IRD clarified various profits tax and stamp duty issues in recently published minutes[1] of its 2024 annual meeting with the HKICPA

The tax treatments clarified included:

(i) foreign mergers under universal succession where Hong Kong branches of foreign companies were involved would be similar to a qualifying amalgamation carried out under the Companies Ordinance of Hong Kong, if the anti-avoidance provisions contained in section 61A and 61B of the Inland Revenue Ordinance (IRO) were not invoked;

(ii) provision of long service payment (LSP) made as a result of the abolition of the offsetting of employers' contributions to mandatory provident funds (MPF) or other retirement schemes against LSP payable to employees would be tax deductible, regardless of which one of the two equally acceptable accounting treatments endorsed by the Hong Kong Institute of Certified Public Accountants (HKICPA) was adopted;

(iii) except for unilateral tax credit in limited situations, foreign tax credit (FTC) would only be granted in Hong Kong if a taxpayer was chargeable to tax overseas in accordance with the terms of a comprehensive avoidance of double taxation agreement (CDTA). As such, taxes paid overseas on service income in a CDTA-jurisdiction that was also taxable in Hong Kong would not be creditable in Hong Kong, if the taxpayer had no permanent establishment (PE) in the overseas CDTA-jurisdiction. Where there was a PE, the limit of the FTC would need to be calculated on an actual rather than a deemed profit basis;

(iv) the term "brought into account for tax purposes" under the tax certainty enhancement scheme (TCES) was intended to mean equity interests that were trading stock would be ineligible for the TCES;

(v) notwithstanding the complicated accounting treatment for sale and leaseback arrangements under Hong Kong Financial Reporting Standard 16 (HKFRS 16), the tax consideration would still be whether the income recognized in, or expense charged to the profit and loss account represented a non-taxable/non-deductible capital item or a taxable/deductible revenue item; and

(vi) distribution of Hong Kong stocks or immovable properties of a general or limited partnership upon the termination of the partnership on a pro-rata basis to its partners, with reference to their respective capital accounts contributions to the partnership would not attract stamp duty in Hong Kong.

The views expressed by the Inland Revenue Department (IRD) on the issues however only represent how the IRD would interpret the various provisions of the IRO as applied to the given facts.

While such views provide some guidance on how the provisions would generally be construed, the application of the provisions to certain other factual situations could be different.

Clients who have any questions on how the provisions would apply to their situations should contact their tax executives.

[1] The minutes of the 2024 annual meeting can be retrieved from the link below:
https://www.hkicpa.org.hk/-/media/Document/APD/TF/Tax-bulletin/035_May-2025.pdf

Foreign mergers involving Hong Kong branches

Foreign mergers are not "qualifying amalgamations", which only cover amalgamation of two or more wholly owned Hong Kong incorporated companies under the Companies Ordinance of Hong Kong. As such, Hong Kong branches of foreign companies involved in a foreign merger cannot avail themselves of the special tax treatments under Part 6C and Schedule 17J of the IRO.

The provisions contained in Part 6C and Schedule 17J of the IRO generally treat the business(es) of the amalgamating company(ies) as being succeeded by the amalgamated company, i.e., the surviving company, thus rendering the amalgamating company(ies) generally not exposed to tax as a result of the amalgamation.

Regarding foreign mergers, the IRD indicated that they were generally effected under universal succession, which was a legal concept under civil law systems. Universal succession provided for the artificial continuance of a person by another, and all the rights and liabilities of the former person would automatically be transferred to and vested in the latter. Though common law system adopted by Hong Kong did not have a concept of universal succession, Hong Kong laws did recognize and accept mergers effected by way of universal succession if the merger was allowed under the law of the jurisdiction of the merging entities.

Section 61A consideration regarding succession of assets and liabilities under a foreign merger

As such, for the purposes of the IRO, if the IRD was satisfied that a foreign merger was not carried out for the purposes of obtaining tax benefits within the terms of sections 61A, the transfer of assets and liabilities to the surviving entity would be by operation of law, thereby not constituting a sale. Furthermore, the surviving entity would generally be treated as far as possible as if it were the continuation of and the same person in law as the merging entity(ies). Thus, the transfer of assets and liabilities under a foreign merger would generally not expose the merging entity(ies) to any tax liabilities in Hong Kong.

Section 61A consideration regarding pre-merging tax losses

In considering whether section 61A would be applicable to a foreign merger, the IRD indicated that whether the merger had created rights or obligations which would not normally be created between persons dealing with each other at arm's length, i.e., one of the seven factors to be considered under section 61A, would be relevant.

In such consideration, the factors such as the same trade test, trade continuation test, financial resources test and post entry test specified under Schedule 17J might come into play in considering whether or how any pre-merging tax losses could be carried forward to offset against the post-merging taxable profits of the surviving entity.

The above seems to indicate that if sections 61A and 61B of the IRO are not invoked, the tax treatments of a foreign merger under universal succession would be similar to those of a qualifying amalgamation.

Provision for LSP

A new law has been passed in Hong Kong whereby effective from 1 May 2025 (the transition date), the employers' rights to utilize their contributions to MPF or other retirement schemes to offset against their obligations to pay LSP to employees for the pre-transition period has been abolished.

Many employers had previously not made any provision for LSP because under the offsetting mechanism, the amount involved might be immaterial. However, as a result of the abolition, the amount involved may become material and many employers may thus now need to make a one-time catch-up provision for LSP in their accounts as a cost for past services provided by employees.

The IRD indicated that such a one-time catch-up provision for costs for past services provided by employees would represent a normal operating expense incurred by an employer, provided that the LSP made was in accordance with the provision of the Employment Ordinance. Therefore, such an expense would be on revenue rather than capital account. As such, the provision would be tax deductible under section 16(1) of the IRO.

This would be the case regardless of which one of the two equally acceptable accounting treatments endorsed by the HKICPA[2] was adopted, notwithstanding that for any one year, the amounts charged to the profit and loss account could be different under these two different accounting approaches.

[2] The bases and the accounting entries of these two equally acceptable accounting treatments endorsed by the HKICPA can be found at: https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/gMPFLSP.pdf

The IRD noted that some of the re-measurements, gains or losses for ascertaining the amount of provision that needed to be made might be reflected as other comprehensive income (OCI) rather than charged to the profit and loss account in the financial statements. Nonetheless, the IRD considered that the amounts charged to the OCI would be regarded as part of the LSP. Thus, the amounts involved would be taxable or deductible as the case may be.

The IRD's above acceptance of either one of the two equally acceptable accounting treatments endorsed by the HKICPA for tax purposes is consistent with the taxation principles stated by Lord Millet in the Court of Final Appeal in the *Secan*[3] case that:

> "Where the taxpayer may properly draw its financial statements on either of two alternative bases, the Commissioner is both entitled and bound to ascertain the assessable profits on whichever basis the taxpayer has chosen to adopt. He is bound to do so because he has no power to alter the basis on which the taxpayer has drawn its financial statements unless it is inconsistent with a provision of the Ordinance…"

On a separate occasion, the IRD has indicated that it would also, as a matter of assessing practice, accept taxpayers claiming the tax deduction for LSP on an "as and when paid" basis, i.e., not following the accounting treatments provided that there would not be any double claims.

Calculation of foreign tax credit (FTC)

The question raised was whether tax suffered in mainland China in respect of service income received by a Hong Kong resident taxpayer on a deemed profit basis would be creditable in Hong Kong if the service income was also chargeable to tax in Hong Kong.

The IRD indicated that under the terms of the CDTA between Hong Kong and mainland China, business profits of a Hong Kong resident taxpayer would only be liable to tax in mainland China if they had a PE located there to which the service income was attributable. Otherwise, the service income as business profits of the Hong Kong resident taxpayer should not be liable to tax in mainland China under Article 7 of the CDTA.

Furthermore, Article 21(2) of the CDTA provided that tax paid in the mainland China in accordance with the provisions of the CDTA in respect of any item of income derived from sources in mainland China by a Hong Kong resident taxpayer should be allowed as a credit against Hong Kong tax imposed on that resident.

If, for any reasons, absent a PE, the tax authorities in mainland China imposed tax on the service income on a deemed profit basis, the tax so charged would then not be in accordance with the provisions of the CDTA. Thus, the tax paid in mainland China on such basis would not be creditable or deductible in Hong Kong.

In such cases, if despite the objection lodged against the imposition of tax, the tax authorities in mainland China insisted on taxing the service income, the taxpayer could request the IRD to invoke the mutual agreement procedure under the CDTA as a means of seeking to resolve the dispute with the tax authorities in mainland China.

Where the Hong Kong resident taxpayer had a PE in mainland China, the tax paid in respect of the service income attributable to the PE on a deemed profits basis would then be creditable in Hong Kong, in an unlikely situation that the service income involved could not be claimed as offshore sourced in Hong Kong,

However, the FTC creditable in Hong Kong would be restricted to the profits tax payable in Hong Kong in respect of the service income calculated under the provisions of the IRO on an actual rather than deemed profit basis.

Therefore, in the event that the tax paid in mainland China in respect of the service income calculated on a deemed profit basis was greater than that calculated on an actual profit basis under the IRO, the excess portion of the tax paid in mainland China would not be creditable. Neither would it be deductible for tax purposes in Hong Kong.

It appears that the basis of FTC claims in Hong Kong explained above by the IRD would also apply to any tax paid in respect of a representative office (RO) established by a Hong Kong resident taxpayer in mainland China, which may often be taxed in mainland China on a deemed profit basis by grossing up the expenses incurred by the RO.

That means, unless the activities of the RO exceed those permitted and therefore the RO is effectively an operating branch or PE of a Hong Kong resident taxpayer, any corporate income taxes suffered in mainland China in respect of the activities of the RO would not be creditable or deductible in Hong Kong.

[3] *Commissioner of Inland Revenue v Secan Ltd. & Ranon Ltd.* 5 HKTC 266

TCES for non-taxation of onshore equity disposal gains

Under the TCES, subject to certain other conditions, onshore gains in respect of the disposal of any part of an equity interest representing at least 15% of the total equity interests of an investee entity that has been held by the investor for at least 24 months would automatically be regarded as non-taxable capital income. That means the non-taxable claim would not then need to be determined based on the normal "six badges of trade" test.

An exception for the above rule under the TCES is that the equity interest held has been "brought into account for tax purposes".

The IRD explained that the term "brought into account for tax purposes" under the TCES was intended to mean that equity interests that were trading stock of a taxpayer would not be eligible for the TCES.

For example, if any unrealized fair value gain or loss arising from, or provision for diminution in value of equity interests (specified equity interests) had been brought into account under an assessment or loss statement for a year of assessment, such sum would be regarded as "brought into account for tax purposes" and the specified equity interests would be regarded as trading stock ineligible for the TCES.

The IRD added that for a taxpayer holding equity instruments that did not prepare financial statements with a specified reporting standard (essentially fair value accounting) under section 18G of the IRO or did not make an election under section 18H for fair value accounting for tax purposes, any profit or loss on their equity instruments would be taxed on a realization basis. Under such circumstances, only profit or loss that was realized from actual disposal of equity instruments that was included in an assessment or loss statement would be regarded as "brought into account for tax purposes" under the TCES.

The IRD's explanation in the immediately preceding paragraph seems to be relevant to certain situations. For example, a previous gain or loss in respect of the disposal of part of a tranche of equity interests, that was acquired on the same occasion and represented at least 15% of the total equity interests in an investee entity that had been held for at least 24 months, had been offered for tax assessment or claimed for tax deduction. In such case, any subsequent gains derived from the disposal of the remaining equity interests in the investee entity held under this tranche of investment would be ineligible for the TCES.

Tax treatment for sale and leaseback transactions recognized under HKFRS 16

Under HKFRS 16, the accounting treatment of a sale and leaseback of an asset by the original owner (seller-lessee) is complicated.

Conceptually, as the original owner of the asset, the seller-lessee is regarded as having the right-of-use (ROU) of the asset before the sale of the asset to the buyer in a sale and leaseback transaction. Thus, under HKFRS 16, the sale and leaseback transaction would be treated as the seller-lessee retaining part of the ROU under the terms of the leaseback arrangement.

Briefly, the amounts charged to the profit and loss account under the complicated accounting treatment for a year during the leaseback period would generally involve (i) sums representing the rental payments for the leaseback period and (ii) sums representing the previous unrecognized gain or loss on the disposal of the asset to the buyer.

The IRD stated that the tax principle involved was whether the amounts charged to the profit and loss account represented a disallowable or non-taxable capital item or a deductible revenue item.

Applying this tax principle, sums (i) referred to above would be a deductible revenue item under section 16(1), if the asset was used for the production of profits chargeable to tax in Hong Kong during the leaseback period. Sums (ii) would however be a capital loss disallowable under section 17(1) or non-taxable gain under section 14(1) of the IRO, if the asset disposed of was a fixed asset of the seller-lessee.

Clients who wish to understand more about the complicated accounting treatment under HKFRS 16 for a sale and leaseback arrangement can refer to item A1(a) of the minutes of the 2024 annual meeting.

Stamp duty – distribution of Hong Kong stocks or immovable properties upon termination of a limited and general partnership

Distribution of Hong Kong stocks or immovable properties to shareholders upon the dissolution of a corporation on a pro-rata basis to their respective shareholdings in the corporation generally would not attract stamp duty in Hong Kong. The IRD has previously indicated that such a distribution would not involve a change in the beneficial ownership of the Hong Kong stocks or immovable properties under section 27(5) of the Stamp Duty Ordinance (SDO).

The issue is whether the same rule applies to the distribution of Hong Kong stocks or immovable properties to the partners of a general or limited partnership upon termination of the partnership on a pro-rata basis with reference to the capital accounts of the partners involved.

The IRD indicated that the same rule applied to such a distribution if the assets concerned were the assets of the partnership.

The IRD added that whether the stocks or immovable properties were partnership properties or not was to be decided by reference to whether they satisfied the conditions stipulated under section 22(1) of the Partnership Ordinance (Chapter 38) that they were (i) originally bought into the partnership stock; or (ii) acquired on account of the firm; or (iii) acquired for the purposes and in the course of the partnership business. In addition, the stocks or immovable properties must be held and applied by the partners exclusively for the purposes of the partnership agreement.

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