

The IRD's views on various tax issues expressed in the 2021 annual meeting with the HKICPA

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In brief

The minutes¹ of the 2021 annual meeting between the Inland Revenue Department (IRD) and the Hong Kong Institute of Certified Public Accountants (HKICPA) held on 14 May 2021 were recently released. The meeting minutes summarise the IRD's views on various issues related to profits tax, salaries tax, transfer pricing, double taxation agreements and administrative matters expressed during the meeting.

This news flash discusses the IRD's views or clarifications on selected important Hong Kong profits tax and international tax issues and shares our observations. For a full list of the tax issues discussed in the meeting, please refer to the meeting minutes¹ available on the HKICPA's website.

In detail

Profits tax issues

1. Tax treatment of impairment loss on leases

As explained in the IRD's guidance published on its website on *Profits Tax Treatment of Leases Where HKFRS 16 Applies*², an impairment loss on a right-of-use (ROU) asset (i.e. a lease) would be allowed for deduction over the remaining term of the lease on a straight-line basis. During the annual meeting, the IRD clarified that such deduction would be allowed starting from the time immediately after the impairment loss was made, provided that it was made in compliance with HKFRS 16 and Hong Kong Accounting Standard 36. The same basis should be adopted for the taxation of any subsequent partial or full reversal of the impairment loss.

Our observations: As an impairment loss may be made at a certain point of time during the year (e.g. interim period end) and not necessarily at the end of the year, the IRD's clarification on the timing of deduction should be welcomed.

2. Application of the source principles to a data centre / server permanent establishment (PE)

The IRD reiterated the general principle that a data centre / server alone might not constitute a PE of a non-resident enterprise. The main factors to be considered in determining whether a PE is constituted include what kind of activities was carried out through the data centre / server, whether the activities constituted the core operations of the enterprise, and whether the data centre / server was at the disposal of the enterprise.

Once it has been established that a data centre / server has constituted a PE of a non-resident enterprise in Hong Kong, the IRD would adopt a two-step approach to ascertain whether such PE would be chargeable to

profits tax in Hong Kong. Profits would first be attributed to the PE in accordance with the separate enterprises principle, and then the source of profits would be determined in accordance with the operations test.

In determining the source of profits, the proper approach is to focus more on the core operations and the place where those operations have been carried out, rather than on what has been done electronically or the location of the data centre / server alone. The IRD, however, commented that whilst it did not necessarily mean that the profits attributable to a PE had to be chargeable to profits tax, in practice, it might be difficult to conclude that the profits attributable to a PE in Hong Kong did not arise in Hong Kong.

Our observations: Non-resident enterprises that operate their businesses through a data centre / server in Hong Kong should carefully evaluate whether such data centre / server would constitute a PE in Hong Kong, and if so, adopt the two-step approach to assess whether the profits attributable to such PE are sourced in Hong Kong, hence chargeable to profits tax. For more information on the IRD's view on the treatment of server PE in Hong Kong, please refer to the revised Departmental Interpretation and Practice Notes No. 39 (DIPN 39)³ and our *Hong Kong Tax News Flash, Issue 5, April 2020*⁴.

3. Taxation of financial instruments – interaction between source and fair value taxation

The IRD confirmed that the election for fair value taxation should not affect the chargeability of profits under the source rule. The source of profits from securities trading is a question of fact. Regard should be had to the location where the contract of purchase and contract of sale were effected. The IRD reiterated its general position that where either the contract of purchase or contract of sale in respect of trading securities was effected in Hong Kong, the initial presumption would be that the source of trading profits should be in Hong Kong. In case where the contract of purchase of the trading securities was effected in Hong Kong, the fair value gain on such trading securities would generally be regarded as sourced in Hong Kong irrespective of where the contract of sale would subsequently be effected. Accordingly, the fair value gain recognised in the profit and loss account should be chargeable to profits tax under fair value taxation.

Nonetheless, the IRD also acknowledged that both the sale and purchase transactions are equally important in determining the source of profits derived from securities trading and that the above is a complicated issue which may require further thought.

Our observations: The election for fair value taxation is generally irrevocable and an assessment that has become final and conclusive could not be revised unless there was an error or omission in the tax return. Hence taxpayers should carefully consider whether to elect for fair value taxation. Once an election is made, the fair value gains on financial instruments will be chargeable to tax if such gains are sourced in Hong Kong and are revenue in nature.

The IRD's initial presumption that the profits from trading securities are sourced in Hong Kong where either the contract of purchase or contract of sale in respect of the trading securities was effected in Hong Kong is apparently challengeable depending on the specific facts. It is uncertain how receptive and flexible the IRD would be in handling such challenges in practice.

4. Substantial activity threshold requirements under the tax concession regimes for ship leasing activities

Whilst the substantial activity threshold requirements (i.e. having an adequate number of full-time employees and incurring an adequate amount of operating expenditure) should generally be applied on an entity basis, the IRD confirmed that a group outsourcing arrangement could be accepted with reference to the view of the Forum on Harmful Tax Practices of the Organisation for Economic Cooperation and Development (OECD). The IRD would consider all relevant factors, including what kind of activities were carried out by the outsourced company, the number of ship owners that it served, and whether the number of the full-time employees and the amount of operating expenditure incurred in Hong Kong were commensurate with and adequate for the carrying out of core income generating activities (CIGAs), to determine whether the substantial activity threshold requirements could be satisfied.

Our observations: As there are other tax concession regimes subject to similar substantial activity threshold requirements (e.g. tax concession regimes for insurance related businesses, carried interest and single family office (proposed) etc.), it would be reasonable to assume that the same approach is equally applicable to those regimes.

5. Main purpose test for tax concession regimes

The IRD clarified that the main purpose test served as an anti-avoidance measure targeting at taxpayers who sought to abuse the tax concessions by artificial means and siphon the profits into Hong Kong to take advantage of the tax concessions without any commercial reasons and business substance established in Hong Kong. Whether the main purpose or one of the main purposes of setting up business in Hong Kong was to obtain tax benefit was a question of fact. Therefore, the IRD assured that the main purpose test would not operate to deny tax concessions for most genuine businesses with CIGAs carried out in Hong Kong. In general, the IRD would not regard obtaining tax concessions in a normal course as the main purpose and hinder the potential investors from setting up their businesses in Hong Kong.

Our observations: The IRD's assurance that the main purpose test would not operate to deny tax concessions for genuine businesses with CIGAs and business substance in Hong Kong is welcomed.

Transfer pricing issues

Transfer Pricing (TP) Form IR1475

Form IR1475 is a survey form issued by the IRD on taxpayers' compliance with the TP rules and documentation requirements. The IRD indicated that, through the information provided in Form IR1475, regular desk-based reviews and TP audits would be conducted. The IRD acknowledged that some taxpayers might encounter difficulties in completing Form IR1475 and suggested that they contact the assessors for assistance and clarification. The IRD would also carefully consider comments from external parties and fine-tune Form IR1475 where appropriate.

Our observations: Subsequent to the annual meeting, the IRD enhanced the Form IR1475 taking into account the feedback of some external parties, as notable in the revised version of the form issued to selected taxpayers in November 2021. In view of the proactive approach taken by the IRD in relation to ensuring taxpayers' compliance with the TP rules and documentation requirements, it is expected that more TP reviews and audits will be conducted very soon. Taxpayers with controlled transactions with non-Hong Kong resident associated persons, especially those required to prepare master files and local files in Hong Kong, should carefully review their TP policies and documentation to ensure compliance with the requirements and the policies and documentation can withstand questions and challenges from the IRD.

Double taxation agreements

Progress of Multilateral Convention to Implement Tax Treaty Related Measures to prevent Base Erosion and Profit Shifting (Multilateral Instrument)

In June 2017, Mainland China signed the Multilateral Instrument with application to be extended to Hong Kong SAR. The IRD updated the attendees that Mainland China was taking steps to approve the Multilateral Instrument and would deposit an instrument of approval with the OECD and make reservation and notifications applicable to Hong Kong SAR under the Multilateral Instrument. Thereafter, the Chief Executive in Council would make an order to give effect to the Multilateral Instrument in Hong Kong SAR, subject to negative vetting by the Legislative Council.

Our observations: Subsequent to the annual meeting, the OECD announced that Mainland China deposited an instrument of approval for the Multilateral Instrument on 25 May 2022⁵, which also covered Hong Kong SAR's bilateral tax treaties. The Multilateral Instrument will enter into force on 1 September 2022 for Mainland China. For Hong Kong SAR, the effective date is subject to the Hong Kong SAR's legislative procedures as mentioned above.

The takeaway

Whilst the IRD's views expressed in the meeting minutes are not legally binding, they serve as a good reference of the IRD's stance on various emerging tax issues. Taxpayers may take into consideration the views expressed by the IRD in the meeting minutes in preparing their profits tax filings or planning their business operations. Professional advice should be sought where appropriate.

Endnotes

1. The 2021 annual meeting minutes between the IRD and the HKICPA can be accessed via this link:
https://www.hkicpa.org.hk/-/media/Document/APD/TF/Tax-bulletin/032_May-2022.pdf
2. The IRD's guidance on the profits tax treatment of leases where HKFRS 16 applies can be accessed via this link:
https://www.ird.gov.hk/eng/tax/bus_lease16.htm
3. The revised DIPN 39 can be accessed via this link:
<https://www.ird.gov.hk/eng/pdf/dipn39.pdf>
4. Hong Kong Tax News Flash, Issue 5, April 2020 can be accessed via this link:
<https://www.pwchk.com/en/hk-tax-news/2020q2/hongkongtax-news-apr2020-5.pdf>
5. The OECD's announcement on Mainland China depositing an instrument of approval can be accessed via this link:
<https://www.oecd.org/tax/beps/china-deposits-an-instrument-for-the-approval-of-the-multilateral-beps-convention.htm>

Let's talk

For a deeper discussion of how this impacts your business, please contact:

PwC's Corporate Tax Leaders based in Hong Kong

Charles Lee
+852 2289 8899
charles.lee@cn.pwc.com

Jeremy Ngai
+852 2289 5616
jeremy.cm.ngai@hk.pwc.com

Jeremy Choi
+852 2289 3608
jeremy.choi@hk.pwc.com

Rex Ho
+852 2289 3026
rex.ho@hk.pwc.com

Cecilia Lee
+852 2289 5690
cecilia.sk.lee@hk.pwc.com

Jenny Tsao
+852 2289 3617
jenny.np.tsao@hk.pwc.com

Kenneth Wong
+852 2289 3822
kenneth.wong@hk.pwc.com



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For more information, please contact:

Long Ma
+86 (10) 6533 3103
long.ma@cn.pwc.com

Gwenda Ho
+852 2289 3857
gwenda.kw.ho@hk.pwc.com

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