Hong Kong: Inland Revenue shares its views on various salaries tax issues

December 10, 2014

In brief

In the 2014 annual meeting (Meeting) between the Hong Kong Inland Revenue Department (IRD) and the Hong Kong Institute of Certified Public Accountants (HKICPA), the IRD expressed its views on a number of salaries tax issues that are of interest to taxpayers. Some of the issues discussed are solely related to the interpretation and application of the domestic law of Hong Kong while others involve the application of Hong Kong tax treaties. The more important issues discussed in the Meeting include: (1) deemed vesting of share awards upon departure from Hong Kong; (2) taxation of employee share awards; (3) computation of days spent overseas for exclusion of foreign income in a unilateral relief claim; (4) taxation of performance fees received by investment managers/advisors; and (5) source of pension benefits under a tax treaty.

While the Meeting minutes are not law and taxpayers can hold a different view from those expressed by the IRD in the Meeting, the minutes serve as a good reference of the IRD's stance on various salaries tax issues. Companies with employees working in Hong Kong should take into account the views expressed by the IRD in the Meeting minutes when discharging their reporting obligations and formulating their employee compensation policies, and seek professional advice to understand the possible approaches in managing these complex tax issues.

In detail

The IRD and HKICPA's Meeting occurred in February of this year and the corresponding minutes have recently been published. The IRD's views on a number of more important salaries tax issues discussed during the Meeting are summarized below. For a full list of salaries tax issues discussed in the Meeting, please refer to the Meeting minutes available on the HKICPA's website which can be accessed by clicking here.

Deemed vesting of share awards upon departure from Hong Kong

Under the IRD's current practice, individuals permanently departing from Hong Kong may elect for a notional exercise of the share options granted to them prior to their departure from Hong Kong and apply for a re-assessment if the gain upon the actual exercise is less than the amount assessed upon the notional exercise. The IRD, however, stated in the Meeting that it will not entertain similar application for re-assessment in the case of a deemed vesting of share awards upon a taxpayer's departure from Hong Kong.

The IRD explained that the tax treatment for share options and share awards are different as they are chargeable under different sections of the Inland Revenue Ordinance (IRO). Share awards are taxable perquisites and are deemed to accrue on the last day of employment under the IRO even though they are vested after the cessation of employment. On the other hand, share option gains should be assessed in the year in which the share options are exercised notwithstanding the employment has ceased based on the specific charging section for share options in the IRO and case law. The IRD cited *CIR v Sawhney [2006] 3 HKLRD 21* in the Meeting.

Taxation of employee share awards

Taxing share award benefits using the upfront approach

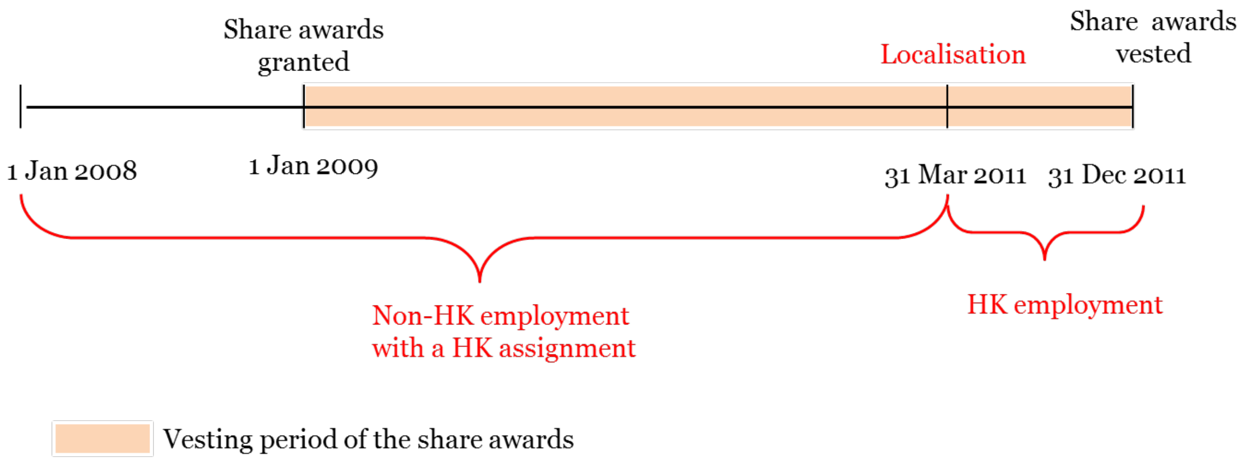
Generally speaking, share award benefits would be taxed at 'vesting' which is defined as entitlement of ownership that is free of all conditions. Uncertainties may, however, arise in some cases as to whether the 'free of all conditions' criterion is satisfied and whether an 'upfront approach' or a 'back end approach' should be applied in taxation of the share awards. The IRD clarified that the upfront approach would generally be applied in the following situations and employers who need more tax certainty are suggested to apply to the IRD for a ruling:

- the employee has all the rights of a normal shareholder at the date of grant (e.g., he is registered as a shareholder, allowed to vote in the general meeting and entitled to receive dividend, etc.) and there will not be any forfeiture risks even though there is a requirement to sell back the shares to the company at the prevailing fair market value upon cessation of employment; or
- the employee has acquired full economic benefits and ownership of the shares at the time of grant except subject to a forfeiture risk that is remote or a contingency which is exceptional (e.g., committing a criminal offence).

Share awards granted during overseas employment but vested in a full year of Hong Kong employment

In the Meeting, the salaries tax treatment for share awards granted to employees in Scenario I below was discussed. The share awards were granted to an employee during the Hong Kong assignment period of his non-Hong Kong employment. The vesting of share awards did not take place in the year of localisation to a Hong Kong employment (effective March 31, 2011) but rather only took place in the following year of assessment when the employee had a full year of Hong Kong employment. The 3-year vesting period (i.e., 1,095 days) of the share awards covered periods of both non-Hong Kong employment and Hong Kong employment of the individual. In such case, the IRD takes the view that the whole share award benefit is subject to tax, and time apportionment for the portion of share award income attributable to the period of non-Hong Kong employment is not applicable as the benefit is vested and accrued in a year of assessment where the employee has no non-Hong Kong employment for the whole year.

<u>Scenario I</u>

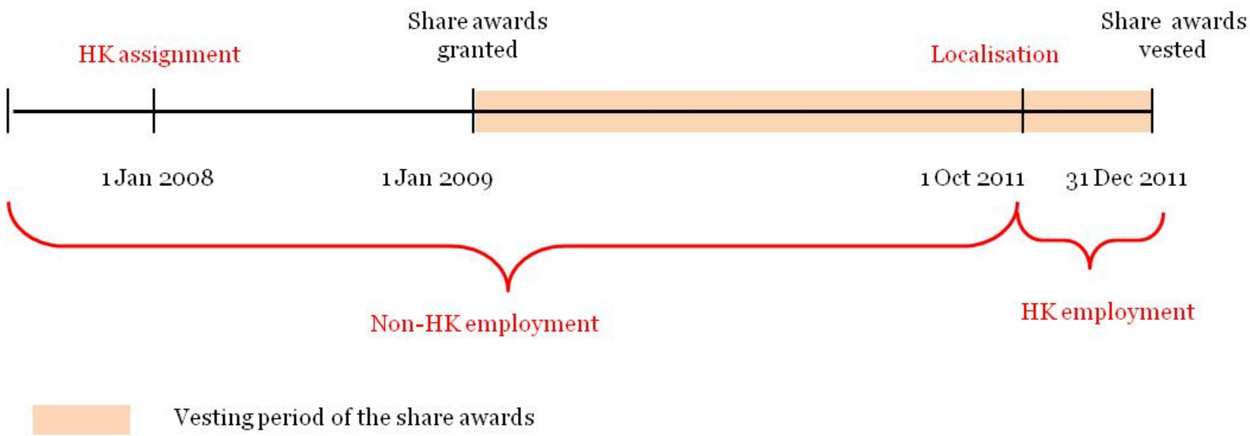


Vesting period	No. of days	Type of employment	Taxable share awards
1/1/2009 to 30/3/2011	819	Non-HK employment	$T1 = $A x 819/1,095
31/3/2011 to 31/12/2011	276	HK employment	$T2 = $A x 276/1,095

Where $A is the value of the share award income

PwC comment: The above position taken by the IRD seems to contradict with its position that share awards should be deemed to accrue on the last day of employment even if they are vested after the cessation of employment as discussed above. It also contradicts the IRD's view expressed in both the 2011 and 2013 Meetings that generally share award income derived in the case of a change from non-Hong Kong employment to Hong Kong employment (or vice versa) would first be split into two portions - one attributable to the period of non-Hong Kong employment (and thus should be eligible for time apportionment and reported in an additional Cessation Notification [Form IR56F] for the year of cessation of non-Hong Kong employment), and the other attributable to the period of Hong Kong employment (and thus should be fully taxable without time apportionment and reported in the relevant Employer's Return [Form IR56B] for the year of vesting), as illustrated in Scenario II below which was adopted in the 2013 Meeting.

Scenario II



Vesting period	No. of days	Type of employment	Taxable share awards
1/1/2009 to 30/9/2011	1,003	Non-HK employment	$T1 = $A x 1,003/1,095 x F
1/10/2011 to 31/12/2011	92	HK employment	$T2 = $A x 92/1,095

Where $A is the value of the share award income,
and F is the time apportionment factor for year of assessment 2011/12 (i.e., from 1/4/2011 to 30/9/2011)

It would be important for the IRD to clarify the above seemingly inconsistency in its views expressed in the 2014 Meeting as compared with views they expressed in earlier meetings in order to provide clarity on the taxation position. Employers are strongly encouraged to alert their employees who had or would be having a change of employment to the above uncertainty, and seek professional advice in managing and negotiating their share income reporting position with the IRD if necessary.

Computation of days spent overseas for exclusion of foreign income in a unilateral relief claim

As a unilateral double tax relief under the Hong Kong domestic tax law, a taxpayer may claim exemption from salaries tax for income relating to services rendered in the overseas jurisdiction if tax of similar nature as salaries tax has been paid on that income in that overseas jurisdiction and the same income is also subject to salaries tax in Hong Kong. The current practice of the IRD is to compute the income earned overseas by using the number of calendar days, instead of working days, spent overseas. The IRD reiterated in the Meeting that its current practice is consistent with the rule of law and the standard used by the Board of Review so it will continue to use the calendar day basis in processing the exemption claims even if an overseas tax authority might adopt a different basis of apportionment (such as working day basis). If the employers and employees consider the facts and circumstances of the overseas employment services and income may warrant a different apportionment basis, they are encouraged to consult their professional advisors to assess the tax position in advance of negotiation with the IRD.

Taxation of performance fees received by investment managers/advisors

As part of the discussion on profits tax issues, the IRD mentioned in the Meeting that management fees or performance fees (which may be payable in the form of dividends or distributions) received by investment managers/advisors rendering their asset management services in Hong Kong will be subject to profits tax in Hong Kong since the fees are derived from services rendered in Hong Kong. The IRD's comments on the taxation of investment managers/advisors may have implications for individuals as well since in some cases, employees of the investment managers/advisors may also receive performance fees in the form of carried interest/profit distributions from their employers.

The taxation of carried interest/performance fees received by employees of fund managers/advisors has been a controversial issue in Hong Kong as well as in many other locations. Depending on factors such as capital contribution requirement (if any), the remuneration structure and terms of the employment contracts/agreements between the individuals and their employers, the carried interest/performance fees received by these individuals could possibly be regarded as a return on investment (which is outside the charging scope of salaries tax) or remuneration for employment services performed (which will be subject to salaries tax if with a Hong Kong source).

It is important to take a totality of facts review of the above features of the investment arrangement for carried interest/profit distribution in order to ascertain the nature of income and the corresponding tax position. The tax filing position adopted by the employers and the employees in other locations should also be taken into consideration in order to strengthen the position adopted in their Hong Kong tax filing. Based on our observation, employers are advised to review and communicate the tax position with their employees prior to finalising the employees' agreement to invest in the carried interest/profit distribution arrangement so that the employees could make an informed decision in this respect.

Source of pension benefits under a CDTA

Under the Pensions article of some Hong Kong tax treaties (e.g., the treaties with Canada and the UK), Hong Kong has the taxing right (either exclusive or non-exclusive) on the pension benefits *arising in* Hong Kong and paid to a resident of a treaty partner. However, the term 'arising in' is not defined in those treaties although certain guidance on the interpretation of such term is included in the Commentary to the Model Tax Convention of the Organisation for Economic Co-operation and Development.

In this regard, the IRD clarified that this term should be interpreted based on the Hong Kong domestic law. That is, the IRD will regard the pension as arising in Hong Kong if the fund from which the pension is paid is managed and controlled in Hong Kong. The IRD also indicated that it had communicated the above position to treaty partners during treaty negotiations so as to prevent double taxation arising from conflicts in the interpretation of the source of the pension. However, the IRD has exclusive taxation right over arrangements in which individuals might participate to secure retirement benefits and which was recognised for tax purposes (i.e., a recognised retirement scheme) in Hong Kong under certain Hong Kong tax treaties. In that case, pension paid to a resident of a treaty partner may be taxed exclusively in Hong Kong if the pension is regarded as having a Hong Kong source and taxable under the domestic law of Hong Kong.

Therefore, employers operating overseas pension schemes in Hong Kong are recommended to review and ascertain the appropriate salaries tax position to manage the reporting exposures on the pension scheme distributions.

The takeaway

While the Meeting minutes are not law and taxpayers can hold different views from those expressed by the IRD, the minutes serve as a good reference of the IRD's stance on various salaries tax issues. Companies with employees working in Hong Kong should take these views into account when discharging their reporting obligations and formulating their employee compensation policies, and seek professional advice to understand possible approaches in managing these complex tax issues.

Let's talk

If you would like further advice or information in relation to the issue outlined above, please contact your Global Mobility engagement team or one of the following professionals from PwC Hong Kong:

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