Hong Kong: The IRD's recent comments on various salaries tax issues

March 27, 2017

In brief

In the 2016 annual meeting between the Hong Kong Inland Revenue Department (IRD) and the Hong Kong Institute of Certified Public Accountants (HKICPA), the IRD commented on a number of salaries tax issues that may be of interests to taxpayers. The more important issues discussed include: (1) an employer's filing obligations in a group restructuring; (2) the taxation of vested but not yet withdrawn benefits under schemes registered or exempt from registration under the Occupational Retirement Schemes Ordinance (ORSO schemes); (3) application of the 'proportionate benefit rule' for mandatory provident fund schemes (MPF schemes) and recognized occupational retirement schemes (ROR schemes) and (4) the tax treatment of termination payments.

While the meeting minutes are not law and are not legally binding, they 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 when discharging their reporting obligations and formulating their employee compensation policies. Employers should also seek professional advice to understand the possible approaches in managing these complex tax issues.

In detail

The IRD and HKICPA held their regular annual meeting in March 2016 to discuss and exchange views on, among others, various salaries tax issues and the related minutes were released in late December 2016. The IRD's views on the 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.

Employer's filing obligations in a group restructuring

In a group restructuring, employees of a Hong Kong company (transferor company) may be transferred to another Hong Kong group company (transferee company) under the same employment terms and conditions, and the accrued benefits in the retirement scheme of the transferor company will be rolled over to the transferee company without any disruption.

The IRD advised that while whether there is a change of employment is a question of fact to be determined by taking into account all the circumstances of the case, the above transfer of employees within a group, *prima facie*, represents a termination of the employees' employment with the transferor company and a commencement of their employment with the transferee company.

As such, the transferor company and the transferee company are required to file the Notification of Cessation of Employment (Form IR 56F) and Notification of Commencement of Employment (Form IR56E) for the transferred employees respectively.

However, for the sake of administrative convenience and streamlining the employer's filing requirements, the IRD indicated in the meeting that it is prepared to consider, on a case by case basis and upon application, to dispense with such filings if:

- there is in fact continuous employment of the staff transferred after the inter-group transfer; and
- the transferee company undertakes to include in its Employer's Return (Form IR 56B) in respect of these transferred employees all their emoluments covering the whole basis period for the year of assessment in which the transfer occurred, including the emoluments from the transferor company up to the date of transfer, as if there had been no change of employment.

In making the application, the transferor company and the transferee company have to jointly give prior written notice to the IRD of the group restructuring exercise and provide certain details about the companies, the transferred employees, and the related employment arrangements.

This streamlined arrangement is also applicable to merger or amalgamation of companies pursuant to the laws of Hong Kong or an overseas jurisdiction.

PwC observation: The Companies Ordinance that came into effect on March 3, 2014 provides for, among others, a court-free procedure for corporate amalgamations in Hong Kong. While the latest guidance on corporate amalgamations issued by the IRD in December 2016 is silent on the employer's filing requirements of the amalgamating and amalgamated companies in the year of amalgamation, the above IRD comments can serve as a reference on the employer's filing obligations in the year of amalgamation. As highlighted in the next salaries tax issue discussed below, care should be taken to review the terms of the rollover of the accrued benefits between the retirement schemes of the transferor and transferee companies to ensure that the correct salaries tax treatment is adopted.

(Note: The IRD's guidance on its current assessing practice of corporate amalgamations can be accessed on the IRD's website.)

Taxation of vested but not yet withdrawn benefits under ORSO schemes

In the 2016 annual meeting, the IRD indicated that in the situation where an employee is given a choice to withdraw or not to withdraw the vested portion of the employer's contributions under an ORSO plan when he/she terminates employment with a Hong Kong employer, the employee will be subject to salaries tax on the vested employer's contributions at the time he/she can choose to withdraw the contributions, even though there is no actual withdrawal.

This is because at the time the employee is provided with an option to withdraw the vested benefits attributable to the employer's contributions from the plan, he/she is entitled to claim payment of the vested benefits and therefore the amount will be regarded as 'income accrued' under section 11D(b) of the IRO. In addition, if the employee decides to take the option of not withdrawing the amount, the amount would have been dealt with on his/her behalf or according to his/her direction and therefore would be deemed to have been received by that person and subject to salaries tax pursuant to section 11D(a) of the IRO.

The same tax treatment will apply irrespective of whether there will be any further vesting of the employer's contributions under the ORSO plan as a result of, for example, the employment services provided by the employee to another overseas group company under a new non-Hong Kong employment that he/she entered into with that group company.

Application of the 'proportionate benefit rule' for MPF and ROR schemes

In the past, based on paragraph 19 of Departmental Interpretation and Practice Notes (DIPN) No. 23 (Revised) and a pamphlet entitled 'Employer's Tax Obligation under MPF schemes and ROR schemes' issued by the IRD, there has been a general understanding that investment income attributable to (1) the employer's voluntary contributions under an MPF scheme or (2) the employer's contributions under a ROR scheme can be excluded in computing the accrued benefit for the purpose of applying the 'proportionate benefit rule'.

However, the IRD clarified its position in the 2016 annual meeting that for the purpose of calculating the proportionate benefits, the accrued benefits should be the vested balance of the investment attributable to employer's voluntary contributions (i.e., including both the employer's voluntary contributions and the investment return arising from such contributions) under a MPF scheme,

and that the same principle should apply to an ORSO scheme. The IRD further disclosed that it will clarify its interpretation and practice when updating DIPN 23 (Revised) and the pamphlet.

PwC observation: The IRD's position above is based on the current wording of the IRO section that defines 'proportionate benefit'. Prior to 1998, the definition referred to '...the accrued benefit as represents the employer's contributions under the scheme ...' However, the phrase *'as represents'* was changed to *'as is attributable to'* in 1998 and the IRD takes the view that the legislative change means investment return that is attributable to the employer's voluntary contributions under a MPF scheme or the employer's contributions under a ROR scheme should also be included as accrued benefits, although no corresponding change was made to paragraph 19 of DIPN 23 (Revised) to reflect this view when the DIPN was updated in 2006.

While taxpayers and tax practitioners are expecting the IRD to provide more guidance on the above position in applying the 'proportionate benefit rule' in the next update of DPN 23 (Revised), one may possibly argue that the investment return arising from the employer's contributions after such contributions have been vested in the employees (and in the case where there is no vesting period involved the employer's contributions are effectively 'immediately vested at the time of contribution') should be regarded as investment gains derived by the employees rather than employment income, and should therefore not be subject to salaries tax. In this regard, a clarification from the IRD on whether it is prepared to accept using the vesting date of the employer's contributions to distinguish between (potentially) taxable accrued benefits and non-chargeable investment gains will be much welcomed.

Tax treatment of termination payments

It has been the IRD's practice to accept that severance payment and long service payment made in accordance with the Employment Ordinance (EO) of Hong Kong as not chargeable to salaries tax. However, any payment in excess of the statutory amount may be chargeable to salaries tax if such excess is in fact reward for employment services rendered.

The non-taxability of severance payment is on the basis that it represents a compensation for loss of employment by reason of redundancy rather than emolument for employment services. As for long service payment, although it is *prima facie* an 'income from employment', the IRD's established practice is not to assess the payment taking into account the potential hardship for a taxpayer receiving such payment and that the payment is intended as some form of provision for the employee's future.

In the 2016 annual meeting, the issue of whether a termination payment made pursuant to the law of other jurisdictions is taxable was raised. The IRD advised that in order to claim the payment as non-taxable for salaries tax purpose, the onus is on the taxpayer to prove to the IRD's satisfaction that its nature is not an 'income from employment' or is sufficiently similar to the statutory severance payment, or long service payment under the EO.

PwC observation: The IRD's comments above are consistent with the fundamental principle that taxability of an amount received by an employee for salaries tax purpose will depend on its nature and whether it represents a reward for employment services rendered. Whether the amount is paid in accordance with Hong Kong or foreign laws should not be a determining factor.

The takeaway

While the meeting minutes are not law and are not legally binding, 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.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your regular Global Mobility Services engagement team or one of the following team members:

Global Mobility Services – Hong Kong

James Clemence, *Asia Leader*
+852 2289 1818
james.clemence@hk.pwc.com

Mandy Kwok
+852 2289 3900
mandy.kwok@hk.pwc.com

Robert B Keys
+ 852 2289 1872
robert.b.keys@hk.pwc.com

Theresa Chan
+852 2289 1887
theresa.ky.chan@hk.pwc.com

Berin Chan
+852 2289 5504
berin.db.chan@hk.pwc.com

Louis Lam
+852 2289 5528
louis.cs.lam@hk.pwc.com

Steven Lim
+852 2289 3998
steven.lim@hk.pwc.com

Global Mobility Services – United States

Peter Clarke, *Global Leader*
+1 (203) 539-3826
peter.clarke@pwc.com