



## **Deduction for share-based payments**

The Inland Revenue Department (IRD) recently revised its position in respect of the basis on which a deduction for share-based payments can be claimed.

### **Background**

The deduction of share-based payments for Hong Kong Profits Tax purposes is determined under the general deduction provision, Section 16(1) of the Inland Revenue Ordinance, which provides that a deduction for outgoings and expenses is only allowable to the extent they are incurred in the production of profits chargeable to Profits Tax.

In respect of share-based payments, the IRD has long held the view that a deduction is only allowable where a share-based payment is settled with shares acquired from the market. Up until recently, where the obligation was fulfilled by the issue of new shares, a deduction was not allowed on the grounds that it did not satisfy the "incurred" test. For share-based payments that involved an intra-group recharge arrangement for the Hong Kong taxpayer, a similar approach was applied by the IRD wherein a deduction was only allowed to the extent that the recharge represented the acquisition cost of shares purchased from the market by the parent entity. That is, a deduction was not allowed for a recharge where the parent issued new shares. This practice has been a point of contention between taxpayers and the IRD for a number of years.

### **Revised position**

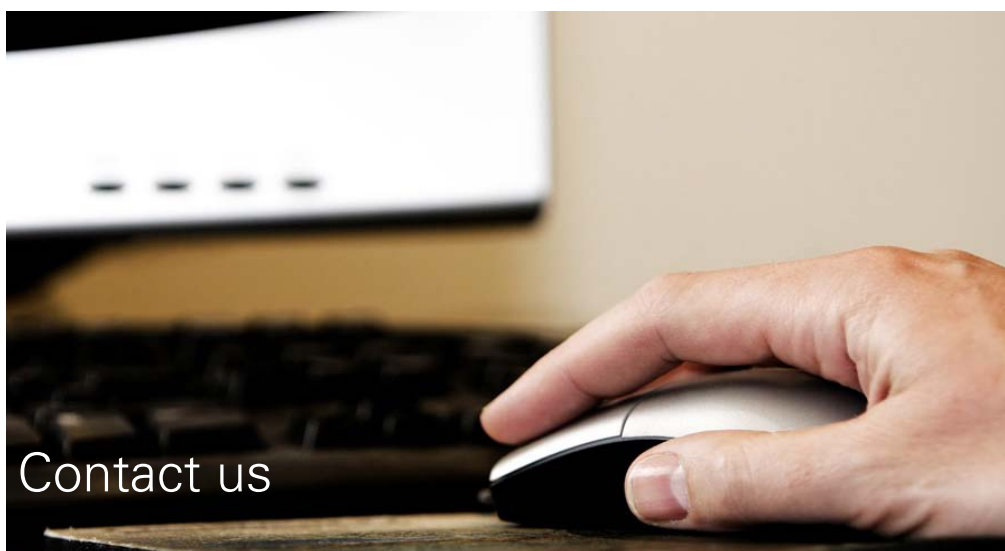
The IRD has revisited its position with a view to resolving the many prolonged disputes that they have with taxpayers on this issue. The IRD will now accept that a share-based expense is deductible even where it includes the issue of new shares to the entity. Under the revised position the IRD will now adopt the following positions for recharge arrangements where they are supported by a written recharge agreement:

- A recharge in relation to both the new issue of shares as well as the acquisition of shares from the market by a group entity can be allowable.

- The timing of the deduction is the point of exercise of the stock option or the point of vesting of the share award.
- The deduction claimed must not be excessive (for example, it should not be more than the open market value of the shares acquired at the date when the stock option / share award is exercised / vested less the amount or value of the consideration given by the grantee / awardee for the grant and / or exercise of the option / award, as the case may be).
- Where any option shares / award shares are subsequently forfeited or cancelled, any deduction previously allowed should be written back as a trading receipt and offered for assessment.

### **Comment**

The IRD's announcement is welcome. The IRD's previous practice of disallowing a deduction where the parent entity issued new shares was contentious and led to many protracted disputes. That said, the IRD's position on the timing and quantum of deduction may continue to be points for continuing disputes. For instance, it is arguable that a Hong Kong taxpayer should be allowed a deduction in the year of assessment in which payment for a recharge is made.



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