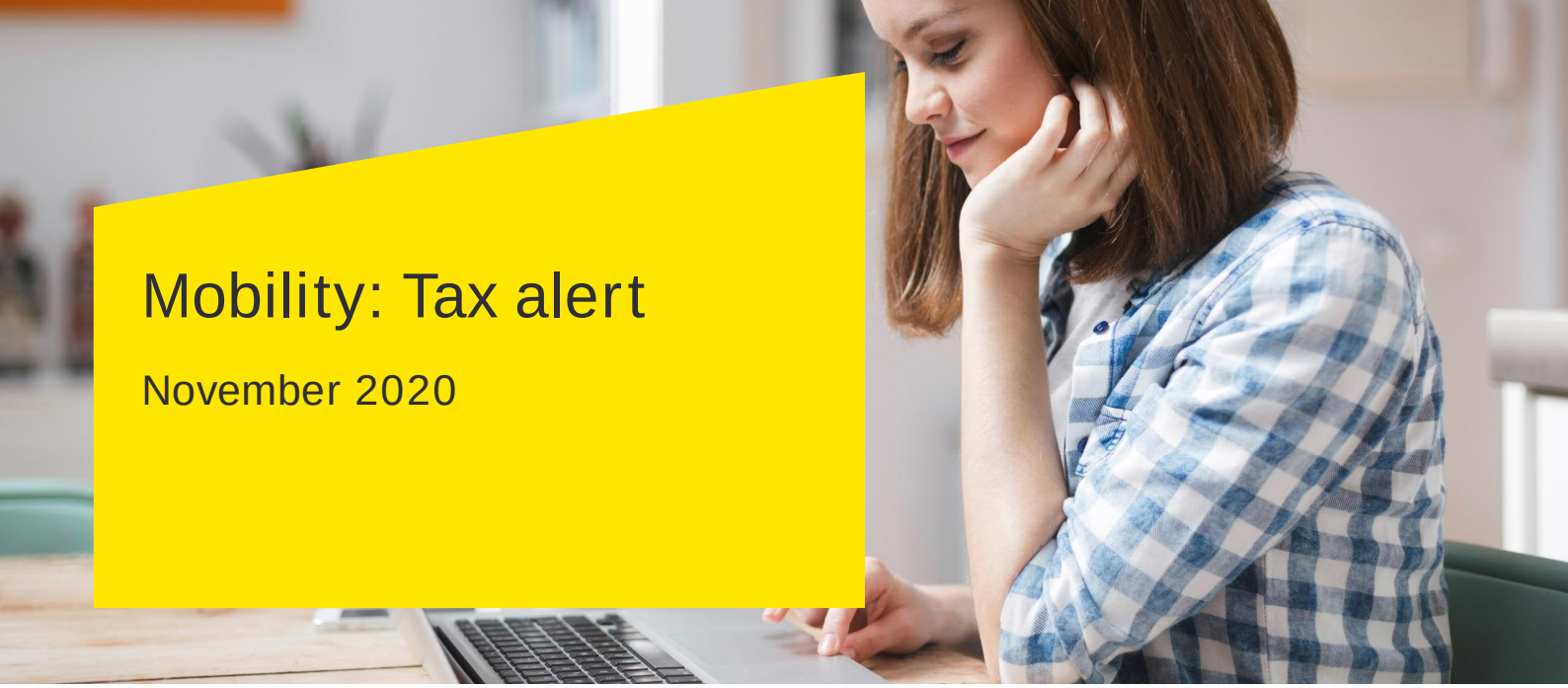

Mobility: Tax alert

November 2020

Hong Kong

Insights from the 2020 Annual Meeting between the Inland Revenue Department and the Institute of Certified Public Accountants

Executive summary

Recently, the Hong Kong Institute of Certified Public Accountants (HKICPA) published a Tax Bulletin covering its Annual Meeting with the Inland Revenue Department (IRD) on 15 May 2020. The HKICPA and the IRD exchanged views on a range of salaries tax issues such as procedures surrounding the tax reporting of bonuses, impact of the Greater Bay Area subsidy, and tax treatment of termination payments. This alert summarises the key points and takeaways exchanged between the HKICPA and the IRD.

(1) Taxation of discretionary bonus

The HKICPA posed a question to the IRD regarding the taxation treatment of discretionary bonuses paid to an assignee after he/she has departed from Hong Kong. The fact pattern proposed by the HKICPA is outlined below:

- Period of Hong Kong assignment: 1 January 2019 to 31 October 2019;
- Relocation to another group company on 1 November 2019;
- In May 2020, discretionary bonus of HK$A relating to financial year ended 31 December 2019 was paid to the assignee;
- The employment contract stipulates that the individual's entitlement to discretionary bonuses in any year is subject to conditions relating to the individual's performance, the financial results of the group for the relevant year and the general economic environment at the time the bonuses are awarded;
- If the assignee renders services in Hong Kong during visits of no more than 60 days in year 2020/21, would any part of HK$A be taxable for salaries tax purposes?

The IRD responded as follows:

- Based on the facts as stated in the example, it is not clear whether the discretionary bonus awarded is attributable to services rendered in the year of assessment 2019/20 or year of assessment 2020/21 or both;
- If the bonus is attributable solely to the year of assessment 2020/21 services, the taxpayer can claim a full exemption from salaries tax under the "60-days" rule;
- If the bonus is attributable solely to the year of assessment 2019/20, it will be taxed as income in 2020/21 based on number of days spent in Hong Kong in the year of assessment 2019/20;
- Furthermore, depending on the facts and merits of each case, anti-avoidance provisions might be invoked to tax bonuses derived from services rendered in Hong Kong;
- Complications might also arise as to when bonuses could be regarded as "accruing" to a taxpayer under Section 11D(b) of the Inland Revenue Ordinance (IRO). This section stipulates that an income accrues when there is an entitlement to claim payment. In the example, if the taxpayer was entitled to claim the bonus before 31 March 2020 notwithstanding that the bonus was paid in May 2020, the bonus would be included as assessable income of the taxpayer for the year of assessment 2019/20.

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- In any case, employers are reminded to report the discretionary bonus in the employer's return according to Notes and Instructions for Forms IR56B/G, i.e., reported in either the year of assessment 2019/20 or 2020/21 depending on when the employee was entitled to claim payment of the bonus, irrespective of the date of the actual payment. A note might however be added under item 14 (Remarks) of the Forms indicating the number of days the employee stayed in Hong Kong during the year of assessment in which the employee rendered services to earn the bonus.

EY observations
Leaving aside the potential application of anti-avoidance provisions, if the discretionary bonus only accrued to the taxpayer in May 2020, the bonus should arguably be income of the taxpayer for the year of assessment 2020/21. Proceeding on this basis, the bonus should not be subject to tax in Hong Kong, given that the taxpayer rendered services during visits of not more than 60 days in Hong Kong during the year of assessment 2020/21.

The IRD's apparent position that, if the bonus could be said to be attributable to services of the taxpayer rendered in Hong Kong during the previous year, i.e., the year of assessment 2019/20, the bonus would nonetheless be taxable in Hong Kong appears to be inconsistent with the taxation of restricted stock awards (RSUs) accrued to a taxpayer in similar circumstances (See footnote 1 below).

For RSUs accrued in similar situations, only the taxpayer's days of services in Hong Kong for the year of accrual would be considered in determining whether the taxpayer is liable for tax in Hong Kong. This would be the case even though the RSUs so accrued is subject to a vesting period that includes a previous year of assessment during which the taxpayer has rendered services in Hong Kong during visits exceeding 60 days.

We would welcome IRD's clarification on this apparent discrepancy between the taxation of discretionary bonuses and RSUs.

(2) Greater Bay Area tax subsidy
In order to attract talent to work in the Greater Bay Area (GBA), China announced tax subsidies to provide tax relief for eligible talents working in nine cities within the GBA. The GBA tax subsidies, in general, are calculated as the excess of China Individual Income Tax (China IIT) paid over 15% of taxable income.

The HKICPA posed a question whether the GBA tax subsidies represented income that is subject to Hong Kong salaries tax.

The IRD noted that Sections 8 and 9 of IRO shall govern whether an amount is income derived from an employment, i.e., income subject to salaries tax shall include payments made in return for acting as or being an employee, and such payments can be from the employer or "others". While not all the nine cities have announced detailed rules at the time of the Annual Meeting, the IRD stated that the GBA tax subsidies, even though could be regarded as income from employment, would generally be wholly attributable to the individual's services in the Mainland. Thus, it is likely the GBA subsidies are not chargeable to Hong Kong salaries tax under section 8(1A)(a) of the IRO.

However, for Hong Kong resident taxpayers who render services both in Hong Kong and the Mainland in connection with an employment, the income from which is wholly chargeable to tax in Hong Kong, the receipt of GBA tax subsidies could affect the foreign tax credit (FTC) claims of such taxpayers in Hong Kong. In such cases, the IRD reminded taxpayers that where the FTC claims were initially made based on the China IIT originally paid, the taxpayers are obliged under section 50AA(5) of the IRO to notify the IRD within 3 months after receipt of GBA tax subsidies to adjust the excessive FTC initially claimed in Hong Kong.

EY observations
The IRD's stance on the source of GBA tax subsidies seems clear, in that there are good grounds to attribute this solely to services rendered in the Mainland. However, we note complications arise when the taxpayers, who are required by their employers to render services both in the Mainland and Hong Kong, are covered under tax equalisation or tax protection policies where it is the employer who becomes responsible for the China IIT expense.

Although the application deadline (August 2020) for the 2019 China IIT preferential subsidy has passed already, the employer should review and/or update its tax equalisation policy urgently as the first GBA tax subsidies are expected to be paid as early as December 2020.

(3) Tax treatment of termination payments
While the recent Court of Final Appeal decision in *Commissioner of Inland Revenue v Poon Cho-ming, John* FACV No. 1 of 2019 concludes that a payment in lieu of bonus and share option gain arising from a separation agreement, which are paid to the employee to make him go away quietly, should not be subject to salaries tax, the IRD advised employers to continue reporting termination payments in employer's returns. Taxpayers have the right to raise an objection if they do not agree with the IRD's tax assessment and the IRD will consider the facts and merits of each case to determine the correct salaries tax treatment. The IRD has no plans to issue further guidance or a practice note on termination payments.

EY observations
It is well established from case law that if the termination payments are made for past, present or future services, they would likely be treated as taxable income for salaries tax purposes. The IRD has largely followed precedents from prior cases – there is no single or definitive set of conditions giving rise to non-taxable termination payments; each case will stand on its own facts and circumstances.

(4) Comprehensive Double Tax Agreement (CDTA): demand of provisional salaries tax
Commencing from the year of assessment 2018/19, taxpayers deriving income from both Hong Kong and a foreign jurisdiction with a CDTA entered with Hong Kong cannot claim unilateral income exemption under Section 8(1A)(c) of the IRO. A claim for tax credit under Section 50 of the IRO should be made instead.

The IRD reaffirmed that according to the law, the tax credit for the current year of assessment was only allowed to reduce current year tax, and thus, it will not have the effect of reducing provisional taxes, which are typically charged as a tax in the following tax year. Unless there is a law change, the IRD is obliged to follow the law even if it represents hardship for the taxpayers and no administration measures are available.

EY observations
Taxpayers are recommended to be aware of their increased cashflow burden as a result of this clarification.

(5) Housing benefits provided to employee by a third party
Rent-free accommodation provided to an employee by an employer or an associated corporation shall be taxed based on "rental value", which is calculated at a deemed percentage (for example 10% for flat) of assessable income. In the case where a non-Hong Kong employer assigns its foreign employee to work in the office of an unrelated third-party client in Hong Kong, a question arises whether the provision of rent-free accommodation by the client (that is not an associated corporation) to the foreign employee shall also trigger rental value to be levied on the foreign employee. When determining the taxability of such housing benefits, the IRD would examine all the relevant facts, including whether the third-party client provided the housing benefit on behalf of the employer, and whether there was any recharge of the costs of the housing benefit to the employer. The IRD suggested that if tax certainty is desired, an application for an advance ruling can be made.

EY observation
Rent-free place of residence or rental reimbursement schemes are commonly provided to employees in Hong Kong; the tax law and its application are relatively clear in straightforward cases where the accommodation is provided by the employer or an associated corporation. With the rise of the gig economy and remote work, it is possible other permutations will arise, which will require further consideration and if necessary, further consultation with the IRD is recommended.

(6) Certificate of residence (CoR) for individuals
An individual is a Hong Kong temporary resident if he or she stays in Hong Kong for (1) more than 180 days during a year of assessment or (2) more than 300 days in two consecutive years of assessment, where one of which is the relevant year of assessment.

Hong Kong CoR certificates are issued in respect of calendar years, rather than a year of assessment. Thus, a question was posed to the IRD that if an individual was in Hong Kong for less than 180 days in 2018/19 but more than 300 days in 2018/2019 and 2019/2020, would the taxpayer qualify for CoR for calendar years 2018, 2019 and 2020? The IRD confirmed a CoR would be issued for 2018 and 2019, but not for 2020.

EY observations
Individuals who wish to apply for Hong Kong CoR should be mindful that CoR are issued in respect of calendar years, which does not match with tax assessment years that run from 1 April to 31 March of each year. There is sometimes a time lag between the tax filing deadline and the first opportunity at which Hong Kong CoR can be applied for. For example, a foreign individual who arrives in Hong Kong on 1 February 2020 would be required to file a Hong Kong individual income tax return by 2 July 2020 in respect of the year of assessment 2019/20. However, at the filing deadline time (2 July 2020), an application for CoR would not have been conclusive as he/she would not have spent more than 180 days in Hong Kong to qualify as a temporary resident. This time lag may result in taxpayers having to wait and carry out re-filing once CoR status is confirmed, and thus individuals and employers should be wary of the timing of any Hong Kong arrival date to ease tax compliance burden.

For more details, please do not hesitate to contact your local EY advisor or one of the contacts listed below.

Footnote 1 : In the 2019 Annual Meeting between the IRD and the HKICPA, the IRD clarified that with respect to vesting of restricted stock awards to a taxpayer who had spent less than 60 days in Hong Kong in the year of vesting, such income shall be capable of being exempted from salaries tax provided there was no change of the taxpayer's non-Hong Kong employment.

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