



Inland Revenue Department  
Hong Kong

## **DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES**

### **NO. 23 (REVISED)**

#### **RECOGNIZED RETIREMENT SCHEMES**

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the laws as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued in November 1993.

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### CONTENT

	Paragraph
<b>Introduction</b>	1
<b>Retirement schemes under different regimes</b>	
Approved Retirement Schemes	4
Recognized Occupational Retirement Schemes	5
Mandatory Provident Fund Schemes	7
Recognized Retirement Schemes	8
<b>Some important definitions</b>	
Distinction between “Retirement” and “Termination of service”	12
Contributions to MPF schemes	13
<b>Salaries tax liability of employees</b>	
Amounts attracting salaries tax liability	18
Proportionate benefit	23
Permanent departure from Hong Kong without termination of service	29
Accrued benefits received or taken to have been received from MPF schemes	30
Changing from ROR schemes to MPF schemes	33
Restriction where the employer is not chargeable to tax	39
<b>Deduction allowed to employees</b>	41
<b>Deduction allowed to employers under profits tax</b>	
Contributions made by employers	43

<b>Assessability of sums received by employers</b>	
Refund of contributions to employers	57
Offsetting of severance and long service payments	58
Investment income of recognized schemes	60
<b>Deduction allowed to self-employed persons and assessability of sums received</b>	62
<b>Estate duty consideration</b>	65
<b>Reporting requirements of employers</b>	66

## **INTRODUCTION**

In recognition of the need to provide retirement benefits to employees, tax relief in relation to the setting up of and benefits withdrawn from retirement schemes were made available to employers and employees as early as 1955. The tax concessions and administration provisions in the Inland Revenue Ordinance (“the IRO”) evolved with the development of more sophisticated regulatory frameworks on retirement schemes in Hong Kong. Major changes were made in 1993 following the introduction of the Occupational Retirement Schemes Ordinance (Cap. 426) (“the ORSO”) and in 1998 to pave the way for the implementation of the mandatory provident fund system (“the MPF system”).

2. The Mandatory Provident Fund Schemes Ordinance (Cap. 485) (“the MPFSO”), which provides for the operations and regulations of the MPF system in Hong Kong, was enacted in 1995. The MPFSO was amended before its commencement by Ordinance No. 4 of 1998 and other legislations. The MPF system fully started operation from 1 December 2000.

3. The purpose of these Practice Notes is to explain the principal features in the IRO in so far as they affect employers and employees in regard to contributions to and withdrawals from retirement schemes. These Practice Notes have included those parts from the previous Practice Notes 23 on Recognized Occupational Retirement Schemes and three MPF Circular Letters issued by the Department in so far as they are still relevant. The relevant sections of the IRO are stated in square brackets in these Notes.

## **RETIREMENT SCHEMES UNDER DIFFERENT REGIMES**

### ***Approved Retirement Schemes***

4. Before the commencement of the ORSO on 15 October 1993, there was no statutory body in Hong Kong to regulate the operations of retirement schemes established for the benefits of the employees. At that time, the Commissioner of Inland Revenue (“CIR”) approved retirement schemes that satisfied the conditions set out in the Inland Revenue (Retirement Scheme) Rules as approved retirement schemes under the then section 87A of the IRO. Tax relief was also granted to approved retirement schemes (“ARS”).

### ***Recognized Occupational Retirement Schemes***

5. After the ORSO came into operation on 15 October 1993, the Registrar of Occupational Retirement Schemes assumed responsibility for the registration and regulation of retirement schemes. Following the repeal of section 87A of the IRO and the Inland Revenue (Retirement Scheme) Rules by the Inland Revenue (Amendment) (No. 5) Ordinance 1993 (“the 1993 Amendment Ordinance”) on 19 November 1993, CIR ceased to approve retirement schemes.

6. The 1993 Amendment Ordinance also brought about a number of other changes to the IRO that had an impact on both salaries tax and profits tax. The major thrust of these changes was to reinstate, in statutory form, those requirements contained in the repealed Inland Revenue (Retirement Scheme) Rules that had taxation implications. In the main, the changes preserved the practical position that had long prevailed under those Rules. The principal features of provisions affecting employers and employees will be explained more fully later in these Notes.

### ***Mandatory Provident Fund Schemes***

7. The introduction of the MPF system in Hong Kong called for further changes to the IRO. A mandatory provident fund scheme (“MPF Scheme”) means a provident fund scheme registered under the MPFSO [section 2(1)]. Except for the exempt persons stipulated in the MPFSO, the MPF system covers employees and self-employed persons aged between 18 and 65. Under the MPFSO, employers are required to enrol employees in an MPF scheme. Every MPF scheme has to be registered with the MPF Scheme Authority. Persons exempt from MPF schemes include:

- (a) employees and self-employed persons who have attained the age of 64 when the MPFSO is implemented;
- (b) domestic employees;
- (c) self-employed hawkers;
- (d) people covered by statutory pension and provident fund schemes, such as civil servants and subsidized or grant school teachers;

- (e) members of occupational retirement schemes which are granted exemption certificates;
- (f) people from overseas who enter Hong Kong for employment for less than 13 months, or who are covered by overseas retirement schemes; and
- (g) employees of the European Union Office of the European Commission in Hong Kong.

Details relating to the operations of the MPF system can be found on the website of the MPF Scheme Authority at [www.mpfa.org.hk](http://www.mpfa.org.hk).

### ***Recognized Retirement Schemes***

8. Before going into detail about the tax treatments of contributions to and benefits received from retirement schemes under different regimes, it is necessary to refer to the meaning of various schemes as they appear in the IRO and their significance.

9. The terms “occupational retirement scheme” and “recognized occupational retirement scheme” were introduced by the 1993 Amendment Ordinance to the IRO. “Recognized occupational retirement scheme” (“ROR scheme”) was defined to include those ARS where the approval had not been withdrawn, schemes registered under the ORSO or exempted from registration under the ORSO, etc. The term “mandatory provident fund scheme” was added by Ordinance No. 4 of 1998. As mentioned above, an MPF scheme means a provident fund scheme registered under MPFSO.

10. In 1998, the term “recognized retirement scheme” was further added to the IRO as a collective term for the two types of retirement schemes that may enjoy tax benefits. The term “recognized retirement scheme” means either a ROR scheme or an MPF scheme.

11. The change from one regime to the next very often involves the winding up of schemes registered under an old regime and the establishing of a scheme under the new regime. For example, when ORSO came into operation, schemes previously approved by CIR under the repealed section 87A could be registered upon application as a ROR scheme. CIR’s approval under section 87A was deemed to have been withdrawn when a scheme became a

ROR scheme or if the scheme was not so registered by 15 October 1993. Similarly, on or before the commencement of the MPF contribution provisions on 1 December 2000, there were options available to employers operating ROR scheme in changing to schemes under the MPF system. The options included the following:

- Existing ORSO scheme was converted to an MPF-exempted ORSO scheme (upon application and subject to approval by the MPFA) and either the employer did not establish an MPF scheme or the employer established an MPF scheme to operate concurrently with the MPF-exempted ORSO scheme.
- Existing ORSO scheme was retained to provide top-up benefits and the employer established an MPF scheme in which all employees were enrolled.
- Existing ORSO scheme was wound-up and the employer established an MPF scheme.

Different options can have different taxation implications and they will be discussed in more detail later in these Notes<sup>1</sup>.

## **SOME IMPORTANT DEFINITIONS**

### ***Distinction between “Retirement” and “Termination of service”***

12. For purposes of the exemption provisions of sections 8(2)(c) and (cc) of the IRO, the terms, “retirement” and “termination of service”, are defined in section 8(3). “Retirement” means:

- A retirement from the service of the employer at some specified age of not less than 45 years; or
- A retirement after some specified period of service with the employer of not less than 10 years; or
- The attainment of the age of 60 or some specified age of retirement, whichever is the later.

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<sup>1</sup> See paragraphs 33 to 38.

“Termination of service” means a termination of employment other than upon retirement, death or incapacity. Withdrawals from recognized retirement schemes on retirement and those on termination of service have different tax implications.

### ***Contributions to MPF schemes***

13. Employers, employees and self-employed persons are required to make contributions to the MPF schemes they have joined out of or by reference to the income of the employees or the self-employed persons. By definitions under the MPFSO and the IRO, contributions are classified into mandatory contributions and voluntary contributions. Mandatory contributions and voluntary contributions attract different tax treatments.

### **Mandatory contributions**

14. For the purposes of the IRO, mandatory contribution means the mandatory contribution paid to an MPF scheme in accordance with the MPFSO. It is calculated on the basis of 10% on an employee’s relevant income, with the employer and the employee each paying 5%. Contributions are generally made on a monthly basis. There is a 30-day non-contributory period for an employee who takes up a new employment. Self-employed persons (including sole proprietors and partners of a partnership business) have to contribute 5% of their relevant income. They can opt to make contributions on a monthly or yearly basis.

15. Employees earning less than \$5,000 a month are not required to contribute, but their employers have to contribute 5% of the employee’s income. The mandatory contribution is capped at \$1,000 per month for employees earning more than \$20,000 per month, or \$12,000 per year. These maximum and minimum levels of income also apply to self-employed persons.

16. The relevant income of the employee on which the calculation of contribution is based includes wages, salaries, leave pay, fee, commission, bonus, gratuity, perquisite or allowance, but exclude housing allowance, housing benefit, severance and long service payments. The relevant income of a self-employed person is basically his assessable profits calculated in accordance with the IRO, as shown in his most recent notice of assessment.

## **Voluntary contributions**

17. In addition to mandatory contributions, employers, employees and self-employed persons can make contributions or increase their contributions to an MPF scheme on a voluntary basis in accordance with section 11 of the MPFSO. Unlike mandatory contributions, voluntary contributions made by employees and self-employed persons are not deductible for tax purposes.

## **SALARIES TAX LIABILITY OF EMPLOYEES**

### *Amounts attracting salaries tax liability*

18. Persons with income arising in or derived from Hong Kong from an office or employment are chargeable to salaries tax. The term income from an office or employment is defined in section 9(1). Other than pensions (which are specifically chargeable under section 8(1)(b)), assessability of amounts received by an employee from retirement schemes, whether by way of commutation or otherwise, is as follows:

- Amounts received from a pension or provident fund, scheme or society which is not a ROR scheme or an MPF scheme, as is attributable to the employer's contributions, are chargeable [section 9(1)(aa)].
- Where the amount from a ROR scheme is received not because of termination of service, death, incapacity or retirement of the employee, the full amount of the employer's contributions under the scheme in respect of the employee concerned is chargeable [section 9(1)(ab)(i)].
- Where the amount is received from a ROR scheme because of termination of service - the amount of the employer's contributions that exceeds the proportionate benefit<sup>2</sup> as calculated in accordance with section 8(5) is chargeable [section 9(1)(ab)(ii)].

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<sup>2</sup> See paragraphs 23 to 28 on "Proportionate benefit".

- Any payment received by an employee, pursuant to a judgment given under section 57(3)(b) of the ORSO that is attributable to his employer's contributions to the occupational retirement scheme in respect of which the judgment was given, is chargeable [section 9(1)(ac)]. Section 57(3) of the ORSO allows the Court to determine the amount of any shortfall in the funding of a beneficiary's vested benefits under a scheme and to make an order against the employer for that shortfall.
- So much of the accrued benefit that an employee has received, or is taken to have received from an MPF scheme otherwise than on retirement, death, incapacity or termination of service, as is attributable to his employer's contributions to the scheme, is chargeable [section 9(1)(ad)].
- So much of the accrued benefit that an employee has received, or is taken to have received from an MPF scheme, as is attributable to his employer's voluntary contributions to the scheme which exceeds the proportionate benefit calculated in accordance with section 8(5), is assessable [section 9(1)(ae)].

After the employee's total income for a year of assessment has been ascertained in accordance with the above, the charging sections, either 8(1), 8(1A) and/or 8(1B) will be applied according to the employee's situations.

19. It should be noted that in the case of ROR schemes, liability arises when the amount is received, unless it is received under circumstances where exemptions are applicable. Regarding accrued benefits from MPF schemes, liability can arise when the benefit is taken to have been received<sup>3</sup>. In general, only benefits attributable to the employer's voluntary contributions attract tax liability. The withdrawal of accrued benefits attributable to the employee's contributions and investment income from the trust funds is not chargeable to salaries tax. Such withdrawals may be viewed as withdrawals of the scheme member's savings.

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<sup>3</sup> Elaboration in paragraphs 30 to 32 on "Taken to have been received".

20. To give symmetry to the assessment provisions, section 8(2) contains provisions on exemption of accrued benefits received from recognized retirement schemes. The table below summarizes the position:

Circumstances under which the accrued benefits are received	Recognized Occupational Retirement Schemes		Mandatory Provident Schemes	
	Sums attributable to		Accrued benefit attributable to	
	Employee's contributions	Employer's contributions	Employee's mandatory and voluntary contributions	Employer's mandatory and voluntary contributions
Retirement	Exempt	Exempt	Exempt	Exempt
Death	Exempt	Exempt	Exempt	Exempt
Incapacity	Exempt	Exempt	Exempt	Exempt
Termination of service	Exempt	Exempt but "Proportionate Benefit Rule" applies [s.8(2)(c)(i)] [s.8(2)(cc)(i)] [s.9(1)(ab)(ii)]	Exempt	<u>Mandatory:</u> Exempt <sup>4</sup> <u>Voluntary:</u> Exempt but "Proportionate Benefit Rule" applies [s.8(2)(cc)(ii)] [s.9(1)(ae)]
Permanent departure from Hong Kong but without terminating service	Exempt	Assessable in full [s.9(1)(ab)(i)]	Exempt	<u>Mandatory:</u> Exempt [s.8(2)(cb)] <u>Voluntary:</u> Assessable in full <sup>5</sup> [s.9(1)(ad)]
Any circumstances other than those listed above	Exempt	Assessable in full [s.9(1)(ab)(i)]	Exempt	Assessable in full [s.9(1)(ad)]

<sup>4</sup> The accrued benefit received under the circumstance is not regarded as income in section 9(1)(ad).

<sup>5</sup> See paragraph 29.

21. In the case of a ROR scheme that has lost its “recognized” status, only relevant sums paid prior to the loss of that status can be considered for exemption under section 8(2)(c) or (cc). All payments received subsequent to the revocation of recognition will be considered for assessment under section 9(1)(aa).

22. Where the employer has not paid the whole of the severance or long service payment to an employee as required by the Employment Ordinance, the employee may, by virtue of sections 12A(3) and (4) of the MPFSO, require the approved trustee of the MPF scheme to pay him the shortfall out of the accrued benefit attributable to the employer’s contribution. See Example 5 under paragraph 24 on the situation involving setting off of severance payment or long service payment against the taxable accrued benefits received. The sum received by the employee attributable to voluntary contributions of the employer is exempt under section 8(2)(cc)(ii), subject to the proportionate benefit rule and the restriction under sections 8(7) and (8). See worked examples under paragraph 39 on the application of these sections and their relationship to sections 8(4) and (5). The sum received attributable to the employer’s mandatory contributions is not taxable.

***Proportionate benefit***

23. Special conditions apply to limit the amount of the employer’s voluntary contribution component of any payment received upon termination of service that may be exempted from salaries tax under section 8(2)(c) or (cc). The maximum amount that is exempt from salaries tax is the lesser of the relevant amount received or the proportionate benefit. Mathematically, the proportionate benefit is calculated using the formula set out in section 8(5):

$$\text{Proportionate benefit} = \text{Accrued benefit} \times \frac{\text{completed months of service}}{120}$$

***Accrued benefit***

If the person is a member of a ROR scheme, accrued benefit refers to the maximum benefit that the person would have been entitled to receive from the scheme as if the person had retired when his employment was terminated. If a person is a member of an MPF scheme, accrued benefit refers to that benefit

which is attributable to the employer's voluntary contribution in respect of the person for his service.

### *Complete month of service*

This term refers to the number of completed months of service that the person has completed with the employer. It is referable to the whole period of employment that the employee had with the employer. This term should not be confused with the number of days or months that the employee has rendered services in Hong Kong for purposes of sections 8(1A) and/or 8(1B).

### **Examples**

24. The following examples illustrate the application of the proportionate benefit calculation. In all cases, the "accrued benefit" and the "payment received" are the respective amounts attributable to the employer's voluntary contributions only.

#### Example 1

- (i) Period of service: 5 years
- (ii) Accrued benefit on termination of service: \$100,000
- (iii) Payment received from the scheme: \$50,000

Calculation of proportionate benefit [section 8(5)]:

$$\begin{aligned}\text{Proportionate benefit} &= \$100,000 \times \frac{60}{120} \text{ months} \\ &= \underline{\$50,000}\end{aligned}$$

Calculation of taxable benefit [section 8(4)]:

$$\begin{aligned}\text{Taxable benefit} &= \text{Payment received} - \text{proportionate benefit} \\ &= \$50,000 - \$50,000 \\ &= \underline{\text{NIL}}\end{aligned}$$

### Example 2

- (i) Period of service: 5 years
- (ii) Accrued benefit on termination of service: \$100,000
- (iii) Payment received from the scheme: \$60,000

Calculation of proportionate benefit [section 8(5)]:

$$\begin{aligned}\text{Proportionate benefit} &= \$100,000 \times \frac{60}{120} \text{ months} \\ &= \underline{\$50,000}\end{aligned}$$

Calculation of taxable benefit [section 8(4)]:

$$\begin{aligned}\text{Taxable benefit} &= \$60,000 - \$50,000 \\ &= \underline{\$10,000}\end{aligned}$$

### Example 3

- (i) Period of service: 5 years
- (ii) Accrued benefit on termination of service: \$100,000
- (iii) Payment received from the scheme (in accordance with vesting scale approved earlier by CIR): \$60,000

Calculation of proportionate benefit [section 8(4)]:

$$\text{Proportionate benefit} = \underline{\$60,000}$$

Calculation of taxable benefit [section 8(4)(a)]:

$$\begin{aligned}\text{Taxable benefit} &= \$60,000 - \$60,000 \\ &= \underline{\text{NIL}}\end{aligned}$$

### Example 4

- (i) Employee had a transfer of benefits from a scheme operated by a previous employer.
- (ii) Period of employment with previous employer: 2 years
- (iii) Period of employment with current employer as at date of termination of service: 5 years

- (iv) Period of service recognized by scheme: 7 years
- (v) Accrued benefit on termination of service: \$100,000
- (vi) Payment received from the scheme: \$70,000

Calculation of proportionate benefit [section 8(5)]:

$$\begin{aligned} \text{Proportionate benefit} &= \$100,000 \times \frac{84}{120} \text{ months} \\ &= \underline{\$70,000} \end{aligned}$$

Calculation of taxable benefit [section 8(4)]:

$$\begin{aligned} \text{Taxable benefit} &= \$70,000 - \$70,000 \\ &= \underline{\text{NIL}} \end{aligned}$$

#### Example 5

- (i) Period of service: 5 years
- (ii) Made redundant by the employer at the end of the period of service, at which time monthly salary was \$10,000 per month
- (iii) Employer would pay either severance payment according to Employment Ordinance or accrued benefit under the MPF scheme, whichever was the higher
- (iv) Severance payment was calculated as:  $\$10,000 \times \frac{2}{3} \times 5 = \$33,333$
- (v) Accrued benefit attributable to the employer's voluntary contribution under the scheme: \$70,000
- (vi) Payment received from the scheme: \$70,000

Calculation of proportionate benefit [section 8(5)]:

$$\begin{aligned} \text{Proportionate benefit} &= \$70,000 \times \frac{60}{120} \text{ months} \\ &= \underline{\$35,000} \end{aligned}$$

Calculation of taxable benefit [section 8(4)]:

$$\begin{aligned} \text{Taxable benefit} &= \$70,000 - \$35,000 \\ &= \underline{\$35,000} \end{aligned}$$

In view of redundancy, the taxable benefit is further reduced by an amount representing the severance payment under the Employment Ordinance and only the difference is chargeable to tax. In this example,  $\$(35,000 - 33,333) = \$1,667$  is subject to salaries tax.

25. The accrued benefit is the maximum benefit that the person would have been entitled to receive from a ROR scheme in respect of his recognized service as if he had retired on the date of termination of employment [section 8(6)(a)]. Where a scheme contains more than one method for calculating the retirement benefit that would have been payable on that date, the option which provides the greatest benefit to the employee is to be used.

26. In the case of a scheme which is a defined contribution scheme, the accrued benefit will be the aggregate contributions made by or in respect of that person. For defined benefit schemes the accrued benefit, for the purposes of the proportionate benefit calculation, must be calculated in accordance with the method recommended by the actuaries of the scheme. Actuaries are not required to obtain CIR's approval for the calculation method recommended for any scheme. However, if a particular recommended method has resulted in an accrued benefit, which, when taking into account the period of employment and the salary received during that period, appears to be somewhat excessive, CIR may obtain independent actuarial advice. In this regard taxpayers will, of course, have the usual right of objection and appeal in respect of the chargeable income calculation. In any event, in calculating the proportionate benefit, only that amount of the accrued benefit that represents the employer's contributions is taken into account.

27. Where there has been a transfer of benefits from a scheme operated by a previous employer to the current employer's scheme, the service with the previous employer that has been recognized by the present scheme as qualifying service with the current employer can be taken into account in calculating the completed months of service.

28. Accrued benefit arising from mandatory contributions made by the employers and employees has to be preserved until the scheme member attains the retirement age of 65 as stipulated in the MPFSO. Early withdrawal of the accrued benefit is however allowed in the circumstances applicable to the scheme member as follows:

- (a) early retirement and attainment of age 60;
- (b) permanent departure from Hong Kong;
- (c) total incapacity;
- (d) death; and
- (e) having a small balance account of less than \$5,000 and providing that the scheme member has not made contributions to a scheme for 12 months and has declared to retire.

***Permanent departure from Hong Kong without termination of service***

29. Section 9(1)(ad) of the IRO provides that income from any employment includes the accrued benefit that an employee has received, or is taken to have received, from a mandatory provident fund scheme (otherwise than on retirement, death, incapacity or termination of service), as is attributable to contributions paid to the scheme by the employee's employer. However, under section 8(2)(cb), specific exemption has been accorded to accrued benefit received from the approved trustee of a mandatory provident fund scheme, on a person's retirement from employment, death or incapacity or permanent departure from Hong Kong, as is attributable to mandatory contributions. The net effect of these two provisions is that for cases where there is permanent departure from Hong Kong but without termination of service, the accrued benefits received which is attributable to the employer's mandatory contributions are not taxable, but those attributable to the employer's voluntary contributions are taxed in full. On the other hand, if the accrued benefit is to remain with the scheme and only paid out to the employee when one of the exemption conditions is satisfied, e.g., retirement, there should be no tax liability.

***Accrued benefits received or taken to have been received from MPF schemes***

30. Under the MPF system, it is permissible for an employee member who has terminated his service with an employer to retain his accrued benefits in the same MPF scheme to which his former employer has made contribution, or to transfer the accrued benefits to another MPF scheme, for example, one sponsored by his new employer. In both situations, the employee member is taken to have received the accrued benefit, pursuant to section 8(9).

31. Section 8(2)(cb) exempts accrued benefit received from an MPF Scheme on a person's retirement from employment, death, incapacity or permanent departure from Hong Kong as attributable to mandatory contribution. The situation described in the foregoing paragraph, i.e., an employee terminating his service, does not fall within the exemption provisions of section 8(2)(cb). On the other hand, section 9(1)(ad) excludes as income, accrued benefit from an MPF Scheme received or taken to have been received on retirement, death, incapacity or termination of service as is attributable to the employer's contributions (both mandatory and voluntary). When the above provisions are taken together, the accrued benefit attributable to the employer's mandatory contributions in situation of termination of service and transfer of the benefit to another MPF Scheme should be exempt. Accrued benefit attributable to the employer's voluntary contributions in the same situation should also be exempt but subject to the proportionate benefit rule. By section 9(1)(ae), so much of the accrued benefit that an employee has received or is taken to have received from an MPF Scheme as is attributable to the employer's voluntary contributions that exceeds the proportionate benefit will be included as the employee's income.

32. There are situations involving transfer of benefits from one MPF scheme to another but without termination of service or any of the exemption conditions being satisfied. For example, the employer sets up a new MPF scheme and transfers all employees from the old MPF scheme to the new scheme, or there is a transfer of schemes upon the employee's permanent departure from Hong Kong without termination of service. In these kinds of situations, the employees should be taken to have received the accrued benefit attributable to the employer's contributions. By virtue of section 9(1)(ad), the accrued benefit is chargeable to tax in the year of transfer. The exemption provisions in sections 8(2)(cb) and (cc)(ii), which refer to receipts on retirement, death, incapacity and termination of service, would have no application. However, the Department recognizes that, in the circumstances described above, the employee concerned has not actually received, and cannot choose to receive, the accrued benefits and the benefits may be subject to tax again when they are finally received by the employee. As a concession, the Department would not seek to assess the transferred benefits in the year of transfer. Their chargeability will be determined when they are received by the employee or when there is a termination of service.

## *Changing from ROR schemes to MPF schemes*

### **Application of section 8(4)**

33. When a person “switched” from a scheme approved by the Commissioner prior to the repeal of section 87A of the IRO (“section 87A Scheme”) to one established subsequently, a question may arise as to whether the vesting scale of the section 87A Scheme can be carried across to the new scheme if it is more advantageous to employees than the proportionate benefit rule itself. The latter part of section 8(4) provides that where, in the case of a ROR scheme approved by CIR under section 87A before its repeal, if an amount payable on termination of service in accordance with the rules of such scheme exceeds the proportionate benefit so calculated, the amount payable is to be taken as the proportionate benefit.

34. The above provision takes into consideration that there is a substitution of one scheme by another. This may occur where the trustees of a scheme switch the funding from one investment vehicle to another in a way which entails termination of the scheme and its replacement by a new scheme. In this regard, if the substance of the new scheme is essentially the same as the original scheme (i.e. identical membership; transfer of all investments and funds to the new scheme; no change to vesting scale; and terms and conditions relating to membership and members’ rights substantially unaltered) it will generally be treated on the basis that it represents a continuation of the original scheme.

35. For illustration, the latter part of section 8(4) is applied in the following situations:

- (a) A section 87A Scheme which operated as a ROR scheme, was converted into an MPF-exempted scheme.
- (b) The employer established an MPF scheme to replace the ROR scheme which was previously a section 87A Scheme. Members were required to join the MPF scheme and the ROR scheme would be wound up. Before the commencement of the MPF contribution provision on 1 December 2000, members transferred all their benefits from the ROR scheme to the new MPF scheme.

36. In the above situations, the new scheme is recognized as a continuation of an earlier scheme, the Commissioner's approval of the earlier scheme under section 87A will be preserved, i.e. it will be taken to apply to the new scheme. Nevertheless, changes of this nature should be notified to the Commissioner within one month of implementation.

37. The treatment applicable to the situation mentioned in paragraph 35(b) is by concession only. If the individual member was transferred from a ROR scheme to a new MPF scheme on or after the commencement of the MPF contribution provisions, the person's membership in the first scheme is considered to cease in all respects upon payment of the transfer value from the first scheme to the new scheme. It follows that if a termination payment is subsequently received from the new scheme, it will be regarded as having arisen from that scheme. In this situation, the proportionate benefit rule, rather than the provision in the latter part of section 8(4) will apply to the payment.

### **Salaries tax implications to the employees**

38. A number of scenarios have been identified. They are summarized as follows:

#### Scenario 1

*The employer converts an existing ROR scheme to an MPF-exempted ORSO scheme. The MPF-exempted ORSO scheme can remain open or closed to new members.*

There is no tax implication for employees upon conversion of the schemes. The scheme remains a ROR scheme. Any sum withdrawn upon termination of service is exempt subject to the proportionate benefit rule. Withdrawal upon retirement, death or incapacity is exempt.

## Scenario 2

*The employer retains an existing ROR scheme at the same time an MPF scheme is set up. Existing scheme members may join the MPF scheme, with the choice to:*

- (a) withdraw the accrued benefit attributable to the employer's contribution under the ROR scheme,*
- (b) remain in the ROR scheme to provide top-up benefit to be received in future, or*
- (c) transfer the accrued benefit attributable to the employer's contribution from the ROR scheme to the MPF scheme.*

The tax implication in respect of each choice is as follows:

- (a) The amount received is fully taxable. None of the conditions for exemption, i.e., termination of service, retirement, death and incapacity, is satisfied.
- (b) There is no tax implication in the interim as no payment is received. If withdrawal of the accrued benefit from the ROR scheme is made only when one or more of the conditions for exemption is satisfied, the amount received is exempt, subject to the proportionate benefit rule in the case of termination of service.
- (c) There is no tax implication in the interim as no payment is received. The accrued benefit would be treated as if it remained in the ROR scheme. Alternatively, the accrued benefit transferred to the MPF scheme is deemed to be a voluntary contribution from the employer to the MPF scheme. If withdrawal of the accrued benefit is made only when one or more of the conditions for exemption is satisfied, the amount received is exempt, subject to the proportionate benefit rule in the case of termination of service. The provision in the latter part of section 8(4) will only apply as a concession if the ROR scheme in question qualifies for its application and the transfer of the accrued benefit took place before 1 December 2000.

### Scenario 3

*The existing ROR scheme is wound up when the employer sets up an MPF scheme which all employees are required to join.*

The same considerations in (a) and (c) of Scenario 2 will be applicable.

#### ***Restriction where the employer is not chargeable to tax***

39. Where the accrued benefit withdrawn by an employee is attributable to the voluntary contributions paid by an employer who is not chargeable to profits tax, the amount of the accrued benefit attributable to the employer's contribution to be excluded from the income of the employee shall not exceed an amount equal to 15% of the total remuneration of the employee in the period of 12 months preceding the date on which the accrued benefit is received multiplied by the employee's completed years of service with the employer, as reduced by so much of the accrued benefit received by the employee as is attributable to the mandatory contribution of the employer [section 8(8)]. In practice, this restriction is generally applicable to cases where the employer is a charitable body or other non-commercial organization such as a university. Examples illustrating how the Proportionate Benefit Rule and the restrictions under sections 8(7) and (8) work are set out below:

#### **Examples**

An employer who is a charitable institution operates an MPF scheme. On top the mandatory contributions, the employer made voluntary contributions to the scheme at 16% of her employees' relevant income. An employee who earned an annual income of \$100,000 withdrew from the scheme all his accrued benefits attributable to the employer's contributions in the following circumstances.

**(a) On retirement, death or incapacity with 10 years of service**

Accrued benefit attributable to employer's mandatory contribution payable to the employee as advised by the scheme trustee \$50,000 [A]

\$50,000 is exempt under section 8(2)(cb)

Accrued benefit attributable to employer's voluntary contribution payable to the employee as advised by the scheme trustee \$160,000

Exemption amount: 15% limit under sections 8(7) and (8) (\$100,000 x 15% x 10 - \$50,000, i.e., [A]) \$100,000

Taxable benefit (\$160,000 - \$100,000), i.e., excess over 15% limit \$60,000

**(b) On termination of service with 6 years of service**

Accrued benefit attributable to employer's mandatory contribution due to the employee as advised by the scheme trustee \$30,000 [B]

(Cannot be received by employee unless employee departed from Hong Kong permanently at the same time)

Accrued benefit attributable to employer's voluntary contribution due to the employee as advised by the scheme trustee \$96,000

Exemption amount: 15% limit under sections 8(7) and (8) (\$100,000 x 15% x 6 - \$30,000, i.e., [B]) \$60,000 [C]

Exemption amount under proportionate benefit rule (\$96,000 x 72/120) \$57,600 [D]

Taxable benefit taken to have been received (\$96,000 - \$57,600, i.e., [D]) \$38,400

(The smaller of the two exemption limits will be applied)

(c) **On termination of service with 8 years of service**

Accrued benefit attributable to employer's mandatory contribution due to the employee as advised by the scheme trustee \$40,000 [E]

(Cannot be received by employee unless employee departed from Hong Kong permanently at the same time)

Accrued benefit attributable to employer's voluntary contribution due to the employee as advised by the scheme trustee \$128,000

Exemption amount: 15% limit under section 8(7) and (8)  
(\$100,000 x 15% x 8 - \$40,000, i.e., [E]) \$80,000 [F]

Exemption amount under proportionate benefit rule  
(\$128,000 x 96/120) \$102,400 [G]

Taxable benefit taken to have been received  
(\$128,000 - \$80,000, i.e., [F]) \$48,000  
(The smaller of the two exemption limits will be applied)

40. It should be pointed out that the Department may, in exceptional cases, apply the restriction to cases where the employer, though carrying on business, is not chargeable to profits tax (for example, because its profits are wholly derived outside Hong Kong) if it is found that advantage is being taken of the tax status of the employer to reduce the employee's salaries tax liabilities.

**DEDUCTION ALLOWED TO EMPLOYEES**

41. Section 26G of the IRO applies in relation to the year of assessment commencing on 1 April 2000 and to all subsequent years of assessment. As provided by this section, contribution made by an employee to a recognized retirement scheme is an allowable deduction under salaries tax and personal assessment. Recognized retirement schemes include both ROR schemes and MPF schemes. The amount of deduction, however, is limited to that specified

under Schedule 3B of the IRO which is equivalent to the maximum amount of mandatory contributions payable in accordance with the MPFSO. The current maximum amount is \$12,000 per year. A person taking up more than one employment may be required to make contributions to more than one scheme. He can claim deduction of mandatory contributions paid on all schemes, with the aggregate deductions claimed not exceeding the limit of \$12,000 per year. Any sum allowable as a deduction under Part IV (Profits Tax) cannot be deducted again under section 26G. In other words, contributions made by self-employed persons and claimed as allowable deduction for profits tax purposes cannot be claimed as a deduction under section 26G.

42. In the case of contributions made by a person to a ROR scheme, the amount allowed for deduction is the lesser of the actual amount contributed or the amount of mandatory contribution that that person would have been required to pay as an employee had that scheme been an MPF scheme. The total deduction allowable to a person for a year of assessment under this section cannot exceed the amount specified in Schedule 3B (currently \$12,000 per year of assessment).

## **DEDUCTION ALLOWED TO EMPLOYERS UNDER PROFITS TAX**

### ***Contributions made by employers***

43. Special contribution, as distinct from ordinary annual contribution in the case of a ROR scheme or regular contribution in an MPF scheme, or a premium, other than an ordinary annual premium in respect of a contract of insurance under a ROR scheme, shall be allowed as a deduction but to the extent that it is made in respect of individuals employed for the purposes of producing profits chargeable to profits tax and that it is not excessive in view of all the relevant circumstances. Deduction shall be allowed at an even rate over the basis period of each of the five years of assessment commencing from that year during whose basis period the special contribution was actually made [section 16A].

44. For this purpose, contributions made to an MPF scheme at regular intervals of similar or substantially similar amounts or of amounts calculated by reference to a scale or a fixed percentage of a person's salary or other remuneration are treated as regular contributions [section 16A(3)].

45. Ordinary annual contribution to or ordinary annual premium for a contract of insurance under a ROR scheme or regular contributions (mandatory or voluntary or both) to an MPF scheme by an employer for the benefit of his employees are in general outgoings or expenses allowable for deduction under section 16(1) to the extent that they are incurred in the production of profits in respect of which the employer is chargeable to profits tax. The deduction is, however, limited to 15% of the total emoluments of the employee for the period to which the payments relate [section 17(1)(h)]. For this purpose, “total emoluments” refers to total taxable emoluments of an employee from the employment or office and includes all allowances and benefits in kind. Provision for ordinary or regular payment referred to in section 17(1)(h) in excess of the 15% limit will also not be deductible [section 17(1)(i)].

46. Where a provision for the payment of any contributions has been allowed in a prior year, the payment subsequently made is not deductible [section 17(1)(k)].

47. Any provision made for payment or contribution to retirement schemes, which are not ROR schemes, will not be deductible [sections 17(1)(j) and (l)].

48. Accounting for retirement schemes is governed by Hong Kong Accounting Standard 19 Employee Benefits (“HKAS 19”) issued by the Hong Kong Institute of Certified Public Accountants. For defined contribution schemes, the accounting and taxation treatments for the contributions are normally straightforward. Ordinary annual contributions or premium and regular contributions paid and payable for a period will be charged as expenses in the profit and loss account of the period concerned and allowed for taxation purposes, subject to the 15% limit.

49. Accounting for defined benefit schemes is much more complex. Under such a scheme, the employer is responsible for the ultimate payments of scheme benefits to employees as promised, which are usually determined by reference to employees’ earnings and years of service. The employer has to bear the actuarial risk (that benefits will cost more than expected) and investment risk of scheme assets. Thus, the cost to the employer of providing the promised retirement benefits cannot be measured by the amounts of contributions currently due alone.

50. HKAS 19 requires that an entity participating in a defined benefit scheme shall recognize in its profit and loss account the net total of a number of items. In normal situations, the net total would be made up of the following:

- current service cost, i.e. the increase in the present value of the defined benefit obligation resulting from employee service in the current period;
- interest cost, i.e. the increase in the present value of a defined benefit obligation which arises because the benefits are one period closer to settlement;
- the expected return on any scheme assets; and
- actuarial gains and losses recognized in accordance with HKAS 19.

51. For a ROR scheme that is a defined benefit scheme, the net total charged as an expense to the employer's profit and loss account is treated, for profits tax purposes, as a provision for payment of contributions to the retirement scheme and allowed for deduction, to the extent that the amount does not exceed 15% of the total emoluments of the employees for the period covered. Where the net total is a credit to the profit and loss account, the amount credited will be included in the employer's assessable profits. The actual contributions paid reduce the accrued defined benefit liability in the balance sheet and are not recognized as expenses in the profit and loss account. As the provision has been allowed, the contributions paid are not allowed for deduction again. The Department considers that the treatment stated above is in line with the principle established in the case of *Secan Ltd. & Ranon Ltd. v. CIR 5 HKTC 266* that assessable profits and losses must be ascertained in accordance with the ordinary principles of commercial accounting as modified to conform with the IRO in that the amount allowed as an expense is computed in accordance with generally accepted accounting principles currently in force subject to the 15% restriction placed under the IRO.

52. Special contributions made are allowable under section 16A, provided that no deduction has been allowed for any provision for its payment [sections 16A(1) and 17(1)(k)]. Given the way the employer's obligation is measured under HKAS 19, the Department envisages that, at least in some circumstances, a special contribution paid may have previously been included in the net totals charged in the profit and loss accounts and allowed for deduction. In those circumstances, a part of the net totals previously allowed and attributable to the special contribution will have to be added back. The amount of such adjustments will be determined by reference to the details of each case.

53. On first adoption of HKAS 19 (or its predecessor, Statement of Standard Accounting Practice 34 Employee Benefits), the transitional liability<sup>6</sup> may be in excess of the liability that would have been recognized under the entity's previous accounting policy. In this situation, the entity has to make an irrevocable choice to recognize the excess either immediately as a prior period adjustment or as an expense on a straight-line basis over up to five years. In either case, the excess is not deductible for profits tax purposes as it is not a provision for ordinary annual contributions. However, deduction may be claimed under section 16A when the entity makes special contributions to fund the transitional liability.

54. Where the transitional liability is less than the liability under the previous accounting policy, HKAS 19 requires the entity to recognize the surplus immediately as a prior period adjustment. The surplus so recognized is not taxable. However, if an entity receives a cash refund from the trustee of the scheme, the refund is taxable by virtue of section 15(1)(h).

55. Retirement schemes established under ORSO have separate legal identities from those of their sponsoring employers. Any losses incurred on the disposal of investments held by ORSO schemes at the time when they are liquidated are not deductible in determining the assessable profits of the employers who established the schemes.

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<sup>6</sup> Which is basically measured by the difference between the present value of the defined benefit obligation at the date the standard is adopted and the fair value of scheme assets at that date.

56. On the other hand, costs incurred by an employer in establishing an MPF scheme, amending the rules of an ORSO scheme to comply with the MPF regulations or winding up an ORSO scheme will ordinarily be deductible. Such expenses are regarded as effecting a change in the basis on which a business remunerates its employees and not a change in the structure of the business.

## **ASSESSABILITY OF SUMS RECEIVED BY EMPLOYERS**

### ***Refund of contributions to employers***

57. Section 15(1)(h) of the IRO deems sums received by or accrued to a person as an employer, by way of refunds of contributions made to a ROR scheme or of voluntary contributions paid to an MPF scheme, to the extent deduction has been allowed in ascertaining his assessable profits, to be taxable. Employer contributions to an ORSO scheme repaid to the employer upon winding up of the scheme are taxable on the employer. Any excess recoupment (being investment income of the ORSO scheme) is not taxable in the hands of the employer.

### ***Offsetting of severance and long service payments***

58. Under the Employment Ordinance (Cap. 57) an employer can offset the amount of severance payment or long service payment payable to an employee out of the MPF scheme's accrued benefits derived from the contributions made by the employer for the employee. If the contributions made by the employer exceed the amount of severance/long service payment, the remaining balance has to be retained in the employee's account of the scheme. On the other hand, if the contributions made by the employer cannot fully offset the severance/long service payment, the employer must pay the outstanding balance.

59. Where an employer has paid to an employee severance or long service payment, he may, by virtue of sections 12A(1) and (2) of the MPFSO, require the approved trustee of the MPF scheme to pay to him an amount representing the employee's accrued benefit attributable to the employer's contributions not exceeding the amount of the severance/long service payment

he paid to the employee. Such a payment to the employer is a refund of the contributions he previously made to the MPF scheme as a result of the reduction of the benefit of the employee as stipulated under section 31IA of the Employment Ordinance. The portion of the refund which is attributable to the voluntary contributions made by the employer is chargeable to tax under section 15(1)(h)(ii) to the extent that it is previously allowed as a deduction in ascertaining the employer's assessable profits. The portion of the refund, which is attributable to the mandatory contributions to the extent that deduction has previously been allowed, should be set-off against the severance payment or long service payment claimed as an allowable deduction.

### ***Investment income of recognized schemes***

60. The question has, at times, arisen as to whether the operation of an occupational retirement scheme by an employer, say through a trustee, constitutes the carrying on of a business. In deciding this point, the most important determinant is the purpose for which the fund is established. Section 2(1) of the ORSO gives a clear statement of the purpose. It is to provide benefits in the form of pensions, allowances, gratuities, etc., upon termination of service, death or retirement to, or in respect of, employees.

61. ROR schemes are established under statutory control to receive, hold and manage funds earmarked for the provision of employee benefits rather than to provide employers with "profits" per se. In holding and managing funds, the trustees of retirement schemes will from time to time, and perhaps occasionally with a degree of frequency, acquire and dispose of investments. That notwithstanding, as retirement schemes are operated for the common advantage of their constituent members (i.e. the employees), the trustees' fiduciary duties are to maintain the investment funds in a healthy financial state to meet long-term commitments. Taken overall, recognized retirement schemes and their trustees are not considered to be subject to profits tax on their investment income.

## **DEDUCTION ALLOWED TO SELF-EMPLOYED PERSONS AND ASSESSABILITY OF SUMS RECEIVED**

62. A self-employed person who is either a sole proprietor or a partner of a partnership is also required to join an MPF scheme. Under section 16AA(1)<sup>7</sup>, any mandatory contributions he or she pays in the basis period for a year of assessment are deemed to be expenses wholly and exclusively incurred in the production of profits chargeable to tax of that trade, profession or business and shall be allowed as a deduction in ascertaining the person's assessable profits. However, under section 16AA(2), such deductions cannot exceed the limit specified under schedule 3B as reduced by any sum allowable under section 26G of the IRO. Provisions in this section override those in section 17(1)(a)(ii) which is applicable to a proprietor and section 17(2)(d)(iii) which is applicable to partners and the partner's spouse. Any sum allowable as a deduction under profits tax will not be allowable for deduction under section 26G.

63. Voluntary contributions to an MPF scheme paid by self-employed persons are not deductible as they are expenditure of a private nature and are not incurred in the production of profits chargeable to tax [sections 17(1)(a)(ii) and 17(2)(d)(iii)]. Likewise, any contributions made to an MPF scheme by a sole proprietor in respect of his or her spouse or by a partnership in respect of a partner's spouse are not allowable under sections 17(2)(c) and 17(2)(d)(iii) respectively.

64. The paragraphs on "Assessability of sums received by employers" are also applicable to self-employed persons.

## **ESTATE DUTY CONSIDERATION**

65. Section 10(h) of the Estate Duty Ordinance (Cap. 111) provides that no estate duty shall be payable in respect of accrued benefits passing on the death of a deceased member of an ORSO scheme. Similar exemption provisions have been enacted as section (10)(i) in respect of accrued benefits of a deceased member of a provident fund scheme registered under the MPFSO

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<sup>7</sup> Section 16AA applies to the year of assessment commencing on 1 April 2000 and to all subsequent years of assessment. (31 of 1998 s. 2(2); L.N. 175 of 2000)

that are to be paid in accordance with section 15(4) of that ordinance. With the abolition of estate duty with effect from 11 February 2006, accrued benefits of a deceased who passes away on or after that day will have no estate duty implication at all.

## **REPORTING REQUIREMENTS OF EMPLOYERS**

66. It remains the employer's responsibility to report to the CIR by way of Employers' Return (I.R. 56B), among other things, the amount of an employee's gross income from employment (i.e. before deducting any contributions made to a recognized retirement scheme) as well as the taxable amount, if any, of benefits received or taken to have been received by the employee from the scheme.

67. Employers must record and retain, for each employee who migrates from an ORSO scheme to an MPF scheme or from one MPF scheme to another, the details of the employer's contributions included in the voluntary contributions transferred. Where accrued benefits attributable to the employer's contributions are received or taken to have been received other than upon termination of service, retirement, death or incapacity, employers have an obligation to report the taxable amount received by the employee in the Employer's Return for that year.