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

*TaxB 34* *April 2024*

# Tax Bulletin

## 2023 Annual Meeting

**The Inland Revenue Department**

*and*

**The Hong Kong Institute of Certified Public Accountants**

**2023**
**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 2023.

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.

## List of Discussion Items

### PART A – MATTERS RAISED BY THE INSTITUTE

#### *A1. Profits Tax Issues*

A1(a) Review of the tax treatment for reinstatement cost

A1(b) Tax treatment of founder shares of Special Purpose Acquisition Companies (SPACs)

A1(c) E-commerce

A1(d) Taxability of dividends or profit distributions made by a tax-exempt fund when received

A1(e) Unified fund exemption (UFE) regime for an open-ended fund company (OFC)

A1(f) Taxation of interest income

A1(g) Tax concessions for certain shipping-related activities

A1(h) Penalty imposed under a tax audit case

#### *A2. Salaries Tax Issues*

A2(a) Employees working remotely overseas or in the Mainland of China

A2(b) Reimbursement of relocation expenses

A2(c) Facilitating measures with respect to filing of employer's returns under the Top Talent Pass Scheme

***A3. Transfer pricing (TP)***

A3(a) Whether capital assets qualifying for depreciation allowances can be transferred at below market price and avoid being adjusted by the IRD by relying on section 50AAJ of the IRO

A3(b) Information exchange for overseas TP audit

***A4. Foreign-sourced income exemption (FSIE) regime***

A4(a) Economic substance requirements (ESR)

A4(b) Corporate Income Tax levied at both federal and state/regional levels

A4(c) Condition of "Received in Hong Kong"

***A5. Departmental Policy and Administrative Matters***

A5(a) IRD's plan on electronic filing (e-filing) of profits tax returns

A5(b) Lodgement of profits tax returns and filing deadlines for 2021/22

**PART B – MATTERS RAISED BY THE IRD**

***B1. Investigation and Field Audit: Discrepancies Detected by Field Audit***

***B3. Date of Next Annual Meeting***

**2023**
**ANNUAL MEETING BETWEEN**
**THE INLAND REVENUE DEPARTMENT AND**
**THE HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**

## Full Minutes

The 2022/23 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department was held on 12 May 2023 at the Inland Revenue Department.

## In Attendance

### Hong Kong Institute of Certified Public Accountants (the Institute)

| | |
|---|---|
| Ms Sarah Chan | Chair, Taxation Faculty Executive Committee |
| Mr Eugene Yeung | Deputy Chair, Taxation Faculty Executive Committee |
| Mr Anthony Chan | Member, Taxation Faculty Executive Committee |
| Mr Edward Lean | Member, Taxation Faculty Executive Committee |
| Ms Grace Tang | Member, Taxation Faculty Executive Committee |
| Ms Gwenda Ho | Member, Taxation Faculty Executive Committee |
| Mr Jack Fernandes | Member, Taxation Faculty Executive Committee |
| Ms Kathy Kun | Director, Tax Services, PwC Hong Kong |
| Mr Peter Tisman | Director, Advocacy and Practice Development |
| Ms Selraniy Chow | Associate Director, Advocacy and Practice Development |

### Inland Revenue Department (IRD)

| | |
|---|---|
| Mr Tam Tai-pang, Ashley | Commissioner of Inland Revenue |
| Mr Chan Sze-wai, Benjamin | Deputy Commissioner of Inland Revenue (Technical) |
| Mr Leung Kin-wa, Wesley | Deputy Commissioner of Inland Revenue (Operations) |
| Ms Chan Shun-mei, Michelle | Assistant Commissioner of Inland Revenue, Unit 1 |
| Ms Tang Hing-kwan, Marina | Assistant Commissioner of Inland Revenue, Unit 2 (Acting) |
| Mr Ng Man-kwan, Raymond | Assistant Commissioner of Inland Revenue, Unit 4 (Acting) |
| Ms Chan Tsui-fung, Canice | Chief Assessor (Tax Treaty) |
| Mr Tsui Chung-leung, Steven | Chief Assessor (Tax Treaty) |
| Ms Pan Hiu-yan, Sabrina | Senior Assessor (Research) |

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

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

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

## PART A - MATTERS RAISED BY THE INSTITUTE

### Agenda Item A1 - Profits Tax Issues

**(a) Review of the tax treatment for reinstatement cost**

The FAQs posted on the IRD's website indicate that reinstatement costs for premises incurred upon the expiration of a lease would generally be disallowable under section 16 of the Inland Revenue Ordinance (IRO) as a capital cost of acquiring a lease. Furthermore, as such costs are not regarded as being incurred in the construction of a commercial building or structure, or the acquisition of a relevant interest in such a building or structure, they would also not qualify for commercial building allowance in Hong Kong.

The Institute notes that, since June 2015, following a review of the tax treatment of reinstatement costs, and subject to certain conditions, the Inland Revenue Authority of Singapore (IRAS) has changed its position from regarding such costs from being a disallowable capital item to being a tax-deductible revenue item, forming part of the cost of renting the property for use in the business in the first place. Please refer to this link to the announcement of the IRAS for more details: https://taxsg.com/2015/06/16/iras-updates-online-content-on-tax-treatment-of-reinstatement-costs/

To help boost Hong Kong's competitive position, would the IRD consider conducting a review to see whether Hong Kong should adopt a tax treatment for reinstatement costs similar to the treatment currently adopted in Singapore?

The IRD responded as follows –

- Section 16(1) of the IRO provided that, in ascertaining the profits in respect of

which a person was chargeable to profits tax for any year of assessment, there should be deducted all outgoings and expenses to the extent to which they were incurred during the basis period for that year of assessment by such person in the production of profits, in respect of which he was chargeable to Profits Tax for any period. Section 17(1)(c) of the IRO provided that no deduction should be allowed in respect of any expenditure of a capital nature.

- Generally, a lease which conferred an exclusive possession of a property was a capital asset and any cost incurred for acquiring it was also of a capital nature. Where a lessee was obligated to reinstate the condition of the premises back to its original state at the end of the lease, the reinstatement cost should be regarded as part of the capital cost of acquiring the lease. The expenditure was therefore capital instead of revenue in nature and thus, was precluded from deduction under section 17(1)(c).

- The tax treatment of reinstatement costs in Singapore was provided in the website of the IRAS as follows:

  "*Generally, reinstatement costs (i.e. expenses incurred to reinstate premises to its original condition before vacating it at the end of the tenancy agreement) are not tax-deductible as they are considered capital expenditure disallowed under Section 15(1)(c) of the Income Tax Act 1947. This is because such expenditure is usually incurred in respect of business premises vacated and no longer used for acquiring income.*

  *However, tax deduction can be claimed for reinstatement costs when:*

  - *Costs claimed do not relate to any provisions made under the Financial Reporting Standard (FRS) 16[1] (i.e. the expense has been incurred);*
  - *Costs claimed are contractually provided for in the tenancy agreement. These are considered as part of the costs of renting the property for use in the business in the first place; and*
  - *The premises are not vacated due to any cessation of business.*

  *[1] Under paragraph 16 of FRS 16, the cost of an item of property, plant and equipment includes the initial estimate of the costs of dismantling and removing the item and restoring the site on which the item is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.*"

  (emphasis added)

- The IRAS clearly stated in the above extract that reinstatement costs were generally capital expenditure and not deductible for tax purposes. It appeared that IRAS, as a practice only, would allow deduction of reinstatement costs where three specified conditions were fulfilled.

- The tax law regarding deduction of capital expenditures in Hong Kong was clear

and there was no room for the IRD to provide any concessionary treatment. Given their capital nature, reinstatement costs were not allowable for tax deduction under section 17(1)(c).

Ms Grace Tang and Ms Sarah Chan asked whether deduction of reinstatement costs could be granted if conditions similar to the three prescribed by the IRAS were met, in order to enhance the competitiveness of Hong Kong. CIR said that the IRD was obliged to follow the law. As the available information indicated, the IRAS merely allowed such deduction on a concessionary basis. It did not accept that the relevant deductions were revenue in nature.

[Post-meeting note: In the 2024-25 Budget Speech, the Financial Secretary proposed to grant tax deduction for expenses incurred in reinstating the condition of the leased premises to their original condition.]

**(b) Tax treatment of founder shares of Special Purpose Acquisition Companies (SPACs)**

SPACs are publicly traded companies, formed for the sole purpose of raising capital through an initial public offering (IPO) and using the IPO proceeds to acquire one or more unspecified businesses in the future.

The management team that forms the SPAC (commonly known as the "sponsors") are responsible for forming the SPAC entity, raising capital in the SPAC IPO transaction, identifying potential targets for acquisition, promoting the acquisition among the SPAC shareholders and consummating the acquisition.

SPAC sponsors typically do not have an employment agreement or management agreement with the SPAC and are not permitted to receive compensation for their services. As a result, the sponsors are generally granted an initial, separate class of shares for nominal consideration. These "founder shares" will be automatically converted to public shares on the completion of acquisition of a target business. At a later stage, the sponsors may sell the shares and derive a gain on disposal.

We would like to seek the IRD's view on the tax treatment of the founder shares, in particular whether it would be considered as an investment income for setting up an entity (i.e. SPAC) and taking early-stage risks, and hence not taxable when the shares are granted, converted or sold.

The IRD responded as follows –

- Profits tax was charged under section 14 of the IRO on a person carrying on a trade, profession or business in Hong Kong in respect of the person's assessable profits arising in or derived from Hong Kong from such trade, profession or business. Capital gains were generally not chargeable to profits

tax in Hong Kong.

- Whether the founder shares were the sponsors' remuneration for their services rendered in relation to the formation of the SPAC, raising capital in the SPAC IPO transactions and related matters, or were the sponsors' capital investment was a question of fact. The IRD would look at all the facts and circumstances under which the founder shares were granted. If the founder shares were capital investment, any gains arising from the shares should be capital in nature and not taxable. Conversely, if the founder shares were payment for services rendered by the sponsors, the relevant gains would be chargeable to profits tax. In the latter case, the nature of the founder shares was no different from other service income received by the sponsors.

- It was noted that the Institute issued a publication in January 2022 on accounting considerations for SPAC. The publication provided that, given significant services provided by the promoters to the SPAC, it was necessary to assess whether the promoter shares and promoter warrants ("promoter securities" collectively) were given to the promoters in return for services received by the SPAC, such that the promoter securities should be recognised in profit or loss in accordance with Hong Kong Financial Reporting Standard (HKFRS) 2 *Share-based Payment*, or the promoter securities were received by the promoters in their capacity as shareholders, such that Hong Kong Accounting Standard 32 *Financial Instruments: Presentation* should apply. The Institute considered that in many cases, it was likely that the promoter securities would fall within the scope of HKFRS 2.

- Although accounting treatment was not a conclusive factor, it was one of the factors that the IRD would consider in ascertaining the real nature of the sponsor shares. If, after critically assessing all relevant facts and circumstances, the management concluded that the founder shares were issued to the sponsor in return for the services provided to the SPAC, and should be recognised in profit or loss in accordance with HKFRS 2, there seemed no justification for treating the income so recognised as not chargeable to profits tax.

Mr Edward Lean (Mr Lean) noted that the tax treatment of the founder shares was a practical matter. It was common for a SPAC to take a certain period to complete acquisition or close a deal. Thus, if the founder shares were remuneration for services rendered by the sponsor, when the value of the founder shares had to be assessed would be an issue. Mr Benjamin Chan said that whether and if so when the sponsor shares were to be chargeable to tax would depend on the facts and circumstances of each case, in particular the terms and conditions governing the grant of the shares and the obligations to be performed by the sponsor in respect of those shares. Ms Sarah Chan asked, if the sponsor shares were remuneration for service, whether such remuneration could be regarded as offshore if the sponsor's services were rendered outside Hong Kong. Mr Benjamin Chan said that this would depend on whether the remuneration was derived from employment (which was chargeable to salaries tax) or business (which was chargeable to profits tax) as the rules for determining the source of income or profits under salaries tax and profits tax

were different. CIR supplemented that if salaries tax charge applied, it was necessary to consider the source of employment.

**(c) E-commerce**

DIPN 39 on the digital economy, electronic commerce and digital assets includes some simple examples of e-commerce, e.g., sale of goods or services through the internet. We would ask the IRD to consider providing additional examples to illustrate how the source rules apply to other e-commerce operation models, including the following:

- Online intermediaries are online businesses that bring sellers and consumers together. They do not own the products or services and only earn a commission on each transaction made. For example, a non-Hong Kong resident company develops, maintains and operates a global travel shopping website outside Hong Kong. The website is hosted on a server outside Hong Kong. The partner hotels from all over the world (including Hong Kong) sign the standard e-contracts through the website. Commission will be received from the hotel when a user books a hotel room through the website. The company maintains a customer service centre in Hong Kong with staff to answer customers' enquiries.

- Advertising-based model in which information is given away for free and income is derived from advertising on the site. For example, a non-Hong Kong resident company develops and maintains an informational website outside Hong Kong and hosts the website on the server of an internet service provider (not at the company's disposal) in Hong Kong. The company has staff in Hong Kong to prepare and post information on the website which is free of charge to viewers. The company derives advertising fee income from customers who place advertisements through the website from all over the world (including Hong Kong).

- Community-based site (e.g. social media app) that derives income from targeting advertisements to users based on their demographics and location. For example, a Hong Kong company hosts an app / website on a server at its disposal in Hong Kong. The app / website was developed and maintained by its group company outside Hong Kong. The Hong Kong company does not have any physical operations in Hong Kong. It derives advertising fee income from customers who places advertisements through the website from all over the world and the payments are made online.

- Some e-games may allow players to make in-game purchases of virtual goods, e.g. rare characters or weapons. For example, a Hong Kong company holds a licence for an e-game from its overseas group company, which developed the game and the relevant virtual goods outside Hong Kong. The game is promoted in Hong Kong by online advertisements. The game is free of charge to the players. The Hong Kong company derives income from the Hong Kong players who purchases virtual goods through the app / website. No physical operations are required in Hong Kong.

The Institute would ask the IRD to share its preliminary views on the tax treatments in the above scenarios.

The IRD responded as follows –

- Since e-commerce business models were constantly evolving, the IRD did not set out in DIPN 39 (Revised) how the law applied to particular forms of e-commerce. Instead, DIPN 39 set out the taxation principles that broadly applied to e-commerce transactions. Examples were used to illustrate the IRD's views on certain tax issues relevant to e-commerce transactions.
- The IRD took the view that the location of the server alone did not determine the locality of the profits, and the proper approach was to focus more on the core operations that had effected the e-commerce transaction to earn the profits in question and the place where those operations had been carried out, rather than on what had been done electronically (paragraph 17 of DIPN 39).
- For the four digital business models described (i.e. online intermediary, search engine, social network site and online gaming), they were highly digitised, platform-based and might be of diverse monetisation models. An attempt to provide oversimplified examples to illustrate how the source rule applied to these e-commerce models might not be very useful. As the IRD understood it, platform-based operators provided intermediation services across the different sides of a digital market. Typically, a platform-based operator provided goods or services free of charge to end users on the market side, and got compensation by extracting data from users and transactions, and then selling services based on that data to the other side or generating revenues from targeted advertising and monetisation of user data. The success of platform-based operators depended upon network relationship, and linking users through organisation and facilitation of exchange between users was a critical process in developing the network relationship.
- Depending on the type of the business model, the IRD considered that the core functions of platform-based operators might include: network promotion and contract management (e.g. fostering of broad and engaged user communities, sourcing of advertiser customers by demonstrating the wealth of user data, maintaining a database to manage the contracts with advertisers and store user profile data); service provisioning associated with establishing, maintaining and terminating links between users; and network infrastructure operation associated with maintaining and running a physical and information infrastructure (paragraph 7(a) to (c) of DIPN 39). If all the core operations and support activities of a platform-based operator were performed in Hong Kong, the e-commerce profits should be fully chargeable to profits tax even though the server was located outside Hong Kong.
- Based on the examples given, the IRD's views were as follows:

  (i) In the first example given (online intermediary), on the assumption that the

non-Hong Kong resident company did not have any core operations or support activities performed in Hong Kong, it would not be chargeable to profits tax. However, if the staff of the customer service centre in Hong Kong had the authority to conclude contracts with the partner hotels on behalf of the non-Hong Kong resident company and performed core operations or support activities in Hong Kong, the commission income received by the non-Hong Kong resident company would be regarded as derived from Hong Kong and chargeable to profits tax.

(ii) In the second example given (search engine), if the activities conducted by the non-Hong Kong resident company's staff in Hong Kong were an essential and significant part of its search engine business, its profits would be regarded as sourced in Hong Kong. The activities of preparing and posting information on the website, though free of charge to viewers, would attract more viewers to the site which in turn would generate advertising revenue through the use of data from viewers. Such activities might arguably be a significant part of the non-Hong Kong resident company's search engine business, which would constitute the profit-generating operation of the non-Hong Kong resident company.

(iii) In the third example given (social network site), if the core functions and support activities (e.g. conducting marketing activities to generate demand for the advertising services, providing technical consultancy services to potential advertising clients) were not performed in Hong Kong, the Hong Kong company would not be chargeable to profits tax. A server alone in Hong Kong could not be the sole determining factor for the locality of e-commerce profits.

(iv) In the fourth example given (online gaming), it was said that no physical operations were required in Hong Kong. However, how the game was promoted in Hong Kong and by whom as well as how the virtual goods were sold through the app/website were not explained. Given that the Hong Kong company was the e-game licence holder in Hong Kong and that Hong Kong players could purchase in-game virtual goods through its app/website, IRD would examine what kinds of activities were carried out in Hong Kong, or through the server in Hong Kong (if any), by the Hong Kong company, and whether those activities were the core operations of the Hong Kong company's business when considering the source of its e-commerce profits.

- DIPN 39 was revised during the time when the Inclusive Framework on Base Erosion and Profit Shifting had yet to agree on the solution to the tax challenges arising from the digitalisation of the economy (paragraphs 1 to 3 of DIPN 39). The IRD would consider updating DIPN 39 in future, after the rules under Pillar One were implemented in Hong Kong. The IRD would consider adding more examples by then.

Mr Jack Fernandes (Mr Fernandes) said that whilst the IRD put the emphasis on the core operations of a taxpayer who engaged in e-commerce transactions, the physical activities of the taxpayer might not touch Hong Kong. In such circumstances, he

asked whether Hong Kong would follow the OECD principles. Furthermore, he considered that DIPN 39 would have a wider application than Pillar One. Ms Michelle Chan said that the same rule would be applicable, and the issue to consider remained whether the core operations or activities were done in Hong Kong. She also said that DIPN 39 would be updated having regard not only to Pillar One, but also to other developments in relation to e-commerce. Mr Benjamin Chan supplemented that source of profits was an evolving concept. Based on the latest OECD standards, it is expected that profits should be reported where the economic activities that generate them were carried out and where value was created. The IRD would keep track of the latest development of e-commerce.

Mr Eugene Yeung (Mr Yeung) noted that the phrase “core operations” was mentioned by the IRD a number of times in the response. He considered that if minor activities were done in Hong Kong and the director only came to Hong Kong for maintenance work, this should not jeopardise the fact that most activities were done outside Hong Kong. If relevant activities were conducted in different places, on the other hand, he asked whether apportionment would apply. Ms Michelle Chan said that it depended on whether the “minor activities” were essential. In the first example, if the customer service centre only answered queries and did not conclude contracts, the commission income would still be regarded as offshore sourced income. In the fourth example, it was similar to the provision of services (i.e. gaming services) and hence it would be necessary to see whether the activities performed in Hong Kong were essential in producing the chargeable profits. As regards apportionment, it would be necessary to look at the nature of trade and whether it was trading of goods or services; if the former, then apportionment would not apply. Mr Benjamin Chan said that in the fourth example, it seemed difficult to arrive at the conclusion on the source as it would be necessary to know what online game was involved, and where the activities producing the profits were undertaken.

Mr Lean commented that in DIPN 39, it was stated that if all the staff were located in Hong Kong but the servers were located outside Hong Kong, with online payments made and contracts concluded outside Hong Kong, the commission income would be considered as chargeable outside Hong Kong. IRD’s current responses seemed to be premised on a different test and deviate from that adopted in the DIPN. Mr Fernandes asked whether the focus was placed on an activity-based analysis or other factors. Mr Benjamin Chan said that the source concept was evolving but there was no change to the broad guiding principle. It remained important to ascertain where the profit-producing activities were carried out. Whilst the new development in the commercial world had to be taken into account in applying the broad guiding principle, there was no ground to depart from it in determining the source of online services or e-commerce.

Mr Anthony Chan referred to the fourth example on online games and said that based on experience, the games were usually developed by group companies outside Hong Kong, and the intra-group Hong Kong company simply obtained the right to use the game and concluded a hosting agreement with the app store located overseas. Since all the crucial transactions were concluded outside Hong Kong, the Hong Kong company, as the game provider, would have no knowledge of the identity and number

of the Hong Kong buyers or subscribers across the globe. In such circumstances, he asked whether the income received by the Hong Kong company from the app store would be considered as onshore or offshore sourced. Ms Michelle Chan said that there were several matters that needed to be ascertained. For example, what activities were carried out by the Hong Kong company to procure the licence to use the game; the terms of the agreement; how and where the agreement was negotiated or concluded. In the extreme circumstances, if all the activities were carried out outside Hong Kong, the income would be regarded as offshore sourced. Mr Anthony Chan asked whether the income received by the Hong Kong company would still be considered as offshore sourced if there were Hong Kong players. Ms Michelle Chan said that this would boil down to the difference between trading in Hong Kong and trading with Hong Kong.

**(d) Taxability of dividends or profit distributions made by a tax-exempt fund when received**

As reflected in Item A1(b) of the 2015 annual meeting, it appears that, so long as a company is carrying on business in Hong Kong, the company will be regarded as chargeable to profits tax in Hong Kong. As such, dividends paid by the company will be treated as exempt income in the hands of the recipients, under section 26(a) of the IRO, notwithstanding that the dividends are paid out of non-chargeable capital gains or offshore profits of the company.

The Institute would like to know whether the same treatment would also apply to dividends or profit distributions paid out by a tax-exempt fund in Hong Kong. If so, this would mean that, apart from the potential application of the deeming provisions, dividends or profit distributions made by such a fund from its tax-exempt profits would be treated as exempt income in the hands of the recipients, under either sections 26(a) or 26(b) of the IRO, given that such a fund would necessarily be carrying on business in Hong Kong.

The IRD responded as follows –

- The IRD's explanation in item A1(b) of the 2015 annual meeting would apply to the generality of the cases, including dividends or profits distributions paid out by a fund exempted under section 20AN of the IRO.
- Having said that, the IRD also stayed vigilant to any arrangement which aimed to exploit the exemption provided under section 26 by structuring any taxable income derived by a person as tax-exempt dividends or profits distributions. Where appropriate, the IRD would consider tackling such an arrangement pursuant to the general anti-avoidance provisions under section 61 and 61A of the IRO.

Ms Grace Tang said that this was intended to be a straightforward question. Ms Sarah Chan noted that the IRD made reference to anti-avoidance rules in the

response. Mr Benjamin Chan said that the response might not be too straightforward in the case of funds. For example, in the case of distribution of carried interest, it might be possible that an investment fund manager might structure the remuneration package such that service or management fees were repackaged as dividends, thereby creating an opportunity of tax avoidance. Hence, it was considered necessary to highlight the availability of the anti-avoidance provisions in case of any transactions intended to obtain a tax benefit.

**(e) Unified fund exemption (UFE) regime for an open-ended fund company (OFC)**

The Institute notes from Chapter 11 of the Code on Open-Ended Fund Companies (OFC Code), issued by the Securities and Futures Commission in September 2020, that private OFCs are now allowed to invest in all asset classes without any restriction. In addition, section 20AN(2)(c) of the IRO stipulates that the assessable profits derived by OFCs from transactions in asset classes not specified in Schedule 16C of the IRO (non-Schedule 16C assets) are also exempted from profits tax.

The combined effect of the revised OFC Code and section 20AN(2)(c) suggests that a private OFC will be tax exempt in respect of its assessable profits derived from transactions in both Schedule 16C and non-Schedule 16C assets, unless the tax exemption does not apply pursuant to other provisions of the UFE regime (e.g. sections 20AP, 20 AQ and 20AS of the IRO).

Section 20AS of the IRO denies the tax exemption under the UFE regime to an OFC if the OFC (1) carries on a direct trading or direct business undertaking in relation to the non-Schedule 16C assets in Hong Kong or (2) holds non-Schedule 16C assets that are utilized to generate income.

Given there is an increased use of an OFC to invest in non-Schedule 16C assets (e.g. cryptocurrencies), the Institute would like to clarify the following issues:

(i) With regard to the interpretation of "carrying on a direct trading or direct business undertaking in Hong Kong" for the purpose of section 20AS(a), the Institute would like to confirm that day-to-day buying and selling activities in respect of investments in non-Schedule 16C assets (e.g. cryptocurrencies) performed by an OFC will not be regarded as carrying on a direct trading or direct business undertaking in Hong Kong.

(ii) If the IRD regards the above as "carrying on a direct trading or direct business undertaking in Hong Kong", could the IRD provide examples to illustrate how an OFC could engage in transactions in non-Schedule 16C assets and at the same time not be regarded as carrying on a direct trading or business undertaking and, therefore, eligible to enjoy the tax exemption under section 20AN(2)(c)?

(iii) With regard to the interpretation of "holding assets of a non-Schedule 16C class that are utilized to generate income", for the purpose of section 20AS(b), the

Institute would like to clarify whether an OFC holding a non-Schedule 16C asset (e.g. cryptocurrencies) for investment purposes, with an objective to eventually dispose of it for a profit, will be regarded as "holding assets of a non-Schedule 16C class that are utilized to generate income".

(iv) If the IRD regards the above as "holding assets of a non-Schedule 16C class that are utilized to generate income", could the IRD provide examples to illustrate how an OFC can hold non-Schedule 16C assets and at the same time not be regarded as "holding assets of a non-Schedule 16C class that are utilized to generate income" and, therefore, eligible to enjoy the tax exemption under section 20AN(2)(c)?

The IRD responded as follows –

- Whether the activities carried on by an OFC would be considered as "a direct trading or a business undertaking in non-Schedule 16C assets" or "holding non-Schedule 16C assets that were utilized to generate income" for the purposes of section 20AS was a question of fact, taking into account the facts and circumstances of each case. Having said that, Chapter 11 of the OFC Code provided that a private OFC must not be a business undertaking for general commercial or industrial purpose. A private OFC would generally be regarded as "a business undertaking for general commercial or industrial purpose" if it engaged predominantly in: (a) a commercial activity, involving the purchase, sale and / or exchange of goods or commodities; and/or (b) an industrial activity, involving the production of goods or construction of properties (see paragraph 11.4 of the OFC Code). In determining whether an OFC should be denied profits tax exemption under section 20AS, the IRD would have due regard to the guidelines provided in paragraph 11.4 of the OFC Code.
- Since the mode of operation of each OFC differed, it would be difficult to specify with examples under what circumstances an OFC could be regarded as carrying on a direct trading or direct business undertaking in non-Schedule 16C assets, or holding such assets for generating income. Generally, an OFC's transactions in non-Schedule 16C assets would not qualify for profits tax exemption, if such transactions related to assets that were usually purchased and sold in the normal course of business of a commercial or industrial enterprise, in particular those mentioned in section 20AM(7), and the OFC constituted a business undertaking for general commercial or industrial purposes.

**(f) Taxation of interest income**

It has long been the IRD's assessing practice to apply the "provision of credit" test to determine the source of interest income if (1) the interest is earned by persons other than financial institutions and (2) the loans are regarded as "simple loan of money". The Institute also notes that, in the 2011 annual meeting, Agenda item A1(h), the IRD advised

that in general, the “provision of credit test” was applicable to a company other than a financial institution where mere lending of the company’s own surplus funds was involved.

Paragraph 4 of DIPN 13 (Revised) mentions that the “provision of credit” test is not applicable where the loans are not “simple loans of money” and that according to the Orion Caribbean case, the operation test should be applied to determine the source of interest income when the taxpayer is carrying on a “money lending business”. Paragraph 9 of DIPN 52 elaborates on what factors will be considered by the IRD when determining whether a corporation is carrying on an “intra-group financing business” based on the Shun Lee case and Chinachem case.

In this regard, the Institute would like to ask the following:

Despite the above guidance in DIPNs 13 and 52, there is no definition or clear guidance on what should be regarded as a “simple loan of money”. To provide greater clarity and certainty to taxpayers, could the IRD (1) explain the principles adopted, and the factors taken into account, in considering whether a loan is a “simple loan of money”, and (2) specify the legal basis/case authority for such principles and factors adopted.

The Institute has seen some IRD assessors treating a one-off loan provided by a Hong Kong intermediate parent company to its subsidiary as not a simple loan of money, merely because the Hong Kong intermediate company financed the loan via an interest-free loan obtained from its parent company. What is the legal basis for considering that such a one-off loan is not a simple loan of money?

The Institute sets out below 3 common intra-group loan arrangements:

**Scenario 1**: A Hong Kong company lends a one-off interest-bearing loan of HK$1 million to its subsidiary that is funded by its own surplus cash

**Scenario 2**: A Hong Kong company lends a one-off interest-bearing loan of HK$1 million to its subsidiary that is funded by an equity injection from its parent company

**Scenario 3**: A Hong Kong company lends a one-off interest-bearing loan of HK$1 million to its subsidiary that is funded by an interest-free loan borrowed from its parent company

In the Institute’s view, the loans in all of the above three scenarios are “simple loans of money” and, therefore, the “provision of credit” test should apply in all three scenarios. In particular, the Institute is of the view that, other things being the same, the mere fact that the loan is funded by an interest-free loan from the parent company should not affect the nature of the loan to the subsidiary as a simple loan of money. The Institute would like to understand whether the IRD agrees with the above analysis and, if not, the reasons / legal basis for not treating the above as simple loans of money.

In addition, the Institute has seen different practices adopted by different assessors in

considering whether a loan is a simple loan of money. For example, for loans with similar arrangements and loan features lent by different group companies (all investment holding companies) to other companies within the group, different tax treatments may apply because the cases are handled by different assessors. In this regard, the Institute would to ask whether the IRD would consider putting in place measures to minimise any inconsistencies.

Will similar factors as those listed in paragraph 9 of DIPN 52, and the benchmark set out in paragraph 10 of DIPN 52, for determining whether a corporation is carrying on an intra-group financing business, also be used to determine whether a taxpayer is carrying on a money lending business?

The IRD responded as follows –

(i) The term "simple loan of money" was not defined in the IRO. Whether the provision of a loan constituted a "simple loan of money" was a question of fact to be determined by the totality of the circumstances in each case. The IRD would take into account all the relevant facts, including the nature of the business carried on by the parties involved, how the money lending transaction was negotiated, concluded and carried out, the contractual terms of the loan, and whether the money lending transaction in question was part of an arrangement, or related to another transaction, in determining whether the loan could be regarded as a "simple loan of money".

In a case where a company was not carrying on the business of a financial institution, money lending or intra-group financing, the mere lending of its own surplus fund would, in general, be accepted as a "simple loan of money". In contrast, where the lending of a company's fund: (a) was made from borrowing; or (b) formed an integral part of its business, the lending would not normally be accepted as a "simple loan of money".

(ii) The fact that a loan was one-off did not necessarily mean that it should be a "simple loan of money", or that the operation test could not be applied to determine the source of the interest on the loan. It had to be emphasised that the operation test was not confined to a money lending business where frequent loan transactions were involved. As pointed out by the Privy Council in *Commissioner of Inland Revenue v Orion Caribbean Ltd (in voluntary liquidation)* [1997] HKLRD 924, where the money had to be borrowed before it could be lent, it would be surprising that regard should be had solely to the place of lending, to the exclusion of the place of borrowing. In the given case, the one-off loan provided by the Hong Kong intermediate company to its subsidiary would not be accepted as a "simple loan of money" as the lending was not made simply by the exploitation of money owned by it. Rather, the intermediate company borrowed a loan, regardless of whether it was interest-free or not, from its parent company for on-lending to the subsidiary.

(iii) In applying the legal authority and principle stated in the answer to Agenda

Item A1(f)(ii) above, and based on the limited facts provided in the question, the IRD's comments in relation to the three given scenarios were as follows:

**Scenario 1**: The one-off interest-bearing loan would be accepted as a "simple loan of money", as the Hong Kong company used its own surplus funds to finance the lending. Thus, the "provision of credit test" would be applicable.

**Scenario 2**: Provided that the equity injection did not involve any borrowing of money or any complex financing arrangement, the one-off interest-bearing loan would be accepted as a "simple loan of money", since the injected equity would be considered as the company's own funds. Thus, the "provision of credit test" would be applicable.

**Scenario 3**: The Hong Kong company's borrowing and on-lending of money to its subsidiary would generally not be accepted as a "simple loan of money". Thus, the operation test would be applicable.

(iv) As mentioned in the answer to item A1(f)(i) above, whether the provision of a loan constituted a "simple loan of money" was a question of fact to be determined by the totality of the circumstances in each case. Different tax treatments would be adopted for cases with different scenarios. It would not be possible, nor appropriate, to lay down a hard and fast rule. In any event, the IRD would apply the relevant legislative provisions and legal authorities in considering offshore claims of interest income, based on the facts of each case.

(v) Whether a company was carrying on a money lending business was a question of fact. The factors listed out in paragraph 9 of DIPN 52 were relevant but not conclusive in determining whether a company carried on a money lending business. It was worth noting that one of the indicia of a money lending business was that the company was willing to lend to all and sundry provided they were, from its point of view, eligible (see *Lichfield v Dreyfus* [1906] 1 KB 584 at page 589). Other relevant factors could be found in the Board of Review's decision in *D38/89*, 4 IRBRD 433. Given the legal principle in *Lichfield v Dreyfus*, the benchmark set out for intra-group financing business in paragraph 10 of DIPN 52 was inapplicable in determining whether a company carried on a money lending business.

Mr Yeung said that it seemed that the Department was mindful whether the lender used its own funds or funds borrowed from another person. In Scenario 3, if the lender used its own share capital, the outcome would have been very different from the current outcome as mentioned by the IRD above. Ms Michelle Chan said that the legal principle in the *Orion Caribbean* case should be followed. Both the place of lending and the place of borrowing were relevant. In the circumstance where it was not a simple loan of money, the operation test should apply. Mr Lean asked about the case of *Lichfield v Dreyfus*. Ms Michelle Chan explained that the principle drawn from the case was that in a money lending business, the lender should be willing to lend to all borrowers, so long as they had the financial capacity to repay the principal and interest of the loan. Lending money to related parties only could not constitute a money lending business.

Ms Grace Tang raised for discussion whether the outcome in Scenario 3 would be different if the parent company was cash-rich and had surplus funds, and it was not necessary for the Hong Kong company to borrow from outsiders. Ms Michelle Chan replied that the outcome would be the same since, in determining the source of profits, one should focus on the operations of the taxpayer and not the parent company. Ms Grace Tang said that since only an intra-group relationship existed, and there was no capitalisation of funds, the outcome should be similar to Scenario 1. Ms Michelle Chan said that, if it involved an equity injection from the parent company to the Hong Kong company, the case would be similar to Scenario 2. On the other hand, if it involved an injection of cash by the parent company to the Hong Kong company in the form of a loan, the case would be similar to Scenario 3. Ms Kathy Kun (Ms Kun) asked whether the outcome would be different if there were no repayment terms of the loan. Ms Michelle Chan said this would depend on the facts and circumstances of the case.

Mr Benjamin Chan said that the operation test would be the default test in determining the source of profits. It was only where the interest income was derived from a simple loan of money, the provision of credit test would apply. As regards what constituted a simple loan, the IRD's stance was that, if a company had surplus funds to lend to borrowers, the lending would be a simple loan and the provision of credit test would be applicable. However, if there was a need to finance the lending, this was not a simple loan and the operation test would apply. In determining the relevant test that was applicable, both the lending and the borrowing sides would be looked at. Mr Lean did not agree that the operation test was the default test, yet Mr Benjamin Chan noted that the operation test was consistently adopted by the courts in determining the source of profits. Mr Yeung considered that Scenarios 2 and 3 only differed in legal forms. He said that there was not good reason to result in different outcomes. Mr Wesley Leung said that a taxpayer was always free to decide how to structure the terms of the transactions to which the corresponding tax consequences would follow.

**(g) Tax concessions for certain shipping-related activities**

The recently-enacted Inland Revenue (Amendment) (Tax Concessions for Certain Shipping-related Activities) Ordinance 2022 added new sections 14ZD, 14ZM and 14ZV to the IRO, to provide for profits tax concessions to corporations that are respectively qualifying ship agents, qualifying ship managers and qualifying ship brokers (collectively, "qualifying shipping commercial principals").

One of the qualifying conditions under these new sections requires a qualifying shipping commercial principal to be a standalone corporate entity solely engaging in the relevant qualifying activity specified in the relevant part of Schedule 17FB to the IRO.

If a taxpayer undertakes specified activities falling within different parts of Schedule 17FB, it would apparently not be eligible for the tax concessions. The taxpayer may need

to rely on the safe harbour rule or obtain a Commissioner's determination.

As the name of the ordinance suggests, these activities are related and it is not uncommon for taxpayers to undertake these three categories of activities in a single entity. Such taxpayers may also not qualify for the safe harbour rules, which require at least 75% of their total profits derived from, and total assets used for, the relevant qualifying activity.

Instead of advising taxpayers to restructure their businesses to qualify for the tax concessions, the Institute would like to know whether there are any plans to amend the IRO to address the aforesaid situation. Furthermore, would the IRD, as an interim measure, consider granting tax concessions to such taxpayers provided that they satisfy all the other qualifying conditions?

The IRD responded as follows –

- The Inland Revenue (Amendment) (Tax Concessions for Certain Shipping-related Activities) Ordinance 2022 had incorporated certain anti-abuse features so as to safeguard the integrity of the tax system and comply with international tax rules. One of the anti-abuse features was the adoption of an entity-based approach, requiring a qualifying shipping commercial principal to be a standalone corporate entity predominantly engaging in relevant qualifying activity (i.e. a qualifying ship agency activity, qualifying ship management activity or qualifying ship broking activity), to prevent loss transfer via partnership and ring fence the tax benefits to the corporate entity. That said, to provide flexibility, safe harbour rules had been put in place, to allow a qualifying shipping commercial principal to engage in other non-qualifying profit generating activities, subject to specified limits (i.e. the percentage of profits and assets related to those activities should be not more than 25% of its aggregate profits and assets).
- Any amendments to the safe harbour rules would call for a policy change and require careful consideration. At present, the IRD was bound to apply the existing safe harbour rules.

Mr Fernandes said he understood that the granting of tax concessions under preferential regimes had to be accompanied by anti-avoidance measures. However, from a commercial point of view, not all activities were carried out by a single entity. He asked whether the IRD would adopt a pragmatic approach in respect of the safe harbour rule, given that the profits in recent years might fluctuate due to Covid-19. Mr Benjamin Chan said he fully understood the concerns of industry from a commercial perspective. However, the separate entity concept followed the design of other preferential tax regimes. The safe harbour rule already provided certain leeway, if the prescribed conditions were met. The IRD was bound to follow the design mechanism of the regime. Unless warranted by exceptional circumstances, such as where the rules were considered not applicable, the IRD would adopt the Commissioner's determination approach. Responding to a question from Ms Sarah Chan, Mr

Benjamin Chan confirmed that, if a taxpayer was in doubt, advance ruling could be applied for.

**(h) Penalty imposed under a tax audit case**

The Institute understands that it is the practice of Unit 4 of the IRD to impose a penalty with reference to the commercial restitution, which effectively takes into account the time value of money forgone as a result of the "delay" in tax collection, in tax audit cases. However, due to the special working arrangements during the COVID-19 pandemic over the past three years, IRD officers were not always able to conduct tax audit reviews efficiently, causing certain delays in the tax collection process.

As these delays were not solely caused by the taxpayers, will the IRD take this into account when calculating the penalties and/or the commercial restitution?

The IRD responded as follows –

- In the past few years, Hong Kong's economy had continued to suffer from the impacts of the unstable local epidemic situation. To reduce the flow of people and social contacts in the community, so as to curb the further spread of the Covid-19 virus, the IRD had urged members of the public to use electronic services and implemented a work-from-home arrangement intermittently to protect the health of the IRD staff. For the Field Audit and Investigation Unit, extra efforts were made to put in place special measures to monitor the case progress and minimise the adverse impact due to the postponement or cancellation of meetings with taxpayers and their representatives. Active communications with taxpayers and their representatives could still be maintained through correspondence, phone call, email or facsimile. In cases where discussion was considered necessary, teleconferences were arranged, to explain the proposed basis of settlements, clarify doubtful areas and enable different parties to exchange views. According to the IRD's statistics, most, if not all, of the field audit and investigation cases could be processed within a reasonable time, although special work arrangements had been implemented intermittently during the past three years.
- According to paragraph 2 under Part D of the Penalty Policy Statement involving field audit and investigation cases, the scale of any penalty to be imposed on a taxpayer was basically a function of the nature of omission or understatement of income or profits, the degree of his/her co-operation or disclosure and the length of the offence period. For cases completed after 30.11.2003, the Commercial Restitution (C.R.) stood at 7% per annum, monthly compounded for periods up to and including 30.11.2003, and at the best lending rate monthly compounded for periods after 30.11.2003. The purpose of computing compound interest was to compensate the HKSAR Government for the loss of the use of the money.
- The percentages in the penalty loading table of the Penalty Policy Statement

were for general guidance only. The compound interest computed at C.R. should be regarded as only one of the factors in determining the amount of penalty to be imposed. The penalty imposed might be adjusted upwards or downwards, depending on the facts and circumstances of each case. Some of the aggravating and mitigating factors to be considered by the Commissioner in determining the ultimate penalty were listed in the Penalty Policy Statement.

- During the time of the Covid-19 epidemic, some taxpayers and their representatives might be stranded overseas or in the Mainland, due to, e.g., tight border controls or cancellation/suspension of flights, and so could not provide the required information and documents on a timely basis. Such delays were not uncommon at that time and, depending on the particular circumstances and facts of each case, might be taken as a mitigating factor by the Assessor, when computing and recommending the quantum of final penalty for the Commissioner's consideration.

## Agenda Item A2 - Salaries Tax Issues

### (a) Employees working remotely overseas or in the Mainland of China (the Mainland)

Remote working arrangements are increasingly prevalent among today's workforce. These include long-term remote working arrangements whereby an individual is employed by a Hong Kong employer but resides overseas, or in the Mainland. In this regard, the Institute would like to confirm whether the IRD agrees to the tax treatment in the example below, in relation to remote working arrangements outside Hong Kong.

**Example**

***Background***

- An individual is a tax resident of the Mainland and is subject to tax in the Mainland on his income, in accordance with the comprehensive avoidance of double taxation arrangement between the Mainland and Hong Kong (Mainland-HKSAR DTA). He does not qualify as a Hong Kong tax resident.
- The individual is employed by a Hong Kong resident employer who pays the individual's remuneration into his bank account in the Mainland.
- The individual works primarily remotely and resides in the Mainland, but also agrees with his employer that he will travel to Hong Kong each quarter and work in Hong Kong for, say, 80 days a year.

***Tax treatment***

- The individual does not qualify for full exemption from Hong Kong salaries tax under section 8(1A)(b) and section 8(1B) of the IRO, as he renders part of his services in Hong Kong and visits Hong Kong for more than 60 days during the YA.
- The individual does not qualify for full exemption under paragraph 2 of Article 14 of the Mainland-HKSAR DTA, as his employer is resident in Hong Kong.
- Pursuant to paragraph 1 of Article 14 of the Mainland-HKSAR DTA, "…salaries, wages and other similar remuneration derived by a resident of [the Mainland] in respect of an employment shall be taxable only in [the Mainland] unless the employment is exercised in [Hong Kong]. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in [Hong Kong]".
- The OECD commentary in this regard sets out that, "Paragraph 1 establishes the general rule as to the taxation of income from employment (other than pensions), namely, that such income is taxable in the State where the employment is actually exercised… Employment is exercised in the place where the employee is physically present when performing the activities for which the employment income is paid…" (page C(15)-1 of Model Tax Convention on Income and on Capital 2017).
- Applying paragraph 1 of Article 14 of the Mainland-HKSAR DTA, the individual should be subject to salaries tax only on income derived from the 80 days of employment exercised in Hong Kong.

The IRD responded as follows –

- The individual had an employment that was sourced in Hong Kong. His income did not qualify for exemption under section 8(1A)(b)(ii), as read with section 8(1B), as he would work in Hong Kong during his stays in Hong Kong that exceeded a total of 60 days in a year of assessment. Further, his remuneration derived from the employment might be taxed in Hong Kong under Article 14 of Mainland-HKSAR DTA because: (a) the employment was to be exercised in Hong Kong (see paragraph 1 of Article 14); and (b) his remuneration was paid by a Hong Kong resident employer (i.e. paragraph 2(2) of Article 14 is not satisfied).
- On the facts now available, Hong Kong had a taxing right over the individual's remuneration, but only to the extent that the remuneration was derived from the exercise of employment in Hong Kong. As such, only the income attributable to his services rendered in Hong Kong should be taxable in Hong Kong, despite the fact that his employment was sourced in Hong Kong.
- It was, however, pertinent to note that as the individual also worked in the Mainland, he had the primary obligation to report his tax position to the relevant tax authority therein, inter alia, on the application of Mainland-HKSAR DTA in the present case.

Mr Anthony Chan said he wanted to confirm the understanding that, since the individual rendered part of his services in Hong Kong and had visited Hong Kong for more than 60 days during the year of assessment, time apportionment would not be allowed, but for the provisions of the Mainland-HKSAR DTA. Ms Marina Tang reiterated that Hong Kong would tax the individual's income to the extent of his remuneration as was derived from Hong Kong, i.e., income attributable to 80 days of employment exercised in Hong Kong. Mr Anthony Chan then asked about the application of time apportionment to Hong Kong employment in general. Mr Benjamin Chan said that time-apportionment of income was generally not applicable to a Hong Kong employment. However, the present case involved a Mainland resident having exercised his employment in Hong Kong. Thus, the provisions of the Mainland-HKSAR DTA needed to be observed.

**(b) Reimbursement of relocation expenses**

According to paragraph 19 of DIPN 41 – Taxation of holiday journey benefit, the payment ***made*** by an employer for the relocation of an employee and his family in or out of Hong Kong, upon assumption of a new post or termination of an existing post here, as the case may be, would be outside the scope of the charge to salaries tax. For any such trips, any stopover visits to another place en route to or from Hong Kong would be disregarded as a concession.

The Institute would like to clarify whether the term "made", as used above, would also

cover a reimbursement of such relocation expenses from the employer to the employee.

The IRD responded as follows –

- By virtue of section 9(1)(a) of the IRO, all perquisites, whether derived from the employer or others, were included as income from an office or employment and were thus chargeable to salaries tax. Section 9(1)(a)(iv) provided an exception in that any amount paid by the employer to a third party in discharge of the employer's own contractual liability was not to be included as the employee's income. Section 9(2A)(c) of the IRO, however, provided that the exemption under section 9(1)(a)(iv) would not apply where any amount paid by an employer was in connection with a holiday journey. The term "holiday journey" was defined in section 9(6) of the IRO as either "a journey taken for holiday purposes", or "where a journey is taken for holiday and other purposes, that part of the journey taken for holiday purposes".
- Paragraph 19 of DIPN 41 sought to clarify that any payment made by an employer in connection with a journey which was not for holiday (e.g. a journey to or out of Hong Kong upon assumption of a new post or termination of an existing post) was excluded from the charge to salaries tax. The exclusion was provided under section 9(1)(a)(iv), which only applied to payment made by the employer in discharge of its own liability. It did not apply to a reimbursement made by an employer for relocation expenses incurred by an employee. Relocation expenses incurred by an employee were domestic or private in nature. Further, reimbursement made by an employer would be in discharge of the personal liability of the employee. On the authority of *CIR v Humphrey* [1970] 1 HKTC 451 and *David Hardy Glynn v CIR* [1990] 3 HKTC 245, such reimbursement should be taxable as a perquisite under section 9(1)(a).

Ms Gwenda Ho (Ms Ho) asked whether an employee's air ticket expenses would be considered as domestic in nature, if the purchase cost was paid by him/her initially, and was subsequently reimbursed by the employer. Ms Marina Tang said that the focus was not on whether the expenses were domestic in nature. In the event that an employer purchased and paid for an employee's air ticket directly, the employer would be discharging its own contractual liability. If an employee purchased and paid for the air ticket, and was subsequently reimbursed by the employer, this would constitute a discharge of the employee's personal liability and the reimbursement would be chargeable to salaries tax. CIR said that it was necessary to look at the contractual obligations, such as whether the payment for the air ticket was the employer's liability, and whether the invoice of the air ticket was issued to the employer. Mr Yeung agreed with CIR's view and said that the crux of the matter was to look at who had the liability to pay for the air ticket. He considered it essential to look at the employment contract. Mr Benjamin Chan commented that one could not just focus on the employment contract, but to examine the actual operations and contractual obligations to ascertain whether the expenses were the liability of the employer or the employee.

Mr Anthony Chan asked whether the air fares were deductible on the basis that the

amounts paid should not be capital in nature. Mr Benjamin Chan said air fares for relocation would not be considered as being incurred in the production of assessable income. CIR reminded practitioners that, if the employment contract had already provided that the air fares were to be borne by the employer, it would be better for the employer and employee to stick to the original arrangement to avoid dispute with the IRD.

**(c) Facilitating measures with respect to filing of employer's returns under the Top Talent Pass Scheme**

As the Immigration Department has introduced the Top Talent Pass Scheme through which a successful applicant can work in Hong Kong without securing a job offer with a local sponsor in advance, there may be an increasing number of foreign talents working in Hong Kong whose employers do not have any business presence in Hong Kong. Will the IRD consider any measures to facilitate the filing of Employer's Returns by the aforementioned overseas employers, or waiving the filing requirements for such Employers' Returns?

The IRD responded as follows –

- An employer who employed in Hong Kong an individual who was, or was likely to be, chargeable to salaries tax was required to furnish an Employer's Return of Remuneration and Pensions (Employer's Return), and report, among others, details of the remuneration paid to that employee in the relevant year of assessment. The employer might file the Employer's return in (a) paper form by post or in person; or (b) electronic records through the Employer's Return e-Filing Services under the IRD's e-TAX system.
- An overseas employer that did not have business presence in Hong Kong might electronically file the Employer's Return, which was considered more convenient, cost-effective and environment-friendly.
- To make use of the Employer's Return e-Filing Services, an authorised signer of the employer, whether a Hong Kong or non-Hong Kong resident, should first sign up for a personal e-TAX account. Upon successful application, a set of Tax Identification Number and Access Code would be issued to the authorised signer, through which he / she could register his / her e-TAX account, and then complete, sign and file the Employer's Return online. An authorised signer referred to a person in any one of the following capacities: (a) proprietor of a sole proprietorship; (b) precedent partner of a partnership; (c) company secretary / manager / director / investment manager (only applicable to a corporation that was an open-ended fund company) / provisional liquidator / liquidator of a corporation; (d) principal officer of a body of persons; (e) agent of a non-resident person.

- With the increase in awareness of businesses to go electronic in recent years, the present arrangements for the filing of Employer's Return in electronic form were feasible for employers located in Hong Kong or elsewhere.
- There was no waiving of the filing requirements for overseas employers that did not have business presence in Hong Kong, as all employers, irrespective of whether they were Hong Kong or non-Hong Kong resident, or whether they had a business presence in Hong Kong, were required to comply with the same requirements.
- Separately, it should be remembered that section 51(2) of the IRO provided that every person who was chargeable to tax for any year of assessment should inform the Commissioner, in writing, that he/she was so chargeable, not later than 4 months after the end of the basis period for that year of assessment (i.e., on or before 31 July, for a salaries tax case). Hence, any successful applicant under the Top Talent Pass Scheme who worked in Hong Kong should inform the Commissioner of his/her chargeability to tax, in writing, within the stipulated time. Failure to do so might result in a heavy penalty.

Mr Anthony Chan asked whether a non-Hong Kong employer was required to file an Employer's Return, and if necessary, how to file the Employer's Return in practice. Ms Marina Tang said an overseas employer which had employees in Hong Kong would be required to file an Employer's Return. The employer had to first notify the IRD of its name, correspondence address and the employees' details. Since the employer would not have a file number, a dummy number would be allotted, and an Employer's Return would then be issued.

Mr Yeung asked whether an overseas employer would be taken as having a permanent establishment (PE) in Hong Kong, such that it would need to obtain a business registration. Mr Benjamin Chan said that whether an overseas employer was required to obtain a business registration depended on whether it carried on a business in Hong Kong. If the overseas employer had a PE in Hong Kong and carried on business in Hong Kong through the PE, it would be required to apply for business registration. Having employees stationed in Hong Kong was not a conclusive factor, and would not automatically give rise to profits tax implications for the overseas employer. Ms Grace Tang asked whether a secondment would mitigate the issue. Mr Benjamin Chan reiterated that whether an overseas employer had employees in Hong Kong, irrespective of how the employees were engaged (through direct employment in Hong Kong, or secondment from other territories), was only one of the factors to be considered in determining whether the employer had a PE in Hong Kong. In any case, if an overseas employer had engaged any employee under a secondment in Hong Kong, it would be required to file Employer's Return for the secondee.

## Agenda Item A3 – Transfer pricing (TP)

**(a) Whether capital assets qualifying for depreciation allowances can be transferred at below market price and avoid being adjusted by the IRD by relying on section 50AAJ of the IRO**

Would the IRD advise, where capital assets that qualify for depreciation allowances (e.g., plant and machinery) are transferred 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, is it the case that, provided that the conditions of section 50AAJ are satisfied, CIR would not invoke section 38B of the IRO to adjust the actual transaction price?

The IRD responded as follows –

- Section 50AAF of the IRO required the computation of income or loss from transactions with associated persons on the basis of the arm's length provision, instead of the actual provision, for tax purposes. However, section 50AAJ(2) sought to exempt domestic transactions between associated persons from the application of section 50AAF provided that the no actual tax difference condition or the non-business loan condition was met, and the actual provision did not have a tax avoidance purpose.
- Section 38B of the IRO, on the other hand, expressly provided that where an asset which qualified for initial or annual allowances was sold, and the seller controlled the buyer, or vice versa, or both were under common control, or the sale was between a husband and wife, the Commissioner should, if he was of the opinion that the sale price of such asset did not represent its true market value at the time of such sale, determine such true market value, and the amount so determined should be deemed to be the sale price of such asset for the purpose of calculating the allowances and charges provided for in Part 6 of the IRO.
- Sections 38B and 50AAJ(2) were two separate provisions and were to apply under different conditions. There was no provision under the IRO which provided that section 38B would not be applicable where the conditions under section 50AAJ(2) were satisfied. That was to say, the Commissioner could invoke section 38B to adjust the sale price for the purpose of calculating the capital allowances and charges, if the circumstances warranted.

**(b) Information exchange for overseas TP audit**

The intercompany pricing of multinational corporations with related party transactions between Hong Kong subsidiaries and overseas affiliates will be scrutinised by both the IRD and the overseas tax authorities. We have seen some cases where an overseas

tax authority launched a TP audit on the overseas affiliate and indicated that they may launch a request for information in Hong Kong through the IRD.

The Institute would like to ask whether, in practice, the IRD received such information requests from overseas tax authorities for the purpose of an overseas TP audit and, if so, under what conditions the IRD would share the taxpayer's information with the overseas tax authority. Further, would you notify taxpayers in Hong Kong what information has been shared with overseas tax authorities?

The IRD responded as follows –

- Exchange of information (EOI) was an essential tool for tax authorities worldwide to detect and prevent cross-border tax evasion and avoidance, and to foster local tax compliance.
- Hong Kong had made use of comprehensive avoidance of double taxation agreements/arrangements, tax information exchange agreements and the Convention on Mutual Administrative Assistance in Tax Matters (collectively the EOI Instruments) as instruments for EOI with other jurisdictions. The IRD did receive requests from tax authorities outside Hong Kong under the EOI Instruments for information involving TP issues.
- Where an EOI Instrument was in force between Hong Kong and a tax jurisdiction outside Hong Kong, if a tax official from that jurisdiction needed information in the course of a tax examination or audit but such information was not available within that jurisdiction and appeared to be available in Hong Kong, the competent authority of that jurisdiction might lodge a request under the EOI Instrument to the competent authority of Hong Kong for such information. If the competent authority of Hong Kong was satisfied that the information requested was foreseeably relevant to the administration or enforcement of the tax laws of the requesting jurisdiction, for periods after the relevant provisions of the EOI Instrument became effective, Hong Kong was obliged to gather and exchange information in accordance with the provisions of the EOI Instrument. Example 3 in the Departmental Interpretation and Practice Notes No. 47 was a scenario relating to the foreseeable relevance issue under a TP audit.
- The Inland Revenue (Disclosure of Information) Rules (Cap. 112BI) (Disclosure Rules) provided a set of fair procedures to protect the confidentiality and privacy right of taxpayers in Hong Kong. Under the Disclosure Rules, unless in exceptional circumstances, the Commissioner was obliged to notify the person, who was the subject of a disclosure request, of the nature of the information requested and that person might request a copy of the information that the Commissioner was prepared to disclose or had disclosed (as the case might be) to the requesting jurisdiction. The Commissioner was not required to notify that person only if he had reasonable grounds to believe that all the known addresses of that person were inadequate for the purpose for giving the notification, or that the notification was likely to undermine the chance of success of the investigation

in relation to which the request was made (which in practice was advised by the requesting jurisdiction).

Mr Fernandes asked whether the taxpayer concerned in an EOI request would be notified by the IRD of the information requested and had the opportunity to review the information. Mr Steven Tsui said that the Disclosure Rules provided for a notification and review system under which, unless in exceptional circumstances, the relevant taxpayer would be given the right to be informed about the information to be, or which had been, disclosed, and the right to request amendment if the said information did not relate to him or was factually incorrect. As mentioned above, there would be no notification only if the known addresses of the taxpayer were inadequate or the notification would likely undermine the chance of success of the investigation.

Mr Fernandes said he could not find any published data on the implementation of EOI on request, but noted that there were published data on the implementation of Automatic Exchange of Financial Account Information and Mutual Agreement Procedure. He invited the IRD to consider publishing data on EOI requests. Mr Benjamin Chan said that the OECD did not publish data on EOI requests, and the IRD simply followed the OECD's practice. He remarked that certain statistical data on EOI requests handled by the IRD were available in the peer review report on EOI on request in respect of Hong Kong, published by the Global Forum on Transparency and Exchange of Information for Tax Purposes.

Ms Ho commented that from time to time, taxpayers would receive formal notices from the IRD requesting the provision of information but the Assessor would not disclose the reason behind the IRD's request for such information (e.g. whether the information requested was initiated by an EOI request). Ms Canice Chan explained that Assessors were empowered to collect information for local tax purposes and/or foreign tax purposes. Pursuant to the confidentiality provisions of the EOI instruments, the IRD was obliged to treat information contained in correspondence with EOI partners as strictly confidential. In accordance with the international standard, the IRD could disclose only the minimum information contained in an EOI request to taxpayers to enable the collection of the requested information. Mr Fernandes commented that information to be collected for an EOI request should be foreseeably relevant rather than just a "fishing expedition". Ms Canice Chan said it was prescribed in the Disclosure Rules that an EOI request should contain, among other things, particulars demonstrating the relevance of the information requested. An EOI request would not be approved unless the competent authority of Hong Kong was satisfied that the standard of "foreseeable relevance" was met.

Mr Peter Tisman (Mr Tisman) asked whether it was common for foreign competent authorities to request waiving notification to the taxpayer. Ms Canice Chan said such requests had been encountered before, while most of the EOI requests went through the normal notification process. Mr Fernandes asked whether the number of EOI requests had increased in the past year. Ms Canice Chan responded that the number of EOI requests had dropped during the period of the COVID-19 pandemic, but had now risen back to normal.

**Agenda Item A4 – Foreign-sourced income exemption (FSIE) regime**

**(a) Economic substance requirements (ESR)**

(i) In assessing the ESR, the Institute would like to ask for further information regarding:

A. the expected approach and frequency of conducting reviews of the adequacy of the economic substance and the performance of the specified economic activities in Hong Kong by taxpayers; and

> The IRD responded that, if a taxpayer wished to make a claim for FSIE on the grounds that the ESR were complied with, it should provide the required information in its tax return and relevant supplementary form. Similar to other deduction or exemption claims, the IRD would select some (not all) FSIE claims for desk-based reviews and audits every year. There was no specified frequency for the reviews and audits of FSIE claims.

B. whether board minutes with brief descriptions summarising the discussion of the strategic decisions made would be sufficient for the purposes of a review, and other evidence required by the IRD (if any).

> The IRD responded that the minutes of the board meetings recording the discussion on making and managing investments in Hong Kong could be accepted as a sufficient proof that the multinational enterprise (MNE) entity had made strategic decisions, as well as managed and borne principal risks in respect of the relevant assets in Hong Kong. However, the entity also needed other supporting evidence to substantiate that the other parameters of the ESR (e.g. number of qualifying employees employed and amount of operating expenses incurred in Hong Kong) were satisfied.

(ii) The Institute understands that it is the IRD's position that no double counting of qualifying employees / human resources of an entity to which relevant activities are outsourced is allowed in assessing whether the number of qualifying employees/ human resources is adequate. However, it is common for the qualifying employees/ human resources of an outsourced entity to be shared among outsourcing entities within the group to perform the specified economic activities. In such circumstances, the Institute would like to ask how the IRD will assess the adequacy of qualifying employees; for example, an indication of a range of values and/or a proportional formula (if applicable) would be helpful.

> The IRD responded that whether the adequacy test was met with no double counting was not a pure arithmetic question. The average number of employees per outsourcing entity could be a good starting point, but due regard should also be made to the size and nature of assets held by each outsourcing entity, the amount of

specified foreign-sourced income earned by the entity and the complexity of specified economic activities required to be performed for each entity. Generally, in handling the cases involving "shared outsourced entity", the IRD would first request an explanation on the operation of the outsourcing arrangement. Documentary evidence would only be called for where the circumstances warranted it. If MNE entities wished to obtain upfront certainty on the acceptability of outsourcing arrangement, they were encouraged to apply for an advance ruling.

(iii) Under the FSIE regime, the reduced ESR applies to a pure equity holding entity (PEHE) and one specified economic activity under the reduced ESR is "holding and managing equity participations". However, it seems that, if an entity holds both equity participations and a loan, it would be a non-PEHE and the normal ESR would apply. Could the IRD provide examples of what activities would satisfy the "holding and managing equity participations" of a PEHE, and the difference in ESR between these examples and a non-PEHE.

The IRD responded as follows –

- In assessing whether a PEHE satisfied the reduced ESR, the IRD would take into account the actual operation and commercial reality of the entity. Generally, the specified economic activities of a PEHE included exploring investment opportunities, evaluating feasibility of investments, making decisions on the holding and selling of equity interests, monitoring investment performance, calculating risks, and reviewing or revising financing arrangement for acquiring equity interests.
- For a non-PEHE, the entity could acquire, hold, manage or dispose of any assets (not just equity interests). For example, where a non-PEHE engaged in lending of loans, its specified economic activities include analysing the creditability of the borrower, monitoring the borrower's fulfilment of obligations to pay interest and make repayment of principal, and taking enforcement actions against the borrower in case of default.

**(b) Corporate Income Tax (CIT) levied at both federal and state/regional levels**

Some jurisdictions levy CIT at both federal and state/regional levels. A case in point is Switzerland, which levies a federal CIT at a flat rate of 8.5% and each canton (region) levies cantonal and communal CITs at varying rates. In such cases, what does the "applicable rate" refer to:

(i) the highest corporate tax rate levied at the federal level only; or
(ii) the aggregate of the highest corporate tax rate levied at the federal level and the relevant cantonal (regional) level; or
(iii) the actual tax rate imposed on the relevant income or profits?

The IRD responded that, for the purposes of the "subject to tax" condition under the participation exemption, section 15N(9) of the IRO defined the "applicable rate" to mean the rate of a "similar tax" applicable to the foreign-sourced income concerned. As defined in section 16(2I)(b), "similar tax" meant a tax that is of substantially the same nature as profits tax under the IRO. In ascertaining the applicable rate in cases where an income or profits of an entity was or were taxed at both federal and state/regional levels, the IRD would take the applicable rate as the aggregate of respective headline tax rates at the federal level and the state/regional level (i.e. method (ii) above) provided that both taxes levied at different levels were of substantially the same nature as Hong Kong profits tax.

**(c) Condition of "Received in Hong Kong"**

The Institute would like to know whether certain interpretations similar to those applied in Singapore regarding what constitutes "received" in respect of foreign-sourced income would be adopted by the IRD under Hong Kong's FSIE regime.

(i) If an MNE entity has a mixed pool of funds kept in an overseas bank account, comprising specified foreign-sourced income ("SFSI") and non-SFSI funds, including capital funds, will the IRD adopt a similar approach to that adopted by Singapore in determining whether the SFSI from the mixed pool is remitted to Hong Kong or not?

The IRD responded as follows –

- An MNE entity was encouraged to keep sufficient records to track and trace the SFSI for determining whether the income should be regarded as received in Hong Kong under section 15H(5) of the IRO.
- Having said that, the IRD recognised that an MNE entity may, for some practical reasons, need to place its SFSI in an overseas bank account comprising non-SFSI funds. Given the fungible nature of funds and practical difficulties encountered by an MNE entity in identifying SFSI funds from the bank account, the IRD was prepared to adopt a pragmatic approach to determine whether a remittance from a mixed pool of funds included any SFSI, as follows:
  - (a) The MNE entity should ascertain the balance of SFSI funds ("Balance A") and the balance of non-SFSI funds ("Balance B") kept in the overseas bank account immediately before the remittance was made.
  - (b) Where the MNE entity withdrew a fund from the bank account—
    - (i) If the fund was used to satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong, or to buy outside Hong Kong any movable property which was intended to be brought into Hong Kong, it was presumed that the fund was first sourced from the non-SFSI funds (i.e. Balance B). If Balance B was not adequate to cover the fund, the excess of the fund over Balance B

would be regarded as sourced from the SFSI funds (i.e. Balance A);

(ii) If the fund was used for purposes other than those mentioned in (b)(i), it was presumed that the fund was first sourced from the SFSI funds (i.e. Balance A). If Balance A was not adequate to cover the fund, the excess of the fund over Balance A would be regarded as sourced from the non-SFSI funds (i.e. Balance B).

(c) When a remittance was made—

(i) If the amount of the remittance was no more than Balance B, no specified foreign-sourced income would be regarded as remitted to Hong Kong;

(ii) If the amount of the remittance was more than Balance B, the excess of the remittance over the amount of Balance B would be regarded as SFSI remitted to Hong Kong.

**Illustrative example**

Company-HK derived SFSI of F$60 and F$40, and other income of F$20 and F$30, in Year 1 and Year 2 respectively. All income was deposited into an overseas bank account. In Year 2, Company-HK used the funds in the bank account to satisfy debts of F$20 and F$30, incurred in respect of its trades carried on in and outside Hong Kong, respectively. Afterwards, Company-HK remitted F$80 from the bank account to Hong Kong.

The extent of the remittance sourced from the SFSI was determined as follows:

| | Balance A | Balance B | Total |
|---|---|---|---|
| | F$ | F$ | F$ |
| **Year 1** | | | |
| SFSI deposited into the account | 60 | -- | 60 |
| Other income deposited into the account | -- | 20 | 20 |
| | 60 | 20 | 80 |
| **Year 2** | | | |
| SFSI deposited into the account | 40 | -- | 40 |
| Other income deposited into the account | -- | 30 | 30 |
| | 100 | 50 | 150 |
| Less: Discharge of debt in respect of trade carried on in Hong Kong | -- | (20) | (20) |
| Discharge of debt in respect of trade carried on outside Hong Kong | (30) | -- | (30) |
| | 70 | 30 | 100 |

| Less: Remittance to Hong Kong | (50) | (30) | (80) |
| --- | --- | --- | --- |
| | 20 | -- | 20 |

Out of the remittance of F$80, F$50 would be regarded as SFSI received in Hong Kong.

(ii) Will the IRD adopt the approach that a passive investment holding company would not be regarded as carrying on a trade or business for the purposes of the FSIE regime? As such, the use of foreign-sourced income, say, in the form of dividends, by such a company to settle its overseas professional fees and interest expenses would not constitute the company receiving the unremitted foreign-sourced income in Hong Kong. If so, would the IRD consider providing guidance on what constitutes a passive investment holding company?

The IRD responded that whether an entity carried on a trade or business was a question of fact. It was well established that "carrying on" of a business implied a repetition or series of acts (not just a single transaction) in the pursuit of a commercial gain: *DEF v CIT* [1961] 27 MLJ 55 at 59B-C. It usually called for some activity on the part of the taxpayer and a gainful use of its property: *American Leaf Blending Co Sdn Bhd v DGIR* [1979] AC 676 at 684C–D. In general, it would be very difficult for an investment holding entity to establish that its acquisition, holding and selling of assets were not activities on its part and did not constitute a gainful use of assets, even though such activities might not be substantial.

**Agenda item A5 – Departmental Policy and Administrative Matters**

**(a) IRD's plan on electronic filing (e-filing) of profits tax returns**

The Institute understands that the IRD aims to implement mandatory e-filing of profits tax returns by MNEs, through the newly developed tax portals, from 2025 and the ultimate goal is to achieve full-scale implementation of mandatory e-filing by 2030.

To facilitate early planning by taxpayers and tax representatives, it would be helpful if the IRD would provide a more definite timeline and also indicate which entities will be in scope for 2025; in particular, could the IRD advise whether the IRD will follow the threshold under Country-by-Country Reporting in defining the in-scope MNEs.

The IRD responded as follows –

- As mentioned in Agenda Item B2(b) of the 2021 Annual Meeting and Agenda Item A5(b)(i) of the 2022 Annual Meeting, the IRD was actively taking forward the project on e-filing of profits tax returns (the e-Filing Project) by phases. This year, the IRD had already enhanced the existing eTAX services to enable more corporations and businesses (excluding sole-proprietorship businesses) to voluntarily e-file their profits tax returns together with financial statements and tax computations in inline eXtensible Business Reporting Language (iXBRL) format. The implementation of mandatory e-filing would be initiated by phases, starting with large MNEs first and then progressing to small and medium-sized entities. The ultimate goal of the IRD was to achieve full-scale implementation of mandatory e-filing by 2030.
- Section 51AAB of the IRO allowed the Commissioner to specify, through subsidiary legislation in a gazette notice, the classes or descriptions of taxpayers who had to furnish their tax returns in the form of an electronic record. Before the implementation of mandatory e-filing, the IRD would gauge views from stakeholders for formulating the subsidiary legislation, which would be subject to negative vetting by the Legislative Council.
- In mapping out the scope of taxpayers for the first phase of mandatory e-filing, the IRD would make reference to the threshold requirement for filing a Country-by-Country Return. That was, an MNE group whose annual consolidated group revenue for the preceding accounting period reached at least EUR 750 million would be in-scope for the first phase of mandatory e-filing. This specified threshold was similar to the one in the global anti-base erosion (GloBE) rules under Pillar Two of the BEPS 2.0 proposals, which targeted MNE groups with an annual consolidated group revenue equivalent to or exceeding EUR 750 million in at least two of the previous four fiscal years. It was expected that such MNE groups, which had already got used to e-filing their Country-by-Country Returns and would likely be required to e-file the coming GloBE Information Returns in future, would have more resources to adapt to

the new iXBRL filing requirements.

- As regards the implementation timeline, the IRD proposed to implement the mandatory e-filing of profits tax returns by in-scope MNEs, starting from the year of assessment 2025/26. This would allow MNE groups to have sufficient time to get familiar with the new iXBRL filing requirements after the roll-out of voluntary e-filing in 2023 and ensure smooth transition to mandatory e-filing.
- The IRD planned to consult stakeholders, including the Institute, on the implementation plan in the second half of 2023, so as to allow MNE groups to make early preparations. The IRD aimed at introducing a piece of subsidiary legislation into the Legislative Council in the first quarter of 2024. Meanwhile, the IRD would continue reviewing the voluntary e-filing services and listening to stakeholders' feedback. Taking this opportunity, the IRD would like to appeal to the Institute to encourage its members to participate in voluntary e-filing this year. Any feedback from the Institute was always welcome.

Ms Grace Tang asked about the kind of early preparation that was in place. Mr Lean said taxpayers were concerned about how the GloBE rules would be implemented in Hong Kong. He commented that companies needed to know whether they would be regarded as being located in Hong Kong from the perspective of the GloBE rules. In this regard, the issue of whether a general definition of "Hong Kong tax resident" had to be provided in the IRO was relevant and should be decided early.

Ms Michelle Chan said that consultation with MNE groups on Pillar 2 would start in due course. Mr Benjamin Chan explained that the Government aimed to consult the industry on its implementation plan, covering the domestic minimum tax (DMT), GloBE rules and relevant filing requirements in the second half of 2023. He added that the IRD would discuss with the Financial and Treasury Services Bureau on how best the consultation could be conducted. Indeed, the OECD had not yet finalised all the administrative guidance in relation to the GloBE rules; and the IRD aimed to align the design of the DMT with the GloBE rules. Further, given that the MNE groups subject to the GloBE rules would be the target of the first phase of mandatory e-filing, the IRD would try to consult the industry on the implementation plan for both the GloBE rules and mandatory e-filing at the same time.

**(b) Lodgement of profits tax returns and filing deadlines for 2022/23**

The Institute would ask the IRD to share the latest statistics on tax return filing and information on the 2022/23 tax filing deadlines.

Four tables at Appendix A showed the lodgement statistics for 2021/22 Profits Tax Returns in respect of corporations and partnerships.

- Table 1 showed that the IRD issued some 21,000 more returns in the 2021/22 bulk issue exercise, and that some 24,400 returns were not filed by the due dates.

- Table 2 showed the filing position under different accounting date codes.
- Table 3 showed the progressive filing results. Upon request from the industry last year, the filing deadlines for 2021/22 returns were further extended to 30 September 2022 and 30 November 2022 for "D" code and "M" code respectively. Though there were improvements in the lodgement rates for "D" code returns (from 75% to 90%) and "M" code returns (from 74% to 78%) by the deadline, the overall performance was still far from satisfactory. The graduated lodgement rates worsened and were significantly below the lodgement 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 2022/23 Profits Tax Returns

The 2022/23 Profits Tax Returns for "active" files were bulk-issued on 3 April 2023. The extended due dates for filing 2022/23 Profits Tax Returns were shown below:

| Accounting Date Code | Extended Due Date | Further Extended Due Date if opting for e-filing |
|---|---|---|
| "N" code | 17 May 2023 | 17 June 2023 |
| "D" code | 15 August 2023 | 15 September 2023 |
| "M" code | 15 November 2023 | 15 December 2023 |
| "M" code – current year loss cases | 31 January 2024 | 31 January 2024 (same as paper returns) |

Despite the above extension, tax representatives were encouraged to file as many returns as possible well before the extended due dates. Tax representatives were also encouraged to participate in voluntary e-filing of profits tax returns, so as to enjoy a further one-month extension of filing deadline.

Taking this opportunity, the IRD would like to draw the Institute members' attention to the new filing requirements and e-filing modes with effect from 1 April 2023. Particular attention should be paid to the following:

- All corporations and businesses, regardless of the amount of their gross income and the mode of return filing, had to submit profits tax returns together with all supporting documents (including financial statements and tax computations). These included small corporations and businesses with gross income not exceeding HK$2 million, which would no longer be permitted to file profits tax returns without supporting documents.
- All relevant supplementary forms and other forms required to be furnished with

the profits tax return had to be e-filed under eTAX services provided at GovHK.

- If a taxpayer chose not to e-file the return, the taxpayer had to print and sign a paper Control List for the supplementary forms and/or other forms e-filed and then furnish the signed Control List together with the profits tax return and supporting documents in paper form.

Ms Michelle Chan explained the statistics contained in the tables. She took the opportunity to encourage HKICPA members to file returns electronically to enjoy the 1-month extension. CIR asked whether there was any feedback on the enhanced e-filing services for profits tax returns. Mr Fernandes said that his firm had participated in the trial run which contained a channel to provide feedback. Ms Sarah Chan said that larger firms, like MNE groups, wanted to get ready early since they were all aware that e-filing would be mandatory by 2025. Mr Tisman said that the Institute had received requests for events or demonstrations on e-filing. Ms Michelle Chan said that an online demonstration was available on the IRD's website, and training and briefing sessions for certain professional bodies had been arranged. She added that the IRD was willing to provide training for HKICPA members.

## PART B – MATTERS RAISED BY THE IRD

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

Appendix B was compiled by the IRD to illustrate the specific problem areas detected in corporations with tax audits completed during the year ended 31 December 2022. Comparative figures for the years 2020 and 2021 were included.

Field Audit teams uncovered discrepancies in 341 corporation cases, of which 288 carried clean auditors' reports. The amount of discrepancies detected in the clean report cases accounted for 85% (2021: 92%) of the total discrepancies detected in the year 2022 and total tax of $687 million was recovered from these cases. The average understatement per clean report case was $17.62 million (2021: $22.80 million) while tax undercharged per clean report case was $2.4 million (2021: $3.4 million).

In 2022, discrepancies resulted mainly from understatement of gross profit, incorrect claims of offshore profits and adjustment of technical items. In the majority of the cases, the discrepancies were detected after examining the business ledgers and source documents.

In 2022, there was no case in which the IRD considered that the auditor should have detected the irregularities through the statutory audit.

**Agenda Item B2 – Date of Next Annual Meeting**

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

# Lodgment of Corporations and Partnerships Profits Tax Returns

**Table 1**
**Lodgment Comparison from 2019/20 to 2021/22**

| | Y/A 2019/20 | Y/A 2020/21 | Y/A 2021/22 | Comparison 2020/21 and 2021/22 |
|---|---|---|---|---|
| 1. Returns issued on 1 April or 4 May | 204,000 | 202,000 | 223,000 | 10% |
| 2. Returns not filed by due date | | | | |
| "N" code | 2,700 | 3,300 | 3,100 | -6% |
| "D" code | 7,200 | 8,300 | 7,400 | -11% |
| "M" code | 12,400 | 14,700 | 13,900 | -5% |
| | 22,300 | 26,300 | 24,400 | -7% |
| 3. Compound offers issued | 5,400 | 6,900 | 7,600 | 10% |
| 4. Estimated assessments issued | 8,800 | 11,600 | 8,900 | -23% |

**Table 2**
**2021/22 Detailed Profits Tax Returns Statistics**

| | "N" | "D" | "M" | Total |
|---|---|---|---|---|
| Total returns issued | 25,000 | 81,000 | 117,000 | 223,000 |
| Failure to file on time | 3,100 | 7,400 | 13,900 | 24,400 |
| Compound offers issued | 1,000 | 2,600 | 4,000 | 7,600 |
| Estimated assessments issued | 1,300 | 2,600 | 5,000 | 8,900 |

**Table 3**
**Represented Profits Tax Returns - Lodgment Patterns**

| Code | Lodgment Standard | Y/A 2021/22 | Y/A 2020/21 |
|---|---|---|---|
| D - extended due date on | | | |
| 30 September 2022 | 100% | 90% (1) | - |
| 16 August 2021 | 100% | - | 75% |
| M - 31 August | 25% | 14% | 14% |
| M - 30 September | 55% | 20% | 19% |
| M - 31 October | 80% | 31% | 34% |
| M - extended due date on | | | |
| 30 November 2022 | 100% | 78% (2) | - |
| 15 November 2021 | 100% | - | 74% |

Notes: (1) 9% lodged within a few days before 30 September 2022 (29% lodged within a few days before 16 August 2021)

(2) 21% lodged within a few days before 30 November 2022 (25% lodged within a few days before 15 November 2021)

**Table 4**
**Tax Representatives with Lodgment Rate of Less Than 78% of "M" Code Returns as at 30 November 2022**

1,483 tax representatives have "M" code clients. Of these, 644 (43%) firms were below the average performance rate of 78%. An analysis of the firms, based on size, is as follows-

| | | Current Year Performance | | | | Last Year Performance | | | |
|---|---|---|---|---|---|---|---|---|---|
| | No. of clients per firm | Total No. of firms | No. of firms below the average of 78% | No. of non-compliance cases | % of total non-compliance cases | Total No. of firms | No. of firms below the average of 74% | No. of non-compliance cases | % of total non-compliance cases |
| Small size firms | 100 or less | 1,382 | 599 | 5,264 | 70% | 1,384 | 630 | 5,758 | 71% |
| Medium size firms | 101 - 300 | 94 | 44 | 2,190 | 29% | 87 | 43 | 2,320 | 29% |
| Large size firms | over 300 | 7 | 1 | 102 | 1% | 7 | 0 | 0 | 0% |
| | | 1,483 | 644 | 7,556 | 100% | 1,478 | 673 | 8,078 | 100% |

## Table 1 [Appendix B]

Analysis of Completed FA Corporation Cases for the years ended 31 December 2020, 2021 and 2022

| Auditor's Report = Unqualified | Number 2020 | Number 2021 | Number 2022 | Discrepancy Amount by Nature 2020 | Discrepancy Amount by Nature 2021 | Discrepancy Amount by Nature 2022 | Tax Undercharged by Nature 2020 | Tax Undercharged by Nature 2021 | Tax Undercharged by Nature 2022 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | $ | $ | $ | $ | $ | $ | |
| Sales omitted | 48 | 49 | 58 | 62,167,273 | 59,993,235 | 49,923,542 | 7,890,853 | 8,081,873 | 6,584,107 | ↑ |
| Purchases overstated | 15 | 11 | 11 | 49,026,448 | 37,955,961 | 37,080,899 | 7,299,611 | 7,955,046 | 5,723,893 | |
| Gross profit understated | 37 | 33 | 42 | 814,659,600 | 72,549,382 | 112,139,969 | 131,892,653 | 9,854,050 | 17,060,401 | FOR |
| Expenses over-claimed | 114 | 87 | 96 | 150,828,962 | 176,744,684 | 66,913,566 | 22,507,369 | 26,977,704 | 7,579,244 | AUDIT |
| Technical adjustments | 82 | 76 | 83 | 29,484,527 | 109,962,323 | 70,273,261 | 3,029,692 | 16,310,509 | 8,793,000 | YEAR |
| Offshore income / profits disallowed | 12 | 18 | 11 | 88,132,024 | 146,747,692 | 82,092,640 | 13,848,818 | 23,187,921 | 11,791,219 | ONLY |
| Other | 123 | 89 | 113 | 167,135,665 | 400,211,845 | 292,527,205 | 25,620,300 | 63,003,826 | 40,054,271 | |
| TOTAL | 431* | 363* | 414* | $1,361,434,499 | $1,004,165,122 | $710,951,082 | $212,089,296 | $155,370,929 | $97,586,135 | ↓ |
| **Total number of cases for unqualified Auditor's Report** | 307* | 272* | 288* | (D) | (E) | (F) | (G) | (H) | (I) | |
| | (A) | (B) | (C) | | | | | | | |
| **Average amount per case** | | | | $4,434,640 | $3,691,784 | $2,468,580 | $690,845 | $571,217 | $338,841 | |
| | | | | (D)/(A) | (E)/(B) | (F)/(C) | (G)/(A) | (H)/(B) | (I)/(C) | |

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

| | | Total Discrepancy for All Years 2020 | Total Discrepancy for All Years 2021 | Total Discrepancy for All Years 2022 | Total Tax Undercharged for All Years 2020 | Total Tax Undercharged for All Years 2021 | Total Tax Undercharged for All Years 2022 |
|---|---|---|---|---|---|---|---|
| **Other statistics for the above cases:** | **Total amount** | **$6,075,473,883** | **$6,202,914,132** | **$5,075,086,618** | **$930,164,546** | **$937,065,123** | **$686,984,945** |
| | **Average amount per case** | **$19,789,817** | **$22,804,831** | **$17,621,829** | **$3,029,852** | **$3,445,092** | **$2,385,364** |

| Auditor's Report = Qualified | Number 2020 | Number 2021 | Number 2022 | Discrepancy Amount by Nature 2020 | Discrepancy Amount by Nature 2021 | Discrepancy Amount by Nature 2022 | Tax Undercharged by Nature 2020 | Tax Undercharged by Nature 2021 | Tax Undercharged by Nature 2022 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | $ | $ | $ | $ | $ | $ | |
| Sales omitted | 26 | 9 | 18 | 33,239,140 | 6,424,396 | 34,893,063 | 4,838,005 | 790,808 | 4,996,982 | ↑ |
| Purchases overstated | 2 | 8 | 1 | 19,463,392 | 14,993,386 | 76,862 | 2,780,627 | 1,619,219 | 9 | |
| Gross profit understated | 10 | 12 | 13 | 13,887,085 | 31,601,863 | 17,849,608 | 1,982,706 | 4,945,834 | 2,932,785 | FOR |
| Expenses over-claimed | 27 | 16 | 9 | 7,699,017 | 5,811,526 | -36,249 | 925,575 | 410,850 | -106,861 | AUDIT |
| Technical adjustments | 14 | 13 | 15 | 7,455,642 | 12,234,165 | 18,807,703 | 832,436 | 1,472,301 | 3,065,150 | YEAR |
| Offshore income / profits disallowed | 5 | 1 | 1 | 26,240,002 | 2,740,572 | 9,993,054 | 4,169,345 | 341,874 | 1,648,854 | ONLY |
| Other | 23 | 18 | 23 | 41,969,334 | 15,961,407 | 39,342,872 | 3,900,107 | 2,117,314 | 4,215,786 | |
| TOTAL | 107* | 77* | 80* | $149,953,612 | $89,767,315 | $120,926,913 | $19,428,801 | $11,698,200 | $16,752,705 | ↓ |
| **Total number of cases for qualified Auditor's Report** | 68* | 52* | 53* | (D) | (E) | (F) | (G) | (H) | (I) | |
| | (A) | (B) | (C) | | | | | | | |
| **Average amount per case** | | | | $2,205,200 | $1,726,295 | $2,281,640 | $285,718 | $224,965 | $316,089 | |
| | | | | (D)/(A) | (E)/(B) | (F)/(C) | (G)/(A) | (H)/(B) | (I)/(C) | |

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

| | | Total Discrepancy for All Years 2020 | Total Discrepancy for All Years 2021 | Total Discrepancy for All Years 2022 | Total Tax Undercharged for All Years 2020 | Total Tax Undercharged for All Years 2021 | Total Tax Undercharged for All Years 2022 |
|---|---|---|---|---|---|---|---|
| **Other statistics for the above cases:** | **Total amount** | **$808,236,856** | **$512,489,520** | **$872,939,590** | **$118,534,361** | **$69,062,275** | **$124,497,955** |
| | **Average amount per case** | **$11,885,836** | **$9,855,568** | **$16,470,558** | **$1,743,152** | **$1,328,121** | **$2,349,018** |

| | 2020 | 2021 | 2022 |
|---|---|---|---|
| **Grand total number of cases** | 375 | 324 | 341 |

| | | Total Discrepancy for All Years 2020 | Total Discrepancy for All Years 2021 | Total Discrepancy for All Years 2022 | Total Tax Undercharged for All Years 2020 | Total Tax Undercharged for All Years 2021 | Total Tax Undercharged for All Years 2022 |
|---|---|---|---|---|---|---|---|
| **Other statistics for the above cases:** | **Grand total amount** | **$6,883,710,739** | **$6,715,403,652** | **$5,948,026,208** | **$1,048,698,907** | **$1,006,127,398** | **$811,482,900** |
| | **Average amount per case** | **$18,356,562** | **$20,726,554** | **$17,442,892** | **$2,796,530** | **$3,105,331** | **$2,379,715** |

**Extracts of Analysis in Appendix B**

| | | 2021 | 2022 |
|---|---|---|---|
| (a) | No. of corporation cases with discrepancies uncovered | 324 | 341 |
| (b) | No. of corporation cases in item (a) carried clean auditor's reports | 272 | 288 |
| (c) | Total discrepancies detected in all cases | $6,715M | $5,948M |
| (d) | Total discrepancies detected in clean auditor's report cases | $6,203M | $5,075M |
| (e) | Percentage of (d) over (c) | 92% | 85% |
| (f) | Total tax uncovered in clean auditor's report cases | $937M | $687M |
| (g) | Average understatement per clean auditor's report case | $22.80M | $17.62M |
| (h) | Average tax undercharged per clean auditor's report case | $3.4M | $2.4M |