Chapter 8

PROFITS TAX: SPECIAL ITEMS, BUSINESSES AND TAXPAYERS

E-COMMERCE AND DIGITAL ECONOMY

¶8-2750 Overview

The IRO currently does not contain any provisions that deal specifically with e-commerce. As such, the principles laid down by the profit tax provisions of the IRO and the common law apply.

In light of the uncertainty on e-commerce taxation, the Inland Revenue Department issued DIPN No 39 (Revised): Digital Economy, Electronic Commerce and Digital Assets in March 2020.

The Inland Revenue Department acknowledges that the Organisation for Economic Co-operation and Development ("OECD") is formulating a new set of international tax rules to address the taxing rights on income generated from cross-border activities in a digital economy, which is also known as the Action 1 (Addressing the Tax Challenges of the Digital Economy) of the OECD/G20 Base Erosion and Profit Shifting ("BEPS") Project. With the changes in the international tax rules and the delivery of the final report of the OECD, the DIPN No 39 (Revised) is expected to be further updated. (DIPN No 39 (Revised), paras 2 and 3).

As discussed in ¶6-0200, section 14 of the IRO sets out the following three conditions before the charging sections can apply:

- the person concerned must carry on a trade, profession or business in Hong Kong;
- the profits to be charged must come from the trade, profession or business carried on by the person in Hong Kong; and
- the profits must be "profits arising in or derived from Hong Kong."

¶8-2760 Trade, profession or business carried on in Hong Kong

Whether a person carried on a trade, profession or business in Hong Kong is largely a question of fact and degree. Section 50AAK(1) provides that a non-resident is deemed as carrying on a trade, profession or business in Hong Kong if it has a PE in Hong Kong. On the other hand, if the non-resident does not have a PE in Hong Kong, it does not necessarily follow that the non-resident is not carrying on a trade, profession or business in Hong Kong (DIPN No 39 (Revised), para 13).

Whether the non-resident, who is a resident person of a territory that has a Comprehensive Double Tax Agreement (CDTA) with Hong Kong, has a PE in Hong Kong is determined in accordance with the PE article of the relevant CDTA. However, if the non-resident is from a non-CDTA territory, whether it has a PE in Hong Kong is determined pursuant to Part 3 of Schedule 17G of the Inland Revenue Ordinance (DIPN No 39 (Revised), para 21). In other words, if the non-resident in a non-CDTA territory (1) has a fixed place of business in Hong Kong and (2) the activities carried on by it are not merely preparatory or auxiliary, it will be considered as having a PE in Hong Kong.

When a server is at the disposal of a non-resident, a permanent establishment may be created if it is considered as a fixed place of business and an essential and significant part of the business activity of the person is conducted through the server (DIPN No 39 (Revised), para 27). This approach follows the OECD commentary. As such, if the server is capable of concluding contracts, processing payments or delivering digital goods in Hong Kong without human intervention, the server would constitute a PE in Hong Kong since the operations of the server cannot be considered preparatory or auxiliary.

Having said that, where the non-resident hosts the website through a server operated by an internet service provider in Hong Kong under a website hosting arrangement, the server is not at the disposal of the non-resident and the website does not constitute a fixed place of business in Hong Kong.

¶8-2770 Locality of e-commerce profits

A taxpayer carrying on business in Hong Kong does not automatically mean that the profits from the business are "profits arising in or derived from Hong Kong." The question of profit source is actually one of the most problematic issues in Hong Kong revenue law as the IRO does not offer a comprehensive set of source rules. The issue becomes more complicated for e-commerce due to the "virtual" nature of the transactions.

In *HK-TVB International v Commissioner of Inland Revenue* and *Magna Industrial Company Ltd v Commissioner of Inland Revenue* cases, it was decided that the principal place of business was critical in deciding the locality of profits. In this regard, the Inland Revenue Department is of the view that the principal place of business is the location of core business operations performed by a physical office, rather than the location of server alone. It is the human *management and control* in the physical office which makes the server becomes functional, no matter what have been done electronically (DIPN No 39 (Revised), paras 14 and 15).

Accordingly, the Inland Revenue Department provides a general principle:

A company which has *all* of its business operations in Hong Kong, apart from operating a server which is at its disposal and located outside Hong Kong for e-commerce purposes, will be liable to profit tax, and vice versa (DIPN No 39 (Revised), para 19).

Note that the server in question can be used:

- to give information about products and services;
- to process on-line purchase orders;
- to deliver digitised products and services electronically; and
- to process payments (DIPN No 39 (Revised), para 17).

The Inland Revenue Department will look beyond the presence of the server and examine the core operations that have effected the e-commerce transactions to earn the profits and the place where those operations have been carried out to determine the source (DIPN No 39 (Revised), para 17).

DIPN No 39 (Revised) does not discuss whether apportionment of profits rules for conventional business is applicable when an e-commerce company only has *part* of its business operations in Hong Kong.

While determining the locality of profits, software, server as well as the Internet Service Provider who merely operates a server are not regarded as an agent of the taxpayer (DIPN No 39 (Revised), para 18).

¶8-2780 Characterisation of income

As discussed in ¶6-2260, even if the receipts are not chargeable under section 14, they may still be deemed as Hong Kong-sourced receipts and be chargeable under section 15(1)(b) or (ba) if they are received or accrued to a taxpayer for the use of, or the right to use, in or outside Hong Kong for:

- a patent, design, or trademark;
- copyright material;
- layout-design (topography) of an integrated circuit;
- performer's right;

- plant variety right;
- a secret process or formula; or
- any other similar property.

However, under section 21A, only 30% (10% for sums received or accrued before 1 April 2003) of the receipts are chargeable to tax (unless they are derived from an associate and 100% of the sum is chargeable under certain circumstances).

Thus, for e-commerce taxation, it is important to distinguish whether the sums are chargeable under section 14 (as discussed in ¶8-2760 and ¶8-2770) or chargeable as royalties or licence fees for intellectual property that fall within section 15(1)(b) and (ba).

A distinction needs to be drawn between a payment for the use of or the right to use:

- the copyright which subsists in the software program (where section 15(1)(b) or (ba) would be applicable as the payment is regarded as royalty); and
- only the actual software program (where section 15(1)(b) or (ba) would not be applicable as the payment is for a product or service).

A good example for the latter case would be pre-packed *(shrink-wrapped) software* where the copyright remains with the vendor.

The same situation would apply for *digital software downloadable* from the Internet for the payer's own use only with no transfer of copyright. The Inland Revenue Department is of the view that the downloading is merely incidental to the process of acquiring, capturing and storing the digital signals, for which the payment is actually made. The payment is thus regarded as a business income and not a royalty under section 15(1)(b) or (ba).

It follows that if the vendor is a "non-resident person" not carrying on business in Hong Kong, it will not be liable to profits tax under section 14(1), 15(1)(b) or 15(1)(ba), and the customer would not have any "withholding tax obligation" under section 20B. The Inland Revenue Department finds that this treatment of electronic transactions is consistent with that in physical form.

The same will also apply for the following cases (DIPN No 39 (Revised), examples 8 to 9):

(i) *application service provider* — who provides software application operated and maintained outside Hong Kong (without transfer of its own copyright), which automates a particular back office function (e.g. payment) to a Hong Kong customer; and

(ii) *content acquisition transactions* — where a Hong Kong server operator pays a non-resident person to create new online content specially for the server and the copyright of the content belongs to the operator.

Only in cases where payments are for the use of, or the right to the use, copyright material will the payment be regarded as a royalty for section 15(1)(b) or (ba) chargeable to a "non- resident person" not carrying on business in Hong Kong (the vendor will still be chargeable under section 14 if he or she is carrying on business in Hong Kong) (DIPN No 39 (Revised), para 38).

The copyright would allow the payer to:

(i) make copies for distribution to the public;

(ii) prepare derivative programs; and

(iii) publicly display the program.

On 23 January 2019, the OECD issued a *Policy Note on Addressing the Tax Challenges of the Digitalization of the Economy.* The Policy Note proposed a consensus-based long-term solution for digital economy internationally. The Policy Note follows with a Consultation and a Programme of Work. (see ¶16-5300.) The Hong Kong Government may make legislative and/or further practice changes on the e-Commerce once there are consensus view.

FINANCIAL INSTRUMENTS

¶8-3300 Overview

The Inland Revenue Department issued DIPN No 42 in November 2005 to set out its views regarding the tax treatment of gains and losses in respect of various financial instruments to which the prevailing accounting standards apply, i.e. HKAS 32 and HKAS 39, issued by the Hong Kong Institute of Certified Public Accountants in May 2004. HKAS 32 and HKAS 39 set out requirements for the presentation of financial instruments and the principles for the recognition and measurement of financial instruments. These accounting standards superseded SSAP 24 and became effective on 1 January 2005.

HKAS 32 defines "financial instrument" as "any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity." Financial assets and financial liabilities are divided into four categories under HKAS 39 namely:

(i) financial assets or financial liabilities at fair value through profit or loss ("FVTPL");

(ii) held-to-maturity investments;

(iii) loans and receivables ("L&R"); and

(iv) available-for-sale financial assets ("AFS").

Effective for the financial period commencing from 1 January 2018, Hong Kong Financial Reporting Standard 9 (HKFRS 9) (the Hong Kong equivalent of IFRS 9) replaced the HKAS 39. Like HKAS 39, HKFRS 9 requires Hong Kong reporting entities to account for financial instruments on a fair value basis and recognize unrealized revaluation gain or loss arising from these revaluations as income or losses in the year they arise, though HKFRS 9 introduces changes to the classification and measure of debt and equity instruments into the following three categories:

(i) amortized costs;

(ii) fair value through other comprehensive income ("FVTOCI"); and

(iii) fair value through in profit or loss ("FVTPL").

Despite the above, International Accounting Standards Board agreed to provide entities whose predominant activities are insurance related the option of delaying implementation of HKFRS 9 until 2021 when IFRS 17 is expected to be effective.

DIPN 42 was revised in June 2020 to include the Inland Revenue Department's interpretation and practices in relation to the replacement of HKAS 39 by HKFRS 9, and the assessing practices under DIPN 42 (Revised) applied in relation to a year of assessment for which the basis period begins on or after 1 January 2018.

¶8-3305 Timing of assessment

Prior to the enactment of *Inland Revenue (Amendment) (No.2) Ordinance 2019*, the Inland Revenue Department's position was to follow the accounting treatment stipulated in HKAS 39 in recognising profits or losses in respect of financial assets of revenue nature. Valuation methods previously permitted for financial instruments, such as the lower of cost or net realisable value basis, will not be accepted.

In the judgment of *Nice Cheer Investment Limited v CIR* (2011) HKRC ¶90-240, the Court of First Instance, however, held that unrealised gains arising from fair market value revaluation of the taxpayer's trading securities, which were recognised in its profit and loss account in accordance with ordinary accounting principles, to be non-taxable under section 14(1), while unrealised losses may be deductible. The decision is affirmed by the Court of Appeal in *Commissioner of Inland Revenue v Nice Cheer Investment Limited* (2012) HKRC ¶90-248 and the Court of Final Appeal in *Nice Cheer Investment Limited v CIR* (2013) HKRC ¶90-252 (see ¶7-3030).

In view of the fact that some taxpayers may incur substantial costs in re-computing their profits from fair value basis (as required by HKAS 39) to realisation basis, the Inland Revenue Department, as an interim administrative measure, accepted 2013/14, 2014/15, 2015/16, 2016/17, 2017/18, 2018/19 and 2019/20 (for basis period beginning before 1 January 2019 or are temporarily exempted from applying HKFRS 9 (e.g. insurers)) profits tax returns prepared on fair value basis (see ¶7-3030). The Inland Revenue Department is prepared to accept a re-computation to the realisation basis by concession. Taxpayers may request to revise the assessable profits within 6 years after the end of the year of assessment under Section 60 or 70A.

Due to the lack of legal backing of the interim administrative measure and in order to formally address the concern of taxpayers about the substantial costs involved and practical difficulties faced in re-computing their profits on a realization basis for tax purpose, *Inland Revenue (Amendment) (No. 2) Ordinance 2019* was enacted on 1 March 2019 to provide a legal basis of allowing taxpayers to opt for the fair value basis and aligning the tax and accounting treatments of financial instruments in certain circumstances. Sections 18G and 18H allow the taxpayer to elect to align the tax treatment of financial instruments with their accounting treatment and Sections 18G and apply to the year of assessment for which the basis period begins on or after 1 January 2018.

Taxpayers who prepare their financial statements in accordance with HKFRS 9, IFRS 9 or a financial reporting standard adopted by a jurisdiction other than Hong Kong, which is, in the Commissioner's opinion, equivalent to IFRS 9, can elect in writing to align the tax and accounting treatments of financial instruments. An election, once made, is irrevocable, unless an approval from the Commissioner to revoke the election is obtained on the basis that:

(i) There are good commercial reasons for the revocation; and

(ii) The avoidance of tax is not the main purpose, or one of the main purposes, for the revocation (e.g. in a merger or an acquisition where a company which has elected to adopt the fair value basis has become part of a group that adopts the realization basis for tax filing purposes).

Upon the election for assessment on the fair value basis, the tax treatment of financial instruments will generally align with the accounting treatment. The timing in the recognition of profit, gain, loss, income or expenses per HKFRS 9 on financial assets and financial liabilities will normally be followed for profits tax purposes. In general, revocation of an election should have no retrospective effect. If the revocation is approved by the Commissioner, the election will only cease to have effect from the year of assessment specified by the Commissioner.

Whether there are good commercial reasons for revocation of an election is a question of fact and each case should be considered on its own facts and merits. In a business merger/acquisition/disposal/restructuring, a company may be taken over by a group of companies that adopts a different tax treatment for financial instruments. Revocation of election in such a case will be considered as having good commercial reasons.

The mere reduction in the amount of tax payable is a factor for deciding whether there is a tax avoidance motive but it alone is not equivalent to tax avoidance. The Commissioner will consider the taxpayer's purpose of revocation when processing the application of revocation.

Based on the DIPN 42 (Revised), the timing of assessment would be as follows:-

(a) For financial assets or financial liabilities measured at amortized cost, gains or losses on disposal will be assessed or deducted for the year in which the financial assets and financial liabilities are derecognized. Foreign exchange gains or losses will be assessed or deducted for the year in which they are recognized in profit or loss. Interest, discount, premium income or premium expenses from debt instruments will be assessed or allowed for deduction for the year in which they are recognized in profit or loss through the amortization process by using the effective interest method. In other words, for financial assets, discount or premium income will not be deferred for assessment until the financial instrument is redeemed. For financial liabilities, discount expenses will not be fully deductible for the year in which the financial instrument is issued.

(b) For financial assets measured at FVTOCI, the gains or losses recognized in other comprehensive income will not be assessed or deducted until the assets are derecognized. The cumulative gain or loss previously recognized in other comprehensive income will be assessed or deducted for the year in which it is reclassified from equity to profit or loss upon derecognition. Foreign exchange gains or losses will be assessed or deducted for the year in which they are recognized in profit or loss. Interest, discount or premium income from debt instruments will be assessed for the year in which it is recognized in profit or loss through the amortization process by using the effective interest method. Similarly, discount or premium income will not be deferred for assessment until the financial instrument is redeemed.

(c) For financial assets or financial liabilities measured at FVPL, all gains or losses, including fair value changes and related exchange differences, will be assessed or deducted for the year in which they are recognized in profits or loss, even though they are not realized. Interest, discount or premium income from debt instruments or premium expenses in respect of debt instruments will be assessed or allowed for deduction for the year in which they are recognized in profit or loss.

In addition, there are some special treatments to be made as follows:-

(a) Equity instruments that are measured at FVTOCI but held on revenue account, all gain or loss derived from the disposal, including the cumulative gain or loss recognized in other comprehensive income, will not be recycled to profits or loss when they derecognized and is chargeable to tax or allowable as a deduction for the year of disposal.

(b) Financial liability that is measured at FVTPL but held on revenue account, the amount of fair value changes attributable to changes in the credit risk of that liability will be recognized in other comprehensive income and will not be recycled to profit or loss when it is derecognized and is chargeable to tax or allowable as a deduction for the year of disposal.

(c) Any interest, discount, premium or expenses recognized in respect of a preference share which is classified as a financial liability is not deductible. Dividends declared will not be deductible as interest expenses and will not be assessed as interest income.

Reclassification of financial assets

As indicated in the decision by the Court of Final Appeal in *Nice Cheer Investment Limited v CIR* (2013) HKRC ¶90-252, unrealised revaluation gain from trading securities is not taxable until the relevant gain is realised, and unrealised loss from trading of securities may be deductible if such loss is likely to be permanent (see ¶7-3030). Nevertheless, under the new Sections 18G and 18H, taxpayer can elect to align the tax treatment of financial instruments with their accounting treatment for the basis period beginning on or after 1 January 2018 (see ¶8-3305).

HKFRS 9 requires that when an entity changes its business mode for managing financial assets, it should reclassify its affected financial assets prospectively from the reclassification date (this applies to financial assets that are debt instruments only, as equity instruments must be measured at FVTPL) and any election to present subsequent changes in fair value in other comprehensive income is irrevocable. From a Hong Kong profits tax perspective, where the financial assets are of a revenue nature, the gain or loss arising from the reclassification will be taxed or allowable for deduction if they are charged to the profit and loss (DIPN 42 (Revised), para 61).

On the other hand, where any gain or loss arising from reclassification from the adoption of HKFRS 9 is charged to other comprehensive income, the amount will not be taxed or allowable for deduction. Instead, the cumulative amount in other comprehensive income will be taxed or allowable for deduction for the year in which it is recognized in profit or loss upon derecognition (DIPN 42 (Revised), para 61).

Unless the entity could establish a change of intention towards the financial asset upon reclassification, the reclassification alone cannot operate to change the nature of the financial asset.

¶8-3310 Legal form and economic substance

HKAS 32 requires the issuer of a financial instrument to classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the economic substance of the arrangement. The Inland Revenue Department takes the view that in analysing a financial instrument, the starting point is to decide its nature according to its legal form rather than the accounting treatment or the underlying economic characteristics (DIPN No 42 (Revised), Appendix 2, para 12).

HKAS 32 also requires the issuer of a compound financial instrument to split the instrument into a liability component and an equity component to be presented separately in the balance sheet. Since the accounting treatment will reflect the economic substance, the interest, discount, premium and expense attributable to equity component of the compound financial instrument should be denied deduction. The Inland Revenue Department, while recognising that the accounting treatment might reflect the economic substance, will adhere to the legal form and treat the compound financial instrument for tax purposes as a whole (DIPN No 42 (Revised), Appendix 2 para 14).

¶8-3315 Capital or revenue

The accounting treatment, by itself, cannot operate to change the character of an asset. Whether the asset is of capital or revenue nature is a question of law and all the surrounding circumstances, including the accounting treatment, have to be considered (DIPN No 42 (Revised), Appendix 2, para 3).

Typically, a derivative will be classified as held for trading and the change in fair value and the gain or loss on disposal, recognised in the profit and loss account, are *prima facie* taxable or deductible. Financial assets are trading assets if the taxpayer is a financial institution or it carries on an insurance, money lending, securities dealing or finance business (DIPN No 42 (Revised), Appendix 2, para 4 and 5).

Specific provisions that apply to financial instruments under the IRO, namely sections 14A, 15(1)(j), 15(1)(k), 15(1)(l), 15(1)(la), 15(1)(lb) and 26A, shall not be affected by the accounting practice under HKFRS 9 (DIPN No 42 (Revised), Appendix 2, para 6).

¶8-3320 Capital / Revenue nature of expenditure

HKAS 39 or HKFRS 9 does not prescribe any rules for distinguishing capital and revenue expenditures. Whether the expenditure is capital or revenue in nature is a question of law (DIPN No 42 (Revised), Appendix 2, para 7). For example, profits and losses from forward contracts entered into by a retailer to hedge against foreign exchange risks to reduce fluctuations in inventory cost will be considered as revenue in nature because they relate closely to the purchase of the inventory (DIPN No 42 (Revised), Appendix 2, para 9).

The deduction of expected credit loss recognized under HKFRS 9 will be governed under the newly introduced Sections 18K(3) to (5).

Section 18K(2) provides that any impairment loss recognized by a person in respect of a financial instrument that is not credit-impaired is not deductible and any subsequent reversal of any amount of the impairment loss is not chargeable to tax. Therefore, for Stage 1 and Stage 2 credit risks (i.e. not credit-impaired), any impairment loss recognized in respect of the instrument will not be allowed for deduction. Equally, any subsequent reversal of the impairment loss (i.e. impairment gain) will not be chargeable to tax.

For financial assets that are at Stage 3 credit risks (i.e. credit impaired), deduction is restricted to trade debt and money lent in the ordinary course of money lending business in Hong Kong.

The application of section 18K(3) is not subject to section 16(1)(d) of the *Inland Revenue* Ordinance. An impairment loss is allowable for deduction if the specific conditions in section 18K(3)(a) or (b) can be satisfied, and if it is credit-impaired at the end of the year.

Where a financial institution transfers a credit-impaired loan to another person not by way of a sale in the ordinary course of the transferor's business and a loss allowance (which a deduction was previously allowed to the transferor) in respect of the credit-impaired loan is also transferred to the transferee, special treatment in Section 18K(7) or (8) will apply (see DIPN No 42 (Revised), para 40 to 43).

¶8-3325 Locality of profits

The general principle in determining the source of income is not affected by the accounting practice under HKAS 39 or HKFRS 9. The Inland Revenue Department's views in this area are set out in DIPN No 21 (Revised) (see ¶6-1860).

¶8-3330 Hedge accounting

Hedge accounting means designating a hedging instrument as an offset to changes in the fair value or cash flows of the hedged item which is exposed to a risk of change in value or changes in future cash flows. Application of hedge accounting is permitted under HKAS 39 or HKFRS 9 if certain strict criteria are met.

There are three types of hedging relationships:

(a) fair value hedge;

(b) cash flow hedge; and

(c) hedge of a net investment in a foreign operation.

The Inland Revenue Department considers that the tax treatment for hedging relationship should follow its accounting treatment. Some of the accounting treatments specified in Appendix 1 para 26 to 28 of DIPN No 42 (Revised) are:

(a) In a fair value hedge, the gain or loss from remeasurement is recognised in the profit and loss account or in other comprehensive income if the hedging instrument hedges an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income. At the same time, the carrying amount of the hedged item is adjusted by the hedging gain or loss which shall be recognised in the profit and loss account. If the hedged item is an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income, such gain or loss shall remain in other comprehensive income. When a hedged item is an unrecognized firm commitment, the cumulative change in the fair value of the hedged item subsequent to its designation is recognized as an asset or liability with a corresponding gain or loss recognized in profit or loss.

(b) In a cash flow hedge, the component of equity associated with the hedged item (i.e. cash flow hedge reserve) is adjusted to the lower of the cumulative gain or loss on the hedging instrument from the inception of the hedge and the cumulative change in fair value of the hedged item from the inception of the hedge. The portion of the gain or loss on the hedging instrument that is an effective hedge shall be recognized in other comprehensive income. Any remaining gain or loss on the hedging instrument is hedge ineffectiveness and shall be recognized in profit or loss. The amount that has been accumulated in the cash flow hedge reserve shall be eventually reclassified to profit or loss; or shall be removed and included directly in the initial cost or other carrying amount of a non-financial asset or a non-financial liability resulted from a hedged forecast transaction.

(c) Hedges of a net investment in a foreign operation shall be accounted for in a manner similar to cash flow hedges where the portion of the gain or loss on the hedging instrument relating to the effective hedge shall be recognized in other comprehensive income and the ineffective portion shall be recognized in profit or loss. The amount that has been accumulated in the foreign currency translation reserve shall be reclassified from equity to profit or loss on the disposal of the foreign operation.

If the hedging relationship is qualified for hedge accounting under HKAS 39 or HKFRS 9 and is accounted for as such, the Inland

Revenue Department considers that the hedged item and the hedging instrument should not be considered separately. The nature of the profit or loss arising from the hedging instrument will depend on the nature of the hedged item (DIPN No 42 (Revised), Appendix 2 para 17).

If the hedging relationship is not accounted for under hedge accounting, the hedged item and the hedging instrument will be accounted for separately in the accounts. The tax treatments for the hedged item and the hedging instrument will be considered separately. An exception to this is where the hedging instrument is as a matter of fact a hedge against the hedged item even though hedge accounting is not or cannot be adopted (DIPN No 42 (Revised), Appendix 2, para 19).

For enterprises that control their group financial activities through a central treasury unit, the norm is for the central unit to execute a hedge with an external third party and pass on the terms and conditions of that hedge to a subsidiary through an internal hedge. The Inland Revenue Department holds the view that hedge accounting should normally be available to internal or centralised hedging activities with "matched external transactions" that are entered into on a one-for-one basis (DIPN No 42 (Revised), Appendix 2, para 20).

Section 18L(10) provides that if a hedging instrument is designated, under a hedging arrangement made in good faith, for the purpose of hedging against any risk associated with a hedged item and the hedged item is on capital account, any amount of profit, gain, loss, income or expense recognized in respect of the hedging instrument must be disregarded.

Embedded derivatives

An embedded derivative is a component of a hybrid instrument that contains a non-derivative host contract and is one single instrument in legal form (DIPN No 42 (Revised), Appendix 1, para 30).

For tax purposes, the locality of the profit and loss of a hybrid instrument and whether it is capital or revenue in nature are determined on the basis that the embedded derivative and the host contract is one single instrument. Therefore, the same tax treatment will be applied to the embedded derivative and the host contract despite the fact that they are required to be accounted for separately under certain circumstances (DIPN No 42 (Revised), Appendix 2, para 23).

Where the accounting treatments of changes in the carrying amounts of the embedded derivative and the host contract differ, according to DIPN No 42, the Inland Revenue Department was only prepared to accept the accounting treatment under HKFRS 9 as the tax treatment so far as timing of assessment was concerned.

The Inland Revenue Department did not accept that the entire gain will only be taxed in the year the hybrid instrument is sold (DIPN No 42 (Revised), Appendix 2, para 24). However, pursuant to the Court of Final Appeal's decision in *Nice Cheer Investment Limited v CIR* (2013) HKRC ¶90-252 (see ¶7-3030), such gain may only be taxed upon realisation of the gain, i.e. when the hybrid instrument is sold.

Under Section 18L(6), if a person issues a debt security with an embedded derivative to acquire shares or units in the person and the embedded derivative is recognized as an equity component in accordance with HKAS 32, IAS 32 or an accounting standard adopted by a relevant authority of a jurisdiction other than Hong Kong, as in force from time to time, which is, in the Commissioner's opinion, equivalent to the IAS 32, the part of the interest, discount, premium or expense recognized by the person in respect of the debt security that is attributable to the embedded derivative is not deductible.

¶8-3335 Imputed interest on interest-free loans and non-arm's length loans

Section 18L of the Inland Revenue Ordinance and the revised DIPN 42 (paras 53 – 56) prescribes the profits tax treatment of non-arm's length loans and interest-free loans. Section 18L(9) of the Inland Revenue Ordinance provides that if a loan is made, or a debt security is issued, otherwise than at arm's length, the amount of profit, gain, loss, income or expense in respect of the loan or debt security that is chargeable to tax, or allowable as a deduction, is the amount computed in accordance with the contractual terms of the loan or debt security. Section 18L(9) will not affect the operation of sections 50AAF and 50AAK.

Under HKFRS 9, an entity shall, at initial recognition, measure a financial asset or financial liability at its fair value plus or minus transaction costs. Normally, the fair value of a financial instrument at initial recognition is the transaction price (i.e. the fair value of the consideration given or received). However, if part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument.

If a long-term loan or receivable does not carry interest, the fair value of the long-term loan or receivable will be measured as the present value of all future cash receipts discounted using the prevailing market rate of interest for a similar instrument with a similar credit rating. The difference between the transaction price and the fair value at initial recognition is recognized as a gain or loss unless it qualifies for recognition as some other type of asset. As a result, there will be an imputed gain, loss, income or expense at initial recognition of the financial instrument and a corresponding imputed interest income or expense for amortization. Under section 18L(9) of the Inland Revenue Ordinance, any such imputed profit, gain, loss, income or expenses computed in accordance with HKFRS 9 will not be chargeable to tax or allowable as a deduction. Instead, any actual profit, gain, loss, income or expenses computed in accordance with the contractual terms will be taxable or deductible.

Section 18L(9) normally relates to a non-arm's length loan made or debt security issued to associated persons. The provisions will not be invoked simply because the loan or the debt security carries no interest or the interest is below market rate. If a loan is made or a debt security is issued at an off-market interest rate but with good commercial reasons, section 18L(9) should not be of relevance. In the absence of a tax avoidance purpose, the provisions in section 50AAF will not be invoked to apply to an intra-group interest-free loan of a domestic nature if the no actual tax difference condition or the non-business loan condition in section 50AAJ is satisfied.

EXEMPTION OF FUNDS

¶8-3850 Exemption of funds

Introduction

In order to reinforce the status of Hong Kong as an international financial centre and to enhance its competitiveness among other international financial centres, the Government proposed in the 2003/04 Budget to exempt offshore funds from profits tax. The *Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006* (*2006 Ordinance*) was passed by the Legislative Council to implement the proposal. Broadly speaking, two sets of provisions are introduced into the *Ordinance*: the Exemption Provisions and the Deeming Provisions.

Further, with a view to enhancing Hong Kong's competitiveness as an asset management centre, the Financial Secretary proposed in the 2013/14 Budget Speech to expand the profits tax exemption for offshore funds to include transactions in certain private companies.

On 17 July 2015, the *Inland Revenue (Amendment) (No. 2) Ordinance 2015* (the *2015 Ordinance*) was enacted, expanding profits tax exemption on certain transactions in excepted private companies and special purpose vehicles to offshore private equity funds. The *2015 Ordinance* was principally enacted to extend the profits tax exemption for offshore funds to offshore private equity funds.

The Inland Revenue Department's interpretations of the *2006 Ordinance* and *2015 Ordinance* are contained in DIPN No 43 (Revised) ("Profits Tax Exemption for Offshore Funds") and DIPN No 51 ("Profits Tax Exemption for Offshore Private Equity Funds"), both issued in May 2016, respectively.

In order to address the ring-fencing concern of the European Union Council at both the fund level and investment level, the government reviewed the tax concession arrangements applicable to the fund industry with regard to international requirements on tax co-operation. On 20 February 2019, the *Inland Revenue (Profits Tax Exemption For Funds) (Amendment) Ordinance 2019* (*2019 Ordinance*) was gazetted and became operative on 1 April 2019 to offer unified profits tax exemption to all privately-offered funds (regardless of whether the funds are residents or non-residents).

The Inland Revenue Department's interpretations of the *2019 Ordinance* are contained in DIPN No 61 ("Profits Tax Exemption for Funds").

The Exemption Provisions

Under the *2006 Ordinance* and *2015 Ordinance*, the tax exemption is applicable to non-resident persons even though they do not qualify as funds. On the other hand, the *2019 Ordinance* is only applicable to funds in the form of collective investment schemes as defined under the *Securities and Futures Ordinance*. In other words, the *2006 and 2015 Ordinance* will run concurrently with the *2019 Ordinance*.

Non-resident persons that do not qualify as a "fund" may rely on the *2006* and *2015 Ordinance*, which is less flexible than the 2019 Ordinance.

"The 2006 and 2015 Ordinance"

The exemption provisions provide that a non-resident person is exempt from profits tax in respect of assessable profits derived from specified transactions carried out through or arranged by a specified

