Hong Kong

Inland Revenue Department publishes updated guidance on the salaries tax treatment of contributions to and withdrawals from retirement schemes

Executive summary
On 31 May 2019, the Inland Revenue Department (IRD) released Departmental Interpretation and Practice Notes No. 23 (Revised) – Recognized Retirement Schemes, which updates the Department’s guidance on the salaries tax treatment of contributions to and withdrawals from retirement schemes. This replaces the guidance that was previously issued in September 2006.

The key updates in this practice note are as follows:

► Following recent changes to the Mandatory Provident Fund (MPF) Schemes, there is updated guidance on the tax exemptions in relation to withdrawal of accrued benefits on the ground of terminal illness; withdrawal by instalments; and tax deductible MPF voluntary contributions (TVC) starting from 1 April 2019

► Preparing for the abolition of offsetting severance or long service payments with accrued benefits and how this impacts salaries tax treatment

► Clarifying salaries tax treatment of investment returns and tightening up of a number of definitions

► Corporate tax treatment of contributions made by the employer into a defined benefit scheme shall be aligned to that of defined contribution schemes

Main changes
Tax exemption for withdrawal of accrued benefits on the ground of terminal illness, withdrawal by instalments
Since 1 August 2015, it has been possible to make an early withdrawal of accrued benefits from retirement schemes on the ground of “terminal illness”. Terminal illness is defined as an illness that is likely to reduce the life expectancy of a person to twelve months or less. Applicants wishing to withdraw early on this ground must furnish a medical certificate from a registered medical practitioner. Sums or accrued benefits withdrawn from recognized retirement schemes as a result of terminal illness are exempt from salaries tax.

With effect from 1 February 2016, MPF accrued benefits are allowed to be withdrawn by instalments upon retirement or early retirement. The practice note clarifies that such withdrawal by instalments shall not be subject to salaries tax. However, please note withdrawal by instalments is not generally permissible in the case of permanent departure from Hong Kong, total incapacity, terminal illness etc. Provided certain conditions are met, withdrawal by lump sum may be allowed and usual salaries tax treatment shall prevail.
**Tax deductible MPF voluntary contributions**

Contributions paid into a TVC account in a registered MPF scheme are tax deductible (up to a certain cap) under salaries tax or tax under personal assessment starting from the year of assessment 2019/20. TVC means tax deductible MPF voluntary contributions which are subject to same preservation requirements as MPF mandatory contributions e.g., withdrawal is allowed only upon retirement etc. The maximum tax deduction (the aggregate limits for both qualifying annuity premiums and tax deductible MPF voluntary contributions) for the year of assessment 2019/20 onwards is HK$60,000 per person.

The practice note specifically mentions that the tax deductions are only in respect of contributions made into a TVC account. Voluntary MPF contributions made by an employee that do not go into a TVC account are not tax deductible.

There is further guidance issued by the IRD in DIPN No. 57 “Concessionary Deductions: Section 26N to 26U Annuity Premiums and MPF Voluntary Contributions” that sets out in detail how the tax deductions can be applied. EY has also issued a separate HR alert covering this practice note.

**Offsetting severance or long service payments**

Employers are currently allowed to offset statutory severance or long service payments with accrued benefits from the employer’s mandatory and voluntary contributions in the MPF scheme. The government has announced in its 2018 Policy Address that there are plans to abolish this. Until such time, whilst the offset is still available, the practice note sets out an example on the salaries tax treatment:

- 5-years’ service at the time of redundancy with salary of HK$22,500 per month
- Statutory severance payment was calculated as: HK$22,500 × 2/3 × 5 years = HK$75,000
- Employer offsets statutory severance payment with its mandatory and voluntary contributions in the MPF scheme
- Accrued benefits attributable to the employer’s mandatory contributions HK$40,000 and voluntary contributions HK$30,000 under the scheme was paid to Employee upon request
- Severance payment received from Employer after setting off the accrued benefits above: HK$75,000 – (HK$40,000 + HK$30,000) = HK$5,000*
- Calculation of proportionate benefit (“PB”):
  - PB = HK$30,000 × 60 months/120 months = HK$15,000
- Calculation of taxable benefit:
  - Taxable benefit = HK$30,000 – HK$15,000 = HK$15,000

*Under the relevant provisions of the Employment Ordinance, given that the Employer had already made mandatory and voluntary contributions to the MPF scheme in the aggregate of HK$70,000, the Employee would only be entitled to receive a severance payment of HK$5,000.

As such, while the Employee’s receipt of the mandatory contributions of $40,000 to the MPF scheme by the Employer is tax exempt under section 9(1xad) of the Inland Revenue Ordinance, the taxability of the receipt of the voluntary consideration of HK$30,000 is subject to the proportionate benefit rule.

Under the PB rule, where an employee’s relevant services are 10 years or more, the relevant amount received will be tax exempt. Where the relevant services are less than 10 years, the tax-exempt amount will be proportionately reduced.

**Accrued benefits**

When calculating the proportionate benefit, accrued benefit means:

- the maximum benefit that the person would have been entitled to when his employment was terminated in respect of a recognized occupational scheme; and
- the benefit that is attributable to the employer’s voluntary contribution in respect of a MPF scheme.

The practice note clarifies that accrued benefits shall include the investment return arising from the employer’s voluntary contributions.

**Definitions**

There is now a definition of terminal illness, which is separate to incapacity, which means a permanent unfitness to perform work. The practice note clarifies that work or employment must have ceased in order for the withdrawal of accrued benefits on the ground of incapacity to be exempt from tax.
Employers’ tax deduction

Accounting for retirement schemes is governed by Hong Kong Accounting Standard 19 Employee Benefits (“HKAS 19”), issued by the Hong Kong Institute of Certified Public Accountants. For defined benefit schemes, a tax deduction for corporate tax purposes was previously allowed to follow the commercial accounting treatment, subject to an overall cap that the deduction shall not exceed 15% of the total emoluments of the employee for the period to which the payments relate. The practice note is now updated to specifically clarify that commercial accounting treatment does not represent the true cost to the employer and tax deduction for the employer shall be same as for defined contribution scheme, i.e., the ordinary annual contributions paid are allowable for deduction, subject to the 15% cap.

Other issues

► The practice note contains a number of examples illustrating the salaries tax treatment with respect of transfer of accrued benefits, including how to count the number of service years for the purposes of calculating proportionate benefit.
► There is no tax implication on the employee upon transfer of the accrued benefit attributable to mandatory contributions under the Employee Choice Arrangement.
► For the purposes of calculating the employer mandatory contributions to MPF, housing allowance and other housing benefit expressed in monetary terms are included in the definition of “relevant income”.
► In context of international law and double tax treaty, situs of pension shall be the situs of the fund from which the pension is paid. This is usually the place where the fund is managed and controlled.

What does this mean for employers?

Employers should review their retirement schemes in order to evaluate the salaries tax implications, as well as employer and employee reporting obligations in relation to contributions to and withdrawals from retirement schemes.

If you require further information in relation to retirement schemes, please do not hesitate to contact your local EY advisor or one of the contacts listed below.

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EYG no. 003221-19Gbl

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