Hong Kong Tax Alert

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IRD clarifies certain profits tax issues in its annual meeting with the HKICPA

In its 2021 annual meeting with the Hong Kong Institute of Certified Public Accountants (HKICPA)[1], the Inland Revenue Department (IRD) indicated that:

i. where the server permanent establishment (PE) located outside Hong Kong of a Hong Kong resident enterprise forms an essential and significant part of its e-commerce business, then part or all the profits of the enterprise could be regarded as being non-taxable offshore Hong Kong profits;

ii. the transfer of trading stock at below market value, whether upon cessation of business or not, would not be subject to tax adjustments under the arm's length transfer price rules under certain conditions;

iii. while taxation based on fair value accounting would not affect the chargeability to tax of a financial instrument held for trading purposes under the source principles, taxpayers would have to predict the onshore-versus-offshore nature of the ultimate profits before such an instrument is sold or realized;

iv. charter hire income in respect of an ocean-going voyage of a ship that would fall under section 23B of the Inland Revenue Ordinance (IRO), and therefore would not be chargeable to tax in Hong Kong, would not then be deemed to be taxable under section 15(1)(o), i.e., section 23B operates to the exclusion of section 15(1)(o); and

v. genuine businesses established in Hong Kong with a view to enjoying the tax concessions under the preferential tax regimes and the tax treaty network of Hong Kong would be most unlikely to fall foul of the anti-avoidance provisions of the "main purpose test".

This alert discusses the issues involved. Clients who have questions on the views expressed by the IRD in the meeting, or would like to discuss in greater detail how such views might impact their business operations, should seek professional tax advice.

1. Minutes of the 2021 annual meeting between the HKICPA and the IRD can be retrieved from: https://www.hkicpa.org.hk/-/media/Document/APD/TF/Tax-bulletin/032_May-2022.pdf

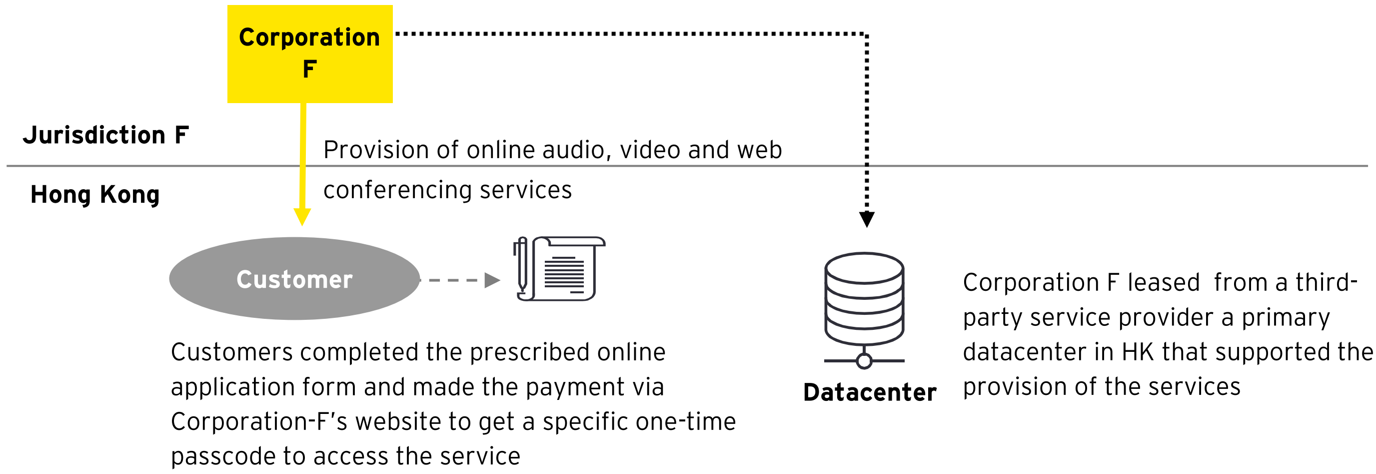
Application of the source principles to a datacenter or server PE

In its revised practice note no. 39 (Revised DIPN 39) issued in March 2020, the IRD illustrated by way of an example (Example 5) that a non-Hong Kong resident enterprise which merely maintained a server in Hong Kong would be regarded as having a PE in Hong Kong and be assessed to Hong Kong profits tax accordingly[2].

However, a seemingly reverse scenario to the aforesaid example appeared in paragraph 19(a) of Revised DIPN 39, where the IRD apparently disregarded a Hong Kong resident enterprise's server located outside Hong Kong. Instead, the IRD indicated that if the core operations and support activities of the relevant e-commerce business, apart from operating a server PE located outside Hong Kong, were performed by the Hong Kong resident enterprise in Hong Kong, the profits of the Hong Kong resident enterprise would be fully chargeable to tax in Hong Kong as being Hong Kong sourced profits.

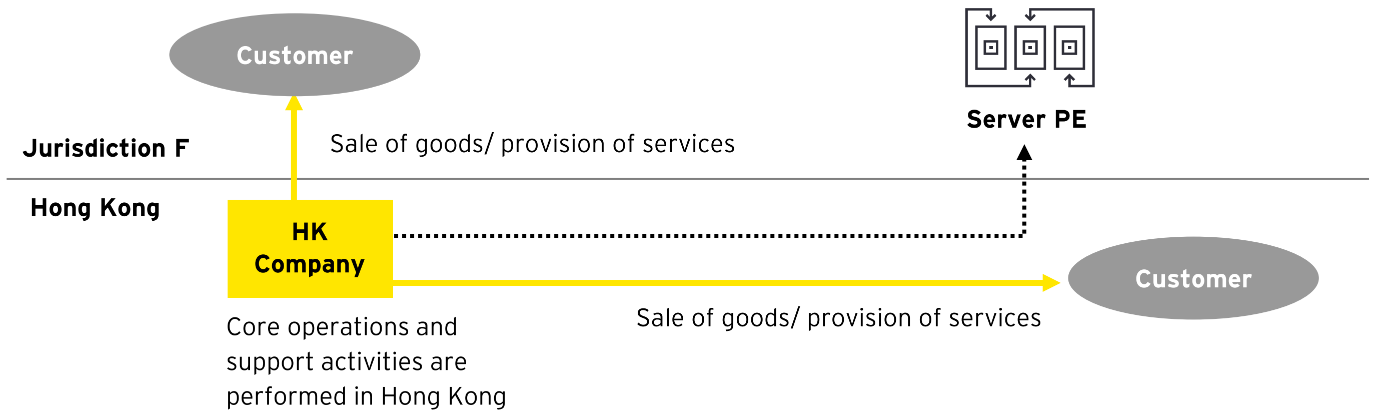
The above two examples are illustrated in the diagrams below.

Example 5 in Revised DIPN 39



IRD's conclusion: if the datacenter was at the disposal of Corporation F and an essential and significant part of the business activity of Corporation F was conducted through or from the datacenter, the datacenter could be regarded as a PE. As such, profits attributable to the datacenter or server PE, ascertained based on the transfer pricing rule under the Authorised OECD Approach, would be assessed to tax in Hong Kong accordingly.

Example in paragraph 19(a) of Revised DIPN 39



IRD's conclusion: if the Hong Kong resident enterprise performed all the core operations and support activities in Hong Kong, the profits from its e-commerce transactions conducted through the server PE would be fully charged to profits tax in Hong Kong as being Hong Kong sourced profits.

2. *Clients may refer to our Hong Kong Tax alert – 1 April 2020 (2020 Issue No. 3) for a detailed discussion of Revised DIPN 39.*

HKICPA's questions

The HKICPA sought clarifications from the IRD how the tax positions of the above two examples can be reconciled, including the interaction between the PE concept and the territorial source principles under section 14 of the IRO.

IRD's reply

The IRD explained that Example 5 of Revised DIPN 39 only served to illustrate the concept of server PE. It did not state that a non-resident person with only a datacenter or server PE in Hong Kong would necessarily be chargeable to tax in Hong Kong under the source rule. Nor did it deal with apportionment of onshore and offshore profits.

The IRD reaffirmed its position that in determining whether a datacenter or server PE in Hong Kong of a non-resident person would be chargeable to profits tax in Hong Kong, it would adopt the "two-step" approach indicated in DIPN 60: (i) profits would first be attributed to the PE in accordance with the separate enterprises principle; and then (ii) the source of the profits would be determined in accordance with the operation test.

Nonetheless, the ascertainment of the source of profits was a practical, hard matter of fact. The IRD reiterated that as explained in paragraph 17 of Revised DIPN 39, the location of the server PE alone would not determine the locality of the profits, and the proper approach was to focus more on the core operations for the e-commerce transaction and the place where those operations had been carried out, rather than on what had been done electronically. If all the core operations and support activities of an e-commerce business were performed in Hong Kong, the e-commerce profits would be fully chargeable to profits tax, even though the server was located outside Hong Kong as illustrated in paragraph 19(a) of Revised DIPN 39.

EY observations

The IRD's response seems to imply that the example as illustrated in paragraph 19(a) is not an exact reverse of Example 5, i.e., while the datacenter located in Hong Kong of non-resident Corporation F in Example 5 formed an essential and significant part of its e-commerce business, the server PE located outside Hong Kong of the Hong Kong resident enterprise in paragraph 19(a) did not.

As such, the implication would be that where the server PE located outside Hong Kong of a Hong Kong resident enterprise does form an essential and significant part of its e-commerce business (vis-à-vis other core income-generating activities carried out in Hong Kong), i.e., a true reverse position of Example 5, then part or all the profits of such a Hong Kong resident enterprise could be regarded as being non-taxable offshore Hong Kong profits.

Circumstances under which the transfer of trading stock at below market value may be adjusted

HKICPA's questions

The HKICPA sought comments on the tax implications for the transfer of trading stock, in particular the transfer of real estate properties and listed securities, at below market value between two Hong Kong taxpayers under the following scenarios:

i. where the transfer at below market value was made not upon cessation of business, whether the two Hong Kong taxpayers can rely on the domestic nature of the transaction under the conditions as specified in section 50AAJ such that the transaction would be exempted from having to comply with the arm's-length transfer pricing rule (i.e., Rule 1) as specified under section 50AAF of the IRO.

ii. where the transfer at below market value was made upon cessation of business, whether the two Hong Kong taxpayers can rely on the conditions as specified in section 15C(a) of the IRO such that the transaction price would be accepted by the IRD, i.e., whether section 15C(a) would operate to the exclusion of the arm's-length transfer pricing Rule 1 and the general anti-avoidance provisions of the IRO.

IRD's reply

Scenario (i) where no cessation of business was involved

The IRD stated that where the trading stock was transferred at below market value "otherwise than in the course of trade", sections 15BA(4) and (5), which override the provisions for exempted domestic transactions contained in section 50AAJ, would operate to substitute the market price of the trading stock for the transaction price for tax purposes.

On the other hand, where the trading stock was transferred at below market value "in the course of trade", sections 15BA(4) and (5) would then have no application. In such a case, the two Hong Kong taxpayers can rely on the provisions for domestic exemption transactions contained in section 50AAJ as exempting them from having to comply with the arm's-length transfer pricing Rule 1 as specified in section 50AAF of the IRO.

Scenario (ii) where cessation of business was involved

The IRD confirmed that so long as the conditions contained in section 15C(a) were satisfied, the arm's-length transfer pricing Rule 1 would not operate to substitute the market price of the trading stock for the transaction price, i.e., section 15C(a) would operate to the exclusion of the arm's-length transfer pricing Rule 1.

However, the IRD indicated that for blatant tax avoidance arrangement it might invoke the general anti-avoidance provisions contained in sections 61 and/or 61A of the IRO to counteract any tax benefit obtained through non-arm's length transactions between related parties.

EY observations

For non-cessation of business cases which can rely on the provisions for domestic exemption transactions contained in section 50AAJ, the IRD's position that no tax adjustment would be made to substitute the market price of trading stock for the transaction price, if such a transfer is made "in the course of trade", is clear.

What is not so clear is when such a transfer would be regarded as being made "otherwise in the course of trade", to which section 15BA(4) and (5) would then operate to substitute the market price of trading stock for the transaction price.

For cessation of business cases, the IRD's confirmation that section 15C(a) operates to the exclusion of the arm's-length transfer pricing Rule 1 is welcome news.

Interaction between source of profit and taxation based on fair value accounting

Sections 18G to 18L of the IRO allow taxpayers who prepare financial statements in accordance with Hong Kong Financial Reporting Standard No. 9 to make an irrevocable election to align the tax treatment of financial instruments with their fair value accounting treatment.

In other words, once an election is made, taxation would be based on the profits or losses (including fair value changes) as reflected in the accounts rather than on realization basis.

This would require taxpayers, when filing a tax return, to determine the onshore-versus-offshore nature of any fair value changes of a financial instrument held for trading purposes. Such a determination could pose a problem where there is uncertainty as to how the future sale or realization of the financial instrument will be effected.

? *HKICPA's questions*

The HKICPA outlined the example of a taxpayer trading in an instrument and electing to be assessed on a fair value basis, offering the fair value gain of the instrument for tax assessment in Year 1 on the basis that (i) the purchase of the instrument was effected in Hong Kong; and (ii) the sale of the instrument was expected to be effected in Hong Kong. Thereafter, because of a subsequent change in the operational mode of the taxpayer, the sale of the instrument in Year 3 was actually effected outside Hong Kong, thereby realizing the fair value gain of the instrument recognized in Year 1.

The HKIPA questioned whether such a taxpayer could re-open the Year 1 assessment to exclude the fair value gain of the instrument, an offshore claim being justified in view of the overall fact-pattern of the case including the sale of the instrument being effected outside Hong Kong?

IRD's reply

The IRD explained that the legislative intent of enacting sections 18G to 18L was to provide for the alignment of the tax treatment of financial instruments with their accounting treatment (i.e., tax-to-follow-accounting) upon a taxpayer's election. As such, any claim for assessment on a realization basis would not be entertained once an election for assessment on the fair value basis was made.

Nonetheless, the IRD affirmed that the fair value accounting did not affect the chargeability of profits to tax under the source rule. If the source of the profits was outside Hong Kong, even though a fair value gain was recognized in the profit and loss account, the gain could be excluded from the tax computation. On the other hand, if the source of the profits was in Hong Kong, the fair value gain recognized in the profit and loss account should be chargeable to tax and offered for assessment in Hong Kong.

Applying the above to the example, the IRD noted that as the purchase of the instrument concerned was effected in Hong Kong, the source of the profits was presumably in Hong Kong and the offshore claim could not be accepted. Taxpayers that did not agree with an assessment had the right to contest the IRD's views through the objection and appeal channel provided in the IRO.

EY observations

Pursuant to section 70 of the IRO, an assessment is final and conclusive if no valid objection has been lodged within the time limit (generally within one month after the date of issue of the notice of assessment).

Nonetheless, section 70A of the IRO provides that a taxpayer can apply to re-open a final and conclusive assessment if the taxpayer can establish to the satisfaction of the assessor that the assessment is excessive by reason of an "error or omission" in any return or statement submitted. Compared to objecting an assessment, the time limit for lodging a section 70A claim is much longer, namely six years from the end of the relevant year of assessment or six months after the date of the issuance of the assessment whichever is later.

However, case law precedents show that it may be difficult for the taxpayer in the above example to persuade the assessor that offering the fair value gain in respect of the instrument in Year 1 constitutes an "error of law" or an "error of fact" for the purposes of section 70A, the taxpayer having deliberately and conscientiously decided to offer the fair value gain for assessment in its tax return based on the circumstances known at the relevant time.

As such, in an unusual situation, if after an election has been made it is not possible to predict whether the fair value gain in respect of a financial instrument held for trading purposes is sourced in Hong Kong, taxpayers may in the first instance need to exclude such gain from the tax computation. This would particularly be the case where there is a reasonable prospect that the profits ultimately realized could be argued as being offshore sourced.

Interaction of section 23B and the deeming provision contained in section 15(1)(o)

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HKICPA's questions

Charter-hire or leasing income earned by a person, who carries on "business as an owner of ships" in Hong Kong, for granting a right to use a ship for an ocean-going voyage would not be chargeable to tax in Hong Kong under section 23B of the IRO.

However, under section 15(1)(o) of the IRO, sums received by a corporation which carries on business of granting a right to use a ship to another person, are deemed to be chargeable to tax in Hong Kong, even if the ship is ocean-going or used outside Hong Kong.

The HKICPA asked how section 23B would interact with section 15(1)(o) of the IRO.

IRD's response

The IRD stated its view that section 23B of the IRO is a specific regime for the ascertainment of the assessable profits of a ship operator who provides services for the carriage by sea of passengers and/or goods as a ship owner (which is defined to also include a charterer).

Charter-hire or leasing income of a ship owner-cum-operator in respect of an ocean-going voyage would fall under section 23B of the IRO and therefore not chargeable to tax in Hong Kong, only if the chartering activities were incidental to the services of the ship owner-cum- operator for the carriage by sea of passengers and/or goods.

It was however not possible to lay down a hard and fast rule for determining what constituted "incidental chartering activities" of a ship-owner-cum-operator. Each case would be considered on its own facts and circumstances. Basically, the ship owner-cum-operator should be primarily engaged in the business of the carriage by sea of passengers and/or goods.

Where such charter-hire or leasing income of a ship owner-cum-operator fell under section 23B and therefore not chargeable to tax in Hong Kong, the deeming provision contained in section 15(1)(o), which supplements section 14, of the IRO would not operate to deem the charter-hire or leasing income to be chargeable to tax in Hong Kong. This is because section 23B, being a specific tax regime, governs exclusively the taxation of a ship owner-cum-operator.

Otherwise, such charter-hire or leasing income of the ship owner-cum-operator would be chargeable to tax in Hong Kong under section 14, as supplemented by section 15(1)(o), of the IRO.

Furthermore, the recently introduced preferential tax regime, under which qualifying ship leasing income of qualifying ship lessors and qualifying ship leasing managers would be charged to tax in Hong Kong at half the normal corporate tax rate of Hong Kong under section 14O et seq of the IRO, would not apply to a ship owner-cum-operator.

In fact, section 15(1)(o) of the IRO was only enacted to ensure that the ship leasing income of a qualifying ship lessor or a qualifying ship leasing manager would be chargeable to tax in Hong Kong, albeit at a concessionary rate, even if the ship concerned was used outside Hong Kong.

EY observations

The HKICPA's question this year has prompted the IRD to confirm that section 23B operates to the exclusion of section 15(1)(o) of the IRO. However, it has not resolved the issue last raised by the HKICPA in the 2016 annual meeting of why only the "incidental chartering activities", but not all kinds of charter-hire or leasing income of a ship-owner-cum-operator, fall within section 23B of the IRO.

Given that the definition of the "business as an owner of ships" to which section 23B is intended to apply is defined to mean "a business of chartering or operating ships", many practitioners are of the view that all charter-hire or leasing income in respect of a ship-owner-cum-operator should fall under section 23B of the IRO.

However, given the strong view of the IRD that only "incidental chartering activities" of a ship owner-cum-operator would fall under 23B of the IRO, this controversial issue may only be resolved through future litigation.

Application of the "main purpose test" contained in preferential tax regimes of Hong Kong

HKICPA's questions

The various preferential tax regimes introduced in recent years contain anti-avoidance provisions which provide that if the main purpose, or one of the main purposes, of entering into an arrangement is to obtain a tax benefit, the relevant profits tax concessions would be denied.

The HKICPA asked whether the establishment of a business in Hong Kong with the primary objective of taking advantage of the Hong Kong tax incentives, or of Hong Kong's tax treaty network, would by itself be regarded as falling foul of the aforesaid "main purpose test"?

IRD's reply

The IRD responded that insofar as preferential tax regimes were concerned, the "main purpose test" targeted taxpayers who sought to abuse the tax concessions or achieve treaty shopping by artificial means and siphon the profits into Hong Kong simply to take advantage of the tax concessions or treaty benefits without any commercial reasons nor business substance established in Hong Kong. The "main purpose test" would not operate to deny tax concessions for most genuine businesses with core income generating activities carried out in Hong Kong.

Whether the main purpose or one of the main purposes of setting up a business in Hong Kong was to obtain a tax benefit was a question of fact. The IRD indicated that it would undertake an objective analysis of all the facts and circumstances of each case, including the aims and objects of all persons involved in putting the arrangement or transaction in place. In any case, there should be a clear distinction between a genuine business undertaking brought about by the conducive environment of Hong Kong, including the availability of a strong pool of talents, a well-developed legal and financial infrastructure, and an artificial arrangement serving no real purpose other than to abuse tax incentives offered by Hong Kong.

Generally, the IRD would not regard obtaining tax concession in a normal course as the main purpose and hinder the potential investors from setting up their businesses in Hong Kong.

EY observations

The IRD's assurance that the anti-avoidance provisions of the "main purpose test' would generally have no application to most genuine businesses set up in Hong Kong under the preferential tax regimes of Hong Kong is welcome news.

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