

Hong Kong Tax Alert

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Legislative proposal for tax deduction of foreign taxes charged on a gross income basis

Many stakeholders have lobbied the Government to reinstate the Inland Revenue Department's (IRD's) previous assessing practice of allowing a tax deduction for foreign taxes charged and paid on a gross income basis in respect of all types of income. Stakeholders note that the reinstatement of this practice, which had applied up until July 2019, would benefit taxpayers.

To address some of their concerns, the Government recently introduced the Inland Revenue (Amendment) (Miscellaneous Provisions) Bill 2021 (the Bill)^{1,2} that seeks to:

- (a) allow a tax deduction of foreign taxes that were charged on a gross income basis in respect of non-interest types of income (e.g., royalties) and paid in a jurisdiction that does not have a comprehensive avoidance of double taxation arrangement with Hong Kong (i.e., paid in a non-Hong Kong's CDTA jurisdiction). Both Hong Kong and non-Hong Kong resident persons would be eligible for this deduction;*
- (b) allow a non-Hong Kong resident person to claim a tax deduction of foreign taxes that were charged on a gross income basis in respect of all types of income and paid in a Hong Kong's CDTA jurisdiction; and*
- (c) impose new restrictive conditions that a non-Hong Kong resident person can only claim a tax deduction in Hong Kong of foreign taxes paid referred to in (a) and (b) above to the extent such foreign taxes are unrelieved for double taxation (by deduction or otherwise) in the residence jurisdiction of the non-Hong Kong resident person.*

Subject to the enactment of the Bill into law, the proposed legislative amendments will apply from the year of assessment beginning on or after 1 April 2021, i.e., not retrospective to reinstate any of the IRD's previous assessing practice.

This proposed legislative amendments are complicated. Clients who would like to understand how the Bill may impact their operations, or wish to express their views on the Bill, can contact their tax executives so that we can address their issues or relay their views to the Government in an appropriate manner.

1. The Bill can be accessed via the following link:
<https://www.gld.gov.hk/egazette/pdf/20212511/es32021251114.pdf>

2. In addition to the proposed amendments discussed in this alert, the Bill also seeks to amend the IRO to (i) codify the current assessing practice on court-free amalgamations; (ii) set out the tax treatment for the transfer or succession of certain specified assets without sale; and (iii) provide legal backing for the electronic submission of tax returns in the near future.

Effect of the IRD changing its assessing practice in respect of tax deduction for foreign taxes

Before the issuance of the revised practice note no. 28 (revised DIPN 28) in July 2019, it had been the long-established assessing practice of the IRD that foreign taxes that were charged on a gross income basis (e.g., withholding tax on interest or royalties) were deductible under the general deduction provision contained in section 16(1) of the Inland Revenue Ordinance (IRO).

In the revised DIPN 28 however, the IRD states that, in general, a tax on profits or income is an appropriation of profits and, therefore, is not an outgoing or expense allowable for deduction under section 16(1) of the IRO. Specifically, revised DIPN 28 states that “foreign taxes on profits or income (e.g., withholding tax on royalties, licensing fees, service fees and management fees), subject to the provisions in section 16(1)(c), are not deductible.” The provisions in section 16(1)(c) however only allow, subject to the application of section 16(2J), a tax deduction of foreign taxes paid in respect of certain interest-types of income³ in a non-Hong Kong’s CDTA jurisdiction.

Interest-types of income

As a result of this change in the assessing practice, only foreign taxes paid in a non-Hong Kong’s CDTA jurisdiction in respect of certain types income displaying the characteristics of interest, would be tax deductible under the specific provisions of section 16(1)(c) of the IRO.

Correspondingly, where such foreign taxes on interest-types of income were paid by a Hong Kong resident person in a Hong Kong’s CDTA jurisdiction, the foreign taxes paid would not be deductible under section 16(1)(c) of the IRO and could only be claimed as a credit under the relevant CDTA.

Where such foreign taxes on interest-types of income were paid by a non-Hong Kong resident person in a Hong Kong’s CDTA jurisdiction, said non-Hong Kong resident person, same as a Hong Kong resident person, would not be able to claim a tax deduction under section 16(1)(c) of the IRO. However, Hong Kong’s CDTAs being not applicable to them, such a non-Hong Kong resident person could only seek double taxation relief in respect of such foreign taxes paid in their residence jurisdiction, where applicable. Otherwise there would be no double taxation relief in respect of such foreign taxes paid by such a non-Hong Kong resident person.

Non-interest types of income

As regards foreign withholding taxes which were charged on a gross income basis in respect of all other types of income e.g., royalties, management or service fees, the result of the IRD’s change in assessing practice was to deny a deduction for foreign taxes paid on such income under section 16(1) of the IRO, i.e., no unilateral tax relief would be available in Hong Kong.

Taxpayers who are Hong Kong resident may however be able to claim double taxation relief in respect of such foreign taxes paid in a Hong Kong’s CDTA jurisdiction by way of a tax credit under the relevant CDTA. Taxpayers who are non-Hong Kong resident could again only seek double taxation relief in respect of such foreign taxes paid in their residence jurisdictions, where applicable.

Lobby for the IRD to reinstate its previous assessing practice

Stakeholders have raised concerns regarding the legal basis of the IRD changing its long-established assessing practice in a manner that denies tax deductions for all foreign taxes paid under section 16(1) of the IRO, albeit charged on gross income basis. These stakeholders consider that such a denial undermines the attractiveness of Hong Kong as a banking center and an intellectual property hub and therefore request that the IRD reinstate its previous assessing practice.

To address some of these concerns, the Government has now introduced the Bill which would allow a tax deduction of foreign taxes paid in certain circumstances and could be regarded as a partial reinstatement of the IRD’s previous assessing practice.

However, at the same time, the Bill would also impose new restrictive conditions that need to be satisfied by a non-Hong Kong resident person before any foreign taxes paid can be claimed for a tax deduction under the IRO.

3. Those types of income that are deemed to be chargeable to tax in Hong Kong under sections 15(1)(f), (g), (i), (ia), (ib), (j), (k), (l), (la) or (lb).

Proposed amendments under the Bill

The Bill proposes the following changes to the relevant provisions of the IRO:

Deduction of foreign taxes charged and paid in respect of certain interest-types of income

- ▶ amends section 16(2J) to extend the existing deduction under section 16(1)(c) of the IRO available for foreign taxes on certain interest-types of income paid by Hong Kong resident and non-Hong Kong resident persons in a non-Hong Kong's CDTA jurisdiction to include foreign taxes paid in a Hong Kong's CDTA jurisdiction by a non-Hong Kong resident person.

The rationale for this extension is that Hong Kong's CDTAs would not be applicable to a non-Hong Kong resident person. As such, unlike a Hong Kong resident person, such a non-Hong Kong resident person would not be able to claim a tax credit for such foreign taxes paid in a Hong Kong's CDTA jurisdiction under Hong Kong's CDTAs. It is for this reason that the Bill proposes to allow a non-Hong Kong resident person to claim a tax deduction of such foreign taxes paid subject to certain new restrictive conditions referred to below; and

- ▶ imposes new restrictive conditions under the proposed new sections 50AA(2A) and (3A) that need to be satisfied before the deduction of such foreign taxes paid by a non-Hong Kong resident person (in either Hong Kong's CDTA jurisdictions or non-Hong Kong's CDTA jurisdictions) would be allowed under the IRO.

Under these proposed restrictive conditions, a tax deduction would be granted in Hong Kong to such a non-Hong Kong resident person only to the extent that such foreign taxes paid are unrelieved for double taxation (whether by deduction or otherwise) in the residence jurisdiction of the non-Hong Kong resident person.

Deduction of foreign taxes charged and paid on a gross income basis in respect of non-interest types of income

- ▶ adds a new section 16(1)(ca) and amends section 16(2J) to allow a tax deduction for foreign taxes on non-interest types of income that were charged on a gross income basis (e.g., royalties) and were either paid (i) by a Hong Kong resident person in a non-Hong Kong's CDTA jurisdiction; or (ii) by a non-Hong Kong resident person in both a Hong Kong's CDTA and a non-Hong Kong's CDTA jurisdiction.

As with the above, a tax deduction would only be granted in Hong Kong to a non-Hong Kong resident person to the extent that such foreign taxes paid are unrelieved for double taxation (whether by deduction or otherwise) in the residence jurisdiction of the non-Hong Kong resident person.

Table 1 and Table 2 of the Appendix to this alert provides a comparison of the tax treatments under the existing assessing regime as detailed in revised DIPN 28 and the proposed deduction regime under the Bill in respect of different types of foreign taxes paid by (i) a Hong Kong resident person; and (ii) a non-Hong Kong resident person.

Effective date

Subject to the enactment of the Bill into law, the above proposed amendments will apply from the year of assessment beginning on or after 1 April 2021, i.e., there will be no retrospective reinstatement of the IRD's previous assessing practice.

Commentary

It may be onerous in principle and practice to satisfy the new restrictive conditions imposed under the Bill before a non-Hong Kong resident person can claim a tax deduction in Hong Kong of foreign taxes paid in respect of both interest and non-interest types of income.

In principle, the issue is whether Hong Kong can grant a relief for double taxation of foreign tax paid by way of a deduction under the IRO, where double taxation relief would also be available in respect of the same foreign tax in the residence jurisdiction of the non-Hong Kong resident person.

Granting such double taxation relief by way of a deduction in Hong Kong under the IRO, albeit at a revenue cost, would enhance the attractiveness of Hong Kong's tax regime. The issue is whether Hong Kong wishes, or is allowed, to do so under the generally accepted norms or rules of international taxation.

In practice, the issue is what kind of evidence is required to be provided to the IRD by such a non-Hong Kong resident person to prove the extent such foreign taxes paid are unrelieved for double taxation in the residence jurisdiction of the non-Hong Kong resident person.

Another issue is what kind of foreign taxes would be regarded as being charged on a gross income basis. While interest and royalties are typically charged on a gross income basis, many other types of income such as management and technical service fees may be charged by applying a deemed profit-rate to the gross income before the nominal tax rate is applied. It is not entirely clear from the Bill (i) whether foreign taxes charged on the latter basis could also be regarded as being charged on a gross income basis; and (ii) whether the situation would be different if a taxpayer has an option to claim a revision of the foreign taxes paid on a deemed profit-rate basis to reflect the profit that has actually been made.

Clients who would like to understand how the Bill may impact their operations, or wish to express their views on the Bill, can contact their tax executives in order that we can address their issues or relay their views to the Government in an appropriate manner.

Appendix

A comparison of the tax treatments under the existing assessing regime as detailed in revised DIPN 28 and the proposed deduction regime under the Bill in respect of different types of foreign taxes paid by (i) a Hong Kong resident person; and (ii) a non-Hong Kong resident person is shown below in Table 1 and Table 2 respectively.

Table 1: Foreign taxes paid by a Hong Kong resident person

Types of foreign taxes	Under the existing assessing regime as detailed in revised DIPN 28	Under the proposed deduction regime under the Bill
On interest-type income paid in a Hong Kong's CDTA jurisdiction	Not deductible. Taxpayer could only seek relief from double taxation by way of a tax credit under the relevant CDTA	Not deductible. Taxpayer could only seek relief from double taxation by way of a tax credit under the relevant CDTA
On interest-type income paid in a non-Hong Kong's CDTA jurisdiction	Deductible	Deductible
On non-interest-type income charged on gross income basis and paid in a Hong Kong's CDTA jurisdiction	Not deductible. Taxpayer can only seek relief from double taxation by way of a tax credit under the relevant CDTA	Not deductible. Taxpayer can only seek relief from double taxation by way of a tax credit under the relevant CDTA
On non-interest-type income charged on gross income basis and paid in a non-Hong Kong's CDTA jurisdiction	Not deductible	Deductible (i.e., a reinstatement of the IRD's previous practice)

Table 2: Foreign taxes paid by a non-Hong Kong resident person

Types of foreign taxes	Under the existing assessing regime as detailed in revised DIPN 28	Under the proposed deduction regime under the Bill
On interest-type income paid in a Hong Kong's CDTA jurisdiction	Not deductible	Deductible, if the set of new restrictions are satisfied
On interest-type income paid in a non-Hong Kong's CDTA jurisdiction	Deductible	Deductible, if the set of new restrictions are satisfied
On non-interest-type income charged on gross income basis and paid in a Hong Kong's CDTA jurisdiction	Not deductible	Deductible, if the set of new restrictions are satisfied
On non-interest-type income charged on gross income basis and paid in a non-Hong Kong's CDTA jurisdiction	Not deductible	Deductible, if the set of new restrictions are satisfied

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