IRD's views on certain profits tax issues expressed in its 2023 annual meeting with HKICPA

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In brief

The minutes of the 2023 annual meeting between the Inland Revenue Department (IRD) and the Hong Kong Institute of Certified Public Accountants (HKICPA or Institute) held on 12 May 2023 were recently released[1]. The meeting minutes summarise the IRD's views on various tax issues expressed during the meeting, including issues related to profits tax (covering the foreign-sourced income exemption [FSIE] regime, transfer pricing and other matters), salaries tax and administrative matters.

This news flash highlights the IRD's views on key profits tax issues other than those related to the FSIE regime. For the IRD's views on issues related to the FSIE regime, please refer to another news flash[2].

In detail

Taxation of interest income

It has long been the IRD's assessing practice to apply the provision of credit test (i.e. where the loan proceeds were first made available to the borrower) to determine the source of interest income earned in respect of a 'simple loan of money' by persons not carrying on the business of a financial institution, money-lending or intra-group financing. In other cases, the operations test (i.e. what the taxpayer has done to earn the profits in question and where he has done it) would apply.

Given the lack of a definition or clear guidance on what constitutes a 'simple loan of money', the Institute asked the IRD to explain the principles and factors involved in determining whether a loan qualifies as such. The Institute illustrated its concern by setting out three common scenarios, whereby a Hong Kong company (HK Co) lends a one-off interest-bearing loan that is funded by different sources to its subsidiary (see the table further below).

The IRD's reply is summarised below:

- the operations 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.
- whether a loan constituted a 'simple loan of money' was a question of fact. The IRD would consider 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.

- 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 generally be accepted as a ‘simple loan of money’. In contrast, where the lending (i) was made from borrowing or (ii) formed an integral part of the company’s business, the lending would normally not be accepted as a ‘simple loan of money’.

- a one-off loan was not necessarily a ‘simple loan of money’. Furthermore, the operations test was not confined to a money lending business and could apply to a one-off loan.

- the IRD’s comments on the three scenarios provided by the Institute regarding HK Co lending a one-off interest-bearing loan to its subsidiary are summarised below:

Scenario	Funding for the loan	The IRD’s view
1	HK Co’s own surplus cash	The loan would be accepted as a ‘simple loan of money’ and the provision of credit test would apply.
2	Equity injection from HK Co’s parent company	Provided that the equity injection did not involve any borrowing of money or complex financing arrangement, the injected equity would be considered as HK Co’s own fund and the loan would be accepted as a ‘simple loan of money’. The provision of credit test would apply.
3	An interest-free loan borrowed from HK Co’s parent company	HK Co’s borrowing and on-lending of money to its subsidiary would generally not be accepted as a ‘simple loan of money’ and the operations test would apply. The outcome would be the same even if the interest-free loan from HK Co’s parent company was financed by the parent company’s own surplus funds.

Our observations: *Based on the IRD’s views, the operations test would apply to determine the source of interest income if the underlying loan was funded by a borrowing. Furthermore, the IRD did not readily accept the proposition that a borrowing with no repayment terms might be considered quasi-equity, stating that the tax treatment would depend on the facts and circumstances of the case. The IRD also emphasised that tax implications are determined by the legal form and structure of the transactions as executed by the taxpayer.*

Under the operations test, interest income would be treated as Hong Kong-sourced and taxable if the relevant profit producing activities were conducted in Hong Kong, irrespective of whether the funds were provided to the borrower in or outside Hong Kong. Note that where the taxpayer is a multinational enterprise entity, even if the interest income is regarded as offshore sourced on the basis that the relevant activities were conducted outside Hong Kong, it would be deemed taxable when received in Hong Kong under the refined FSIE regime unless the economic substance requirement is met.

Where the loan producing taxable interest income is financed by an interest-bearing borrowing, the deduction of the interest expense is subject to various conditions. In particular, interest payable to overseas related parties (that are not financial institutions) is only deductible under limited circumstances. For instance, section 16(2)(g) of the Inland Revenue Ordinance (IRO) provides that interest payable to non-Hong Kong associated corporations (as defined) is deductible if, among other things, it is in relation to an intra-group financing business carried on in Hong Kong by a corporate taxpayer. For companies that are only engaged in occasional intercompany borrowing and lending activities, it seems unlikely that they would be regarded as carrying on an intra-group financing business in Hong Kong, and hence they would not be eligible for an interest expense deduction even if their interest income is taxable.

In view of the potential asymmetric Hong Kong tax treatments for interest income and interest expenses, companies with such intercompany loan arrangements may wish to reassess their tax exposure and revisit the financing arrangements within the group.

E-commerce

The Institute referred to the Departmental Interpretation and Practice Notes No. 39 (DIPN 39) on digital economy, electronic commerce and digital assets, and suggested that the IRD provide additional examples to illustrate how the source rules apply to e-commerce models such as online intermediary, search engine, social network site and online gaming.

The IRD's reply is summarised below:

- since e-commerce business models were constantly evolving, DIPN 39 only set out the broad guiding principles applicable to e-commerce transactions, instead of how the law applied to particular forms of e-commerce.

- in general, the location of the server alone did not determine the locality of e-commerce profits, and the proper approach was to focus more on (i) the core operations that had effected the e-commerce transaction to earn the profits in question and (ii) the place where those operations had been carried out, rather than on what had been done electronically.

- the core operation of an enterprise varied across the different types of e-commerce models and might include: network promotion and contract management; 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.

- although the IRD shared its preliminary views on the tax treatments for the four e-commerce models mentioned by the Institute, it also commented that providing oversimplified examples to illustrate how the source rule applied to such models might not be very useful.

- while the new development in the commercial world had to be considered in applying the broad guiding principle, there was no ground to depart from it in determining the source of profits from online services or e-commerce.

- the IRD would consider updating DIPN 39 in the future, taking into account the implementation of Pillar One in Hong Kong and other e-commerce developments[3].

Our observations: *While the IRD's responses have provided additional guidance subsequent to DIPN 39, there is still considerable uncertainty about which activities are considered 'core' to an enterprise. These can only be determined by considering the business of the enterprise as a whole. Given the complexity and uniqueness of each e-commerce model, businesses may wish to seek professional assistance and conduct a health check exercise to ascertain their tax position based on the specific facts of their case.*

Review of the tax treatment for reinstatement cost

The IRD has indicated on its website that reinstatement cost for premises incurred upon the expiration of a lease is generally non-deductible as it is part of the capital cost of acquiring a lease[4]. It also does not qualify for commercial building allowance as such costs are not incurred on the construction of a commercial building or structure nor incurred to acquire a relevant interest in that building or structure.

The Institute noted that in Singapore, following a review of the tax treatment for reinstatement cost in 2015, the Inland Revenue Authority of Singapore (IRAS) changed its position whereby reinstatement cost (which was previously treated as capital in nature and non-deductible) would be deductible if the following conditions are met:

(i) the cost is the actual amount incurred and is not a provision;
(ii) the cost is contractually provided for in the lease agreement; and
(iii) the premises are not vacated due to any cessation of business.

The Institute suggested that the IRD review whether Hong Kong should align its tax treatment for reinstatement cost with Singapore's current approach[5].

The IRD's reply is summarised below:

- in general, a lease which conferred an exclusive possession of a property was a capital asset. Where a lessee was obligated to reinstate the premises back to their original state at the end of the lease, the reinstatement cost should be regarded as part of the capital cost of acquiring the lease and should be non-deductible.
- the IRAS clearly stated on its website that reinstatement cost was generally a capital expenditure and non-deductible. It appeared to merely allow the deduction of such cost on a concessionary basis provided that the specified conditions were met.
- the tax law regarding the deduction of capital expenditures in Hong Kong was clear and there was no room for the IRD to provide any concessionary treatment.

Our observations: *The Financial Secretary subsequently proposed in the 2024/25 Budget in February 2024 that amendments will be made to the IRO to provide profits tax deduction for reinstatement cost from the year of assessment 2024/25. We welcome the proposed legislative amendment which would establish the legal basis for the deduction of reinstatement cost.*

Based on the latest update on the IRD's website, it appears that the tax deduction would be based on the actual amount of reinstatement cost incurred. While the deduction conditions in Singapore serve as a useful reference, it seems that it may not be necessary for Hong Kong to adopt the requirement that 'the premises are not vacated due to any cessation of business'. A plausible justification for this is that generally, the obligation to reinstate the leased property to its original condition at the end of the lease arose from the terms agreed upon when the lease was entered into. Arguably, this obligation has been incurred for the purpose of producing profits throughout the lease period.

An analogy could be drawn with severance payments made to employees as required under the Employment Ordinance. In the case of CIR v Cosmotron Manufacturing Co Ltd [1997] HKLRD 1161 PC, the Privy Council held that the expenditure incurred to meet existing obligations owed to employees was revenue in nature, even if the event that crystallised the payment occurred after the business had ceased. The purpose of severance payment was to employ staff, as it was a necessary condition of retaining the services of the staff.

Taxability of dividends or profit distributions made by a tax-exempt fund

Section 26 of the IRO provides that the following amounts are exempted from taxation:

(i) a dividend from a corporation which is chargeable to profits tax (per section 26(a)); and
(ii) unless otherwise provided, the profit or loss of a trade, profession or business carried on by another person who is chargeable to profits tax (per section 26(b)).

In the 2015 annual meeting between the IRD and the Institute[6], the IRD indicated that for the purpose of section 26(a), a corporation carrying on a business in Hong Kong would be regarded as chargeable to profits tax even if it only derived non-taxable capital gains and offshore profits, and the dividends received from such a corporation by the shareholders would be eligible for tax exemption.

Given that a tax-exempt fund in Hong Kong would necessarily be carrying on a business in Hong Kong, the Institute asked the IRD whether the above treatment would equally apply to the dividends or profit distributions paid out by a tax-exempt fund in Hong Kong, such that these dividends or profit distributions would be treated as exempt income in the hands of the recipient under section 26(a) or (b), subject to the potential application of the deeming provisions for funds[7].

The IRD's reply is summarised below:

- the IRD's explanation in the 2015 annual meeting would apply to the generality of cases, including dividends or profit distributions paid out by a tax-exempt fund.
- however, the IRD also stayed vigilant to any arrangement involving tax avoidance, such as repackaging the taxable service or management fee income of an investment fund manager as tax-exempt dividends in the case of distribution of carried interest.

Our observations: *We welcome the IRD's clarification as this can provide greater certainty to taxpayers investing in tax-exempt funds in Hong Kong. We also look forward to further actions to be taken by the Government to bolster the asset and wealth management industry, including the enhancement of the preferential tax regimes for funds, single family offices and carried interest as proposed in the 2024/25 Budget.*

Whether assets qualifying for depreciation allowances can be transferred at below market price by relying on the exemption for domestic transactions under transfer pricing Rule 1

When an asset that qualifies for depreciation allowances is sold between related parties, section 38B of the IRO empowers the Commissioner of Inland Revenue (CIR) to determine the asset's true market value at the time of sale if the CIR considers that the sale price of the asset does not represent its true market value. The value determined by the CIR is then deemed to be the sale price of the asset for the purpose of calculating the allowances and charges under the IRO.

Transfer pricing Rule 1 (i.e. section 50AAF of the IRO) requires income or losses from related party transactions to be computed on an arm's length basis for tax purposes. However, section 50AAJ(2) of the IRO provides that domestic related party transactions may be exempt from Rule 1 if certain conditions are met.

In this regard, the Institute asked the IRD if taxpayers could rely on the exemption for domestic transactions under section 50AAJ(2), such that the sale price of an asset qualifying for depreciation allowances would not be adjusted by the CIR under section 38B if the asset was transferred at below market price.

The IRD's reply is summarised below:

- sections 38B and 50AAJ(2) were two separate provisions that applied under different conditions. There was no provision under the IRO which provided that section 38B would not apply if the conditions under section 50AAJ(2) were satisfied. As such, the CIR could invoke section 38B to adjust the sale price of an asset for tax purposes if the circumstances warranted.

Our observations: *In view of the IRD's position, taxpayers involved in a transfer of assets within the group should maintain sufficient documentation to justify that the sale price represents the true value of the assets at the time of sale.*

The takeaway

The annual meeting presented a valuable opportunity to clarify technical issues related to emerging tax matters. The IRD's replies offer useful guidance that will assist taxpayers in assessing their situations. If you have any questions about the views expressed by the IRD in the meeting, or wish to discuss more thoroughly how such views might impact your businesses, please feel free to reach out to us.

Endnotes

1. The meeting minutes can be accessed via this link:
https://www.hkicpa.org.hk/-/media/Document/APD/TF/Tax-bulletin/034_April-2024.pdf

2. The news flash can be accessed via this link:
https://www.pwchk.com/en/hk-tax-news/2024q2/hongkongtax-news-apr2024-7.pdf

3. For further information on Pillar One, please refer to our dedicated webpage on Base Erosion and Profit Shifting 2.0 (i.e. BEPS 2.0), which can be accessed via this link:
https://www.pwccn.com/en/services/tax/international-tax/oecd-beps.html

4. The IRD's dedicated webpage on the tax treatment for reinstatement cost can be accessed via this link:
https://www.ird.gov.hk/eng/faq/rco.htm

5. The IRAS's treatment for reinstatement cost can be accessed via this link:
https://www.iras.gov.sg/taxes/corporate-income-tax/income-deductions-for-companies/business-expenses/tax-treatment-of-business-expenses-(m-r)

6. The minutes of the 2015 annual meeting between the IRD and the HKICPA can be accessed via this link: https://www.hkicpa.org.hk/-/media/HKICPA-Website/HKICPA/section5_membership/Professional-Representation/pdf-file/tax-b/26.pdf

7. The deeming provisions are designed to prevent Hong Kong residents (as defined) from abusing the tax exemption. Broadly, these provisions will deem the underlying exempted profits of the funds to be the assessable profits of a Hong Kong resident investor in such funds if one of the following two conditions is met:

   (i) the Hong Kong resident investor, together with its associates, jointly holds 30% or more of the beneficial interest in the fund; or
   (ii) the Hong Kong resident investor is associated with the fund.

   Nonetheless, the deeming provisions will not be invoked if the CIR is satisfied that the fund is bona fide widely held.

Let's talk

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

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