News Flash
Hong Kong Tax

IRD's views on certain Hong Kong corporate tax issues expressed in its 2022 annual meeting with the HKICPA

9 June 2023
Issue 9

In brief

The minutes of the 2022 annual meeting between the Inland Revenue Department (IRD) and the Hong Kong Institute of Certified Public Accountants (HKICPA or Institute) held on 13 May 2022 were recently released[1]. The meeting minutes summarise the IRD's views on various tax issues expressed during the meeting, including issues related to profits tax, salaries tax, international tax, stamp duty and administrative matters.

This news flash highlights the IRD's views on the key profits tax issues and its approach to processing applications for Hong Kong certificate of residence (HK CoR) lodged by non-Hong Kong incorporated companies.

In detail

Profits tax issues

1. **Commercial building allowance (CBA) for second-hand commercial buildings and structures constructed prior to the year of assessment (YoA) 1998/99**

   Under the Inland Revenue Ordinance (IRO), CBA is granted for capital expenditure incurred on the construction of a commercial building or structure for a maximum period of 25 years, starting from the later of (i) YoA 1998/99 and (ii) the YoA in which the building or structure is first used ('25-year period'). For a commercial building or structure that has been in use since YoA 1998/99, the 25-year period will end after YoA 2023/24.

   Where the relevant interest in a commercial building constructed before YoA 1998/99 is sold for a consideration after YoA 2023/24, while the seller would be subject to a balancing charge on the amount of the sale money over the residue of expenditure immediately before the sale (restricted to the total allowances previously granted), the buyer would not be entitled to any CBA on the residue of expenditure immediately after the sale.

   This asymmetric tax treatment results in an incongruent situation that at least part, if not the whole, of the capital expenditure incurred on construction will not be relieved, even though the building has all along been used for the purpose of producing profits chargeable to tax during the 25-year period.

Given that a significant number of pre-1998/99 commercial buildings were still in use and YoA 2023/24 was fast approaching, the Institute asked the IRD whether there was any scope for granting relief, as a concession, to the buyer in the above situation.

In reply, the IRD reiterated its position expressed during the 2008 annual meeting between the IRD and the HKICPA that if the building was still in use after the 25-year period, there was no provision under the IRO which allowed CBA in respect of such building or structure. The IRD stressed that it had to apply the law within its ambit and there is no room to get around it to provide the concession.

Our observations: *It is understood that the Institute has raised this issue in its tax policy and budget proposals for 2023/24. Hopefully, there will be favourable changes to the IRO that will address the concerns discussed above after consideration by the HKSAR Government.*

2. Deduction of costs incurred on purchasing renewable energy credits or certificates (RECs) or carbon credits

As investors become more socially and environmentally conscious, businesses have been allocating more resources towards improving environmental, social and governance. They may purchase RECs or carbon credits as part of their general business operating costs or to fulfil their social responsibilities. The Institute sought clarifications from the IRD on the tax deductibility of such costs incurred under the following scenarios:

Costs incurred on the purchase of RECs/carbon credits by the taxpayer

The IRD responded that the deductibility of such costs was governed by the normal deduction rules (i.e. sections 16 and 17 of the IRO). In general, costs incurred on the purchase of RECs/carbon credits would be tax deductible if they were sufficiently connected to the taxpayer’s profit-earning process of its business and were revenue in nature. Examples of such costs included purchasing of RECs which formed part of the electricity expenditure and purchasing of carbon credits for the emission of carbon dioxide or other greenhouse gases in the ordinary course of the taxpayer’s business activities.

Conversely, if the purchase of RECs/carbon credits had no or little nexus with the profit-earning process of the taxpayer’s business and was merely used to demonstrate its support towards the development of renewable energy in order to enhance its ‘green image’, such costs would not be regarded as revenue expenditure incurred in the production of chargeable profits and hence would not be tax deductible.

The above tax treatments would equally apply whether the RECs/carbon credits were purchased on a voluntary or compulsory basis.

A group company purchased the RECs/carbon credits and allocated the purchase costs to the taxpayer

The IRD indicated that so long as the arm’s length principle was followed in allocating the purchase costs of RECs/carbon credits to the Hong Kong taxpayer, the allocated costs would be tax deductible if the normal deduction rules as explained above were satisfied.

Our observations: *In light of the IRD’s position, taxpayers are recommended to maintain robust documentation to substantiate that there is sufficient nexus between their expenditure incurred on purchasing RECs/carbon credits and their income generating businesses if they intend to claim the expenditure as deductible.*

3. Application of the anti-round tripping provisions to a resident fund

Prior to the legislative amendments implementing the unified exemption regime for funds (UFR), only non-resident privately-offered funds might enjoy profits tax exemption on specified transactions and incidental transactions (subject to a 5% threshold). To prevent round-tripping of funds by Hong Kong resident persons to take advantage of the profits tax exemption for funds, there are deeming provisions that would render resident persons of a tax-exempt fund chargeable to tax in Hong Kong under certain conditions.

Notwithstanding the implementation of the UFR which extends the profits tax exemption to resident privately-offered funds, similar deeming provisions are incorporated in the UFR.

In general, if a Hong Kong resident person, either alone or jointly with the person's associates, holds a beneficial interest (whether directly or indirectly) of not less than 30% in a fund enjoying profits tax exemption, or any percentage if such fund is the resident person's associate, the resident person is deemed to have derived assessable profits in respect of the profits earned by the fund from transactions carried out in Hong Kong. Where such fund has a beneficial interest in a special purpose entity (SPE) enjoying profits tax exemption, the resident person is deemed to have derived assessable profits in respect of the profits earned by the SPE. Nonetheless, the deeming provisions would not apply if the fund is being regarded as 'bona fide widely held'.

Uncertainty therefore arises as to whether the deeming provisions would apply to a resident fund investing in another resident fund or in an SPE owned by another resident fund. The Institute illustrated the concern by way of the following example:

A resident fund (Fund A) holds more than 30% beneficial interest in another resident fund (Fund B). Both Fund A and Fund B satisfy the conditions for tax exemption under the UFR. Fund B also owns an SPE, the profits of which would also be exempt from tax. The Commissioner is not satisfied that Fund B is a bona fide widely held fund.

Literally interpreted, the Institute considered that the deeming provision could apply such that a corresponding portion of the exempted profits of Fund B and the SPE would be deemed to be the assessable profits of Fund A, notwithstanding that Fund A itself is a tax-exempt fund. Such an interpretation would however appear to defeat the very purpose of exempting funds from tax under the UFR.

The IRD responded that in its view, Fund A did not appear to be a beneficial owner for the purposes of the deeming provisions. This was because Fund A, being a tax-exempt fund, should be an arrangement which satisfied the three requirements of 'fund' under the IRO. These requirements include, among others, (i) the pooling of the capital contributions of the participating persons and the profits or income from which payment is made to them; and (ii) the purpose or effect of the arrangement is to enable the participating persons to participate in the acquisition, holding, management or disposal of the property, or to receive profits or income from those transactions or sums paid out of such profits or income.

Adopting a purposive approach to construe the deeming provisions, the IRD considered that it should be the participating persons (i.e. investors) of Fund A, rather than Fund A itself, that should be regarded as the beneficial owners of interests in the underlying property of Fund A.

The IRD further added that in the given example, as Fund A was a 'fund' and hence considered as an arrangement under the IRO, it could not be regarded as a resident person for the purposes of the deeming provisions.

As such, to determine whether the deeming provisions would be applicable, the IRD would adopt a look-through approach and consider whether any participating person of the fund was a resident person and held a beneficial interest above the prescribed threshold.

Our observations: *We welcome the IRD's clarification that it would adopt a look-through approach in applying the deeming provisions contained in the UFR. This would avert an absurd outcome of having a tax-exempt resident fund with no resident participating persons being caught by the deeming provisions because of its investment in another tax-exempt fund.*

Issuance of HK CoR to non-Hong Kong incorporated companies

As expressed in the 2014 and 2015 annual meetings, the IRD had to act in good faith in accordance with the terms agreed under the relevant comprehensive avoidance of double taxation arrangements (CDTAs), to uphold the purposes for which these CDTAs were signed (i.e. avoid double taxation and prevent fiscal evasion) and to prevent treaty abuse.

For the above reasons, the IRD would not issue a HK CoR on the basis of tax residence alone. The company concerned generally also has to demonstrate that it has commercial substance in Hong Kong before a HK CoR would be issued.

With respect to a non-Hong Kong holding company with management or control exercised in Hong Kong, the Institute asked, if such a company is not required to register under the Companies Ordinance (CO) as it had not established a place of business in Hong Kong, whether it needed to obtain a business registration (BR) under the Business Registration Ordinance (BRO) in its application for a HK CoR.

In reply, the IRD reiterated that in deciding whether a HK CoR could be issued to a non-Hong Kong incorporated company, the IRD would thoroughly examine all the relevant facts and circumstances to determine whether the test on 'management and/or control' specified in the relevant CDTA was satisfied. All relevant factors, including the company's nature of business, its mode of operation, its place of business, its place of board of directors' meetings, and its place of implementation of top management's decisions, would need to be taken into consideration.

As the term 'business' had different meanings under the CO and the BRO, whether a non-Hong Kong incorporated company that was not required to be registered under the CO did not have any bearing on whether such a company was required to obtain a BR under the BRO. Whether a company needed to apply for a BR is governed by the provisions of the BRO and had to be decided based on the facts and circumstances of each case.

The IRD reaffirmed that in determining whether a company was managed or controlled in Hong Kong, the IRD's stance that a BR is not the conclusive factor remained unchanged. If a non-Hong Kong incorporated company did not apply for a BR in Hong Kong on the grounds that it had not established a place of business in Hong Kong, it would have to provide other concrete evidence to establish that it had commercial substance and exercised its management or control in Hong Kong.

Nonetheless, the IRD remarked that the non-Hong Kong incorporated company in such a scenario should have carried out some business activities in Hong Kong and might potentially be required to obtain a BR if the activities undertaken were within the meaning of 'business' laid down in the BRO.

The Institute further asked, with regard to an application for a HK CoR relating to the *Circular of the State Taxation Administration on Matters Concerning 'Beneficial Owners' in Tax Treaties (STA Circular 2018 No. 9)* (PN 9), if a non-Hong Kong intermediate holding company which holds some investments in Mainland China did not have commercial substance in Hong Kong, whether the IRD would be prepared to issue a HK CoR to it based on the commercial substance of its Hong Kong ultimate holding company such that the intermediate holding company would not be required to apply for a BR.

The IRD stressed that its approach as explained above would equally apply to applications for HK CoR relating to PN 9, regardless of the layer at which the intermediate company was located within the holding structure and whether it belonged to a Hong Kong listed group with commercial substance in Hong Kong. In other words, whether the relevant company needed to obtain a BR and would be issued a HK CoR had to be determined on its own facts and circumstances. This was because PN 9 only provided for how the beneficial ownership test was to be applied in Mainland China and did not change the 'resident' concept in the implementation of CDTAs. There was nothing in PN 9 that allowed non-Hong Kong holding companies which hold subsidiaries in Mainland China to be directly regarded as, or even deemed as, Hong Kong residents.

Our observations: *Whilst the IRD's response implies that obtaining a BR in Hong Kong is not a prerequisite before a HK CoR is issued, taxpayers need to carefully consider how it can support that it exercised management or control in Hong Kong without triggering the registration obligation. On the same date the minutes were published, the IRD also announced that it will adjust its approach to the issuance of HK CoR from 12 June 2023. Under the adjusted approach, the IRD will base its decision whether a HK CoR can be issued by reference to the definition of 'resident of Hong Kong' in the relevant CDTA. As non-Hong Kong incorporated companies are nonetheless required to provide extensive and detailed information in the relevant application form to demonstrate that their management or control was exercised in Hong Kong, they should take steps in advance to establish the kind of evidence and commercial substance required for a HK CoR application.*

The takeaway

While the IRD's views expressed in the meeting are not legally binding, they serve as a good reference of the IRD's stance on various emerging tax issues. Taxpayers are advised to note the IRD's latest views on these issues and review how such views

might impact their business operations. Professional advice should be sought where necessary.

Endnotes

1. The meeting minutes can be accessed via this link: https://www.hkicpa.org.hk/-/media/Document/APD/TF/Tax-bulletin/033_May-2023.pdf

Let's talk

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

One-stop tax information platform of Shui Jie 3.0 version
Your exclusive tax think tank

· For Android users, please scan the QR code to access to Tencent App store
· Shui Jie web portal - https://shuijie.pwcconsultantssz.com

In the context of this News Flash, China, Mainland China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

The information contained in this publication is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. Before taking any action, please ensure that you obtain advice specific to your circumstances from your usual PwC's client service team or your other tax advisers. The materials contained in this publication were assembled on 9 June 2023 and were based on the law enforceable and information available at that time.

This News Flash is issued by **PwC's National Tax Policy Services** in Mainland China and Hong Kong, which comprises a team of experienced professionals dedicated to monitoring, studying and analysing the existing and evolving policies in taxation and other business regulations in Mainland China, Hong Kong, Singapore and Taiwan. They support PwC's partners and staff in their provision of quality professional services to businesses and maintain thought-leadership by sharing knowledge with the relevant tax and other regulatory authorities, academies, business communities, professionals and other interested parties.

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

Please visit PwC's websites at http://www.pwccn.com (China Home) or http://www.pwchk.com (Hong Kong Home) for practical insights and professional solutions to current and emerging business issues.

www.pwchk.com

© 2023 PricewaterhouseCoopers Ltd. All rights reserved. PwC refers to the Hong Kong member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.