Hong Kong Institute of
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香港會計師公會

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Tax Bulletin

2021 Annual Meeting

The Inland Revenue Department

and

The Hong Kong Institute of Certified Public Accountants

2021
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 to clarify areas of interpretation, representatives of the Institute met the Commissioner of Inland Revenue (CIR) and members of his staff in May 2021.

As in the past, the agenda took on board items received from a circulation to members of the Institute prior to the meeting. The minutes of the meeting, prepared by the Inland Revenue Department (IRD) 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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2021
ANNUAL MEETING BETWEEN
THE INLAND REVENUE DEPARTMENT AND
THE HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Full Minutes

The 2020/21 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department was held on 14 May 2021 at the Inland Revenue Department.

In Attendance

Hong Kong Institute of Certified Public Accountants (the Institute)

Mr William Chan	Chair, Taxation Faculty Executive Committee
Ms Sarah Chan	Deputy Chair, Taxation Faculty Executive Committee
Ms Agnes Cheung	Member, Taxation Faculty Executive Committee
Mr Edward Lean	Member, Taxation Faculty Executive Committee
Mr Eugene Yeung	Member, Taxation Faculty Executive Committee
Ms Gwenda Ho	Member, Taxation Faculty Executive Committee
Ms Jo An Yee	Member, Taxation Faculty Executive Committee
Ms Kathy Kun	Member, Taxation Faculty
Mr Peter Tisman	Director, Advocacy and Practice Development
Ms Selraniy Chow	Manager, Advocacy and Practice Development

Inland Revenue Department (IRD)

Mr Tam Tai-pang	Commissioner of Inland Revenue
Ms Leung Wing-chi	Deputy Commissioner of Inland Revenue (Technical) (Acting)
Mr Leung Kin-wa	Deputy Commissioner of Inland Revenue (Operations) (Acting)
Ms Chan Shun-mei	Assistant Commissioner of Inland Revenue
Ms Wong Ki-fong	Assistant Commissioner of Inland Revenue
Mr Chan Sze-wai	Assistant Commissioner of Inland Revenue
Ms Leung To-shan	Chief Assessor (Tax Treaty)
Mr Tsui Chung-leung	Chief Assessor (Tax Treaty) (Acting)
Ms Lau Kin	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 committee members of the Taxation Faculty 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.

Mr William Chan on behalf of the Institute's Taxation Faculty thanked CIR for arranging the annual meeting. He 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. He understood that the IRD officers had spent a lot of time in preparing the responses to the questions raised by the Institute and thanked for their hard work. He looked forwarded 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

<u>Agenda Item A1 - Profits Tax Issues</u>

(a) Profits tax treatment of leases where HKFRS 16 applies

In the Tax Information published on the IRD's website in September 2020 on *Profits Tax Treatment of Leases Where Hong Kong Financial Reporting Standard (HKFRS) 16 Applies*, the IRD explained that, in relation to impairment and revaluation adjustment:

"To approximate the accounting effect (i.e. the original depreciation) and therefore tax deductions that would have been available had the impairment not been made, the impairment loss… would be allowed for deduction over the remaining term of the lease on a straight-line basis.

If there was a subsequent partial or full reversal of the impairment loss … the reversal would be spread over the remaining term of the lease on a straight-line basis and taxed accordingly."

In this regard, the Institute would like to clarify the year of assessment (YA) in which the taxpayer can start claiming a deduction of the impairment loss. In particular, Hong Kong Accounting Standard 36 Impairment of Assets (HKAS 36) requires an entity to assess at the end of each reporting period (which includes year end and interim) whether there is any indication that an asset may be impaired, and if so, the entity shall estimate the recoverable amount of the asset. Accordingly, an impairment loss may be made at a certain point in time during the year (e.g. interim period end) and not necessarily at the end of the year. It would appear appropriate for the taxpayer to claim a deduction starting from the month following the month in which the provision was made, as illustrated below:

Example:

On 1 January 2020, Company A rented a shop for 3 years (i.e. 2020 to 2022). It closes its accounts on 31 December each year, and is required to do half-yearly interim reporting. Company A has significantly curtailed its operations due to COVID-19 in the first half of 2020. By the end of June 2020, there was an indication that the right-of-use (ROU) asset (i.e. the shop lease) was impaired and an impairment loss of $2 million was recognised on 30 June 2020 in Company A's profit and loss account for the year ended 31 December 2020 in accordance with HKAS 36.

If we further assume that the present value of the ROU asset is HK$9 million on 1 January 2020, should Company A claim its deduction of impairment loss and depreciation of ROU asset as follows?

Year of assessment	**Impairment loss - Deductible amount ($)**	**Depreciation of ROU asset - Deductible amount ($)**
2020/21	400,000 (i.e. $2m x 6/30)	2,600,000 (i.e., $9m x 6/36 + $5.5m* x 6/30) * 5.5m = $9m - $9m x 6/36 (being the depreciation made in the first six months of 2020) - $2m (being the impairment loss made in June 2020)
2021/22	800,000 (i.e. $2m x 12/30)	2,200,000 (i.e. $5.5m x 12/30)
2022/23	800,000 (i.e. $2m x 12/30)	2,200,000 (i.e. $5.5m x 12/30)
Total	2,000,000	7,000,000

Similarly, should the reversal of the impairment loss and depreciation of ROU asset (if any) be taxable following the above principle?

The IRD responded as follows–

- Under HKFRS 16, a lessee should apply HKAS 36 to determine whether the ROU asset was impaired and to account for any impairment loss identified. HKAS 36 set out certain impairment indications, though not exhaustive, for assessing whether an asset might be impaired. If any of the impairment indications was present, a formal estimate of the asset's recoverable amount had to be made for determining the amount of impairment loss which should be recognized in the profit and loss account. The impairment of an ROU asset, which was made in compliance with HKFRS 16 and HKAS 36, would be accepted for deduction on a straight line basis under profits tax.

- In the example given, the impairment loss of the ROU asset (i.e. the lease) amounting to $2 million was recognized in Company A's profit and loss account on 30 June 2020. In case it was proved to the satisfaction of the IRD that the recognition of the impairment loss was compliant with HKFRS 16 and HKAS 36, and that the recognition was made on 30 June 2020 as claimed, the impairment loss of $2 million would be allowed, as deduction, to be spread over the remaining useful term of the lease (i.e. July 2020 to December 2022) on a straight line basis as announced on the IRD's website. Upon the recognition of the impairment loss of $2 million, the ROU asset would be measured at $5,500,000 [i.e. $9,000,000 (initial recognition) – $1,500,000 (depreciation for January to June 2020) – $2,000,000 (impairment loss)] and depreciation would be charged throughout the remaining useful term of the lease accordingly. The same basis should be adopted where there was a subsequent partial or full reversal of the impairment loss. Once the reversal was recognized in Company A's profit and loss account, it would be spread over the remaining useful term of the lease and taxed accordingly, and depreciation charge should be recomputed.

(b) Whether trading stock transferred at below market price can rely on section 50AAJ or section 15C(a) of the Inland Revenue Ordinance (IRO) from being adjusted by the IRD

The Institute would like the IRD to advise, where trading stock, in particular that in the form of real estate property or listed securities in Hong Kong, is transferred, not upon cessation of business, from one Hong Kong taxpayer to another related Hong Kong taxpayer at below market price, whether reliance can be placed on the exempted domestic transaction provisions of section 50AAJ of the IRO.

In other words, provided that the conditions of section 50AAJ are satisfied, the IRD would not invoke Rule 1 of section 50AAF or case-law principles, such as those established in *Petrotim Securities Ltd v Ayres, 41 TC 389*, to disturb the actual transaction price.

Similarly, where trading stock is transferred upon cessation of business, provided that section 15C(a) is satisfied, the IRD would also not invoke Rule 1 of 50AAF or section 61A of the IRO to disturb the actual transaction price.

The IRD responded as follows–

- Rule 1 required income or loss from transactions between associated persons to be computed on an arm's length basis. Section 50AAF of the IRO contained detailed provisions relating to the application of Rule 1. As regards trading stock, section 50AAF(7) provided that Rule 1 did not apply in relation to a provision made or imposed in relation to any disposal or acquisition of trading stock if section 15BA(4) or (5) applied in relation to the disposal or acquisition. Section 50AAF(8) further provided that Rule 1 did not apply in relation to a provision made or imposed in relation to any trading stock, if section 15C applied in relation to the trading stock.

- Where trading stock was transferred, not upon cessation of business, from a Hong Kong taxpayer (the Transferor) to another related Hong Kong taxpayer (the Transferee) at below market price, otherwise than in the course of trade, section 15BA(4) or (5) would apply to adjust the transaction price to an arm's length price.

In such circumstances, by virtue of section 50AAF(7), Rule 1 would not apply and it was not necessary to consider whether the conditions under section 50AAJ were satisfied.

- Where both the Transferor disposed of and the Transferee acquired the trading stock in the course of trade, section 15BA(4) and (5) had no application. Therefore, section 50AAF would come into play. All relevant facts and circumstances should be considered when deciding whether an actual provision conferred a potential Hong Kong tax advantage under section 50AAF(1)(d) as read with section 50AAJ. If all the conditions stipulated in section 50AAJ(2) were met, the IRD would accept that the transfer of trading stock did not confer a potential advantage in relation to Hong Kong tax. No transfer pricing adjustment would be made under Rule 1.

- For transfer of trading stock upon cessation of business, if the conditions under section 15C(a) were satisfied (i.e. the trading stock was sold or transferred for valuable consideration to a person who carried on or intended to carry on a trade or business in Hong Kong; and the cost whereof might be deducted by the purchaser as an expense in computing the profits from such trade or business in respect of which such purchaser was chargeable to profits tax), the value of the trading stock transferred (i.e. the transaction price) should be taken to be the amount realized on the sale or the value of the consideration given for the transfer. Pursuant to section 50AAF(8), Rule 1 did not apply in relation to the trading stock transferred.

- Having said the above, the IRD might invoke sections 61 and/or 61A to counteract a blatant tax avoidance arrangement involving non-arm's length transactions between related parties.

(c) Application of the source principles to a datacentre or server permanent establishment (PE)

Example 5 of Departmental Interpretation and Practice Notes (DIPN) No. 39 (Revised) indicates that a non-Hong Kong resident enterprise merely locating a datacentre or server PE in Hong Kong is chargeable to tax in Hong Kong.

However, we also note that, in paragraph 19(a) of DIPN 39 (Revised), the IRD apparently takes the position that it is the core operations and support activities performed by the Hong Kong resident enterprise in Hong Kong that are the "profit-producing transactions". Thereby, the IRD has effectively disregarded the location of the server PE outside Hong Kong as being relevant to determining the source of the profits of the Hong Kong resident enterprise.

As such, given that the tax position of the non-Hong Kong resident enterprise in Example 5 is the reverse position of the above Hong Kong resident enterprise, one would expect none of the profits of the non-Hong Kong resident enterprise should be considered as being sourced in Hong Kong.

Conversely, if part of the profits of the above non-Hong Kong resident enterprise is apportioned as being Hong Kong sourced profits, would the IRD accept that part of the profits of the Hong Kong resident enterprise should also be apportioned as being non-taxable offshore profits under section 14 of the IRO (regardless of whether the server PE is located in a Comprehensive Double Taxation Agreement (CDTA) or non-CDTA jurisdiction)?

The IRD responded as follows–

- Example 5 of DIPN 39 (Revised) illustrated the concept of server PE. It did not state that a non-resident person with only a datacentre / server PE in Hong Kong would necessarily be chargeable to tax in Hong Kong under the source rule. Nor did it deal with apportionment of onshore and offshore profits. In that example, the datacentre / server, which was at the disposal of the non-resident person, conducted an essential and significant part of its business activity in the provision of online audio, video and web conferencing services. The datacentre / server thus constituted a PE in Hong Kong and the non-resident person would be regarded as carrying on a business in Hong Kong under section 50AAK(1) of the IRO. Accordingly, profits would be attributed to the datacentre / server PE, having regard to the functions it performed in Hong Kong under section 50AAK(2).

- The IRD would adopt a two-step approach when ascertaining whether a PE of a non-resident person would be chargeable to profits tax in Hong Kong. Profits would first be attributed to the PE in accordance with the separate enterprises principle. Then, the source of the profits would be determined in accordance with the operation test. The ascertainment of the source of profits was a practical, hard matter of fact. It was necessary to appreciate the reality of each case, focusing on effective causes for earning the profits without being distracted by antecedent or incidental matters. Paragraph 19(a) of DIPN 39 (Revised) reflected the application of such principle in determining the locality of e-commerce profits.

- In paragraph 17 of DIPN 39 (Revised), the IRD explained that "the location of the server alone does not determine the locality of the profits, and the proper approach is to focus more on the core operations that have effected the e-commerce transaction to earn the profits in question and the place where those operations have been carried out, rather than on what has been done electronically". If all the core operations and support activities of an e-commerce business were performed in Hong Kong, the e-commerce profits would be fully chargeable to profits tax even though the server was located outside Hong Kong.

- In the case of a Hong Kong resident person, if the profits attributable to the person's server PE in a double taxation agreement or arrangement (DTA) territory had been taxed in that territory, any foreign tax paid in that territory would be allowed as a credit against the profits tax payable by the person in Hong Kong.

Ms Yee said that pursuant to the explanation in paragraph 17 of DIPN 39 (Revised), if the core operations of an enterprise were carried out in Hong Kong and the server was located outside Hong Kong, it appeared to be the IRD's view that the profits of the enterprise were fully chargeable to profits tax in Hong Kong. She sought the IRD's further clarification whether it was possible to apportion the profits as sometimes the server located outside Hong Kong might form part of the core operations of the enterprise. Mr Tisman commented that it would be helpful if the IRD would clarify that example 5 was not the reverse of the situation illustrated in paragraph 19(a) of DIPN 39 (Revised).

In response, CIR explained that a two-step approach would be adopted by the IRD. First, the IRD would ascertain whether profits should be attributed to the PE in accordance with the separate enterprises principle, taking into account the functions performed, assets used and risks assumed by the non-resident enterprise through the PE. Second, the IRD would ascertain whether the source of the profits was in Hong Kong in accordance with the operation test. It did not necessarily mean that the profits attributable to a PE had to be chargeable to tax in Hong Kong. He stressed that the IRD would examine what constituted the core business activities of the enterprise and the place where these activities were carried out. In practice, it might be difficult to conclude that the profits attributable to a PE in Hong Kong did not arise in Hong Kong.

Mr Chan supplemented that paragraphs 122 to 131 of the Commentary on Article 5 of the 2017 Organisation for Economic Cooperation and Development (OECD) Model Tax Convention on Income and on Capital (MTC) had provided a very good guidance on whether the mere use of computer equipment in electronic commerce operations in a country could constitute a PE. The general principle was that a server alone might not constitute a PE. The main factors that would be considered included what kind of activities was carried out through the server, whether the activities would constitute the core operations of the enterprise and whether the server was at the disposal of the enterprise. If the profits generating activities were carried out through the server and the enterprise had the server at its own disposal, then the server would likely constitute a PE. Mr Chan further explained that in scenario 1 of Example 5 of DIPN 39 (Revised), the conclusion that the datacentre could be regarded as a PE in Hong Kong and the profits attributable to the PE were chargeable to profits tax in Hong Kong was premised on the conditions that the datacentre was at the disposal of Corporation-F and an essential and significant part of the business activity of Corporation-F was conducted through or from the datacenter.

(d) Provisional tax payable on royalties

If a taxpayer's final tax payable on royalty for a non-resident will be lower when computed according to section 15(1)(b), less tax reduction, while the treaty rate will result in lower tax for provisional payment, will the IRD accept different ways to compute the final tax and the provisional payment? In other words, could the final tax payable be calculated based on (i) and the provisional tax payable be computed based on (ii) shown below:

(i) amount computed according to sections 15(1)(b) and 21A(1)(b) (i.e. royalty x normal rate of 4.95% (16.5% on 30% under section 21A(1)(b)) less tax reduction;

and

(ii) royalty x treaty rate (without tax reduction).

> The IRD responded that, if the tax reduction resulted in a lower final tax payable when computed under section 15(1)(b) of the IRO, the final tax, in practice, could be charged at the normal rate with the tax reduction while the provisional tax could be charged at the treaty rate.

(e) DIPN 42 (Revised) – Taxation of financial instruments

(i) Financial instruments measured at amortized cost or at fair value through other comprehensive income (FVTOCI) on an "as if" basis

Paragraph 37 of DIPN 42 (Revised) indicates that where a financial instrument measured at amortized cost or at FVTOCI is acquired for trading purposes, impairment losses in respect of such an instrument can be claimed for tax deduction "*as if the financial instrument were measured at fair value through profit or loss (FVTPL) and any fair value changes will be taxed or allowed accordingly*".

In this regard, would the taxation of any fair value gains in respect of such an instrument be limited to the extent impairment losses were previously claimed for tax deduction on the above "as if" basis? In other words, where the impairment losses previously allowed for tax deduction have been fully recaptured, any further fair value gains would not then be taxable on the above "as if" basis until the instrument is disposed of, given that the instrument is measured at amortized cost or FVTOCI.

> The IRD responded as follows–
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> - Paragraph 37 of DIPN 42 (Revised) did not state that where a financial instrument measured at amortized cost or at FVTOCI was acquired for trading purpose, impairment losses in respect of such an instrument could be claimed for tax deduction. That paragraph only stated that if the taxpayer claimed and the assessor was satisfied that such an instrument was acquired for trading purpose, adjustment could be made in tax computation "as if the financial instrument were measured at FVTPL and any fair value changes will be taxed or allowed accordingly". Therefore, it was the fair value changes, not the impairment losses, that would be taxed or allowed for deduction.
>
> - As mentioned in paragraph 33 of the DIPN, section 18K(3) of the IRO provided that deduction of impairment loss in respect of credit-impaired financial assets was only applicable to trade debts and money lent in the

ordinary course of a money lending business in Hong Kong but not others. Thus, if a financial instrument was acquired for trading purpose, say, trading securities, no impairment loss in respect of such trading securities would be allowed for deduction. On the other hand, as such trading securities were normally measured at FVTPL, any expected credit loss should have been reflected in the fair value changes and recognized in profit or loss and would be brought into account for tax purposes accordingly. That said, if such trading securities were not measured at FVTPL but the assessor was satisfied that they were acquired for trading purpose, the trading securities could be treated as if they had been measured at FVTPL since acquisition and any fair value changes that would have been recognized in profit or loss, whether it was a gain or a loss, would be brought into account for tax purposes accordingly.

(ii) Penalty exposures for not tracking the movements

To save taxpayers from tracking which portion of adjustments have been brought into tax, would the IRD consider that a taxpayer files an incorrect return if the taxpayer brings any adjustments of trading assets in other comprehensive income to tax, and ignores any accumulated gains / losses recycled to profit and loss account when such instruments are derecognised?

The IRD responded that where tax adjustments had been made in respect of trading assets measured at FVTOCI as mentioned in the answer to question (e)(i) above, all fair value gains or losses should have been brought into account for tax purposes. It would not be difficult for taxpayers to track the adjustments made. In any event, taxpayers should keep proper records for tax purposes. They should keep track of the movements and ensure that all profits or losses were properly brought into account for tax purposes. Failure to do so might lead to penal actions.

(iii) Interaction between source and fair value taxation

Sections 18G to 18L have brought in assessment to profits tax on a fair value basis (by election). Paragraph 71 of DIPN 42 (Revised) confirms the IRD's assessing practice that, "*in general, the application of the provisions in sections 18I to 18L relating to profits tax assessment on the fair value basis are subject to the other Part 4 provisions (i.e. the source principle and the distinction between capital and revenue remain intact)*". It would be useful if the IRD would provide their view on the following situation:

A taxpayer is trading in securities and makes the election to be assessed on a fair value basis. The fair value gains (and losses) on those securities are brought into account for profits tax purposes. In determining whether those fair value gains are profits arising in or derived from Hong Kong (i.e. Hong Kong source) and therefore chargeable to profits tax, one must consider where the purchase and sale of the securities were effected. However, as the securities have not actually been sold yet, it is not possible to determine if those profits have arisen in or derived from Hong Kong.

How would the IRD approach this case? We consider that, as it is not possible to determine that the fair value gains are Hong Kong sourced, they should not be chargeable until the securities are realized and the source can be ascertained.

If the IRD considers that the source of the fair value gain should be predicted, will they permit / require the assessable profits for that period to be amended if on realization of the securities the prediction of source turns out to be incorrect?

For example, take the case of a taxpayer who has elected for fair value accounting as their tax filing basis under section 18H of the IRO. In Year 1, the taxpayer offered the fair value gain of an instrument for tax assessment on the basis that (i) the purchase of the instrument was effected in Hong Kong; and (ii) the taxpayer then expected that the sale of the instrument would also be effected inside Hong Kong. However, as a result of a subsequent change in the operational mode of the taxpayer, the sale of the instrument in Year 3 was actually effected outside Hong Kong, thereby realizing the fair value gain of the instrument in Year 1. Can the taxpayer in this example re-open the Year 1 assessment in respect of the fair value gain of the instrument if the taxpayer considers that the overall fact pattern of the case, including the sale of the instrument being effected outside Hong Kong, justifies an offshore claim for the profit so realized?

The IRD responded as follows–

- Before the enactment of sections 18G to 18L of the IRO, profits or losses were, as a matter of law, brought into account for tax purposes on a realization basis. To address stakeholders' concern on the substantial costs that would have been incurred to re-compute their profits on a realization basis and upon their request, legislative amendments were made in 2019 whereby sections 18G to 18L were added to provide for the alignment of tax treatment of financial instruments with their accounting treatment (i.e. a fair value basis) by taxpayer's election. Upon election, subject to certain specific provisions, profits or losses recognized in profit or loss, whether realized or unrealized, should be brought into account for tax purposes. Given the clear legislative intent, any claim for assessment on a realization basis would not be entertained once an election for assessment on the fair value basis was made.

- The locality of profit (or loss) from the purchase and sale of securities was a question of fact. In particular, regard should be given to the locality of the place where the contracts of purchase and sale were effected. In the case where either the contract of purchase or contract of sale was effected in Hong Kong, the initial presumption would be that the source of the profit was in Hong Kong. In the given example, since the purchase of the instrument was effected in Hong Kong, it was unlikely that the trading profit could be accepted as offshore sourced even though the sale was subsequently effected outside Hong Kong. Therefore, the taxpayer should offer the fair value gain of the instrument for tax assessment.

Mr Lean understood that it was the legislative intent of sections 18G to 18L to provide for the alignment of tax treatment of financial instruments with their accounting treatment. In the given example, once the taxpayer had elected to be assessed on a fair value basis, it might not be ideal to revert back to the realization basis in the year of sale of the instrument. He noted the IRD's views that the question of apportionment did not arise in relation to trading profits. Thus trading profits were either sourced in or outside Hong Kong. He also understood that where either the contract of purchase or contract of sale of securities was effected in Hong Kong, it was the IRD's initial presumption that the source of the profits was in Hong Kong. However, he considered that the source of profits of a case should depend on the particular facts of the case.

In response, CIR explained that it was the general position of the IRD that, if either the contract of purchase or contract of sale of securities was effected in Hong Kong, the source of the profits should be in Hong Kong. He agreed that the source of profits was a question of fact and a taxpayer always had the right to contest the IRD's views through the objection and appeal channel.

Mr Lean considered that a presumption could be rebutted. He said that if the example was the other way round, i.e. the instrument was purchased outside Hong Kong but was subsequently sold in Hong Kong, he asked whether the taxpayer could assume that the profits were sourced outside Hong Kong and thus it was not necessary to report the profits in the tax return.

Ms Chan explained that fair value accounting did not affect the chargeability of profits under the source rule. If the source of the profits was outside Hong Kong, even though fair value gain was recognized in the profit and loss account, the gain could be excluded from the tax computation. However, if the source of the profits was in Hong Kong, the fair value gain recognized in the profit and loss account should be chargeable to tax and offered for assessment in Hong Kong.

Mr Lean followed up and asked, if the instrument was purchased in Hong Kong and an assessment was issued to the taxpayer on the ground that the fair value gain recognized in the profit and loss account was sourced in Hong Kong, but it later turned out that the instrument was sold outside Hong Kong, whether the IRD would revise the assessment. He considered that the IRD should look at both the places of effecting the purchase and sale transactions and determine which transaction was predominant to produce the profits in question.

Ms Chan responded that if an assessment had become final and conclusive, it could not be revised unless the assessor was satisfied that there was an error or omission in the tax return. Ms Chan also considered that both the sale and purchase transactions were equally important in determining the source of profits derived from securities trading.

CIR acknowledged that this was a complicated issue and that further thought might need to be given to it.

(f) Profits tax exemption for funds

(i) "Managed as a whole" requirement and "pooling" requirement under section 20AM(2)(a) of the IRO

Paragraph 43 of DIPN 61 states that "…*it is apparent that an arrangement intended to have one single investor only is unlikely an arrangement under which the capital contributions and profits or income are pooled and would not satisfy the "pooling" requirement."*. Some of the Institute's members take the following views:

- Section 20AM(2)(a) is an "either or both" requirement. A fund needs not to satisfy the "managed as a whole" requirement under section 20AM(2)(a)(i), so long as the fund satisfies the "pooling" requirement under section 20AM(2)(a)(ii).

  As such, where the "managed as a whole" requirement is not satisfied, a fund would still qualify as a "fund" under section 20AM(2), provided that the "pooling" requirement under section 20AM(2)(a)(ii) together with other requirements as specified in section 20AM(2)(b) and (c) are satisfied.

- Where the "managed as a whole" requirement is satisfied, a fund would nonetheless still have to be somehow a pooling arrangement – given that the optional "pooling" requirement under section 20AM(2)(a)(ii) is somewhat replicated as a pre-requisite condition of the "purpose or effect of the arrangement" requirement under section 20AM(2)(c).

  Is the above interpretation correct? If not, why not? What is the practical difference between the "pooling" requirement under section 20AM(2)(a)(ii) and the "purpose or effect of the arrangement" requirement under section 20AM(2)(c)?

The IRD responded as follows–

- The definition of "fund" in section 20AM of the IRO replicated, with necessary modifications, that of "collective investment scheme" in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571) (SFO). The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019 had not introduced a new definition of "fund" or "collective investment scheme". Broadly speaking, to fall within the definition of "fund", the "managed as a whole" / "pooling", the "no day-to-day control" and the "purpose or effect of the arrangement" requirements must be met at all times during the basis period for the year of assessment.

- As the IRD saw it, the definition of "collective investment scheme" in the SFO was unlikely to cover a "non-collective" arrangement having one single investor only. In paragraph 43 of DIPN 61, the IRD's interpretation, which followed the legislative intent, was that an arrangement under very special circumstances might be accepted or might continue to be accepted as a fund even if it had one investor at a certain point in time within a year of assessment (e.g. during the start-up period or winding-down period).

- Section 20AM(2)(a) provided an "either or both" requirement. Paragraph 44 of DIPN 61 explained that although an arrangement failed to satisfy the "pooling" requirement under section 20AM(2)(a)(ii), it might still qualify as a fund if it could satisfy the "managed as a whole" requirement under section 20AM(2)(a)(i) and other requirements in section 20AM(2)(b) and (c) (i.e. the "no day-to-day control" and the "purpose or effect of the arrangement" requirements) at all times during the basis period for the year of assessment. Likewise, where an arrangement failed to satisfy the "managed as a whole" requirement under section 20AM(2)(a)(i), it might still qualify as a fund if it could satisfy the "pooling" requirement under section 20AM(2)(a)(ii) and all other requirements in section 20AM(2)(b) and (c).

- The concepts of the "pooling" requirement and the "purpose or effect of the arrangement" requirement were different. In simple terms, the "pooling" requirement in section 20AM(2)(a)(ii) referred to the pooling of the capital contributions of the participating persons (referring to investors in a particular arrangement) and the profits or income from which payments were made to them. As explained in paragraph 43 of DIPN 61, the word "pool" was not defined in the IRO and should be accorded its literal meaning. The meaning of "pool" was elaborated by the UK Court of Appeal in *Financial Services Authority v Fradley and another* [2006] 2 BCLC 616 at 626, 630. Under a pooled arrangement, the capital contributions from multiple investors and their profits or income were combined together.

- Paragraph 52 of DIPN 61 further explained the "purpose or effect of the arrangement" requirement in section 20AM(2)(c). The purpose or effect of a fund was to enable the participation or receipt by participating persons of profits, income or returns via the arrangement. Such purpose or effect of an arrangement was a question of fact which depended on the objective evidence.

- If an arrangement provided for the distribution of profits or income, it did not necessarily mean that there was a pooling of profits or income. In the absence of full details, it would be inappropriate to presume that the "pooling" requirement under section 20AM(2)(a)(ii) was a pre-requisite condition of the "purpose or effect of the arrangement" requirement under section 20AM(2)(c). The ultimate analysis was a question of fact, depending on particular circumstances of each case.

(ii) "No day-to-day control" requirement under section 20AM(2)(b) of the IRO

The IRD has clarified in paragraph 51 of DIPN 61 that, in order to satisfy the "no day-to-day control" requirement for the purpose of the definition of "fund" under section 20AM, "*…it is sufficient that any one of the individual participating persons is not a party to exercising day-to-day control, regardless of the extent of their interest in the fund…Even if one investor does not have day-to-day control, the arrangement could still be a fund*". An arrangement will only qualify as a fund if it meets all the requirements set out in section 20AM(2) at all times during the basis period for the year of assessment.

Very often in the initial fund raising period, seed capital will be invested into the fund in order to set it up and while external investors are being sought. Seed capital may be invested by an associate of the investment manager. Some of the Institute's members hold the following views–

(i) an associate of the investment manager who is exercising day-to-day control is a separate person from the latter;
(ii) such a fund does not fall within the exclusion of section 20AM(5); and
(iii) the fund would meet the definition of "fund" as of the initial fund-raising period when only seed capital was invested into the fund.

In this regard, the Institute would like to seek the IRD's comment on the above views.

The IRD responded as follows–

- As explained in Agenda Item A1(f)(i) above, the definition of "fund" under section 20AM referred to a collective investment scheme which must satisfy the three requirements: the "pooling" / "managed as a whole" requirement; the "no day-to-day control" requirement; and the "purpose or effect of the arrangement" requirement at all times during the basis period for the year of assessment. An arrangement under very special circumstances might be accepted, or might continue to be accepted, as a fund even if it had one investor at a certain point in time within a year of assessment (e.g. during the start-up period or winding-down period).

- For the scenario mentioned in the question, it would be unsafe and unsatisfactory to categorically conclude that an arrangement with a seed investment by an associate of the investment manager was qualified as a fund in the initial fund raising period without considering the full facts. In deciding whether the arrangement mentioned in the question could fall within the meaning of "fund" in section 20AM, it was necessary to examine all the facts and circumstances. In particular, the following information must be ascertained–

  (a) whether an associate of the investment manager was the only investor of the arrangement at all times during the basis period for the year of assessment;

(b) whether the associate of the investment manager did not have day-to-day control over the management of the property while the investment manager was responsible for all the day-to-day control under the arrangement;

(c) whether the so-called “associate” of the investment manager fell within the definition of “associate” under section 20AN(6) of the IRO; and whether such associate was a “separate person” from the investment manager. It was not certain whether the term “separate person” in sub-paragraph (i) of the question referred to “separate legal entity”;

(d) whether the arrangement mentioned in the question was an excluded arrangement falling within section 20AM(5). It should be noted that section 20AM(5)(b) specifically excluded an arrangement of group scheme where each of the persons participating in the arrangement was a corporation in the same group of companies as the operator of the arrangement. It referred to an arrangement or structure within a corporate group and did not relate to situations where a fund began in a year of assessment with a single seed investment by an affiliate of the investment manager. It was not certain whether the arrangement mentioned in the question fell within section 20AM(5)(b);

(e) whether other requirements (i.e. the “managed as a whole” / the “pooling” and the “purpose or effect of the arrangement” requirements) under section 20AM(2) were satisfied; and

(f) whether the arrangement mentioned in the question was a business undertaking for general commercial or industrial purposes, including directly engaging in any one or more of the activities specified in section 20AM(7).

(iii) Whether a sub-fund of a foreign umbrella fund can constitute a fund within the meaning of section 20AM of the IRO?

Some of the Institute's members hold the view that a sub-fund may constitute “an arrangement” in respect of which “property is managed as a whole” and “the purpose or effect of the arrangement” is a pooling arrangement for the investment in the property. As such, such a sub-fund could meet the definition of a “fund” as defined in section 20AM of the IRO, notably the definition referring to “an arrangement” rather than a “person” as a whole.

In view of the above, the institute would like to know whether a “sub-fund” of a foreign umbrella fund, e.g. a segregated portfolio company in Cayman Islands, could be regarded on its own as a "fund" under section 20AM?

The IRD responded as follows–

- The term "fund" as defined in section 20AM of the IRO referred to an investment scheme of a collective nature.

- Paragraph 46 of DIPN 61 stated, "If an arrangement (e.g. umbrella fund or protected cell company) involves a number of "separate pools" of assets, then each asset pool will be considered separately for determining whether each pool should constitute a fund. Whether a particular arrangement with separate pools of assets is managed as a whole, as required under section 20AM(2)(a)(i), or on an individual basis, taking into account each investor's interests, has to be decided in light of all the relevant facts and circumstances." In other words, whether a sub-fund would constitute a "fund" depended on the facts and circumstances of each case.

- As the IRD understood it, a segregated portfolio company (SPC) mentioned in the question was an exempted company, registered under the Companies Law of the Cayman Islands, which sought to segregate separate pools of assets and liabilities to specified shareholders or creditors. An SPC was a single legal entity. Each segregated portfolio (SP) of an SPC did not constitute a legal entity that was separate from the SPC. The assets and liabilities of an SP were ring-fenced from the assets and liabilities of other SPs within an SPC.

- In the absence of full details, it was not possible to determine whether a "sub-fund" of a foreign umbrella fund, or SPC mentioned in the question could satisfy the three requirements under section 20AM(2) (i.e. the "managed as a whole" / "pooling", the "no day-to-day control" and the "purpose or effect of the arrangement" requirements). It was not clear whether the sub-fund or SPC was an excluded arrangement falling within section 20AM(5). It was also not clear whether the sub-fund or SPC was a business undertaking for general commercial or industrial purposes and whether the sub-fund or SPC directly engaged in any one or more of the activities specified in section 20AM(7). In this connection, it would neither be safe nor satisfactory to categorically conclude that a "sub-fund" or SPC could be regarded on its own as a "fund" under section 20AM.

(iv) Taxation of open-ended fund company (OFC)

Paragraph 128 of DIPN 61 states that "*[d]espite that an OFC may enjoy profits tax exemption on transactions in assets of a non-Schedule 16C class pursuant to section 20AN(2)(c), if an OFC meeting the definition of "fund" in section 20AM engages in direct trading or direct business undertaking in Hong Kong in assets of a non-Schedule 16C class, or utilizes assets of a non-Schedule 16C class to generate income, it will be assessed to profits tax in respect of its assessable profits earned from the trading, business undertaking or utilization.*"

Some of the Institute's members hold the view that the above statement envisages that not all transactions in non-Schedule 16C assets undertaken by an OFC, albeit chargeable to tax under section 20AS(a) as carrying on "a direct trading or direct business undertaking in Hong Kong in assets of a class that is not specified in Schedule 16C…" and yet not disqualifying the OFC as a fund under sections 20AM(6) and 20AM(7) as amounting to "a business undertaking for general commercial or industrial purposes…"

In this regard, could the IRD give general guidelines and illustrative examples of when a transaction conducted by an OFC would be chargeable to tax only under section 20AS(a) and not disqualify the OFC as a fund under sections 20AM(6) and 20AM(7)? Would the IRD consider accepting that provided (i) the transactions in non-Schedule 16C assets are of an investment-type (other than investment in real estate property); and (ii) the mere holding of the assets concerned would not generate any taxable income, e.g. antiques, fine arts or wines etc., then gains from such investments or speculative dealings not derived from a significant sales organization would not generally be regarded as constituting "a business undertaking for general commercial or industrial purposes" under sections 20AM(6) and 20AM (7)?

The IRD responded as follows–

- An OFC incorporated under Part IVA of the SFO was an open-ended collective investment scheme and was subject to the regulatory requirements of the Securities and Futures Commission (SFC). According to SFC's Codes and Guidelines, an OFC must not be a business undertaking for general commercial or industrial purposes. Therefore, an OFC would generally be accepted as a fund under section 20AM for the purposes of tax exemption.

- Under section 20AN(2) of the IRO, profits tax exemption was given to an OFC in respect of profits derived from qualifying transactions and non-qualifying transactions. Despite that an OFC might enjoy profits tax exemption on transactions in assets of a non-Schedule 16C class pursuant to section 20AN(2)(c), if an OFC meeting the definition of "fund" in section 20AM engaged in direct trading or direct business undertaking in Hong Kong in assets of a non-Schedule 16C class, or utilized assets of a non-Schedule 16C class to generate income, it would be assessed to profits tax in respect of its assessable profits earned from the trading, business undertaking or utilization under section 20AS. The term "trade" as defined in section 2 of the IRO included every trade and manufacture, and every adventure and concern in the nature of trade. Since the mode of operation of each OFC differed, it would be difficult to give general guidelines and illustrative examples to demonstrate when a transaction conducted by an OFC would be only chargeable to tax under section 20AS(a) while it would not disqualify the OFC as a fund under section 20AM(6) and (7).

- In the absence of full details, it was not possible to conclude that (i) the transactions in assets of a non-Schedule 16C class mentioned in the question were of an investment-type; and that (ii) the mere holding of the assets concerned without generating any taxable income would not generally be regarded as constituting “a business undertaking for general commercial or industrial purposes” under section 20AM(6) and (7). The ultimate analysis was a question of fact, depending on the particular facts and circumstances of each case.

(g) Taxation of shipping and ship leasing (Sections 14O et seq, 15(1)(o) and 23B, DIPN 62)

(i) The new ship leasing rules in section 14O et seq of the IRO do not apply where a ship lessor is also a ship operator which may be subject to section 23B. Income from carrying on a business in Hong Kong of granting a right to use a ship is deemed to be taxable under section 15(1)(o) if not otherwise chargeable under any profits tax provisions of the IRO.

The IRD provided guidance on what activities they would regard as being eligible to be taxed under section 23B in its website in February 2021. It is mentioned that "*Charter hire, whether attributable to a time charterparty or a bareboat charterparty, derived by a Hong Kong resident or non-resident ship operator from the operation of ships (wherever registered) outside the waters of Hong Kong and the river trade waters, or commencing from Hong Kong and proceeding to sea, is not chargeable to profits tax under section 23B of the IRO.*"

Where a ship operator carries on its business in Hong Kong and derives charterhire income from ships that mainly navigate outside the waters of Hong Kong, such income would neither be chargeable under section 23B nor eligible for the tax concession under section 14O et seq. Would such income be then deemed taxable under section 15(1)(o)?

The IRD responded as follows–

- Section 15(1)(o) of the IRO ensured that income derived by a ship lessor or ship leasing manager from the carrying on of ship leasing business or ship leasing management business in Hong Kong were chargeable to profits tax, even if the ship concerned was used outside Hong Kong. Sections 14P(1) and 14T(1) of the IRO provided tax concessions for such income so long as they were derived by a qualifying ship lessor or qualifying ship leasing manager from the carrying on of qualifying ship leasing activities or qualifying ship leasing management activities in Hong Kong.

- Section 23B of the IRO was a specific regime for the ascertainment of the assessable profits of a ship operator who provided services for the carriage by sea of passengers and / or goods as a ship owner or charterer, including any incidental chartering activities. Whilst charter hire derived by a ship operator from ships navigating outside the waters of Hong Kong was not chargeable to tax under section 23B, such income would not be deemed taxable under section 15(1)(o).

Ms Sarah Chan sought the IRD's further clarification on the meaning of "incidental chartering activities". She said that in real life, many ship owners carrying on a ship operation business also entered into time charterparty or bareboat charterparty with charterers and received charter hire. She asked whether such income would be regarded as "incidental" and to what extent it would be regarded as incidental to the ship operation business.

In response, CIR explained that section 23B dealt with the ascertainment of the assessable profits of a ship operator, and charter hire derived from incidental chartering activities was also caught by this section. To determine whether an activity constituted incidental chartering activity, it was not possible to lay down a hard and fast rule for each and every scenario. He said that each case would be considered on its own facts and circumstances. Basically, the ship operator should be primarily engaged in the business of the carriage by sea of passengers and / or goods.

(ii) In DIPN 62, the IRD states that the number of full-time employees of a group company can be taken into account, subject to certain conditions, in determining whether the thresholds for the ship leasing and ship leasing management provisions have been met, but does not expressly state whether the requirement for the number of full-time employees would be two for the group as a whole or would be applied per special purpose vehicle (SPV). On the basis that an SPV with a single long-term bare boat charter does not require two (or even one) full time employee to run it, does the IRD agree that the threshold should be applied on a group basis?

The IRD responded as follows–

- To qualify for the tax concessions provided in sections 14P(1) and 14T(1), a qualifying ship lessor or qualifying ship leasing manager was required under section 14W of the IRO to employ an adequate number of qualified full-time employees and incur an adequate amount of operating expenditure for carrying out the core income generating activities (CIGAs) in Hong Kong, which were in any event not less than the thresholds prescribed in sections 5 and 6 of Schedule 17FA. The threshold requirements served to determine whether the CIGAs of a qualifying ship lessor or qualifying ship leasing manager could be considered to be carried out or arranged to be carried out in Hong Kong. The requirements should thus be applied on an entity basis (i.e. per each ship lessor or ship leasing manager) instead of a group basis.

- As explained in Example 22, Example 23 and paragraph 96 of DIPN 62, the employees of a group company and the staff costs of the employees would be taken into account in determining whether the threshold requirements were satisfied by a qualifying ship lessor or qualifying ship leasing manager if:

(a) the CIGAs of the qualifying ship lessor or qualifying ship leasing manager were carried out by the employees seconded by the group company or the group company itself through outsourcing arrangement;

(b) the staff costs were fully borne by, or a service fee was charged to, the qualifying ship lessor or qualifying ship leasing manager on an arm's length basis;

(c) the number of employees and the amount of staff costs were commensurate with the level of the CIGAs carried out by the employees or the group company; and

(d) the qualifying ship lessor or qualifying ship leasing manager had exercised adequate monitoring of the CIGAs outsourced to the group company.

- An employee of a group company might work for different qualifying ship lessors or qualifying ship leasing managers within the group. If the above conditions were satisfied, the employee and the related staff costs would be taken into account in determining whether the threshold requirements were met by each of the qualifying ship lessors or qualifying ship leasing managers.

- If a qualifying ship lessor or qualifying ship leasing manager did not meet the threshold requirement for the number of employees, it was not entitled to the profits tax concessions under the regime. The threshold could not be applied on a group basis by taking into account the employees of the other group companies who had not carried out the CIGAs for the qualifying ship lessor or qualifying ship leasing manager.

Ms Sarah Chan gave an example where the CIGAs were outsourced to a group company and the group company had two full-time employees who served various companies of the whole group, one of which was the ship lessor in Hong Kong. In determining whether the threshold requirements under Schedule 17FA were satisfied, she asked whether the IRD would count the number of full-time employees on a proportionate basis. Mr Yeung gave another example where there were 10 SPVs and all of them outsourced the CIGAs to a group company. The group company had 10 full-time employees who served the SPVs. He asked whether the threshold requirements were satisfied.

In response, Mr Chan explained that all preferential tax regimes were subject to the review of the Forum on Harmful Tax Practices (FHTP) of the OECD. Group outsourcing arrangement could be accepted by the FHTP. To determine whether the threshold requirements under Schedule 17FA were satisfied, the IRD would follow the FHTP guidelines. The assessor would consider all the relevant factors, including what kind of activities were carried out by the outsourced company; the number of ship owners that it served; 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 the CIGAs. The whole picture would be considered and this approach was consistent with the FHTP guidelines. CIR added that complying with the threshold requirements was not a simple mathematic or division exercise.

(h) Main purpose tests for tax concession regimes

In recent years, the government has introduced various tax incentives to enhance Hong Kong's competitiveness in certain industries. The preferential tax regimes contain anti-avoidance provisions to comply with the latest international tax rules. In particular, there are "main purpose tests" in some of the preferential tax regimes e.g. ship leasing, enhanced deduction for research and development expenditures. Where the main purpose, or one of the main purposes, of entering into the arrangement is to obtain a tax benefit, no profits tax concessions will be granted.

As mentioned in some of the government's publications (e.g. IRD's press release, Legislative Council brief, etc.), the tax concessions are expected to help attract the set-up of related business establishments in Hong Kong. Would the IRD consider by default that one of the main purposes for the taxpayer to set up the relevant business in Hong Kong is to obtain tax benefit so that the preferential tax treatment would be denied under the main purpose test? Would the fact that the Hong Kong tax incentive or access to one of Hong Kong’s tax agreements formed a significant part of the decision to set up business in Hong Kong in itself be regarded as falling foul of the anti-avoidance provisions?

The IRD responded as follows–

- The wide adoption of “main purpose test” in the IRO reflected the current international practice to use such test as one of the anti-avoidance measures. In fact, this test was increasingly found in overseas tax legislation and DTAs, including those between Hong Kong and other jurisdictions. In order for a purpose to be “main”, it should have a connotation of importance. The reference to “one of the main purposes” meant that obtaining tax benefit did not need to be the sole or dominant purpose of a particular arrangement. An arrangement might have more than one main purpose and it was sufficient that at least one was to obtain the tax benefit, even if that was not the dominant purpose.

- Insofar as preferential tax regimes were concerned, the main purpose test targeted at taxpayers who sought to abuse the tax concessions or achieve treaty shopping by artificial means and siphon the profits into Hong Kong simply to take advantage of the tax concessions or treaty benefits without any commercial reasons and business substance established in Hong Kong. The main purpose test would not operate to deny tax concessions for the vast majority of genuine businesses with core income generating activities carried out in Hong Kong.

- Whether the main purpose or one of the main purposes of setting up a business in Hong Kong was to obtain a tax benefit was a question of fact. Before reaching a conclusion under the main purpose test, all relevant facts and circumstances had to be considered. In a case where the Hong Kong tax incentive or access to one of Hong Kong's tax agreements had formed a significant part of the decision to set up a business in Hong Kong, the IRD would undertake an objective analysis and look into details as to the aims and objects of the arrangement involved. Where such analysis suggested that the main purpose or one of the main purposes of the arrangement was to obtain a tax benefit, the main purpose test might be invoked to deny the tax concession. In any case, there should be a clear distinction between a genuine business undertaking brought about by the conducive environment (including tax incentives) of Hong Kong, and an artificial arrangement serving no real purpose other than to abuse tax incentives provided by Hong Kong.

Ms Yee welcomed the IRD's clarification as it would provide a sense of comfort to taxpayers who planned to set up their businesses in Hong Kong and enjoy the tax concessions under the preferential tax regimes. Regarding the statement "In a case where the Hong Kong tax incentive or access to one of Hong Kong's tax agreements had formed a significant part of the decision to set up a business in Hong Kong…", she considered that the phrase "a significant part" was vague and subject to interpretation. She sought the IRD's further clarification on the meaning of the phrase. Mr Lean expressed that he had similar concerns. He commented that, while the "main purpose test" was widely used in overseas legislation and DTAs, it was rarely used in relation to tax incentive regimes. He suggested that the IRD consider dropping the main purpose test when introducing tax incentive regimes in future as it was not appropriate to adopt the test in this context.

In response, Mr Chan explained that the "main purpose test" was borrowed from the concept of "principal purpose test" under Base Erosion and Profit Shifting (BEPS) Action 6. The "principal purpose test" was adopted to prevent treaty shopping and abuse of the treaty benefits. The "main purpose test" under the preferential tax regimes was targeted at taxpayers who sought to abuse tax concessions. Mr Chan recalled that when introducing various preferential tax regimes, the government emphasized that Hong Kong had many non-tax advantages such as a strong pool of talents, a well-developed legal system and financial infrastructure, etc. Tax was one of the added advantages. When applying the main purpose test, the IRD would follow the Commentary on Article 29 of the 2017 OECD MTC and conduct an objective analysis (e.g. whether a reasonable person would consider this arrangement as abusing tax concessions). The IRD would consider the facts and circumstances of each case, including the aims and objects of all persons involved in putting the arrangement or transaction in place. Generally, the IRD would not regard obtaining tax concession in a normal course as the main purpose and hinder the potential investors from setting up their businesses in Hong Kong.

Agenda Item A2 - Salaries Tax Issues

(a) Taxation of discretionary bonus and related employer's obligations

The Institute would like to further the discussion on the taxability of the discretionary bonus detailed in agenda item A2(c) of the 2020 Annual Meeting on the basis that there was (a) no deliberate arrangement to defer the discretionary bonus, i.e. no anti-avoidance concerns; and (b) no change in employment upon the individual relocating to work for another group company outside Hong Kong on 1 November 2019. As such, the bonus accrued to the individual in May 2020, i.e. prima facie formed an income item of the individual for the YA 2020/21. Based on the above, the Institute would appreciate if the IRD can further clarify the following issues:

(i) Did the IRD mean that in the above circumstances the source of the discretionary bonus had nonetheless to be attributed to the extent the individual rendered his services in Hong Kong under the non-Hong Kong employment during the YA 2019/20? Put differently, would that mean even if services rendered by the individual in Hong Kong during visits for the YA 2020/21 were not more than 60 days, the discretionary bonus would still be taxable for YA 2020/21, if the individual days-in-and-days-out in Hong Kong for the YA 2019/20 was more than 60 days?

The IRD responded as follows–

- In the example given by the Institute, an employee under non-Hong Kong employment A worked in Hong Kong from 1 January 2019 to 31 October 2019. Under the same non-Hong Kong employment A, he was relocated outside Hong Kong on 1 November 2019. He was chargeable to salaries tax on time-apportionment basis under section 8(1A)(a) of the IRO. Having considered the factors set out in his employment contract, namely, the performance of the employee for the year ended 31 December 2019, the financial result of the group for the same year, and the general economic environment, his employer decided that the employee was entitled to a discretionary bonus and bonus of \$B was accrued to him in May 2020, i.e. YA 2020/21.

- The source of the discretionary bonus was the employee's services rendered for the year ended 31 December 2019 under non-Hong Kong employment A.

- Pursuant to sections 8(1A)(a), 11B and 11D of the IRO, the employee was chargeable to salaries tax on the discretionary bonus in YA 2020/21 and the chargeable amount was as follows:

$$\$B \times C/D$$

where C was the number of working days in Hong Kong plus attributable leave during the period from 1 January 2019 to 31 December 2019; and D was 365 (number of days from 1 January 2019 to 31 December 2019)

- Even if the employee's presence in Hong Kong during visits did not exceed a total of 60 days in the basis period for YA 2020/21, the chargeable amount of the discretionary bonus for that year was $B x C/D.

Mr Yeung commented that employees were usually required to continue their services with the employer until the discretionary bonus was accrued to them. He asked whether the denominator of the formula in the given example (i.e. component D) could cover the period from 1 January 2019 to May 2020.

Ms Wong took note of Mr Yeung's concerns. She explained that the source of the discretionary bonus in the given example was the employee's services rendered for the year ended 31 December 2019 under non-Hong Kong employment A. Therefore, the denominator of the formula should only cover the period from 1 January 2019 to 31 December 2019.

(ii) If so, please advise: (a) whether the days-in-and-days-out factor in the circumstances was ascertained by reference to the YA 2019/20 or the 2019 financial year; and (b) how the employer is to report the discretionary bonus, i.e., by way of amended Form IR56G for 2019/20 or Form IR56B or Form IR56G for 2020/21.

The IRD responded as follows–

- The time apportionment factor C/D was ascertained with reference to the financial year from 1 January 2019 to 31 December 2019 under non-Hong Kong employment A.

- Under the same non-Hong Kong employment A, if the employee intended to leave Hong Kong upon relocation overseas on 1 November 2019 for any period exceeding 1 month, the employer had to file IR56G in YA 2019/20. Upon accrual of the discretionary bonus, the employer had to file IR56G for YA 2020/21 and withhold payment of money to the employee for a period of 1 month from the date of giving the notice.

Mr Yeung said that his colleagues had experienced that once an IR56G in respect of an employee was submitted to the IRD, the employer could not file additional IR56B or IR56G in respect of the same employee to the IRD. The assessor informed the employer concerned that the case had been closed in the system of the IRD and advised the employer to file a notification of chargeability. He sought the IRD's clarification whether the current arrangement was correct.

In response, Ms Wong explained that in the given example, as the discretionary bonus was accrued to the employee in May 2020 and it was an additional payment, by virtue of section 52(7) of the IRO, the employer should withhold money for payment of tax if the employee intended to leave Hong Kong or had left Hong Kong. Therefore, the employer should file an IR56G for YA 2020/21 in respect of the discretionary bonus instead of filing a notification of chargeability.

(iii) How would the IRD's above view on the taxation of the discretionary bonus which was not subject to a vesting period reconcile with (a) the fact that the individual's service performance for the 2019 financial year was only one of the three conditions for the award of the bonus, the other two being unrelated to the service performance of the individual; and (b) the IRD's view as stated in Case 2 of agenda item A2(b) of the 2019 Annual Meeting? In the latter case, the share award benefit which accrued to the employee in 2017/18 after the employee left Hong Kong, would however not need to be attributed to the previous services rendered by the employee in Hong Kong during the vesting period.

The IRD responded as follows–

- The financial result of the group for the year ended 31 December 2019 and the general economic environment were factors set out in the employment contract for the determination of entitlement to discretionary bonus. However, once the bonus was accrued to the employee, it was an income from his employment. For salaries tax purposes, the task was to ascertain that part of the bonus that was derived from his services rendered in Hong Kong, including leave pay attributable to such services. Assessment of the discretionary bonus set out above gave due regard to the exercise of employment A in Hong Kong.

- The view on the share award expressed in Case 2 of agenda item A2(b) of the 2019 Annual Meeting was in line with DIPN 38 (Salaries tax – Employee share-based benefits). The approach in DIPN 38 would be revisited. Assessment would be made according to prevailing practice.

(iv) Would the source and timing for the taxability of the discretionary bonus be different if there was a cessation of the non-Hong Kong employment upon the individual relocating to work for another group company outside Hong Kong on 1 November 2019? In such case, should the discretionary bonus be deemed to have accrued to the individual on the last day of the non-Hong Kong employment pursuant to section 11D(b)(ii) and therefore be taxable in YA 2019/20 (using the days-in-and-days-out factor for YA 2019/20) and reported in an amended 2019/20 Form IR56G?

The IRD responded as follows–

- In the present scenario, the employee was under non-Hong Kong employment E when he was relocated outside Hong Kong on 1 November 2019. Assuming that there was no tax avoidance element in the change from employment A to employment E; the terms and conditions of employment E comprised the same provisions on discretionary bonus as in employment A; and the employee was chargeable to salaries tax on time-apportionment basis under section 8(1A)(a) of the IRO for non-Hong Kong employment E, the position would be as stated below:
    - ✧ The source of the discretionary bonus was the employee's services

rendered for the year ended 31 December 2019 under non-Hong Kong employment A and non-Hong Kong employment E.

- ✧ By virtue of section 11D(b) proviso (ii) of the IRO, the discretionary bonus attributable to the period before 1 November 2019 was deemed to have accrued to the employee on 31 October 2019, the last day of non-Hong Kong employment A.

- ✧ In this connection, the employee was chargeable to salaries tax on the discretionary bonus in YA 2019/20 and YA 2020/21 as follows:

<u>Non-Hong Kong employment A</u>
chargeable amount for YA 2019/20 = $B x F/D

<u>Non-Hong Kong employment E</u>
chargeable amount for YA 2020/21 = $B x G/D

where F was the number of working days in Hong Kong plus attributable leave during the period from 1 January 2019 to 31 October 2019; and G was the number of working days in Hong Kong plus attributable leave during the period from 1 November 2019 to 31 December 2019

- Upon accrual of the discretionary bonus, the employer of employment A had to file additional 2019/20 IR56G for the discretionary bonus accrued under employment A and withhold payment of money to the employee for a period of 1 month from the date of giving the notice; and the employer of employment E had to file 2020/21 IR56B for the discretionary bonus accrued under employment E.

- By virtue of section 11B of the IRO, the assessable income in YA 2019/20 shall be the aggregate amount of income accruing to the employee from both non-Hong Kong employment A and non-Hong Kong employment E in the YA 2019/20.

(b) Certificate of Residence (CoR) for individuals

The Institute would like to confirm whether the individual in the following two situations can obtain a Hong Kong CoR for calendar year 2020:

(i) the individual did not spend more than 180 days in YA 2018/19 but spent more than 300 days in YAs 2018/19 and 2019/20; and
(ii) the individual did not spend more than 180 days in YA 2019/20 but spent more than 300 days in YAs 2018/19 and 2019/20.

If not, would the IRD’s reason be that, for a Hong Kong CoR for calendar year 2020, YA 2018/19 is not the relevant YA to be considered and the relevant YAs are YAs 2019/20 and 2020/21? If that is the case, what is the technical basis for not regarding YA 2018/19 as one of the relevant YAs?

In addition, can the IRD confirm whether a Hong Kong CoR can be granted for calendar year 2020 as soon as the "300-day" requirement has been met for YAs 2019/20 and 2020/21 (say e.g. the "300-day" requirement is met in August 2020)? If not, can the IRD advise when is the earliest date the Hong Kong CoR for the calendar year 2020 can be issued?

The IRD responded as follows–

- The criteria for determining whether an individual was regarded as a Hong Kong resident were specified in each CDTA concluded by Hong Kong. Generally, an individual was regarded as a Hong Kong resident if he:

  (a) ordinarily resided in Hong Kong; or
  (b) stayed in Hong Kong for more than 180 days during the relevant year of assessment or for more than 300 days in two consecutive years of assessment (one of which was the relevant year of assessment).

- If the 180/300-day requirement in (b) was applied, the starting point was to determine the relevant year of assessment. The two situations mentioned in the question referred to an application for a Hong Kong CoR for the calendar year 2020. Given that 9 months out of the 12-month period of the calendar year 2020 fell into the year of assessment 2020/21 (i.e. from April 2020 to December 2020), the IRD believed it was reasonable to take the year of assessment 2020/21 as the relevant year of assessment. The relevant "two consecutive years of assessment" should be:

  (a) 2019/20 and 2020/21; and
  (b) 2020/21 and 2021/22.

An individual could lodge an application for a Hong Kong CoR for the calendar year 2020 once the 300-day requirement had been met for the years of assessment 2019/20 and 2020/21. In other words, the earliest month for lodging such application and issuing of the relevant CoR would be April 2020.

(c) Employer's Return: Reporting requirements in Form IR56M

Form IR56M is used for reporting payments made to persons other than employees (non-corporate local persons), including local individuals and unincorporated businesses. For payments made to non-resident individuals, the payer should provide details of recipients to the IRD in writing. Item 8 of the Form IR56M requires a payer to declare "whether a sum has been withheld from the payment made to the recipient to settle the tax due by the recipient".

We understand that payers in Hong Kong are only required to withhold and pay tax when making the following payments:

- royalty payments to non-Hong Kong residents; and
- payments made to non-Hong Kong resident entertainers or sportsmen.

If the payments made by the Hong Kong payer is not one of the two items stated above, is the payer still required to complete item 8 of the Form IR56M. If yes, why and what purpose does it serve?

The IRD responded that some Hong Kong payers had service contracts containing provisions permitting them to withhold money from fees payable to service providers in settlement of tax chargeable on such fees. In this connection, such Hong Kong payers had to state the amount of sum withheld in item 8 of Form IR56M. For other payers that had not withheld any sums, they could insert 0 (denoting "No") in item 8. The information provided in item 8 facilitated tax collection.

(d) Greater Bay Area (GBA) tax subsidy

This is a follow-up question on agenda item A2(a) of the 2020 Annual Meeting.

Some members of the Institute have expressed the view that while tax subsidies are granted to a qualified taxpayer by the local governments of the GBA, the tax payable by the taxpayer is made to the Central People's Government (CPG). Furthermore, the tax payable under Individual Income Tax (IIT) would also not be affected by the tax subsidies granted by the local governments.

As such, these members hold the view that regardless of whether the tax subsidies form part of the taxable income of a Hong Kong employment as being remuneration paid by someone other than the employer, the receipt of the tax subsidies should not affect the tax credit claim of the taxpayer in Hong Kong. The Institute would appreciate if the IRD can further comment on the issue.

Separately, if the IIT was borne by the employer and has therefore been reported as taxable remuneration of the employee in Hong Kong, what should the employer do when the employee subsequently received the tax subsidies and paid the same to the employer under the tax equalization or reimbursement clauses of the employment contract? Should the employer revise the previously filed return such that the tax borne by the employer is now reduced by the tax subsidies received from the employee? Or should the employer simply reflect the tax subsidies in a subsequent return relating to the period in which the tax subsidies were received by the employer from the employee?

The IRD responded as follows– • Article 2(1) and (3) of the comprehensive double taxation arrangement between the Mainland of China and the Hong Kong Special Administrative Region (Arrangement) stated that the Arrangement shall apply to taxes on income imposed on behalf of One Side or of its local authorities, irrespective of the manner in which they were levied and the Arrangement applies to IIT. Article

21(2) of the Arrangement stated that double taxation shall be eliminated by way of deduction and credit in Hong Kong in respect of tax paid in the Mainland of China. As the IRD saw it, tax subsidy granted by any of the nine cities in the GBA to an individual was a reduction of the IIT previously paid by such individual in the city. Payment of tax subsidy reduced the amount of IIT paid in the Mainland of China. Double taxation relief under the Arrangement would only be applied to the net IIT paid after the tax subsidy.

- When tax subsidy was received by an employee, he was obliged under section 50AA(5) of the IRO to give written notice to the Commissioner of such tax subsidy within 3 months after the tax subsidy was credited to his bank account or otherwise made available to him. Adjustment to double taxation relief already granted would be made in accordance with section 50AA(6).

- Where IIT of an employee was borne by his employer (in Year 1) and the tax subsidy subsequently received by the employee was paid (in Year 2) to the employer under tax equalization or reimbursement clauses of his employment contract (the Sum), negative adjustment would have to be made by the employer to the emoluments accrued to the employee as at date of receipt of the Sum by the employer (in Year 2). For a continuous employment scenario, if the Sum received by the employer fell in a year of assessment (Year 2) later than the year of assessment (Year 1) when the IIT was originally paid by the employer, the negative adjustment would be reflected in the employer's return of the later year of assessment (i.e. Year 2). If the employer's return for Year 2 was filed without taking into account the Sum received, a revised employer's return would have to be filed for Year 2 to reflect the negative adjustment.

Mr William Chan commented that while the tax was paid to the CPG, the tax subsidy was granted to a qualified taxpayer by the local governments of the GBA. The tax subsidy was not a tax refund and it was merely calculated by reference to the tax paid to the CPG. Therefore, he considered that the receipt of tax subsidy should not affect the tax credit claim of the taxpayer in Hong Kong.

In response, Ms Wong explained that Article 2(1) and (3) of the Arrangement stated that the Arrangement shall apply to taxes on income imposed in the Mainland of China, including IIT. Under Article 21(2) of the Arrangement, tax paid in the Mainland of China in respect of any item of income derived from sources in the Mainland of China by a Hong Kong resident shall be allowed as a credit against the Hong Kong tax imposed on that resident. As the IRD saw it, tax subsidy granted by any of the nine cities in the GBA to an individual was a reduction of the IIT previously paid by such individual in the city since the tax subsidy had the effect of reducing the actual IIT liability in the Mainland of China. Therefore, double taxation relief under the Arrangement shall be applied to the net IIT paid after the tax subsidy. She stressed that a taxpayer who received the tax subsidy must give written notice to the Commissioner of such tax subsidy within 3 months after the tax subsidy was credited to his bank account or otherwise made available to him.

<u>Agenda Item A3 – Transfer Pricing / Country-by-Country (CbC) Reporting</u>

(a) Unilateral Advance Pricing Arrangement (APA) applications for domestic transactions

Rule 1 in section 50AAF of the IRO (i.e. arm's length principle) applies to domestic transactions between associated persons unless they fall within the meaning of "specified domestic transactions" (i.e. transactions that do not give rise to an actual tax difference and do not have a tax avoidance purpose).

Meanwhile, it is possible that tax difference can arise in domestic intra-group transactions. For example, a Hong Kong entity receives a taxable service fee from its Hong Kong associate while the service fee is non-deductible for the Hong Kong associate. Given that there is an actual tax difference, such transaction does not fall within the meaning of "specified domestic transaction" and should comply with the arm's length requirement.

Would the IRD welcome unilateral APA application for such domestic intra-group transactions with an actual tax difference?

The IRD responded as follows–

- Section 50AAF of the IRO (i.e. Rule 1) applied where, among others, the actual provision made or imposed as between two persons (i.e. affected persons) conferred a potential advantage in relation to Hong Kong tax on an affected person. However, section 50AAJ(2) of the IRO provided that an actual provision was not taken to confer a potential advantage in relation to Hong Kong tax on either affected person if: (a) the domestic nature condition was met; (b) either the no actual tax difference condition or the non-business loan condition was met; and (c) the actual provision did not have a tax avoidance purpose. It was pertinent to note that provisions relating to Rule 1 did not contain any reference to "specified domestic transaction". Though defined on a basis similar (but not identical) to section 50AAJ(2) to (7), "specified domestic transaction" was a term used in Schedule 17I to the IRO which governed the maintenance of master file and local file.

- The no actual tax difference condition did not seek to achieve tax neutrality in an absolute sense. In order for the condition to be satisfied, it was only required to ensure that: (i) the income or loss of each affected person from the relevant activities was to be brought into account for Hong Kong tax purposes; and (ii) no exemption or concession for Hong Kong tax applied to the relevant income or loss. The mere fact that a payment was taxable in the hand of the payee but not deductible in the hand of the payer was not by itself determinative of whether the no actual tax difference condition was satisfied.

- Section 50AAP(1) of the IRO provided that the Commissioner might make an APA with a person relating to how the person's income or loss was to be computed under section 50AAF. If a transaction involved an actual provision which fell within the application of section 50AAF, subject to the satisfaction of other requirements or conditions under the IRO and DIPN 48, the Commissioner would consider an application for unilateral APA in respect of the transaction notwithstanding that all the affected persons undertook the transaction in relation to their trade, profession or business in Hong Kong. As clearly stated in DIPN 48, an APA could cover domestic transactions. A unilateral APA could be considered where most of the transfer pricing risk lay in Hong Kong.

(b) OECD transfer pricing guidelines on financial transactions

In February 2020, the OECD released guidance on the transfer pricing aspects of financial transactions and the OECD Transfer Pricing Guidance will be updated to include such guidance. Would the IRD follow this guidance when assessing intra-group financing activities?

The IRD responded as follows–

- The OECD released its report entitled *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10* (the FT Guidance) on 11 February 2020. The FT Guidance explained how the analysis for the "accurate delineation of the actual transactions" and control over risks applied for financial transactions. It also provided guidance on specific issues related to the pricing of treasury activities (including intra-group loans, cash pooling, hedging), financial guarantees and captive insurance.

- All along, the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (TPG) was widely adopted by multinational enterprises (MNEs) in pricing intra-group financial transactions (e.g. determining the arm's length interest rate for a tested loan by benchmarking against publicly available data for borrowers with similar terms and conditions). The IRD would also apply the transfer pricing rules under sections 50AAF and 50AAK of the IRO in the way that best secured consistency with the OECD rules, which included the TPG.

- The IRD would take into account the FT Guidance when examining intra-group financing activities. In accurately delineating the actual financial transaction or seeking to price the accurately delineated actual transaction, the IRD would consider all economically relevant characteristics.

(c) Master file and local file requirements

It is quite common for PRC groups listed in Hong Kong to obtain business registration in Hong Kong and subject to Hong Kong profits tax filing. However, in general, almost all of their businesses are conducted outside Hong Kong and their intragroup transactions are not relevant to Hong Kong (e.g. the PRC company listed in Hong Kong would have intercompany transactions with other PRC entities).

In this regard, would those companies still be subject to Hong Kong master file and local file requirements if their business size and intercompany transaction volume exceed the thresholds?

The IRD responded as follows–

- The master file and local file requirements under section 58C of the IRO applied only to Hong Kong entities. Section 58B(2) of the IRO defined "Hong Kong entity" to mean a constituent entity that (a) was resident for tax purposes in Hong Kong under section 50AAC(1) of the IRO; or (b) was a permanent establishment in Hong Kong under Schedule 17G to the IRO. A company incorporated outside Hong Kong could be a Hong Kong entity if it was normally managed or controlled in Hong Kong, or had a fixed place of business in Hong Kong.

- A Hong Kong entity had to prepare and retain a master file and a local file as long as its business size and the total amount of any specified type of its controlled transactions exceeded the exemption thresholds under Part 2 of Schedule 17I to the IRO. The master file and local file should contain all the prescribed information as required under Part 3 of Schedule 17I, whether or not the controlled transactions were relevant to profits tax in Hong Kong.

Ms Sarah Chan said if all the intragroup transactions of the Hong Kong entity in the given example were conducted in the Mainland of China and the entity prepared its own master file and local file based on the Mainland transfer pricing regulations, she asked whether it would be equally acceptable by the IRD from the Hong Kong transfer pricing perspective.

Mr Chan replied that the IRD would adopt a flexible approach provided that all the information required in the IRO was contained in the master file and local file. As the IRD understood it, the requirement for preparing master file and local file in the Mainland of China was consistent with the OECD BEPS Action 13 report. Therefore, the IRD could accept the master file and local file prepared according to the Mainland transfer pricing regulations.

(d) Transfer Pricing Form IR1475

In September 2020, the IRD issued a letter to selected taxpayers requesting them to complete the Transfer Pricing Form IR1475. Given that the master file is in general prepared by the overseas parent company, the Hong Kong subsidiary might have difficulties in gathering information for completing Form IR1475.

(i) What is the purpose of Form IR1475?

(ii) Would the IRD explain the reasons why the information requested under Form IR1475 is more than what is required in the master file?

(iii) What if some of the fields in Form IR1475 are considered not applicable to the selected taxpayer?

(iv) What are the selection criteria for the group's 5 most important financing and service transactions (e.g. based on the entity, service nature, or both the service recipient and provider not being in Hong Kong)?

The IRD responded as follows–

(i) With the enactment of the Inland Revenue (Amendment) (No. 6) Ordinance 2018, transfer pricing rules and documentation requirements had come into operation. While taxpayers were not required to furnish their master files and local files upon filing profits tax returns, they had to declare in their profits tax returns and supplementary forms S2 whether they had undertaken controlled transactions with non-Hong Kong resident associated entities and were required to prepare master files and local files under section 58C. The IRD would conduct regular desk-based reviews and transfer pricing audits to ensure taxpayers' compliance with the transfer pricing rules and documentation requirements. Form IR1475 served to determine whether a taxpayer had maintained a proper master file and local file. The information collected could assist the IRD in assessing the level of transfer pricing risk for a particular taxpayer.

(ii) In designing Form IR1475, the IRD had made reference to the IRO, DIPNs and TPG. It was the IRD's primary aim to minimize the compliance and administrative burden on taxpayers in completing Form IR1475, while securing sufficient information to be collected for evaluating the level of transfer pricing risk for a particular taxpayer.

Recently, the IRD had received feedback from some external parties. The IRD would carefully consider their comments and fine-tune Form IR1475, where appropriate.

(iii) It was understood that Form IR1475 might not be able to cater for each and every scenario. In case taxpayers or their representatives encountered any difficulties in completing Form IR1475, they were welcome to contact the assessors for assistance and clarification.

(iv) A list and brief description of important financing and service arrangements between constituent entities of the group was a piece of information required to be included in a master file. Taxpayers should be able to extract the relevant information from their master files for completing Form IR1475. If there were more than five such financing and service arrangements, the taxpayer was required to provide information on the five most important ones based on the monetary value, irrespective of the tax jurisdiction in which the entity involved was resident, service nature, etc.

(e) Country-by-Country (CbC) reporting

(i) CbC reporting notification

Part 2.7 of the CbC reporting notification concerns whether a Hong Kong entity's non-Hong Kong ultimate parent entity (UPE) / surrogate parent entity (SPE) has notified the tax authority of its jurisdiction of tax residence of its CbC reporting obligation. A Hong Kong entity could complete Part 2.7 as "Yes / No / Notification NOT required in accordance with the laws or regulations of its jurisdiction".

Due date for filing the CbC reporting notification for each jurisdiction varies. In Hong Kong, the CbC reporting notification is to be made within 3 months after the end of the accounting period concerned. If the UPE / SPE is resident in a jurisdiction which requires the UPE / SPE to file the CbC reporting notification by, for example, 6/12 months after the end of the accounting period concerned, the Hong Kong entity will complete part 2.4 of the CbC reporting notification as "No" in case the UPE / SPE has not yet filed the CbC reporting notification. The IRD will then issue the CbC return to the Hong Kong entity for completion. Though the Hong Kong entity can apply for a request for not complying with the notice for filing CbC return (together with the CbC report), this gives rise to additional administrative burden to the Hong Kong entity / service provider.

Would the IRD explain the reason(s) why it is necessary for the Hong Kong entity to declare whether the UPE / SPE has filed the CbC reporting notification and consider waiving this request because details of the UPE / SPE (e.g. full name, jurisdiction of tax residence and Tax Identification Number) have been provided to the IRD to facilitate the automatic exchange of CbC reports with overseas jurisdictions.

The IRD responded as follows–

- Under sections 58F(1) and 58I(1)(a) of the IRO, a Hong Kong entity of a reportable group that was not the group's UPE had to file a CbC return (which included a CbC report) if the group's UPE was not required to file the CbC report in its jurisdiction of tax residence (the Relevant Local Filing Requirement). Section 58F(2), however, provided that the Relevant Local Filing Requirement did not apply if, among others, an SPE was appointed for the group and the SPE had filed the CbC report in its jurisdiction of tax residence which had exchange mechanisms in place with Hong Kong, i.e. the SPE-filing-elsewhere exception under section 58I(2)(a) of the IRO.

- Section 58H of the IRO required a Hong Kong entity to file a notice in respect of its CbC reporting obligation (the CbC Reporting Notification). Under section 58H(1)(b)(iv) or (c)(iii) of the IRO, a Hong Kong entity had to state in the notice, among others, whether the group's UPE or SPE had filed a CbC reporting notification to the tax authority of its jurisdiction of tax residence if the UPE or SPE was resident for tax purposes in a jurisdiction other than Hong Kong (the Relevant Statement). The Relevant Statement, which was required under part 2.7 of the notification form, ensured that the Hong Kong entity would verify the UPE's or SPE's CbC reporting obligation in its jurisdiction of tax residence before filing the notification form. The statement informed whether the UPE was actually required to file, or the SPE had an intention to file, the CbC report in its jurisdiction of tax residence. It provided a solid basis for the IRD to determine the applicability of the Relevant Local Filing Requirement or the SPE-filing-elsewhere exception.

- Where the UPE or SPE had not yet filed a CbC reporting notification to the tax authority of its jurisdiction of tax residence, the Hong Kong entity should select "No" when completing part 2.7 of the notification form. A notice would then be issued to the Hong Kong entity requiring it to file a CbC return by the filing deadline. If it was later revealed that the Hong Kong entity was not required to file the CbC return (e.g. because the UPE had filed a CbC reporting notification to the tax authority of its jurisdiction of tax residence), the Hong Kong entity could simply use an electronic function under "File Return" on the CbC Reporting Portal to submit a request for not filing the CbC return with a reason provided. The steps for submitting such request were simple and clearly explained in the Guide to Return Filing. The Relevant Statement required in the notification form should not give rise to a substantial administrative burden on a Hong Kong entity or its service provider.

Ms Cheung said that the due date for filing the CbC reporting notification in each jurisdiction varied. Sometimes when the Hong Kong entity filed the notification, its non-Hong Kong UPE or SPE might not have filed the notification in its jurisdiction of tax residence. A taxpayer might engage a service provider to file the notification. If there was an additional administrative process between service providers and taxpayers, service providers might need to charge more fees. She asked whether the IRD would consider modifying the question under Part 2.7 of the CbC reporting notification.

Mr Chan took note of Ms Cheung's concerns. He said that the IRD would consider all the views of the industry to refine the CbC Reporting Portal. He explained that it was a statutory requirement to include this statement in Part 2.7 of the CbC reporting notification. Section 58H of the IRO expressly required every Hong Kong entity to verify whether its UPE or SPE had filed a CbC reporting notification to the tax authority of its jurisdiction of tax residence before filing a notification to the IRD. This information was very important to the IRD as once it was decided that the Hong Kong entity was not required to file a CbC report in Hong Kong, the IRD would follow up the CbC report with other jurisdictions instead of the UPE or SPE. He understood that there might be a time gap between the notification deadline in Hong Kong and those in other jurisdictions. Therefore, the IRD introduced a function under the CbC Reporting Portal which allowed a Hong Kong entity to deactivate its CbC return filing obligation. While he took note that this might cause the Hong Kong entity or MNE to have some more work to do, he appealed for the industry's understanding that such information was very important and necessary for the IRD to enforce the CbC reporting requirements.

(ii) Definition of the UPE "is not required" to file CbC report

One of the conditions precedent for requiring filing of CbC report in Hong Kong is that the UPE is not required to file a CbC report in which it is resident for tax purposes. The term "is not required" is not defined in the IRO. If the UPE is required by laws of its jurisdiction of tax residence to file CbC report and has been exempted from filing, either by supplementary local laws or by an application, can a position be taken that the group is required to file CbC reports by laws and therefore the designated Hong Kong entity of the group is not required to file CbC return (including the CbC report) in Hong Kong?

The IRD responded as follows–

- Hong Kong had committed to implementing the BEPS package promulgated by the OECD, including the minimum standards under Action 13 (i.e. CbC reporting). The provisions relating to CbC reporting under the IRO were formulated on the basis of the requirements set out in, among others, the consolidated report published by the OECD, entitled *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 – 2015 Final Report* (the Action 13 Report). To ensure consistent implementation of CbC reporting, the provisions should be construed in the way that was consistent with the relevant OECD's guidance.

- The Action 13 Report provided that local filing could apply if, among others, the UPE of an MNE group was not obligated to file a CbC report in its jurisdiction of tax residence. This condition was prescribed under section 58I(1)(a) of the IRO. In Q&A 4.1 under Part V of the *Guidance on the Implementation of Country-by-Country Reporting*, the OECD clarified that this condition applied not only if the jurisdiction of tax residence of the UPE had not introduced a requirement for a CbC report to be filed, but also where the UPE was not obligated to file a CbC report in the jurisdiction pursuant to a requirement not in accordance with the minimum standards under Action 13.

- Since the question did not shed light on the circumstances under which the UPE was exempted from filing a CbC report in its jurisdiction of tax residence, the IRD could not ascertain whether such exemption was in accordance with the minimum standards under Action 13. As such, it would not be appropriate to take it that the condition under section 58I(1)(a) had not been met and the Hong Kong entity was not subject to local filing in Hong Kong.

Agenda item A4 – Issues Arising from COVID-19 Pandemic

(a) Special arrangement on Hong Kong CoR under COVID-19

Individuals may get stranded overseas in 2020 due to COVID-19. Individuals who ordinarily reside in Hong Kong may unexpectedly, spend a large amount of time overseas. In some cases, individuals may not be able to meet the physical presence test of 180 days in a year of assessment or 300 days for 2 consecutive years of assessment for being tax residents in Hong Kong.

Would the IRD give special considerations for the CoR applications of these individuals for 2019/20, such as granting a CoR if the individual ordinarily resides in Hong Kong although the individual does not satisfy the physical presence tests due to COVID-19?

The IRD responded as follows–

- The OECD issued guidance regarding the impact of the COVID-19 pandemic on tax treaties (the COVID-19 Tax Treaty Guidance) in April 2020, with an updated version released in January 2021. The IRD would generally follow the COVID-19 Tax Treaty Guidance, together with the Commentary on the 2017 OECD MTC, in interpreting and applying tax treaties.

- The COVID-19 Tax Treaty Guidance stated that a dislocation because a person could not travel back to his home jurisdiction due to public health measure of the host jurisdiction should not by itself impact the person's residence status for the purposes of tax treaty. Such a person would unlikely become a resident of the host jurisdiction, and even if he did, he would normally remain a resident of the home jurisdiction under the tie-breaker rules in the relevant treaty.

- Applying the above interpretation, if an individual was stranded outside Hong Kong in 2020 due to COVID-19 pandemic and before the COVID-19 pandemic, he ordinarily resided in Hong Kong, the fact that he could not fulfill the 180/300-day requirement should not by itself impact his status as a resident of Hong Kong. All the relevant facts and circumstances (e.g. whether the individual habitually and normally resided in Hong Kong with some degree of continuity in the past, the nature, duration and reasons of his absence from Hong Kong, where his family members lived and his social and economic ties) would be taken into consideration in determining whether a CoR could be issued to the individual for 2020.

(b) Guidance on implications of COVID-19

(i) The continuing situation with COVID-19 has a significant impact on the travel pattern of expatriates. For tax residents of a jurisdiction which has a treaty with Hong Kong who have originally planned to be on short term assignment to Hong Kong for not more than 183 days (and hence exempted from Hong Kong salaries tax if all relevant condition satisfied), they may have to stay in Hong Kong longer than expected due to COVID-19, and so exceed the 183-day threshold. Similarly, short-term business visitors may be forced to stay in Hong Kong for more than 60 days during a year due to COVID-19. In view of the continuing situation of the COVID-19, would the IRD provide special treatment / concession under this circumstance?

> The IRD responded as follows–
>
> - On international level, in the interpretation of provisions in DTA, the IRD would generally follow the Commentary on Article 15(2) of the 2017 OECD MTC not to count in an individual's "days of physical presence", the days of sickness that prevented the individual from leaving if he would have otherwise qualified for the exemption. Under the COVID-19 scenario, for the purposes of the 183-day test in Article 15(2)(a) and counting the days of physical presence in Hong Kong, days when the individual was prevented from travel due to certified sickness caused by COVID-19 would be disregarded. Due regard would also be given to the COVID-19 Tax Treaty Guidance.
>
> - On domestic level, it had been pointed out in agenda item A2(d) of 2012 Annual Meeting that in the interpretation of the 60-day rule under section 8(1B), the IRD did not have any discretion to exclude the days of physical presence in Hong Kong beyond the control of an employee. It was then expressly stated that days of hospitalization in Hong Kong would be included.

(ii) The extended presence of the expatriates in Hong Kong may also trigger PE issues for the non-resident employer. The OECD issued an analysis of tax treaties and the impact of the COVID-19 crisis on 3 April 2020 and explained that the exceptional and temporary change of the location where employees exercise their employment because of the COVID-19 crisis, such as working from home, should not create new PEs for the employer. Would the IRD share its view in this regard and provide some official guidelines?

> The IRD responded as follows–
>
> - Whether a non-Hong Kong resident person had a PE in Hong Kong within the meaning of the CDTA concerned or Part 3 of Schedule 17G to the IRO (as the case may be) was a question of fact and degree. In determining the issue, the IRD would examine all the relevant facts and circumstances, including the international travel disruption caused by public health measures imposed by governments in response to COVID-19. Given the extraordinary nature of the COVID-19 pandemic, the IRD was prepared to adopt a flexible approach when determining the issue.
>
> - The COVID-19 Tax Treaty Guidance, which was intended to provide more certainty to taxpayers, reflected the general approach of jurisdictions in addressing the impact of COVID-19 on the tax situations of individuals and employers. The IRD would generally follow the Guidance when interpreting

the provisions of CDTAs for tax issues arising from the COVID-19 pandemic. It was important to note that the Guidance was relevant only to circumstances arising during the COVID-19 pandemic when public health measures were in effect. Indeed, the Guidance acknowledged that where an individual continued to, for example, work from home after the cessation of the public health measures, further examination of the facts and circumstances would be required to determine whether a PE existed.

(c) OECD's guidance on transfer pricing implications of COVID-19

Will the IRD follow the OECD's guidance on transfer pricing implications of COVID-19 issued in December 2020 closely? Will the IRD issue any guidance or statement such that taxpayers could better manage their transfer pricing policy under the impact of COVID-19?

In particular, it is quite often the case that MNE groups would set up a transfer pricing model by characterizing some group entities as limited risk entities that are expected to receive a relatively stable return, while the residual profit / loss would be attributed to the principal entities bearing more complex functions and risks in the value chain.

Due to the COVID-19 impact on business in year 2020, it is possible that the MNE groups would have substantial loss. In such circumstance, would the IRD consider accepting a limited risk entity suffering a loss with special factor in year 2020 (e.g. substantial reduction in revenue)?

The IRD responded as follows–

- The OECD issued *Guidance on the transfer pricing implications of the COVID-19 pandemic* (the COVID-19 TP Guidance) on 18 December 2020 to address the practical challenges faced by tax administrations and MNEs on the application of the arm's length principle amid the COVID-19 pandemic period. The COVID-19 TP Guidance explained how the arm's length principle and the TPG applied to issues that might arise or be exacerbated in the context of the COVID-19 pandemic. The COVID-19 TP Guidance maintained that the arm's length principle remained the applicable standard for the purpose of evaluating the transfer pricing issues in controlled transactions. The COVID-19 TP Guidance focused on four issues: (i) comparability analysis; (ii) losses and the allocation of COVID-19 specific costs; (iii) government assistance programmes; and (iv) advance pricing agreements.

- The IRD would generally follow the COVID-19 TP Guidance. As the COVID-19 TP Guidance merely clarified certain transfer pricing issues arising from the COVID-19 pandemic, rather than developed specified guidance beyond what was currently addressed in the TPG, the IRD did not consider it necessary to issue any new guidance or statement on the subject.

- As regards whether a limited risk entity could be accepted as having incurred losses due to the impact of COVID-19, the COVID-19 TP Guidance recognized that the term “limited risk” was not defined in the TPG. There was no general rule that a limited risk entity should not incur losses, though *“simple or low risk functions in particular are not expected to generate losses for a long period of time”* (see paragraph 3.64 of Chapter III of the TPG). It was necessary to analyse the specific facts and circumstances of the case, in particular the risks assumed by the entity. The analysis should be informed by the accurate delineation of the transaction and the performance of a robust comparability study.

- For example, if the analysis showed that there was a significant decline in demand due to COVID-19 and a limited risk entity assumed some marketplace risk, the entity might at arm’s length incur a loss associated with the playing out of the risk. The extent of the loss that might be incurred at arm’s length would be determined by the conditions and economically relevant characteristics of the accurately delineated transaction vis-à-vis those of comparable uncontrolled transactions. However, if the analysis showed that the limited risk entity did not assume any marketplace or other specific risks, the entity should not bear losses arising from the playing out of those risks.

Ms Cheung appreciated the IRD’s responses to the tax issues arising from the COVID-19 pandemic, which were very helpful and generally in line with the OECD guidance. Since the pandemic had lasted for more than one year and might continue, she suggested the IRD publish its views and position on the tax issues arising from the pandemic on a dedicated part of its website for taxpayers’ reference.

[Post-meeting note: The IRD website was updated on 28 July 2021 to explain the department’s approach in handling tax issues arising from the COVID-19 pandemic.]

(d) Timing of the odd issue of profits tax returns

Under the COVID-19 situation in 2020, the bulk issue of 2019/20 profits tax returns to corporations and partnership businesses, the files of which fell within the “active” category in the IRD, took place on 4 May 2020. However, the IRD also issued profits tax returns to some of the “active companies” under the odd issue on an irregular basis in 2020. Due to the special work arrangement or delay in postal service, some of the “active companies” were not aware of the odd issue of profits tax returns leading to late filing of returns. The IRD’s arrangement in 2020 caused difficulties for the companies to manage their return filing.

In 2021, while the COVID-19 pandemic continues, the Institute would like to know the IRD’s plan in the odd issue of profits tax returns for 2020/21.

The IRD responded that in general, profits tax returns were issued to all “active” businesses in the annual bulk return issue exercise with some exceptions. The IRD regularly carried out periodic reviews and arranged odd issue of profits tax returns (periodic issues) where appropriate. For taxpayers who were represented, the extended due dates for submission of profits tax returns with various accounting date codes also applied to periodic issues. In the event of exceptional circumstances, a taxpayer might file an application for extension of time for furnishing the profits tax return. Every application would be considered on its own merits and justifications.

<u>Agenda item A5 - Double Taxation Agreements</u>

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

Hong Kong obtained the endorsement of the CPG to extend the application of the Multilateral Instrument signed in 2017. The Multilateral Instrument will be applied alongside the relevant existing CDTAs concluded by Hong Kong. Can the IRD provide an update on the progress of giving effect to the Multilateral Instrument in Hong Kong?

The IRD responded that China signed the Multilateral Instrument on 7 June 2017. With the CPG's endorsement, the application of the Multilateral Instrument was to be extended to Hong Kong. China, being the signatory, was taking steps to approve the Multilateral Instrument. Upon completion of the approval procedures, China would deposit the instrument of approval of the Multilateral Instrument with the OECD and make reservations and notifications applicable to Hong Kong under the Multilateral Instrument. Thereafter, an order would be made by the Chief Executive in Council under section 49 of the IRO to give effect to the Multilateral Instrument in Hong Kong. The order would be subject to negative vetting by the Legislative Council.

Agenda item A6 – Departmental Policy and Administrative Matters

(a) Lodgment of profits tax returns and filing deadlines for 2020/21

Would the IRD please share with the Institute the latest statistics on tax return filing and information on the 2020/21 tax filing deadlines?

The IRD provided four tables at Appendix A which showed the lodgment statistics for 2019/20 Profits Tax Returns in respect of corporations and partnerships.

- Table 1 showed that the IRD issued some 9,000 more returns in the 2019/20 bulk issue exercise and some 22,300 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 Institute last year, the filing deadlines for 2019/20 returns were further extended to 30 June 2020, 30 September 2020 and 30 November 2020 for "N" code, "D" code and "M" code respectively. Though there were improvements in the lodgment rates for "D" code returns (from 74% to 81%) and "M" code returns (from 68% to 72%) by the deadline, the overall performance was still far from satisfactory. The graduated lodgment rates worsened and were significantly below the lodgment standards. The IRD, through the Institute, urged tax representatives to improve their performance in the coming year.

- Table 4 was a comparative analysis of compliance with the block extension scheme.

Bulk Issue of 2020/21 Profits Tax Returns

The 2020/21 Profits Tax Returns for "active" files were bulk-issued on 1 April 2021. The extended due dates for filing 2020/21 Profits Tax Returns would be as follows–

Accounting Date Code	Extended Due Date	Further Extended Due Date if opting for e-filing
"N" code	31 May 2021	15 June 2021
"D" code	16 August 2021	30 August 2021
"M" code	15 November 2021	29 November 2021
"M" code – current year loss cases	31 January 2022	31 January 2022 (same as paper returns)

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

Mr Yeung commented that in the previous year, there were a lot of Profits Tax Returns issued to taxpayers a few weeks after the bulk issue. Tax representatives could not apply for block extension for such returns. He said that it would be helpful if the IRD would let the public know its schedule of odd issues in advance, so that the tax representatives could plan their resources. Mr William Chan added that most CPA firms encountered staff shortages over the past few years. He hoped that the IRD would give favourable consideration for extension requests.

In response, Ms Chan explained that periodic issues could not be avoided as the IRD had to regularly carry out periodic reviews and arrange odd issue of Profits Tax Returns in cases where circumstances warranted. Similar to returns issued under the bulk issue exercise, the extended due dates for submission of Profits Tax Returns under the Block Extension Scheme also applied to periodic issues for represented cases. If a taxpayer encountered difficulties in meeting the deadline for filing its Profits Tax Return (e.g. change of auditor prior to the filing deadline), it might apply for an extension of time for furnishing its Profits Tax Return. The IRD would consider each case on its own merits.

Mr Yeung understood that periodic issues were not intended to create a burden on tax representatives. However, the IRD made some periodic issues of “D” code returns in the previous year and taxpayers were required to file the returns within one month. This would cause some problems to the taxpayers and their tax representatives.

Ms Chan responded that such periodic issues normally occurred after the usual filing deadlines under the Block Extension Scheme and hence only one month was allowed for taxpayers to furnish their Profits Tax Returns. In any event, under the Companies Ordinance, all companies incorporated in Hong Kong were required to have their financial statements audited by an auditor annually. Therefore, even if no Profits Tax Returns were issued, the IRD expected that companies should have engaged an auditor to audit their financial statements and they should not have great difficulties in filing the tax returns within one month.

(b) Holdover claims of provisional tax payable in Hong Kong

In agenda item A5(c) of the 2012 Annual Meeting, the IRD noted the situation that even though foreign taxes that are creditable in Hong Kong may have been paid outside Hong Kong, such situation was however not one of the stipulated grounds for a holdover claim of the provisional tax payable for the year under sections 63E and 63J of the IRO.

At the same time, the IRD also indicated that it would see whether there is a need to make the provisions of the IRO compatible with the increasing number of tax treaties concluded by Hong Kong.

What are the latest developments for the holdover of both profits and salaries taxes in Hong Kong?

The IRD responded as follows–

- Sections 63E(2) and 63J(2) of the IRO set out the grounds for holding over of payment of provisional salaries tax and provisional profits tax respectively. The creditable foreign taxes mentioned in the question did not fall within these grounds. Thus, the IRD was not empowered to entertain any holdover claim in respect of any tax credit paid outside Hong Kong for the provisional year of assessment.

- From the year of assessment 2018/19 onwards, section 8(1A)(c) was not applicable to income derived by a person from services rendered in a DTA territory. Relief from double taxation in respect of such income could only be provided by way of tax credit under section 50. The IRD would keep a close watch on the trend of tax credit claims subsequent to the aforementioned changes in tax treatments and consider proposing to the policy bureau that amendments be made to the IRO, if necessary.

(c) Tax credit computation for individuals

Some practitioners noted that the IRD would not copy to the tax representatives the tax credit relief calculations with the copy of notice of assessment. Therefore, the tax representatives would need to ask the taxpayers or the IRD for copies of calculations to check the correctness of the notices of assessment. To streamline the operation, the Institute kindly requests the IRD to send copies of the calculations together with the notices of assessment also to the tax representatives in future.

The IRD responded that where assessments were issued as per tax returns or double taxation relief computations prepared by tax representatives, no such computations would be attached to copies of notices of assessments sent to tax representatives. Where computations differed, officers might have inadvertently omitted to send double taxation relief computations to tax representatives occasionally. Officers were reminded to supply such computations in the latter scenario in future.

(d) International Financial Reporting Standard (IFRS) 17 – Insurance Contracts

Has the IRD considered the impact of the introduction of IFRS 17 Insurance Contracts on the taxation of insurers in Hong Kong? Does the IRD envisage any amendments to the IRO in response to the introduction of this new accounting standard?

The IRD responded that sections 23 and 23A contained specific provisions governing the ascertainment of assessable profits of life insurance corporations and non-life insurance corporations respectively. All along, in ascertaining assessable profits of an insurer, no reference would be made to profits or loss recognized in its audited financial statements. Notwithstanding the introduction of IFRS 17 to Hong Kong (i.e. incorporated in HKFRS 17), the operation of the mini-regimes under sections 23 and 23A was not affected. Thus, it was considered that legislative amendments to the IRO were not necessary.

PART B – MATTERS RAISED BY THE IRD

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

The IRD provided a table at Appendix B showing discrepancies detected by field audit. The table was compiled to illustrate the specific problem areas detected in corporations with tax audits completed during the year ended 31 December 2020. Comparative figures for the years 2018 and 2019 were included.

Field Audit teams uncovered discrepancies in 375 corporation cases, of which 307 cases carried clean auditors' reports. Amount of discrepancies detected in the clean report cases accounted for 88% (2019: 75%) of the total discrepancies detected in the year 2020 and total tax of $930 million was recovered from these cases. Average understatement per clean report case was $19.79 million (2019: $11.27 million) while tax undercharged per clean report case was $3.0 million (2019: $1.6 million).

In 2020, discrepancies resulted mainly from understatement of gross profit, over-claiming of expenses and incorrect claims of offshore profits. In the majority of cases, the discrepancies were detected after examining the business ledgers and source documents.

In 2020, there was no case where it was considered that the auditor should have detected the irregularities through statutory audit.

Agenda Item B2 – Profits Tax Issues

(a) Printing templates for Profits Tax Returns

Some tax practitioners had expressed their concern over the difficulties in completing Profits Tax Returns using typewriters. To facilitate completion of Profits Tax Returns by taxpayers and tax practitioners, the IRD had posted the printing templates of Profits Tax Returns for corporations and unincorporated businesses (i.e. BIR Forms 51 and 52). For details, please refer to "Tax Representatives' Corner" on the IRD website (www.ird.gov.hk/eng/tax/taxrep_pt.htm). Tax practitioners could input data in the printing templates and then print the data on the paper Profits Tax Returns issued by the IRD for submission. Since the paper returns were in A3 size, tax practitioners had to use suitable printers or photocopiers with A3 paper tray for printing the data on the paper Profits Tax Returns.

Since the settings of different brands or models of printers might vary, Ms Chan appealed for the tax practitioners' understanding that the printing templates provided by the IRD might not be suitable for all the printers available in the market. As such, before putting the paper Profits Tax return into the printer tray for printing, she suggested that tax practitioners should select a template which would fit with the settings of their printers and perform a test by printing the input data on a draft paper with same size of the return to make sure that the data filled in the template was printed on the right position of the return. She informed the Institute that the IRD would upload to its website another set of printing templates which would allow tax practitioners to adjust the printing position of the input data by using Adobe Acrobat Professional Version.

Mr Lean appreciated the IRD's effort in preparing the printing templates. He asked whether the IRD could offer fillable pdf versions for taxpayers or tax practitioners to complete Profits Tax Returns. Ms Chan explained that there would be some legal constraints. Under the then section 51AA(1) of the IRO, taxpayers should use the paper Profits Tax Returns provided by the IRD for completion and could not use their own papers to print the Profits Tax Returns.

CIR asked whether members of the Institute had any experience in using the printing templates. Ms Cheung said that she had tried to use the printing template but it did not fit her printer. Ms Chan suggested that Ms Cheung could try using the new set of printing templates. She could adjust the printing position of the input data by using Adobe Acrobat Professional Version.

[Post-meeting note: The new set of printing templates was uploaded to the IRD's website on 17 May 2021.]

(b) Electronic filing of Profits Tax Returns

In agenda item A5(b) of the 2019 annual meeting and agenda item A5(e) of the 2020 annual meeting, the IRD disclosed that it had been undertaking a project on electronic filing (e-filing) of Profits Tax Returns (the e-Filing Project). The e-Filing Project, which was a technically-complicated project involving legal and IT perspectives, was in active progress. Taking this opportunity, the IRD would like to update the Institute on the progress of this project.

The Government had introduced an IRO amendment bill into the Legislative Council to provide a new mechanism for filing tax returns. The legislative amendments would support the IRD's plan to enable more businesses to voluntarily e-file Profits Tax Returns and financial statements in 2023, with the ultimate aim of implementing mandatory e-filing of Profits Tax Returns through the newly developed Business Tax Portal by phases starting from 2025, the earliest.

The IRD planned to use iXBRL format for e-filing of financial statements and tax computations and had kick started the development of the IRD Taxonomy Package alongside the iXBRL Preparation Tools. Since the project would drastically change the way taxpayers filed their Profits Tax Returns and might impact the design of accounting software, the IRD conducted a consultation with professional accounting bodies, software developer and consulting firms, including the Institute, during the period from 29 January 2021 to 1 March 2021. The stakeholders' views received during the consultation were being studied and would be taken into account in the process of system design, where appropriate. Meanwhile, the development of the iXBRL Preparation Tools was in progress. Consultation would be carried out once the proposed iXBRL Preparation Tools were close to finalization. The IRD would continue to work closely with professional bodies, including the Institute, and relevant stakeholders throughout the development and implementation process of the new e-filing mechanism and the Business Tax Portal.

CIR thanked and welcomed the Institute's comments on the e-Filing Project. He appealed for the tax practitioners' support and participation in the e-fling of Profits Tax Returns. He said that the IRD would try its best to make the e-filing system as user friendly as possible. He hoped that the IRD could move to digitalization successfully.

Agenda Item B3 – Date of Next Annual Meeting

The date 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 2017/18 to 2019/20

		Y/A 2017/18	Y/A 2018/19	Y/A 2019/20	Comparison 2018/19 and 2019/20
1.	Returns issued on 1 or 3 April or 4 May	188,000	195,000	204,000	5%
2.	Returns not filed by due date				
	"N" code	2,600	3,200	2,700	-16%
	"D" code	9,000	7,600	7,200	-5%
	"M" code	12,900	10,500	12,400	18%
		24,500	21,300	22,300	5%
3.	Compound offers issued	7,300	9,800	5,400	-45%
4.	Estimated assessments issued	11,300	4,600	8,800	91%

Table 2
2019/20 Detailed Profits Tax Returns Statistics

	"N"	"D"	"M"	Total
Total returns issued	23,000	70,000	111,000	204,000
Failure to file on time	2,700	7,200	12,400	22,300
Compound offers issued	600	1,900	2,900	5,400
Estimated assessments issued	1,200	2,900	4,700	8,800

Table 3
Represented Profits Tax Returns - Lodgment Patterns

Code	Lodgment Standard	Y/A 2019/20	Y/A 2018/19
D - extended due date on			
15 August 2019	100%	-	74%
30 September 2020	100%	81% (1)	-
M - 31 August	25%	11%	11%
M - 30 September	55%	17%	16%
M - 31 October	80%	28%	32%
M - extended due date on			
15 November 2019	100%	-	68%
30 November 2020	100%	72% (2)	-

Notes: (1) 13% lodged within a few days before 30 September 2020 (31% lodged within a few days before 15 August 2019 for Y/A 2018/19)

(2) 21% lodged within a few days before 30 November 2020 (18% lodged within a few days before 15 November 2019 for Y/A 2018/19)

Table 4
Tax Representatives with Lodgment Rate of Less Than 72% of "M" Code Returns as at 30 November 2020

1,473 tax representatives have "M" code clients. Of these, 684 (46%) firms were below the average performance rate of 72%. 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 72%	No. of non-compliance cases	% of total non-compliance cases	Total No. of firms	No. of firms below the average of 68%	No. of non-compliance cases	% of total non-compliance cases
Small size firms	100 or less	1,371	628	6,161	66%	1,368	657	6,856	67%
Medium size firms	101 - 300	94	53	2,827	30%	92	44	2,768	27%
Large size firms	over 300	8	3	354	4%	8	4	609	6%
		1,473	684	9,342	100%	1,468	705	10,233	100%

Extracts of Analysis in Appendix B

		2019	2020
(a)	No. of corporation cases with discrepancies uncovered	367	375
(b)	No. of corporation cases in item (a) carried clean auditor’s reports	300	307
(c)	Total discrepancies detected in all cases	$4,513m	$6,884m
(d)	Total discrepancies detected in clean auditor’s report cases	$3,381m	$6,075m
(e)	Percentage of (d) over (c)	75%	88%
(f)	Total tax uncovered in clean auditor’s report cases	$484m	$930m
(g)	Average understatement per clean auditor’s report case	$11.27m	$19.79m
(h)	Tax undercharged per clean auditor’s report case	$1.6m	$3.0m

Analysis of Completed FA Corporation Cases for the years ended 31 December 2018, 2019 and 2020

	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
Auditor's Report = Unqualified	**2018**	**2019**	**2020**	**2018**	**2019**	**2020**	**2018**	**2019**	**2020**
Sales omitted	65	56	48	53,960,621	87,277,778	62,167,273	6,954,336	12,402,793	7,890,853
Purchases overstated	12	19	15	7,727,830	30,670,937	49,026,448	1,240,770	4,581,073	7,299,611
Gross profit understated	28	41	37	98,639,797	68,371,415	814,659,600	6,937,918	10,127,025	131,892,653
Expenses over-claimed	88	106	114	326,952,476	76,721,908	150,828,962	50,197,335	9,619,700	22,507,369
Technical adjustments	92	96	82	77,023,541	51,724,969	29,484,527	11,711,365	5,348,928	3,029,692
Offshore income / profits disallowed	21	22	12	1,670,937,967	95,199,663	88,132,024	276,916,165	13,345,928	13,848,818
Other	104	115	123	74,344,052	130,411,069	167,135,665	11,446,742	17,518,009	25,620,300
TOTAL	410*	455*	431*	$2,309,586,284	$540,377,739	$1,361,434,499	$365,404,631	$72,943,456	$212,089,296
TOTAL NUMBER OF CASES	276*	300*	307*						
AVERAGE AMOUNT PER CASE				$8,368,066	$1,801,259	$4,434,640	$1,323,930	$243,145	$690,845

FOR AUDIT YEAR ONLY

* in one case there may be more than one type of discrepancy

		Total Discrepancy for All Years			Total Tax Undercharged for All Years		
		2018	**2019**	**2020**	**2018**	**2019**	**2020**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$10,605,686,545**	**$3,380,807,219**	**$6,075,473,883**	**$1,631,374,788**	**$484,329,841**	**$930,164,546**
	AVERAGE AMOUNT PER CASE	**$38,426,401**	**$11,269,357**	**$19,789,817**	**$5,910,778**	**$1,614,433**	**$3,029,852**

	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
Auditor's Report = Qualified	**2018**	**2019**	**2020**	**2018**	**2019**	**2020**	**2018**	**2019**	**2020**
Sales omitted	12	11	26	25,668,951	44,782,052	33,239,140	4,189,451	7,258,723	4,838,005
Purchases overstated	2	4	2	8,483,857	6,603,750	19,463,392	1,444,120	655,574	2,780,627
Gross profit understated	18	23	10	28,103,809	33,132,243	13,887,085	3,420,563	4,742,030	1,982,706
Expenses over-claimed	23	21	27	13,849,719	6,887,763	7,699,017	1,928,314	875,955	925,575
Technical adjustments	15	16	14	3,660,449	12,670,487	7,455,642	563,219	1,603,781	832,436
Offshore income / profits disallowed	3	1	5	4,943,011	57,332,058	26,240,002	503,538	9,439,789	4,169,345
Other	26	26	23	36,877,590	58,017,071	41,969,334	5,583,779	8,804,451	3,900,107
TOTAL	99*	102*	107*	$121,587,386	$219,425,424	$149,953,612	$17,632,984	$33,380,303	$19,428,801
TOTAL NUMBER OF CASES	63*	67*	68*						
AVERAGE AMOUNT PER CASE				$1,929,959	$3,275,006	$2,205,200	$279,889	$498,213	$285,718

FOR AUDIT YEAR ONLY

* in one case there may be more than one type of discrepancy

		Total Discrepancy for All Years			Total Tax Undercharged for All Years		
		2018	**2019**	**2020**	**2018**	**2019**	**2020**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$692,428,852**	**$1,131,854,905**	**$808,236,856**	**$105,078,631**	**$165,748,299**	**$118,534,361**
	AVERAGE AMOUNT PER CASE	**$10,990,934**	**$16,893,357**	**$11,885,836**	**$1,667,915**	**$2,473,855**	**$1,743,152**

	2018	2019	2020
TOTAL NUMBER OF CASES	339	367	375

		Total Discrepancy for All Years			Total Tax Undercharged for All Years		
		2018	**2019**	**2020**	**2018**	**2019**	**2020**
Other statistics for the above cases:	**TOTAL AMOUNT**	**$11,298,115,397**	**$4,512,662,124**	**$6,883,710,739**	**$1,736,453,419**	**$650,078,140**	**$1,048,698,907**
	AVERAGE AMOUNT PER CASE	**$33,327,774**	**$12,296,082**	**$18,356,562**	**$5,122,281**	**$1,771,330**	**$2,796,530**