

Hong Kong Tax Alert

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2018/19 profits tax filing - additional forms requiring detailed information to be completed and filed by taxpayers with the IRD

The requirement to provide this additional information is for the purposes of determining a taxpayer's eligibility for preferential tax benefits offered and to ensure their compliance with the transfer pricing regime of Hong Kong.

Efforts will be required to collate and present the relevant information in an appropriate manner. Clients should seek professional tax advice where necessary.

An environment of tax transparency

To enhance its tax competitiveness internationally, Hong Kong has recently introduced several tax measures to increase Hong Kong's attractiveness to investors, particularly for businesses in the financial, innovation and technology sectors.

These tax measures include a two-tiered profits tax rates regime, enhanced tax deductions for expenditure on research and development (R&D), preferential tax regimes for ship owners, aircraft lessors and leasing managers, corporate treasury centers and certain targeted insurance businesses.

However, to prevent potential abuse of these tax measures and to ensure Hong Kong's compliance with the international norm for tax transparency and prevention of avoidance, taxpayers are required to disclose additional detailed information commencing with this April with the filing of their 2018/19 profits tax returns. The relevant disclosures are by way of supplementary forms to be filed together with their 2018/19 profits tax returns.

2018/19 Profits Tax Return - Form BIR 51

Hong Kong Standard Industrial Classification Code

Many more questions are asked of taxpayers in the 2018/19 Profits Tax Returns. One such question of note is that taxpayers are required to state in Box 4.4 of the Form BIR 51 their principal business activity by reference to the 6-digit code applicable under the Hong Kong Standard Industrial Classification as maintained by the Census and Statistics Department (C&SD).

Taxpayers can go to the relevant [webpage](#) of the C&SD to check the industry code to which their principal business activity belongs. If a taxpayer does not have any business activity during the year, they should state "000000" as their industry code.

The purpose of the industry code is to provide the Inland Revenue Department (IRD) with a more accurate and reliable means to categorize and benchmark the income and expenditure patterns of taxpayers in the same line of business, including their gross profit levels. Such information will be very useful for the IRD's risk-based audit approach.

New Supplementary Forms S1 to S10

In addition to completing the 2018/19 Form BIR 51, certain categories of taxpayers will be required to provide the IRD with additional detailed information, by way of completing and filing certain supplementary forms, numbering from S1 to S10. This requirement will apply to taxpayers who:

1. Have elected to be taxed under the two-tiered profits tax rates regime where, not belonging to a Hong Kong listed group, they had connected entities carrying on business in Hong Kong for the year;
2. Belong to an international group which has Country-by-Country (CbC) Report filing obligation in Hong Kong or elsewhere;
3. Have concluded an advance pricing arrangement with the IRD;
4. Have transactions with non-resident associated persons;
5. Have claimed deduction for R&D expenditure under section 16B of the Inland Revenue Ordinance (IRO);
6. Have claimed deduction for expenditure on energy efficient building installation under section 16I of the IRO;
7. Fall within the scope of the preferential tax regimes of Hong Kong listed below as:
 - a. a ship owner;
 - b. a professional reinsurer;
 - c. an authorized captive reinsurer;
 - d. a qualifying corporate treasury center;
 - e. a qualifying aircraft lessor;
 - f. a qualifying aircraft leasing manager.

These supplementary forms will not however be enclosed together with the hard-copy BIR 51 Forms sent to taxpayers by the IRD.

Instead, whenever any of the forms S1 to S10 are applicable, taxpayers will have to go to the IRD's webpage¹ to access and complete the relevant Form(s) electronically. After completing the relevant Form(s) in their electronic format, taxpayers will then have to print, hand-sign and then file the relevant Form(s) together with the Form BIR 51, all in hard-copy format, with the IRD².

Form S1 - The two-tiered profits tax rates regime

Under the IRO, only one of a group of connected entities can elect to be taxed under the two-tiered profits tax rates regime, whereby the first two million of profits will be taxed at the lower half-rate of tax at 8.25%. As such, to prevent potential abuse of the regime and double claims, taxpayers are required to furnish the IRD with certain additional information.

Firstly, taxpayers electing to be chargeable to tax under the two-tiered profits tax rates regime are required to check "Yes" to Box 2.3 of the 2018/19 BIR 51 Form.

For taxpayers who have made such an election and (i) had connected entities carrying on a trade, profession or business in Hong Kong; and (ii) are not a member of a group listed on the Stock Exchange of Hong Kong, they will also need to check "Yes" to Box 9.1

In addition, such taxpayers are also required to complete Form S1 by listing the names of all connected entities carrying on a trade, profession or business in Hong Kong together with their business registration numbers.

Where applicable, such a list will include the name of connected non-Hong Kong resident entities that are deemed to be carrying on a trade, profession or business in Hong Kong (e.g., a non-Hong Kong resident entity which receives royalties from its connected entities in Hong Kong). Such an inclusion is required because those non-Hong Kong resident connected entities will also be eligible for the two-tiered profits tax rates regime in Hong Kong.

¹ Samples of the 2018/19 Profits Tax Return and Supplementary Forms can be accessed from the following [link](#). E-fillable Supplementary Forms will be available for downloading with effective from 1 April 2019 from the following [link](#).

² Those qualifying as a small corporation and opting to file their profits tax returns electronically will not be required to complete and file Forms S1 to S10.

Form S2 - Transfer pricing

The following are required to complete and file Form S2, taxpayers who (i) have transacted with non-resident associated persons; (ii) have entered into an advance pricing arrangement with the IRD; or (iii) belong to a large international group with a consolidated group turnover for a preceding year of not less than HK\$6.8 billion, and therefore have an obligation to file CbC Report in Hong Kong or elsewhere.

Clients may also refer to our previous tax alert issued on 24 January 2019 in which we discussed the type of detailed information required to be provided in Form S2 and the tax implications thereof.

Form S3 - Enhanced tax deductions for R&D expenditure

Under the new regime that provides for enhanced tax deductions for R&D expenditure incurred on or after 1 April 2018, the first two million of qualifying R&D expenditure on qualifying R&D activities will be eligible for a 300% tax deduction and the remainder deductible at 200% (section 16B of the IRO refers).

Other R&D expenditure, including that related to the acquisition of relevant fixed assets, other than land and buildings, may qualify for the normal 100% deduction under section 16B of the IRO.

However, there are restrictions on both the enhanced and normal tax deductions where the R&D activities are not undertaken in-house by the taxpayers themselves but are instead sub-contracted out to be performed by other service providers.

Furthermore, under section 16B of the IRO, where an enhanced or a normal tax deduction for R&D expenditure is allowed, royalty income arising from any intellectual property rights generated as a result of the relevant R&D activities, wherever earned, would be taxable in Hong Kong. Similarly, sales proceeds upon disposal of the intellectual property rights would be taxable in Hong Kong up to the value of the deductions previously allowed.

Taxpayers who claim R&D expenditure for enhanced or normal deductions under section 16B of the IRO are required to complete Form S3. Detailed information including the name and nature of the R&D projects and the types of expenditure involved is required in order that the IRD can determine whether the expenditure is qualifying R&D expenditure on qualifying R&D activities.

Form S4 - Expenditure on energy efficient building installation

Under section 16I of the IRO, taxpayers are eligible to claim a 100% tax write-off on capital expenditure on energy efficient building installations registered under the Hong Kong Energy Efficiency Registration Scheme for Buildings administered by the Electrical and Mechanical Services Department in the year in which the expenditure was incurred.

Such taxpayers are required to complete and file Form S4 detailing the basis of their claims.

Form S5 to Form S10 - Taxpayers qualifying for the preferential tax regimes

All the preferential tax regimes referred to above have strict conditions and terms that taxpayers must satisfy before they can qualify for the tax benefits offered.

Furthermore, under the 2015 Action 5 Report on Countering Harmful Tax Practices of the Base Erosion and Profit Shifting Project undertaken by the Organisation of Economic Co-operation and Development (OECD), there is a local substantial business requirement for preferential tax regimes.

Under the 2015 Action 5 Report, a jurisdiction may only offer a preferential tax regime where the relevant core income generating activities covered by the regime are undertaken by taxpayers in the jurisdiction concerned. Otherwise, such a preferential tax regime will potentially be regarded as a harmful tax practice liable to be sanctioned by other jurisdictions.

To ensure compliance with the local substantial business requirement, a jurisdiction is also required to report annually to the OECD certain norm and statistical figures related to taxpayers who enjoy preferential tax regimes.

In the context of Hong Kong, under section 26AB of the IRO, the Commissioner of Inland Revenue may prescribe, in relation to the local substantial business requirement for the preferential tax regimes referred to above, a minimum threshold of activities in Hong Kong.

Such a threshold, when prescribed, would be measured by indicators such as the number of full time employees in Hong Kong who carry out the activities and have the necessary qualifications; and the amount of operating expenditure incurred in Hong Kong in undertaking the activities concerned etc.

Form S5 to Form S10 are therefore designed with the above in mind, i.e., the forms request detailed information to ensure the eligibility of taxpayers who wish to enjoy the preferential tax regimes and ensure Hong Kong's compliance with the local substantial business requirement.

Qualifying taxpayers, regardless whether they actually claim the tax benefits in a given year, are required to complete these Form(s) whenever they apply to them.

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