The Inland Revenue Department (IRD) states its views on certain profits tax and stamp duty issues

In the 2017 annual meeting between the IRD the Hong Kong Institute of Certified Public Accountants (HKICPA), issues discussed included:

i. the tax treatment of interest earned by a non-resident bond fund;

ii. the tainting effect which a single non-specified transaction would have on the otherwise tax exempt income derived from specified transactions undertaken by a non-resident private equity (PE) fund;

iii. the tax treatment of lease payments incurred by a lessee under a new accounting standard;

iv. whether the conversion of a general legal practice into a limited liability partnership would be treated as a continuation of business; and

v. whether stamp duty group relief previously granted would be withdrawn where the transferee company amalgamates into the transferor company, or another group company, within 2 years from the date of a relevant transaction.

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 on their business operations, should seek professional tax advice.
Interest income of a bond fund exceeding the 5% threshold would be chargeable to tax in Hong Kong

In interpreting the relevant tax provisions for the exemption of nonresident funds in Hong Kong, the IRD has taken the view that interest earned in respect of bonds or notes etc. could only be regarded as income incidental to a specified transaction.

In this context, the specified transaction refers to the buying and selling of the bonds or notes concerned. The IRD considers that the holding of the bonds or notes after they are purchased which gives rise to the interest income, is a separate transaction incidental to the specified transaction.

Being only regarded as income from an incidental transaction but not income from the specified transaction itself, the exemption of such interest income (if otherwise taxable in Hong Kong) will be subject to a 5% threshold test. In other words, such interest income will only be tax exempt in Hong Kong if it does not exceed 5% of the relevant total income of the non-resident fund. Otherwise, such interest income in total will be fully chargeable to tax in Hong Kong.

Because the interest income of a bond fund for any one year may likely exceed the 5% threshold, the HKICPA expressed concern that the above interpretation adopted by the IRD may subject many bond funds to tax in Hong Kong.

Given the above, and in view of the growing popularity of bond funds, the HKICPA asked whether the IRD would consider adopting a more liberal approach to interpreting the relevant tax provisions, or consider amending the definition of “specified transactions” in order to address such concerns.

The IRD however stated that its above interpretation was in line with the legislative intent when the law was enacted in 2006. Given that there has been no change in the legislative intent since the date of enactment, the IRD did not find it appropriate to deviate from its current interpretation of the relevant tax provisions.

The IRD added that even though the Commissioner of Inland Revenue was empowered to amend the definition of “specified transactions”, any such changes would require justifications and in-depth policy consideration. There was no current plan to make such a move to address such concerns.

Tainting effect – a single non-specified transaction would cause income derived from specified transactions of a PE fund to be chargeable to tax in Hong Kong when such income would otherwise be exempt

A non-resident (i.e., offshore) PE fund which carries on business in Hong Kong would be tax exempt in Hong Kong provided that the fund only undertakes certain specified transactions (including deriving income from incidental transactions, subject to the 5% threshold discussed above). Such specified transactions could either be undertaken directly by the PE fund itself, or undertaken through a special purpose vehicle (SPV) company owned by the PE fund.

For PE funds, specified transactions include transactions in certain excepted private companies (EPCs). An EPC is defined as a private company incorporated outside Hong Kong which does not, directly or indirectly, carry on business in Hong Kong through a permanent establishment in Hong Kong or own any immovable property in Hong Kong, subject to a 10% exception threshold. Such qualifying conditions for an EPC have to be satisfied at all relevant times during a 3-year look-back period from the date the private company concerned is disposed of.

While the legislative provisions are clear as regards the tainting effect where all transactions are undertaken directly by a fund itself, there is less clarity where the relevant transactions are undertaken by SPVs owned by the fund, instead of by the fund itself. For example, it may not be so clear whether one transaction in a non-EPC (i.e., a non-specified transaction) undertaken by an SPV would taint or render chargeable to tax in Hong Kong the otherwise tax-exempt income derived from transactions in EPCs (i.e., specified transactions) undertaken by other SPVs. The HKICPA sought clarification from the IRD on this point.

The IRD indicated that it should be clear that a transaction by a PE fund in an overseas private company, directly or indirectly held, which failed to qualify as an EPC, would taint the exemption status of both the PE fund and the SPVs concerned.

The HKICPA then expressed its concern that such a strict interpretation of the tainting effect of the legislative provisions would be onerous and adversely affect the attractiveness of Hong Kong’s offshore PE fund regime vis-à-vis Singapore in particular. The HKICPA considered that it would be fairer if PE funds which carried on both specified and non-specified transactions were chargeable to tax in Hong Kong in respect of income derived from the latter only. This would particularly be the case given that PE funds often do not have sufficient control over the business operations of their investee companies. As a result, PE funds may be unable to ensure that each one of their portfolio investment would necessarily satisfy the qualifying conditions for an EPC throughout the 3-year look-back period.
Whilst duly noting these concerns, the IRD stated that its duty was to administer the law as it was and not what the IRD wished it to be. As such, there was no room for the IRD to relax the tainting effect by only subjecting to tax income derived by a PE fund from non-specified transactions, whilst treating as tax exempt income derived from specified transactions.

Nonetheless, the IRD indicated that the tainting effect should be applied on a year by year basis. Furthermore, to address the industry’s concerns over the tainting effect, the legislative bill for the tax exemption of resident open-ended fund companies (OFCs) would allow OFCs to invest in non-permissible asset classes, subject to a 10% exception threshold.

**Tax treatment for leases not affected by new accounting standard HKFRS 16**

The new Hong Kong Financial Reporting Standard (HKFRS) 16 in respect of Leases issued in 2016 will eliminate the distinction by a lessee of a lease as being an operating lease or a finance lease. Instead, HKFRS 16 introduces a single lessee accounting model under which all leases will be treated similar to a finance lease under the existing Hong Kong Accounting Standard (HKAS) 17.

Under HKFRS 16, the balance sheet of the lessee will recognize a right-of-use asset representing their right to use the underlying leased asset and a lease liability representing the present value of the future lease payments that the lessee is obliged to pay. Depreciation of the leased asset (i.e., the right-of-use asset) and interest on the lease liability will be charged to the profit and loss account of the lessee.

The new HKFRS 16 will be effective for annual periods beginning on or after 1 January 2019, but early adoption is permitted for entities under certain conditions.

The HKICPA sought the IRD’s view on the relevant tax treatment of lease payments incurred by a lessee under the new HKFRS 16 where such payments were for the production of profits chargeable to tax in Hong Kong.

The IRD stated that tax deductions for lease payments incurred by a lessee were governed by sections 16 and 17 of the Inland Revenue Ordinance (IRO). As such, if the lease payments were in the nature of rental for the use of the leased asset only (as often the case under a typical operating lease under the current HKAS 17), the lessee should be entitled to tax deductions in respect of the lease payments. On the other hand, if the lease payments were, in substance, consideration for the sale of goods purported to be a “lease” (as often the case under a typical finance lease under the current HKAS 17), the relevant lease payments excluding the interest element would be outgoings of a capital nature which were not tax deductible for profits tax purposes, although they might qualify for tax depreciation allowances.

The IRD considered that the implementation of HKFRS 16 would have no effect on the operation of sections 16 and 17 of the IRO. As such, the legal form and substance of the relevant contractual arrangements for a lease would still have to be ascertained in order to determine the tax treatment of the lease payments concerned, regardless of the single lessee accounting model to be adopted under HKFRS 16.

**Conversion of a general legal practice into a limited liability partnership would generally be regarded as a continuation of business**

Hong Kong has recently enacted a new law which permits an existing legal practice (generally a partnership or a sole proprietorship) to convert into a limited liability partnership (LLP), subject to an application to the Law Society of Hong Kong and satisfaction of certain conditions.

In response to clarifications sought by the HKICPA, the IRD confirmed that subject to any written agreement between the partners to the contrary, the application of the new law together with section 22(3) of the IRO, would generally render such a conversion as a continuation of business for tax purposes. As such, for tax purposes, there would be no need for the prior legal practice to file a cessation return and no need for the new LLP to file a commencement return.

**Stamp duty group relief previously granted will not be withdrawn even if transferee company subsequently ceases to exist as a separate limited liability company pursuant to an amalgamation**

To qualify for the stamp duty exemption for intra-group transfer of Hong Kong immovable property or stock, the transferor and the transferee companies must not cease to be at least 90% associated within two years after the transfer in question. Otherwise, the exemption previously granted in respect of the transfer will be withdrawn under section 45(5A) of the Stamp Duty Ordinance (SDO).

The HKICPA sought the IRD’s confirmation that the stamp duty exemption previously granted would not be withdrawn even if the shares of the transferee company were cancelled pursuant to a subsequent court-free amalgamation under Hong Kong’s Companies Ordinance. The confirmation was sought because such a cancellation of shares may technically or literally cause the associated relationship between the transferor and the transferee to cease, by reason of section 45(4)(c) of the SDO and there being a change in the percentage of the issued share capital of the transferee in the beneficial ownership of the transferor or a third corporation.

The IRD stated that it considered that such a technical or literal change in the percentage of the issued share capital of the transferee in the beneficial ownership of the transferor or a third corporation was not a situation contemplated by section 45(5A) of the SDO. As such, the stamp duty exemption previously granted would not be withdrawn where the transferee amalgamated into the transferor on the basis that under the Companies Ordinance the transferor and the transferee would be treated as the same entity after a court-free amalgamation. Where the transferee subsequently amalgamated into another group company other than the transferor, the stamp duty exemption previously granted would also not be withdrawn, so long as the amalgamated company remained at least 90% associated with the transferor.
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