by the Institute after the meeting, the IRD clarified that, for the same reason mentioned above, the portion of the Mainland tax paid attributable to the excess deeming profits would not be eligible for deduction. Only the Mainland tax paid in respect of the assessable profits computed in accordance with the IRO that exceeded the credit limit could be allowed for deduction under section 50(5).]

(f) Tax certainty enhancement scheme (the Scheme) for non-taxation of onshore equity disposal gains - interpretation of "brought into account for tax purposes"

Under the Scheme, a sum has been brought into account for tax purposes if the sum has been brought into account for computing the holding entity's assessable profits or losses under: (1) an assessment made on the holding entity that has become final and conclusive under section 70 of the IRO; or (2) a computation of losses issued to the holding entity.

We would like to confirm that "brought into account for tax purposes" means that a gain or profit has been treated as taxable and a loss has been treated as deductible. In other words, for a taxpayer that adopts the realisation basis of taxation, where its fair value gains or losses are treated as non-taxable or non-deductible, such fair value gains or losses will not be regarded as having been brought into account for tax purposes.

The IRD responded as follows –

- The Scheme did not apply to equity interests that were regarded as trading stock. If any unrealised fair value gain or loss arising from, or provision for diminution in value of, equity interests (specified equity interests) had been brought into account under an assessment or loss statement for a year of assessment, such sum would be regarded as "brought into account for tax purposes" and the specified equity interests would be regarded as trading stock.

- For a taxpayer holding equity instruments that did not prepare financial statements with a specified financial reporting standard under section 18G of the IRO or did not make an election under section 18H, any profit or loss on its equity instruments would be ascertained on the realisation basis. Under such circumstance, only profit or loss that was realised from actual disposal of equity instruments would be regarded as "brought into account for tax purposes" under section 9 of Schedule 17K to the IRO.

Ms Vicky Wong (Ms Wong) referred to the following scenario where there was a change of intention in respect of an equity interest and asked how the IRD would regard the equity interest under the Scheme:

> *A taxpayer held an equity interest for trading purpose in Year 0, and its value appreciated from $100 to $110 in Year 1. The $10 fair value gain was not taxed as it was offshore-sourced. In Year 1, the taxpayer*

changed its intention and began holding the equity interest as a capital asset. The taxpayer would have never included the year 1 fair value gain for tax purposes under section 15BA of the IRO as it was offshore sourced.

Mr Benjamin Chan responded that the Scheme only applied to onshore gains arising from disposal of equity interests. "Equity interests regarded as trading stock" referred to trading stock for Hong Kong tax purposes. If the fair value gain of $10 in relation to the equity interest was offshore in nature and not taxable, it was not necessary to consider whether the Scheme was applicable.

(g) Foreign-sourced income exemption (FSIE) regime

(i) Gains that do not constitute specified foreign-sourced income under the FSIE regime

The Institute would like to confirm that any gain recognised by an investor entity from the following transactions with respect to an investee entity does not constitute a specified foreign-sourced income (including, in particular, an "equity interest disposal gain") under the FSIE regime:

(a) Liquidation of the investee entity
(b) Reduction of capital through cancellation of shares by the investee entity
(c) Redemption of shares by the investee entity
(d) Reduction of capital through repurchase of shares by the investee entity

Many practitioners take the view that transactions (a) to (c) do not constitute a "sale" (defined under the FSIE regime, in relation to any property, to mean a transfer of the property (other than a transfer effected by extinguishing the property) for valuable consideration) as there is no transfer of the underlying equity interest in the investee entity in the first place. While transaction (d) involves a transfer, in jurisdictions where the shares repurchased are deemed to be cancelled when acquired by the investee entity, it should be regarded as transfer effected by extinguishing the relevant equity interests, and hence should not constitute a "sale" for purposes of the FSIE regime. Accordingly, any gain derived from any of the above transactions should not be regarded as an "equity interest disposal gain", and is not a specified foreign-sourced income under the FSIE regime.

The IRD responded as follows –

- In section 15H of the IRO, "equity interest disposal gain" was defined as any gain or profit derived from the sale of equity interests (other than partnership interests) in an entity. "Sale", in relation to any property, was defined to mean a transfer of the property (other than a transfer effected by extinguishing the property) for valuable consideration. The word "property" meant any movable property or immovable property and thus included equity interests.

- For transaction (a), in general, once the liquidation of an investee entity commenced, any transfer of shares of the investee entity would be considered as void under the Companies (Winding Up and Miscellaneous Provisions)

Ordinance (Cap. 32). As such, the liquidation of an investee entity did not fall within the definition of "sale" since no transfer of shares of the investee entity was involved, and thus any distribution to the investor entity would not be regarded as "equity interest disposal gain". However, in the cases where actual transfer of shares took place and the shares concerned were not extinguished, any gain derived therefrom would be within the meaning of "equity interest disposal gain" for the purposes of the FSIE regime.

- For transactions (b) and (c), they merely involved extinguishment of shares and thus did not fall within the definition of "sale". Any gain derived from such transactions would not be regarded as an equity interest disposal gain.

- For transaction (d), repurchase of shares was indeed a transaction in which an investor entity sold its shares of an investee entity to the investee entity for valuable consideration. The transaction involved a transfer of property (i.e. shares of the investee entity) and thus fell within the meaning of "sale" as defined in section 15H. Any gain derived therefrom would be regarded as an "equity interest disposal gain". However, if the shares repurchased were deemed to be cancelled under the statutory requirements of the jurisdiction where the investee entity was established or its shares were listed (i.e. the transfer was effected by extinguishing the property), the IRD would accept that such transaction could be accorded with the same tax treatment as that for transaction (b).

(ii) Received in Hong Kong

The Commissioner of Inland Revenue (CIR) ruled in Advance Ruling Case No. 72 that an investment holding company that applied its unremitted offshore dividend income kept overseas to pay for its additional capital investment in a subsidiary was not regarded as having "received" the offshore dividend income in Hong Kong (HK).

Could the IRD elaborate on what basis such application of the unremitted offshore dividend income was not regarded as satisfying a debt incurred in respect of the business of investment holding of the company that was apparently carried on in HK, thereby potentially caught by the deemed receipt rule under section 15H(5)(b) of the Inland Revenue Ordinance (IRO) (in contrast to Illustrative Example 7 provided in the IRD's website)?

In any case, would the additional capital investment in the subsidiary be considered as a movable property acquired by the company, thereby potentially necessitating the company to track how it subsequently disposes of the additional capital investment under section 15H(5)(c) of the IRO?

More specifically, where the movable property acquired is overseas listed or registered securities, when would such securities be considered brought back to HK for the purposes of section 15H(5)(c) of the IRO, e.g. when the certificates for the securities are physically brought back to HK? What would be the situation in terms of the movable properties being brought back to HK where the assets involved are (i) HK or overseas registered intellectual property (IP) and (ii) IP that does not need to be registered anywhere such as copyrights or know-how.

The IRD responded as follows –

- By the operation of section 15H(5)(b), a specified foreign-sourced income would be regarded as received in Hong Kong if it was used to satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong for the purposes of the FSIE regime. In general, the satisfaction of a debt involved repayment of a sum owed or fulfilment of an obligation to pay. Settling the purchase cost of immovable property could be regarded as satisfying a debt since the payment was made to fulfil a paying obligation. However, the act of injecting capital into a subsidiary through subscription of new shares was neither for repayment of a sum owed nor fulfilment of any paying obligation.

- In Advance Ruling Case No. 72 (the Published Ruling), the Applicant had planned to use foreign-sourced dividends received from its wholly owned subsidiary in Jurisdiction F, Company F1, to subscribe new shares to be issued by another wholly owned subsidiary, also in Jurisdiction F, Company F2. The dividends were used for capital expansion of Company F2 through subscription of new shares. They were neither used for repayment of any debt owed by the Applicant to Company F2 nor fulfilment of the Applicant's obligation to pay. As such, the dividends would not be considered as used to satisfy any debt incurred in respect of the Applicant's trade, profession or business carried on in Hong Kong for the purposes of section 15H(5)(b) of the IRO, and thus would not be regarded as received in Hong Kong.

- In Illustrative Example 7, the immovable property was acquired for the use of Company-HK as a showroom or warehouse in Jurisdiction F, which was related to Company-HK's business carried on in Hong Kong. When Company-HK entered into the sale and purchase agreement to acquire the immovable property, it had an obligation to pay the purchase cost. Thus, the dividends were used to satisfy a debt incurred in respect of Company-HK's business carried on in Hong Kong, and would be regarded as received in Hong Kong by virtue of section 15H(5)(b) of the IRO. For the sake of completeness, the IRD considered that the use of specified foreign-sourced income by an investment holding company to purchase shares of an investee entity from a shareholder of the entity, rather than from the investee entity as an issuer, resembled the purchase of immovable property in Illustrative Example 7 and would trigger the operation of section 15H(5)(b).

- There was no definition of "movable property" in the IRO. Yet, in section 3 of the Interpretation and General Clauses Ordinance (Cap. 1), "movable property" was defined to mean property of every description except immovable property. "Immovable property" was defined to mean land, any estate, right, interest or easement in or over any land and things attached to land or permanently fastened to anything attached to land. Thus, an equity interest in an investee entity could be regarded as movable property. If specified foreign-sourced income was used to buy an equity interest in an investee entity (i.e. movable property), the location of such property had to be traced for determining whether the specified foreign-sourced income was to be regarded as received in Hong Kong by virtue of section 15H(5)(c).

- Whether movable property was considered as having been brought into Hong Kong depended on the facts and circumstances of the case, taking into account the nature and form of the asset. In general, the holding of equity interests or shares in an investee entity represented the ownership of and the entitlement to the investee entity's assets, profits and reserves. If a specified foreign-sourced income was used to acquire shares of an investee entity which had no nexus with Hong Kong (e.g. the investee entity being registered and listed overseas and having no operation or assets in Hong Kong), the IRD would regard the shares as located overseas, rather than as having been brought into Hong Kong. For IP, the place where the IP was registered or protected, the place where it was managed, and the place where it was used and thereby created a financial benefit to its owner might be relevant.

Ms Grace Tang inquired about the circumstances whereby shares purchased outside Hong Kong with foreign-sourced dividends would be deemed as brought into Hong Kong for the purposes of the foreign-sourced income exemption (FSIE) regime. Mr Benjamin Chan clarified that, in the IRD's view, shares outside Hong Kong could hardly be considered as being brought into Hong Kong. The mere physical presence of a share certificate in Hong Kong would not be sufficient for it to be deemed as "brought into Hong Kong" for the purposes of the FSIE regime. However, if those shares were subsequently disposed of and the cash received was remitted to Hong Kong, the foreign-sourced dividends could be regarded as being received in Hong Kong. The IRD would upload relevant materials (e.g. frequently asked questions) on its website to provide guidance on how to handle such scenarios.

Ms Grace Tang further inquired whether a taxpayer needed to continue to trace the funds if the cash from the sale of shares was not remitted to Hong Kong but was instead used to purchase other investments. Ms Sarah Chan asked whether there were any time limits for taxing the foreign-sourced dividend income, such as whether income received 20 years later would still be taxable if the economic substance requirement was not met. Ms Grace Tang also suggested considering a tracing period, say 6 years.

Mr Benjamin Chan replied that taxpayers had to trace the funds and there was no specified limit on the number of layers that needed to be traced to determine if the income was received in Hong Kong. If the economic substance requirement was met in the year of accrual, there should be no concern about how the dividend would be handled in the future. The IRD had provided an example in Agenda Item A4(c)(i) of the 2023 Annual Meeting on how to trace the income when it was mixed with funds from other sources. The IRD would explore ways to assist taxpayers with tracing the funds.

Ms Chik asked whether using foreign-sourced dividends to purchase shares would fall under section 15H(5)(b) of the IRO (i.e. satisfying a debt in respect of a business carried on in Hong Kong) if it was a passive investment holding company, not a security trading company. In particular, she noted that in the guidelines provided by Singapore on its website, a passive investment holding company was not considered as carrying on a trade or business in Singapore. She inquired if Hong Kong would adopt a similar approach, i.e. allowing taxpayers to claim that the share purchase was not regarded as satisfying a debt related to a business carried on in Hong Kong.

Mr Benjamin Chan responded that the IRD would consider the nature of the business carried on in Hong Kong when determining the applicability of section 15H(5)(b) of the IRO. Ms Michelle Chan provided an example, stating that if a company was 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 but it could be considered as the purchase of movable property, thus invoking section 15H(5)(c) of the IRO. Regarding the examples provided by Singapore on its website, Mr Benjamin Chan said that the IRD would examine them to determine if they could be applied in Hong Kong, having regard to our own tax laws and interpretation.

Ms Sarah Chan asked if a taxpayer used a foreign-sourced dividend to acquire Intellectual Property (IP) which was used, managed, or developed outside Hong Kong and subsequently registered or used in Hong Kong, whether the dividend would be deemed as received in Hong Kong and taxable at that point. She also inquired about the quantification of the foreign-sourced dividend in such a scenario and whether apportionment would be allowed in case the same IP was used in multiple jurisdictions including Hong Kong. Ms Michelle Chan replied that if the IP was subsequently registered in Hong Kong, it could be regarded as brought into Hong Kong in that year. The IRD would use the original amount of the foreign-sourced dividend for quantification, even if the IP appreciated in value. No apportionment would be allowed as the IRD would tax the amount of the foreign-sourced dividend received by the taxpayer, not the value of the IP brought into Hong Kong. Mr Benjamin Chan agreed that the IP scenarios were complex, as some IPs were territorial, and it could be assumed that they were the same IP.

Ms Grace Tang further inquired if an IP was still managed, protected and registered overseas but licensed to a person in Hong Kong, thus generating royalties from Hong Kong (but without receiving the royalties in Hong Kong), whether it would be deemed as brought into Hong Kong. She further asked whether the answer would be different if the IP was licensed for no consideration to group companies, i.e. no financial benefit would be received.

The IRD considered that given there were many different types of IP and each type of IP might have different statutory requirements on its registration, protection and usage, it would be impossible to give a hard and fast rule on when the IP was brought into Hong Kong. Each case had to be determined on its own facts. The IRD welcomed advance ruling applications from taxpayers in case they came across such scenarios.

[**<u>Post-meeting notes:</u>**

The IRD further clarified as follows –

On the authority of *American Leaf Blending Co. Sd. v. Director of Inland Revenue* [1978] STC 561 and *C.I.R. v. Bartica Investment Limited,* 4 HKTC 166, for a company incorporated for the purpose of making profits for its shareholders, any gainful use to which it put any of its assets prima facie amounted to the carrying on of a business. As such, passive investment holding could amount to "carrying on a business". Having said that, it was the IRD's practice to take a liberal view where the Hong Kong activity was simply the placing of deposits. Such activity was not to be regarded as "carrying on a business". The situation would be different if the business of the company was property or share investment. In the example provided by Singapore on its website, the passive investment holding company derived only passive foreign-sourced offshore investment income. The Inland Revenue Authority of Singapore thus considered such passive investment holding company as not carrying on a trade or business in Singapore. Probably, this was because all the investment activities (e.g. buying and selling overseas listed shares, acquisition of overseas property or placing of deposits with overseas banks) were carried out outside Singapore. Whether a business was carried on in Hong Kong was a question of fact which had to be determined on its own facts and circumstances. Without setting out the full facts, the IRD considered that the example in Singapore could not be adopted in Hong Kong.]

Agenda Item A2 - Salaries Tax Issues

(a) Domestic rents expense deduction

According to section 26X of the IRO, rents paid under a qualifying tenancy of any domestic premises is deductible. Under section 26W, qualifying tenancy means a tenancy in writing that is stamped according to the Stamp Duty Ordinance. However, not all tenancy agreements in the market are stamped as a commercial practice. For instance, the leases of certain serviced apartments are arranged in the form of license agreements instead of traditional tenancy agreements because the licensees do not have exclusive occupation of the property. An instrument which takes effect as a licence is not subject to stamp duty because it does not transfer any proprietary interest in land. Are the rents paid for these serviced apartments allowable for the domestic rents expense deduction with the support of unstamped agreements?

The IRD responded as follows –

- It had been categorically set out in section 26W of the IRO that "qualifying tenancy" in relation to any domestic premises meant a tenancy in writing in respect of the right to the exclusive use of the premises that was, except for government lease, stamped within the meaning of the Stamp Duty Ordinance.

- As a licence did not confer the right to exclusive use of or the proprietary interest in the property (thereby creating no landlord-and-tenant relationship) and is not an instrument chargeable to stamp duty, it did not fall within the meaning of "qualifying tenancy". Hence, the rents paid under a licence in respect of a serviced apartment were not allowable for deduction. In any case, the law imposed no restriction on the types of domestic premises that were leased for residential purpose and did not exclude serviced apartment from the tax deduction regime. If a serviced apartment was leased under a qualifying tenancy for residential use, the rents paid under the tenancy would qualify for deduction.

Mr Louis Lam (Mr Lam) noted that the IRD's above position was in line with the view expressed in the Bills Committee meeting in respect of the Inland Revenue (Amendment) (Tax Deductions for Domestic Rents) Bill 2022. He observed that that some taxpayers might not be aware that the licence agreement was not eligible for stamping, and they might still present the licence agreement to the Stamp Office for stamping in order to claim the domestic rents deduction.

Mr Benjamin Chan responded that in considering whether an agreement was chargeable to stamp duty as a lease, the Stamp Office would review the terms of the agreement to determine if it granted the tenant exclusive possession of the premises. If not, the agreement would not be considered as a lease and thus not chargeable to stamp duty. He clarified that the policy intent was for domestic rents deduction to be allowable only for leases which conferred exclusive possession of the premises. As long as the lease provided for exclusive possession and was stamped in accordance with the Stamp Duty Ordinance, it was eligible for domestic rents deduction, regardless of whether the premises were serviced apartments or normal residential buildings. However, if there was no stamped lease agreement, domestic rents deduction would not be allowed.

(b) Claw-back of share awards

Share award plans may include terms and conditions where the company may claw back shares issued or transferred to an employee under certain circumstances, e.g., there is a material restatement of the company's financials or the employee ceases employment and joins a competitor. The institute would like to seek the IRD's view on the following circumstances:

A company has a share award plan. In 2022/23, the company issued shares for nil consideration to an employee under the plan. The employee obtained legal ownership and the economic benefits of the shares in 2022/23. The income in respect of the shares was reported and taxed in 2022/23.

(i) Subsequently in 2023/24, a material restatement of the company's financials for prior years needs to be made. Therefore, the company claws back all the shares issued to the employee in 2022/23 for nil consideration, under the terms of the share award plan.

(ii) Same as (i) above except that in 2023/24, the employee ceases employment and joins a competitor, so the company claws back all the shares under the terms of the share award plan.

In the above circumstances, would the IRD agree that the company should file a revised 2022/23 employer's return, and accept a request from the ex-employee to revise his/her tax assessment for 2022/23, to exclude from salaries tax the 2022/23 income in respect of the shares which are clawed back in 2023/24?

The IRD responded as follows –

- It was not uncommon that share award plans might contain provisions that the awards were subject to clawback under specified exceptional circumstances. Clawback provisions could be effected by different methods, e.g. transfer of the relevant shares back to the employer, return of the cash value of the relevant shares on the date of grant / vesting, return of sale proceeds of the relevant shares, setting off against the employee's future vesting of other awards, etc. The tax treatment on clawback of share awards would depend on the particular facts and circumstances of individual cases, having regard to the specific terms and conditions of the share award plans. In general, in the circumstances where the employer clawed back all or part of the share awards granted to an employee for nil consideration when the clawback condition occurred and on the assumption that tax avoidance scheme was not involved, it could be accepted that the share benefits previously chargeable were subject to a contingency of the occurrence of the claw back condition which in turn had a bearing upon the actual amount of income which should be brought to charge.

- In both scenarios (i) and (ii) above where the employee returned the granted / vested share benefits to the employer, the value of which had been assessed to tax in 2022/23, the employer could file a revised employer's return for the year 2022/23 reporting the correct amount of income accrued to the employee with a statement explaining the situation giving rise to the correction. The employee could, on the other hand, request to revise the assessment for the year 2022/23.

Mr Lam asked whether the principles discussed would apply regardless of whether an upfront or back-end approach was previously used. Ms Marina Tang confirmed in the affirmative. Mr Lam then asked about the practical grounds to reopen an assessment if a clawback occurred after the limitation period under section 70A had passed. Ms Marina Tang explained that the reopening would not be governed by section 70A of the IRO as there was no error involved. Instead, it would be considered as an objection under section 64(1)(a) of the IRO (commonly referred to as a late objection) since the clawback could not be anticipated when the relevant notice of assessment was issued. The taxpayer should file a notice of objection within a reasonable time, say within one month from the clawback, and ask the Commissioner to extend the period of giving the notice with reasonable cause.

Ms Wong questioned whether dividends or bonus shares received by a taxpayer, which were not subject to repayment to the employer upon clawback, would be taxable. Ms Marina Tang responded that this would depend on the facts and circumstances of the case and whether they had been assessed previously. For example, whether the dividend would be assessed depended on whether the upfront or back-end approach was used. If the dividend had been assessed previously and the taxpayer was not required to return them when the shares awards were clawed back, the dividend income should not be excluded from the assessment. The IRD would examine the terms of the share award plans and consider what was actually being clawed back.

Mr Yeung inquired as to why dividends would be taxable. Mr Benjamin Chan clarified that under the back-end approach, dividends were taxable because at that time the shares had not yet been vested on the taxpayer. Accordingly, the dividends received were not truly dividends but rather a form of employment income in nature of dividend equivalents.

Mr Lam asked whether the IRD would update DIPN 38 in the light of discussions in the annual meetings between the HKICPA and the IRD. Mr Benjamin Chan replied that the IRD was currently reviewing DIPN 38 and would update it based on the latest development, though this process might require some time.

(c) Whether an individual is a Hong Kong resident for the purposes of foreign tax credit (FTC) claims and certificate of resident (CoR) applications

Generally, the CDTAs concluded by HK define a resident, in the case of an individual, to mean an individual who (a) ordinarily resides in HK; or (b) fulfils the 180/300-day physical presence test.

With respect to the requirement in (a), the IRD has indicated in DIPN 44 and the 2018 annual meeting with the Institute that all the relevant facts, including the individual's physical presence in HK, will be considered in determining whether an individual ordinarily resides in HK.

However, some tax practitioners have come across a number of incidents where the assessors give overriding weight to the number of days of physical presence of the individual in HK and less weight to other factors. This is despite the fact that practitioners have provided information and documents to support the case that the individual ordinarily resided in HK, e.g. the immediate family members (including the spouse) primarily resided in HK, and the individual had substantial personal, economic and social ties in HK. Where the individuals concerned cannot satisfy the 180/300-day physical presence test, they will not be issued a CoR or will be denied an FTC claim.

The Institute would like to confirm that there has been no change in practice with respect to the determination of HK residence status of an individual. In our view, it is important for assessors to undertake an objective analysis of all the relevant facts of each case and make their decision based on the merits of each case; otherwise, taxpayers in situations like that outlined above would not be entitled to the benefits under HK's CDTAs, including double taxation relief, as they would not be regarded as HK residents. This may also risk undermining the government's effort to encourage HK taxpayers to consider opportunities to work in other cities in the Greater Bay Area.

The IRD responded as follows –

- The IRD had all along taken the view that the ordinary residence test and the 180/300-day physical presence test were two alternative tests for determining whether an individual was a Hong Kong resident for tax purposes. In this regard, an individual who did not meet the 180/300-day physical presence test might still be regarded as a Hong Kong resident if he met the ordinary residence test.

- In determining the resident status of an individual, the IRD officers would thoroughly examine the relevant facts and circumstances and exercise professional judgment based on the merits of each case. There had been no change in the IRD's practice with respect to the determination of the Hong Kong resident status of an individual.

- It was well-established that the question of ordinary residence was one of fact and degree. In this regard, the IRD would take into account all relevant factors and give them such weight as was appropriate in the overall circumstances of the case. Apart from the number of days that the individual was physically present in Hong Kong, other factors to be considered might include whether the individual habitually and normally resided in Hong Kong with some degree of continuity, the nature, duration and reasons of his absence from Hong Kong, where his family members lived, and whether he had any social and economic ties with Hong Kong. What were the relevant factors and how much weight was to be given to each of them would depend on the actual circumstances of each case. That said, if the number of days of an individual's presence in Hong Kong in a year was minimal, and the reason for his absence (e.g. emigration) clearly suggested that Hong Kong was no longer adopted as his place of residence for a settled purpose as part of the regular order of his life, these were strong indicia that the individual could not be regarded as still ordinarily residing in Hong Kong.

(d) Basis for apportioning income attributable to Hong Kong services under section 8(1A)(a) of the IRO

In the recent Board of Review case D18/22, the Board held that the amount of the income attributable to HK services, under section 8(1A)(a) of the IRO, in respect of the non-HK employment of a taxpayer, who also had a HK employment contract with his employer group, was not to be computed on the usual days-in-days-out formula.

In essence, it seems that the Board considered that when the taxpayer was physically in HK on any day, his services were probably performed partly under his non-HK employment contract and partly under his HK employment contract. As such, some discount should be made in relation to his physical presence in HK attributable to his services performed under his non-HK employment contract, under section 8(1A)(a).

While the appropriate basis of apportionment may necessarily depend on the facts of each case, the Institute would like the IRD to indicate whether a discount such as this would generally be applicable in other similar situations.

The IRD responded as follows –

- Section 8(1A)(a) of the IRO extended the basic charge in section 8(1) to catch income "derived from services rendered in Hong Kong" in case of a non-Hong Kong employment. Although there was no provision in the IRO or set law to specify the basis for apportioning income under section 8(1A)(a) of the IRO, it had been the Department's established practice to use time apportionment to compute the amount of income chargeable to tax under that provision. Besides, the apportionment basis adopted should produce a fair and reasonable result having regard to the facts of each case.

- In light of the special circumstances and facts of the case, the Board of Review in D18/22 found that the taxpayer held both a Hong Kong employment and a non-Hong Kong employment in the same group, and he rendered services in Hong Kong in connection with both of the employments. To compute the amount of the taxpayer's income derived from the non-Hong Kong employment and chargeable to tax under section 8(1A)(a), the Board, after determining the amount of income from the non-Hong Kong employment attributable to services in Hong Kong on a day-in-day-out

(DIDO) basis, made certain adjustments to reflect the value of the taxpayer's work contributed to the non-Hong Kong employment on each day he spent in Hong Kong.

- The decision of the Board on the apportionment basis in D18/22 is fact-specific. In general, the IRD would continue to adopt the traditional DIDO basis for determining the amount of income attributable to services in Hong Kong under section 8(1A)(a) unless it could be proved that another basis or further modification was justified having regard to the facts and circumstances of the case. Having said that, with reference to the Court of Appeal's observations in *Commissioner of Inland Revenue v Lo Wa Ming Patrick* [2022] 2 HKLRD 1162, the IRD would also accept a refined DIDO basis for the purposes of section 8(1A)(a) as follows:

$$\text{Income} \times \frac{\left[\begin{array}{c}\text{Working days}\\ \text{in Hong Kong}\end{array}\right] + \left[\begin{array}{l}\text{Leave days and rest days (Note 1)}\\ \text{attributable to services rendered in}\\ \text{Hong Kong (Note 2)}\end{array}\right]}{\text{Total calendar days}}$$

<u>Note 1</u>: Rest days meant Saturdays, Sundays and public holidays.

<u>Note 2</u>: Leave days and rest days attributable to services rendered in Hong Kong were calculated as follows:

$$\text{Total leave days and rest days} \times \frac{\begin{array}{c}\text{Calendar days (excluding leave}\\ \text{days and rest days) in Hong Kong}\end{array}}{\begin{array}{c}\text{Total calendar days – total leave}\\ \text{days and rest days}\end{array}}$$

Ms Grace Tang inquired whether, in a case with exactly the same fact pattern, the IRD would be prepared to adopt a similar approach to the one used in the Board of Review case, i.e. considering basis other than the traditional DIDO basis. Ms Marina Tang explained that in the Board of Review case, the Board found that the two employment contracts were heavily overlapped and intervened in terms of the taxpayer's work schedule, requiring the taxpayer to provide services to both employers nearly at the same time. Consequently, the Board adjusted the DIDO approach to reflect the value of the taxpayer's work attributable to the non-Hong Kong employment when he was in Hong Kong. In that case, the IRD viewed the situation as a single employment, whereas the Board ruled it as a dual employment. Accordingly, for similar cases, the IRD would examine the terms of both employment contracts to determine if the IRD had a strong case for single employment. If such a case was established, the need to adjustment might not arise. Additionally, the IRD would consider the taxpayer's travel patterns.

Mr Benjamin Chan further clarified that when a taxpayer claimed dual employment for providing similar services, the IRD would assess whether the situation truly constituted two separate employments. If it could be established that there were two employments, the IRD would review the terms of those employments and the manner in which the services were provided to ascertain the apportionment basis for apportioning income under section 8 of the IRO. Since the IRO did not specify a particular apportionment basis, the DIDO approach had been adopted as the general basis. In this regard, the IRD had recently refined its approach in line with the latest Court of Appeal decisions. If there were circumstances for which the facts of a case justified an alternative apportionment basis, the IRD might further consider on this aspect. Summing up, the apportionment basis ultimately adopted would depend on the facts and circumstances of each case.

Mr Lam supplemented that for cross border travellers, there was an increasing trend to adopt dual employment to reflect the services being performed by the employees for each of the dual employers, and to manage permanent establishment exposure. Therefore, it was anticipated that there would be an increasing trend of lodging exemption claim under dual employment for IRD to review, and it would be helpful if further guidance would be made available.

Agenda item A3 – Base Erosion and Profit Shifting Project (BEPS) 2.0 initiative

(a) Implementation of BEPS 2.0 initiative in Hong Kong

The Institute would like to understand the IRD's position and timeline concerning the implementation of BEPS 2.0 initiative in HK. Specifically, we would appreciate your advice on the following matters:

(i) The expected overall timeline, and legislative approach to be adopted, in the implementation of the global anti-base erosion (GloBE) rules, under BEPS 2.0 Pillar Two, in HK?

The IRD responded as follows –

- The timeline and legislative approach for implementation of the GloBE rules and Hong Kong minimum top-up tax (HKMTT) had been set out in the consultation paper on which stakeholders had expressed views. It was the Government's plan to apply the global minimum tax (i.e. the Income Inclusion Rule and Undertaxed Profits Rule (UTPR)) and HKMTT to multinational enterprise (MNE) groups with annual consolidated revenue of at least EUR 750 million starting from 2025. To implement the GloBE rules in Hong Kong, the Government proposed to adopt a hybrid legislative approach by directly incorporating the GloBE Model Rules into the IRO with limited adaptions as far as practicable, and requiring the enacted GloBE rules to be read and applied in a way that best secured consistency with the requirements in the OECD commentary and administrative guidance. This would help ensure that the GloBE rules implemented by Hong Kong would be assessed as qualified rules in the OECD's peer review process and facilitate the consistent application of the rules across jurisdictions. Since the top-up tax would be regarded as profits tax, it was logical to provide the GloBE rules and HKMTT under the IRO and to ride on the existing tax administration mechanism to maintain tax certainty.

- The Government would analyse and consolidate the views collected during consultation and then formulate a suitable framework to implement the GloBE rules and HKMTT. The Government planned to introduce the amendment bill into the LegCo in the second half of 2024.

Mr Jack Fernandes (Mr Fernandes) asked about the anticipated timeline for the release of the draft legislation. Mr Benjamin Chan said that the current plan was to introduce the amendment bill in the second half of 2024. This timeline would allow the IRD to consult with the OECD on key matters, particularly concerning the definition of "tax resident" for the purposes of the GloBE rules and HKMTT. Mr Benjamin Chan said while it was not the usual practice for the Government to share the draft amendment bill for comments, the IRD would continue to conduct engagement sessions with stakeholders to solicit their views. Furthermore, public comments and submissions regarding the amendment bill might be sought during the Bills Committee stage.

[**Post-meeting notes**:

Since the meeting, the position has been updated. According to the Inland Revenue (Amendment) (Minimum Tax for Multinational Enterprise Groups) Bill 2024 (the BEPS 2.0 bill), which was gazetted in December 2024, the UTPR will be implemented on a date to be specified by the Secretary for Financial Services and the Treasury at a later stage.]

(ii) HK's implementation of the GloBE rules is expected to reference the most recent GloBE commentary issued by the Organisation for Economic Cooperation and Development (OECD) and in effect at the time of implementation. How will future changes to commentary be accommodated under the HK regime?

The IRD responded that in implementing the GloBE rules in Hong Kong, the Government would closely follow the GloBE rules so as to ensure that the GloBE rules implemented by Hong Kong would be assessed as qualified rules in the OECD's peer review process. Given that the commentary and administrative guidance were expected to be continually updated, Hong Kong had to give effect to any of these publications to be issued by the OECD from time to time. The IRD recognised the need to have a process that allowed the latest OECD publications be given effect in a timely and efficient manner. The IRD would consult the Department of Justice on the legality of the different approaches to incorporate the subsequently issued commentary and administrative guidance into the legislation so as to determine which one would best suit our implementation framework.

Mr Benjamin Chan further indicated that the IRD was preliminarily considering to incorporate the administrative guidance into the IRO through subsidiary legislation. It would also explore other means to ensure the timely implementation of changes to the OECD's guidance on the GloBE rules in the future.

(iii) We understand HK intends to introduce a definition of "tax resident" as part of its implementation of the GloBE rules and to make it retrospective. If other jurisdictions do not respect the retrospective nature of this change, how will the IRD seek to resolve disputes?

The IRD responded as follows –

- Under Article 10.3.1 of the GloBE rules, an entity that was not a flow-through entity was located in: (a) the jurisdiction where it was a tax resident based on its place of management, place of creation or similar criteria; and (b) in other cases, the jurisdiction where it was created. Paragraph 172 of the commentary to Article 10 stated that the principle underlying the rules in Article 10.3 was to follow the treatment of tax residence under local law. Given that the IRO did not contain a definition of "resident" for general purposes, an entity that was created outside Hong Kong but carried on a business or was managed and controlled in Hong Kong would be located outside Hong Kong for the purpose of collecting top-up tax. To ensure that such entity was located in Hong Kong for the purposes of the GloBE rules and HKMTT, the Government proposed to provide that an entity was a Hong Kong resident entity if–

- in the case where an entity was a company – the entity was incorporated in Hong Kong, or if was incorporated outside Hong Kong, normally managed or controlled in Hong Kong; or
- in any other case – the entity was constituted under the laws of Hong Kong, or if otherwise constituted, normally managed or controlled in Hong Kong.

- Given that some jurisdictions might implement the GloBE rules for a fiscal year beginning on or after 1 January 2024, it was proposed that the above meaning of Hong Kong resident entity would apply retrospectively from 1 January 2024.

- The IRD was of the view that the proposed definition of "Hong Kong resident entity" under our local law with an effective date of 1 January 2024 was in line with the rules under Article 10.3.1 as explained in the commentary, and hence should be respected by other jurisdictions. If an entity was located in more than one jurisdiction under Article 10.3.1, the GloBE tie-breaker rules under Article 10.3.4 would apply to resolve the conflict of residence. Having said that, stakeholders' concerns on whether the proposed definition of "resident" and its retrospective application would be accepted by the OECD and other jurisdictions were noted. The IRD would seek clarification from the OECD in this regard.

Mr Fernandes asked about the status of the consultation process with the OECD. Mr Benjamin Chan responded that the IRD would consult with the OECD before the finalization of the amendment bill.

Mr Yeung asked whether a Hong Kong resident could obtain a CoR for the GloBE purpose. Mr Benjamin Chan clarified that the proposed definition of "resident" was specifically for the purposes of the GloBE rules and HKMTT and was not intended for general purposes. Moreover, the IRD was not aware of any jurisdictions requiring the provision of CoR as a proof of tax residency for the purposes of the GloBE rules and domestic minimum top-up tax. Nonetheless, the IRD would closely monitor the developments at the OECD level to determine if any documentation would be required to establish residency under the GloBE rules.

[**<u>Post-meeting notes</u>**:

Since the meeting, the position has been updated. According to the BEPS 2.0 bill, the definition of "Hong Kong resident entity" will be introduced for general purposes of the IRO.]

(iv) In relation to Pillar One of BEPS 2.0, which aims to re-allocate part of the profits of very large multinationals to the countries where their consumers are, the OECD issued the report on Amount B on 19 February 2024. The Amount B provisions (i.e. the simplified and streamlined approach to applying the arm's length principle to baseline marketing and distribution activities) in the report have now been incorporated into the OECD's Transfer Pricing Guidelines (TPG). While we understand that the IRD would generally follow the OECD's TPG in applying the arm's length principle, we would like to ask which of the following options of Amount B implementation will the IRD adopt effective from 1 January 2025:

1. Not to adopt Amount B
2. Adopt Amount B and opt for the "taxpayer safe harbour" approach
3. Adopt Amount B and opt for the "mandatory rule" approach

The IRD responded as follows –

- The report on Amount B of Pillar One provided an optional simplified and streamlined approach (formerly referred to as Amount B) to the application of the arm's length principle to baseline marketing and distribution activities, with a particular focus on the needs of low-capacity jurisdictions. The content from the report had been incorporated in the TPG.

- According to the report, a jurisdiction might choose to apply the simplified and streamlined approach (the approach) for in-scope transactions of tested parties in its jurisdiction for fiscal years commencing on or after 1 January 2025. A jurisdiction which chose to apply the approach had two options: (a) permitting tested parties resident within the jurisdiction to elect to apply the approach (i.e. the taxpayer safe harbour approach referred to by the Institute) or (b) requiring tested parties resident within the jurisdictions to use the approach in a prescriptive manner where the scoping criteria were met (i.e. the mandatory rule approach referred to by the Institute). Regardless of the option adopted, the outcome determined under the approach by an implementing jurisdiction was non-binding on the counterparty jurisdiction that did not adopt the approach. Subject to their domestic legislations and administrative practices, members of the Inclusive Framework committed to respect the outcome determined under the approach to in-scope transactions where such approach was applied by a low-capacity jurisdiction.

- Generally, the IRD would apply the transfer pricing rules under sections 50AAF and 50AAK of the IRO in the way that best secured consistency with the TPG. Given that the adoption of the approach was optional and the work in relation to Amount B had not yet completed on the OECD level, the IRD would continue to keep a close watch on the latest development in relation to the unfinished work and other jurisdictions' positions regarding adoption of the approach.

Mr Fernandes asked about the timeline for the IRD to clarify its position in relation to Amount B. He also asked whether the IRD would consider a taxpayer as being non-compliant or subject the taxpayer to penalties if another jurisdiction compelled that taxpayer to apply Amount B. Ms Florence Lam explained that in line with the political commitment, Inclusive Framework members would respect an Amount B outcome where it was applied by a "low-capacity jurisdiction" which was defined as a "covered jurisdiction". The OECD would subsequently publish a list of covered jurisdictions on its website. The IRD would continue to refer to the TPG for guidance to in-scope transactions involving a jurisdiction that had not opted to apply the approach.

Mr Benjamin Chan added that, at present, the IRD did not intend to implement the taxpayer safe harbour approach. However, he did not rule out the possibility of doing so in the future, provided that it was appropriately defined and scoped.

(v) What is HK's position regarding signing the Multilateral instrument for Pillar One, Amount A?

The IRD responded that Hong Kong could not be a party to the Multilateral Convention to Implement Amount A of Pillar One (Convention). In case China had signed the Convention, with the endorsement of the Central People's Government (CPG), the application of the Convention would be extended to Hong Kong under Article 42 "Territorial Extension".

Mr Benjamin Chan said that the IRD would closely monitor the development regarding the Convention and maintain a close communication with the State Taxation Administration with regard to the position of the CPG on this aspect.

(vi) What is HK's position regarding signing the Multilateral instrument for implementing the Subject to Tax Rule (STTR)?

The IRD responded that the same applied as for (v) above, Hong Kong could not be a party to the multilateral instrument for implementing the STTR (STTR MLI). In case China has signed the STTR MLI, with the CPG's endorsement, the application of the STTR MLI would be extended to Hong Kong. As part of the requirements of Pillar Two, Hong Kong would only include the STTR in our existing and future comprehensive avoidance of double tax agreements (CDTAs) if requested by developing jurisdictions. More specifically, Hong Kong would incorporate the STTR into the existing CDTAs with the developing jurisdictions only if there were such a request from the jurisdictions concerned.

(b) Review of the tax incentives in Hong Kong in light of the BEPS 2.0 implementation in Hong Kong

We understand from the previous engagement sessions that the government is currently reviewing all existing tax incentives in HK in light of this implementation of BEPS 2.0 in HK. In this regard, and in light of various changes to the tax incentive schemes in Singapore announced in the 2024 Singapore Budget, we would like to ask the following:

(i) the status of the review exercise of incentives in HK;

The IRD responded that the Government had from time to time reviewed Hong Kong's tax system and measures, including the effectiveness of preferential tax regimes and other tax incentives, so as to enhance our tax competitiveness. The enhancement to the aircraft leasing regime to replace the 20% tax base with a tax deduction for the acquisition cost of the aircraft was a clear example of responsive measure to BEPS 2.0. The Government would continue to review the tax system and introduce more measures to further enhance the tax competitiveness of Hong Kong to cope with the ever-changing business environment.

(ii) whether there will be any stakeholder or public consultation on the review/ proposed changes to the existing tax incentives; and

The IRD responded that the Government had been taking a more proactive approach in engaging stakeholders to solicit their views when introducing new tax initiatives. As regards review or proposed changes to the existing tax incentives, the format of consultation would depend on the complexity and nature of the subject matter. Stakeholders might be consulted through the issue of consultation papers, presentation of proposals and holding of briefings and engagement sessions. Irrespective of whether a formal consultation exercise was carried out, the IRD would continue to maintain close collaboration with professional bodies, including the Institute, and welcome views on any specific issues at all times so as to obtain best assurance of future acceptance of the tax measures and initiatives.

(iii) whether any proposed changes, or alternative options to existing incentives (e.g. qualified refundable tax credits) have been formulated so far?

The IRD responded that it had all along worked closely with policy bureaux in assessing potential enhancements and alternative options to the existing tax incentives in relation to their policy areas, taking into account stakeholders' views and drawing on other jurisdictions' experience. The Government acknowledged stakeholders' call for qualified refundable tax credit (QRTC) due to its special treatment on the effective tax rate calculation under the GloBE rules, but was mindful that any unutilised tax credits had to be refunded in cash within four years. The Government would critically consider the suggestion of introducing QRTC and carry out a thorough cost-benefit analysis, particularly having regard to the potential impact of QRTC on the fiscal position of the Government and the risk of abuse as foreshadowed from other jurisdictions' experience.

Mr Fernandes asked whether there was a particular procedure for the IRD's review of the existing incentives that would allow for public input. Mr Benjamin Chan responded that although a specific procedure for public input was not available, IRD would collaborate with the relevant policy bureaux and pertinent sectors during the review process.

Mr Fernandes further asked whether the IRD had coordinated with the OECD to ensure that any new tax incentives or changes to existing tax incentives would be in compliance with the GloBE rules. Mr Benjamin Chan clarified that the GloBE rules set out the requirements that an implementing jurisdiction could not provide benefits in relation to the implementation of the GloBE rules and the rules had to be implemented and administrated in a way that was consistent with the outcome they set forth in order for the rules to be regarded as qualified. Hence, when proposing any new tax incentive, Hong Kong should avoid confining the incentives to MNE groups within the scope of the GloBE rules or linking those incentives to the in-scope MNE groups' top-up tax liabilities.

Agenda item A4 – Stamp Duty

(a) Distribution of Hong Kong stocks or immovable properties upon termination of a limited and general partnership

HK stocks or immovable properties may be distributed upon termination of a limited or general partnership on a pro-rata basis, with reference to the capital accounts of the respective partners involved.

The Institute would like the IRD to advise as to whether it is the case that such a distribution would not attract stamp duty in HK, in similar way to the dissolution of a limited liability company.

> The IRD responded as follows –
>
> - The question was answered on the understanding that the HK stocks or immovable properties mentioned were the partnership properties of a limited partnership or general partnership. Whether the stocks or immovable properties were partnership properties or not was decided by reference to whether they satisfied the conditions stipulated under section 22(1) of the Partnership Ordinance (Cap. 38) that they were (i) originally brought into the partnership stock; or (ii) acquired on account of the firm; or (iii) acquired for the purposes and in the course of the partnership business. In addition, the stocks or immovable properties must be held and applied by the partners exclusively for the purposes of the partnership and in accordance with the partnership agreement.
>
> - In the absence of agreement to the contrary, partnership properties distributed upon termination of the 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 passed upon the distribution. In case there was a conveyance or transfer made to effect the distribution, the instrument was not chargeable with stamp duty by virtue of section 27(5) of the Stamp Duty Ordinance (Cap. 117).

Agenda item A5 – Departmental Policy and Administrative Matters

(a) Filing Form IR56M for "local persons"

Broadly, the IRD may request companies to file forms IR56M to report payments to non-corporate local persons who are not employees. However, the term "local person" is not defined in the IRO or the instructions for Form IR56M; whereas, companies may file forms IR623P to report sums payable to non-resident individuals, who are engaged to provide services or carry out a profession in HK, not in the capacity as employees. The Institute would like to seek the IRD's view on whether a company would be required to file forms IR56M or forms IR623P for the following individuals.

Each individual below is engaged as a consultant and not an employee. The fees exceed HK$25,000 for the year.

(i) The individual is a foreign national who holds a dependant visa, with rights to stay and work in HK. The individual lives in HK and provides the consultancy services in HK. Would the holding of a (non-permanent) HK identity card (required for persons who have been permitted to stay in HK for more than 180 days) be a factor?
(ii) The individual is an HK permanent resident and lives here. The individual travels outside HK for this work and provides all consultancy services outside HK.
(iii) The individual is an HK permanent resident and lives outside HK. The individual will travel to HK to provide consultancy services here.

The IRD responded as follows –

- Form IR56M was a form for the reporting of the payments made to local persons other than employees (i.e. non-employees) while Form IR623P was a form for the reporting of the payments payable to or receivable by non-resident individuals rendering services in Hong Kong other than entertainers / sportsmen. For the avoidance of doubt, if a non-resident individual was employed to render services in Hong Kong as employee, the employer should use Form IR56B/E/F/G rather than IR623P.

- "Local person" or "non-resident" had not been defined in section 2(1) of the IRO. Whether an individual was a "local person" or a "non-resident" of Hong Kong was primarily a question of fact. IRD had all along considered that an individual was a non-resident of Hong Kong if that individual did not have a home or a place of habitual abode in Hong Kong. Conversely, if the individual did have a home or a place of habitual abode in Hong Kong, that individual would be considered as a "local person". It was also pertinent to note that whether an individual was a holder of Hong Kong Identity Card was not a conclusive factor in considering whether he / she was a "local person" or "a non-resident".

- In the above cases, if the conditions of being a local person were fulfilled, a form IR56M should be filed for that individual. Otherwise, a form IR623P should be filed for him / her.

Mr Lam sought clarification from the IRD regarding the necessity of filing Form IR56M in scenario (ii) above. Ms Marina Tang responded that if the individual in question was a local person with a home or place of habitual abode in Hong Kong, the payer was required to submit Form IR56M.

Mr Lam further inquired whether Form IR56M was required to be filed if a non-Hong Kong company paid a service fee to a local person for services which were prohibited to be rendered in Hong Kong. Ms Marina Tang clarified that Form IR56M would not be required, provided that the local person performed absolutely no services within Hong Kong.

Ms Wong pointed out that it might be challenging for the payer to determine whether the recipient had a place of abode in Hong Kong which in turn determined which form was applicable. Ms Marina Tang responded that when it was uncertain whether the recipient was a local person, the payer could adopt a simple approach, such as checking whether the recipient held an HKID card. She noted that many payers commonly used this method as a simplification. However, she reiterated that the possession of a HKID card would not be conclusive as to whether an individual was a local person.

(b) Voluntary electronic filing (e-filing)

The Institute would like to ask:

(i) Whether the IRD will further extend filing deadlines to encourage more voluntary e-filing in the coming years; and

The IRD responded that in the last year, the IRD launched voluntary e-filing of Profits Tax returns where taxpayers could e-file their returns together with the supporting documents (including financial statements and tax computations) in inline eXtensible Business Reporting Language (iXBRL) format on a voluntary basis. The IRD understood that e-filing of supporting documents in iXBRL format was new to Hong Kong. It would inevitably involve time and effort in preparing iXBRL data files for financial statements and tax computations, especially in the first instance. Different forms of support (including provision of free conversion tools, training sessions for accounting and tax practitioners, guidance notes, frequently asked questions, e-Appointment service, online demo videos, etc.) were being provided to facilitate better understanding of the new iXBRL filing requirements by taxpayers. Also, a further one-month extension of filing deadline had been granted to encourage taxpayers or their service providers to participate in voluntary e-filing of Profits Tax returns. While the IRD appreciated taxpayers' and tax practitioners' support and participation in voluntary e-fling, any further extension of time for filing Profits Tax returns would pose major problems for our work on tax assessment and revenue collection. Having said that, in the event of exceptional circumstances, a taxpayer might lodge an application for a further extension of time to e-file the tax return on a case-by-case basis.

Ms Grace Tang inquired whether all entities within the in-scope MNE groups, including those taxpayers which received I.R.C.1812 *Notification of Non-Issue of Annual Return to Corporation* (the I.R.C. 1812 cases) from the IRD, would be subject to mandatory e-filing by 2026. Ms Michelle Chan confirmed in the affirmative. The IRD would reactivate the I.R.C. 1812 cases to ensure that all taxpayers within the in-scope MNE groups would receive and file their tax returns electronically on an annual basis.

Ms Grace Tang further sought clarification on how the IRD would identify which companies belonged to an in-scope MNE group. Ms Michelle Chan explained that the IRD would send a letter to the MNE groups, requesting relevant information. Regarding the I.R.C. 1812 cases, Ms Grace Tang questioned whether taxpayers would need to submit paper forms for unfiled tax returns for previous years to ascertain any losses brought forward. Ms Michelle Chan advised that taxpayers could simply indicate the losses brought forward in their current tax returns without submitting returns for back years. Mr Benjamin Chan added that if there was any doubt regarding the computation of such losses, the IRD might request taxpayers to provide the relevant financial statements and profits tax computations for perusal.

Mr Yeung asked whether taxpayers could also submit their financial statements and profits tax computations for previous years through the e-filing system. Mr Benjamin Chan responded that this option would need to be further explored to determine whether the computer system could support such functionality.

Ms Chik asked about the final criteria for calculating the threshold for mandatory e-filing. Mr Benjamin Chan noted from the consultation that quite a number of respondents supported the alignment of the threshold for mandatory e-filing with that for the GloBE rules and HKMTT. CIR added that the IRD was still considering the criteria and the Commissioner would publish a notice in the gazette in relation to the final criteria.

Ms Agnes Cheung asked about the number and the quality of returns which had been received through e-filing. Ms Michelle Chan reported that approximately 3,000 taxpayers had filed their returns electronically, with the overall quality being satisfactory. The majority of taxpayers had utilised the IRD's conversion tools, and the IRD had not detected any tagging irregularities.

(ii) Whether the IRD would leverage the data provided by e-filing to improve services and streamline the system by, for example:

- Considering reducing the limitation period for the finalization of tax affairs, to, say, three or four years, and according a statement of loss the same status as a notice of assessment

- Strengthening the IRD's tax audit capabilities and shortening timeframes for audits.

The IRD responded as follows –

- Since the implementation of voluntary e-filing in April 2023, the IRD had been progressing to collect digital data of the financial position of businesses in iXBRL format. Yet, e-filing of Profits Tax returns would take years to achieve a high take-up rate. It was not expected that the IRD's efficiency in processing tax returns, raising tax assessments and following up post-assessment matters could be greatly enhanced in the near future by reason of the present e-filing initiative.

- Shortening the timeframe for finalisation of tax assessments and providing a statement of loss the same status as a notice of assessment would require legislative changes. The limitation period applied not only to the IRD in making assessments, but also to taxpayers. The IRO provided that under specified circumstances (e.g. an excessive assessment due to an error or omission in the tax return), a taxpayer might apply for correction of the assessment within six years after the end of the relevant year of assessment. Likewise, a taxpayer who had paid tax in excess of the amount payable under certain circumstances might apply for a refund within six years after the end of the relevant year of assessment. Shortening the limitation period would have a significant impact on the current tax assessment mechanism and the overall government revenue. It might even be necessary to change the present assessment mechanism (e.g. introducing a self-assessment system). This had to be carefully considered after balancing the needs of all taxpayers (including salaries tax and property tax payers) and taking into account the manpower strength of the Department.

- Under the current practice, tax returns received which were suitable for "Assess First Audit Later" would be accepted as correct in the first instance with demand notes issued according to the returned profits. Based on certain pre-set criteria and the data captured from electronic financial statements and tax computations, high-risk cases would then be identified by the computer system for desk audit which normally involved the raising of queries on doubtful claims. Desk audit computer run was usually carried out within one year after raising assessments. For complicated cases, there might be several follow-up enquiries and it often took considerable time for taxpayers to provide the requested information and assessors to examine the replies, thus prolonging the time of processing. On the whole, the IRD considered the existing mechanism for raising enquiries as reasonable. Limiting the period for assessors to raise enquiries, if it were to have legal force instead of as an administrative practice, would also require legislative amendments.

(c) Lodgement of profits tax returns and filing deadlines for 2023/24

The Institute would ask the IRD to share the latest statistics on tax return filing and information on the 2023/24 tax filing deadlines.

Four tables at Appendix A showed the lodgment statistics for 2022/23 Profits Tax returns in respect of corporations and partnerships.

- Table 1 showed that the IRD issued some 4,000 less returns in the 2022/23 bulk issue exercise and some 26,000 returns were not filed by the due dates.
- Table 2 showed the filing position under different accounting date codes.
- Table 3 showed the progressive filing results. Upon request from the industry last year, the filing deadlines for 2022/23 returns were further extended to 29 August 2023 and 29 November 2023 for "D" code and "M" code respectively. The lodgment rates for "D" code and "M" code returns by the deadline were far from satisfactory. The lodgment rate for "D" code returns dropped from 90% to 77% while that for "M" code returns remained at 78%. The graduated lodgment rates worsened and were significantly below the lodgment standards. Tax representatives were urged to improve their performance in the coming year.
- Table 4 was a comparative analysis of compliance with the block extension scheme.

Bulk Issue of 2023/24 Profits Tax Returns

The 2023/24 Profits Tax returns for "active" files were bulk-issued on 2 April 2024. The extended due dates for filing 2023/24 Profits Tax returns were shown below:

Accounting Date Code	Extended Due Date	Further Extended Due Date if opting for e-filing
"N" code	2 May 2024 (no extension)	3 June 2024
"D" code	15 August 2024	16 September 2024
"M" code	15 November 2024	16 December 2024
"M" code – current year loss cases	3 February 2025	3 February 2025 (same as paper returns)

Despite the above extension, tax representatives were encouraged to file as many returns as possible well before the extended due dates.

This was the second year in which the IRD had implemented the voluntary e-filing initiative. The IRD appealed for tax practitioners' support and participation in this year's voluntary e-fling of Profits Tax returns so as to enjoy a further one-month extension of filing deadline.

PART B – MATTERS RAISED BY THE IRD

Agenda Item B1 – Investigation and Field Audit: Discrepancies Detected by Field Audit

Appendix B was compiled to illustrate the specific problem areas detected in corporations with tax audits completed during the year ended 31 December 2023. Comparative figures for the years 2021 and 2022 were included.

Field Audit teams uncovered discrepancies in 396 corporation cases, of which 329 carried clean auditors' reports. Amount of discrepancies detected in the clean report cases accounted for 82% (2022: 85%) of the total discrepancies detected in the year 2023 and total tax of $1,383 million was recovered from these cases. Average understatement per clean report case was $40.40 million (2022: $17.62 million) while tax undercharged per clean report case was $4.2 million (2022: $2.4 million).

In 2023, discrepancies resulted mainly from understatement of sales and overstatement of expenses. In the majority of cases, the discrepancies were detected after examining the business ledgers and source documents.

In 2023, there was no case in which the IRD considered that the auditor should have detected the irregularities through statutory audit.

Agenda Item B2 – Date of Next Annual Meeting

The date of the next meeting would be agreed between the Institute and the IRD in due course.

Lodgment of Corporations and Partnerships Profits Tax Returns

Table 1
Lodgment Comparison from 2020/21 to 2022/23

		Y/A 2020/21	Y/A 2021/22	Y/A 2022/23	Comparison 2021/22 and 2022/23
1.	Returns issued on 1 or 3 April	202,000	223,000	219,000	-2%
2.	Returns not filed by due date				
	"N" code	3,300	3,100	3,100	0%
	"D" code	8,300	7,400	7,600	3%
	"M" code	14,700	13,900	15,300	10%
		26,300	24,400	26,000	7%
3.	Compound offers issued	6,900	7,600	7,900	4%
4.	Estimated assessments issued	11,600	8,900	9,500	7%

Table 2
2022/23 Detailed Profits Tax Returns Statistics

	"N"	"D"	"M"	Total
Total returns issued	24,000	81,000	114,000	219,000
Failure to file on time	3,100	7,600	15,300	26,000
Compound offers issued	1,400	2,500	4,000	7,900
Estimated assessments issued	1,000	2,700	5,800	9,500

Table 3

Represented Profits Tax Returns - Lodgment Patterns

Code	Lodgment Standard	Y/A 2022/23	Y/A 2021/22
D - extended due date on			
29 August 2023	100%	77% [(1)]	-
30 September 2022	100%	-	90%
M - 31 August	25%	13%	14%
M - 30 September	55%	18%	20%
M - 31 October	80%	31%	31%
M - extended due date on			
29 November 2023	100%	78% [(2)]	-
30 November 2022	100%	-	78%

Notes: (1) 27% lodged within a few days before 29 August 2023 (9% lodged within a few days before 30 September 2022)

(2) 18% lodged within a few days before 29 November 2023 (21% lodged within a few days before 30 November 2022)

Table 4

Tax Representatives with Lodgment Rate of Less Than 78% of "M" Code Returns as at 29 November 2023

1,500 tax representatives have "M" code clients. Of these, 660 (44%) firms were below the average performance rate of 78%. An analysis of the firms, based on size, is as follows-

		Current Year Performance				Last Year Performance			
	No. of clients per firm	Total No. of firms	No. of firms below the average of 78%	No. of non-compliance cases	% of total non-compliance cases	Total No. of firms	No. of firms below the average of 78%	No. of non-compliance cases	% of total non-compliance cases
Small size firms	100 or less	1,404	621	5,453	75%	1,382	599	5,264	70%
Medium size firms	101 - 300	87	39	1,849	25%	94	44	2,190	29%
Large size firms	over 300	9	0	0	0%	7	1	102	1%
		1,500	660	7,302	100%	1,483	644	7,556	100%

Table 1 [Appendix B]

Analysis of Completed FA Corporation Cases for the years ended 31 December 2021, 2022 and 2023

	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature			
Auditor's Report = Unqualified	**2021**	**2022**	**2023**	**2021**	**2022**	**2023**	**2021**	**2022**	**2023**	
				$	$	$	$	$	$	
Sales omitted	49	58	110	59,993,235	49,923,542	341,167,150	8,081,873	6,584,107	40,682,199	
Purchases overstated	11	11	15	37,955,961	37,080,899	19,242,114	7,955,046	5,723,893	3,101,204	
Gross profit understated	33	42	27	72,549,382	112,139,969	41,323,306	9,854,050	17,060,401	3,769,502	FOR
Expenses over-claimed	87	96	120	176,744,684	66,913,566	519,090,718	26,977,704	7,579,244	39,560,403	AUDIT
Technical adjustments	76	83	73	109,962,323	70,273,261	29,876,032	16,310,509	8,793,000	3,641,513	YEAR
Offshore income / profits disallowed	18	11	7	146,747,692	82,092,640	72,991,814	23,187,921	11,791,219	12,009,849	ONLY
Other	89	113	94	400,211,845	292,527,205	620,537,111	63,003,826	40,054,271	83,652,027	
TOTAL	363*	414*	446*	$1,004,165,122	$710,951,082	$1,644,228,245	$155,370,929	$97,586,135	$186,416,697	
Total number of cases for unqualified Auditor's Report	272*	288*	329*							(I)
	(A)	(B)	(C)							
Average amount per case				$3,691,784	$2,468,580	$4,997,654	$571,217	$338,841	$566,616	
				(D)/(A)	(E)/(B)	(F)/(C)	(G)/(A)	(H)/(B)	(I)/(C)	
	* in one case there may be more than one type of discrepancy									
				Total Discrepancy for All Years			**Total Tax Undercharged for All Years**			
				2021	**2022**	**2023**	**2021**	**2022**	**2023**	
Other statistics for the above cases:	**Total amount**			**$6,202,914,132**	**$5,075,086,618**	**$13,293,074,686**	**$937,065,123**	**$686,984,945**	**$1,382,673,292**	
	Average amount per case			**$22,804,831**	**$17,621,829**	**$40,404,482**	**$3,445,092**	**$2,385,364**	**$4,202,654**	

	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature			
Auditor's Report = Qualified	**2021**	**2022**	**2023**	**2021**	**2022**	**2023**	**2021**	**2022**	**2023**	
				$	$	$	$	$	$	
Sales omitted	9	18	18	6,424,396	34,893,063	39,559,884	790,808	4,996,982	5,425,400	
Purchases overstated	8	1	6	14,993,386	76,862	21,450,264	1,619,219	9	3,624,232	
Gross profit understated	12	13	16	31,601,863	17,849,608	43,751,840	4,945,834	2,932,785	6,162,965	FOR
Expenses over-claimed	16	9	23	5,811,526	-36,249	21,378,916	410,850	-106,861	3,142,096	AUDIT
Technical adjustments	13	15	17	12,234,165	18,807,703	63,218,024	1,472,301	3,065,150	10,208,284	YEAR
Offshore income / profits disallowed	1	1	2	2,740,572	9,993,054	132,724,003	341,874	1,648,854	21,768,534	ONLY
Other	18	23	19	15,961,407	39,342,872	37,218,491	2,117,314	4,215,786	5,084,245	
TOTAL	77*	80*	101*	$89,767,315	$120,926,913	$359,301,422	$11,698,200	$16,752,705	$55,415,756	
Total number of cases for qualified Auditor's Report	52*	53*	67*							
Average amount per case				$1,726,295	$2,281,640	$5,362,708	$224,965	$316,089	$827,101	
	* in one case there may be more than one type of discrepancy									
				Total Discrepancy for All Years			**Total Tax Undercharged for All Years**			
				2021	**2022**	**2023**	**2021**	**2022**	**2023**	
Other statistics for the above cases:	**Total amount**			**$512,489,520**	**$872,939,590**	**$2,819,736,991**	**$69,062,275**	**$124,497,955**	**$425,761,771**	
	Average amount per case			**$9,855,568**	**$16,470,558**	**$42,085,627**	**$1,328,121**	**$2,349,018**	**$6,354,653**	

Grand total number of cases	324	341	396						
				Total Discrepancy for All Years			**Total Tax Undercharged for All Years**		
				2021	**2022**	**2023**	**2021**	**2022**	**2023**
Other statistics for the above cases:	**Grand total amount**			**$6,715,403,652**	**$5,948,026,208**	**$16,112,811,677**	**$1,006,127,398**	**$811,482,900**	**$1,808,435,063**
	Average amount per case			**$20,726,554**	**$17,442,892**	**$40,688,918**	**$3,105,331**	**$2,379,715**	**$4,566,755**

Extracts of Analysis in Appendix B

		2022	2023
(a)	No. of corporation cases with discrepancies uncovered	341	396
(b)	No. of corporation cases in item (a) carried clean auditor's reports	288	329
(c)	Total discrepancies detected in all cases	$5,948M	$16,113M
(d)	Total discrepancies detected in clean auditor's report cases	$5,075M	$13,293M
(e)	Percentage of (d) over (c)	85%	82%
(f)	Total tax uncovered in clean auditor's report cases	$687M	$1,383M
(g)	Average understatement per clean auditor's report case [(d) / (b)]	$17.62M	$40.40M
(h)	Average tax undercharged per clean auditor's report case [(f) / (b)]	$2.4M	$4.2M