

HONG KONG TAX

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FOREIGN TAX DEDUCTION



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Highlight

The Inland Revenue (Amendment) (Miscellaneous Provisions) Bill 2021 (the Bill) was passed by the Legislative Council on 2 June 2021 and the relevant ordinance was gazetted on 11 June 2021. Amongst others, the Bill seeks to amend the Inland Revenue Ordinance (IRO) with a view to enhancing the foreign tax deduction regime. In particular, non-Hong Kong resident persons can claim tax deduction in respect of foreign taxes paid on specified interest, gains and profits even though they are paid in a territory with a double tax arrangement (DTA) in force with Hong Kong (DTA territory). The deduction of foreign tax also extends to tax charged on gross income like withholding tax on royalties. These changes are effective from the year of assessment 2021/22.

Change in rules and practice over time

As a general rule under section 16(1) of the IRO, all outgoings and expenses are deductible to the extent to which they are incurred during the basis period for a year of assessment by the taxpayer in the production of its assessable profits. Taxes which are charged on profits are not "outgoings and expenses" and are generally not deductible. However, section 16(1)(c) of the IRO provides that foreign tax paid in respect of certain specified interest, gains and profits¹ are deductible. While section 16(1)(c) does not allow deduction for foreign tax charged on income other than those specified, it was the general prevailing practice for taxpayer to claim deduction under section 16(1) on withholding taxes charged on gross income when tax credit under DTA is not available. This practice was in line with the IRD's view as set out in the old Departmental Interpretation and Practice Notes No. 28 (DIPN 28) - Profits Tax: Deductibility of Foreign Taxes first issued in July 1997².

Section 16(1)(c) was amended under the Inland Revenue (Amendment)(No. 6) Ordinance 2018 (2018 Amendment) to restrict the deduction of foreign tax charged on interest, gains or profits to those paid in non-DTA territories only. With effect from the year of assessment 2018/19, where foreign tax charged on specified interest, gains and profits arose from a DTA territory, tax deduction is not allowed but relief by way of tax credit can be sought under the DTA. The IRD considered that this approach also applies to other withholding taxes and revised DIPN 28 in July 2019 which specifically states that *"foreign taxes on profits or income (eg withholding tax on royalties, licensing fees, service fees and management fees), subject to the provisions in section 16(1)(c), are not deductible"*.

What's "new"

Stakeholders have raised concerns about the change as a consequence of the 2018 Amendment. They consider that it could negatively affect the Hong Kong branches of foreign corporations which are regarded as non-Hong Kong resident persons for tax purpose. In particular foreign banks with branches in Hong Kong could end up in an anomalous situation where they can neither claim tax credit on the withholding tax on interest under a DTA nor claim a tax deduction under section 16(1)(c) due to the restriction imposed in the 2018 Amendment. In addition, the public also consider that the current scope of deduction for foreign tax paid is too narrow and called for expansion of the scope to cover foreign tax paid in respect of other income such as royalties.

Taking into consideration of the above, the following changes were made to the foreign tax deduction regime:

- i. Section 16(1)(ca) is added to extend foreign tax deduction to cover "specified tax" paid in a foreign territory. "Specified tax" refers to tax charged on a certain percentage of income received or receivable by the person from a foreign territory without deduction for the outgoings and expenses when computing the amount of tax charged to the person in that territory (such as

withholding tax on royalty). Like section 16(1)(c), deduction under section 16(1)(ca) is subject to the conditions in section 16(2J) and section 50AA.

- ii. Section 16(2J) is amended such that the deduction restriction for section 16(1)(c) and section 16(1)(ca) only applies to tax paid in a DTA territory by a Hong Kong resident person, effectively extending the deduction to non-Hong Kong resident persons who paid tax in the DTA territories.
- iii. Section 50AA(2A) was added such that deduction of foreign tax paid by a non-Hong Kong resident person (in either DTA territory or non-DTA territory) will be provided only to the extent of the portion of foreign tax paid for which the person would not be entitled to utilise for claiming any relief (whether by deduction or otherwise) in his jurisdiction of residence.

The amendments will only apply in relation to a year of assessment beginning on or after 1 April 2021 (ie year of assessment 2021/22).

Commentary

The changes on foreign tax deduction regime are welcomed as it rectifies the anomalous situation brought by the 2018 Amendment where a non-Hong Kong resident person cannot obtain any tax credit or tax deduction in Hong Kong on foreign tax paid in DTA territory. It also restores the position on deduction of foreign tax paid on gross income before the IRD revised DIPN 28 in 2019. In response to the request for clarification as to whether foreign tax charged on a deemed profit basis is considered as tax charged on gross income, the HKSAR Government stated that the deductibility would depend on the basis of the relevant tax computation. Subject to other conditions, foreign taxes on deemed profit should be deductible if they are charged based on turnover.

Please be reminded that the foreign tax minimisation steps introduced in the 2018 Amendment also applies to the deduction under sections 16(1)(c) and 16(1)(ca). Taxpayers should exercise due care in completing their profits tax return and seek advice from professionals where necessary.

¹ Refers to interest, gains or profits from the sale, disposal, redemption, maturity or presentment of a certificate of deposit, bill of exchange or regulatory capital security which are deemed to be receipts arising in or derived from Hong Kong under section 15(1) of the IRO.

² The old DIPN 28 states that where the foreign tax *"can properly be described as a charge on earnings (rather than on profits) that is payable regardless of whether or not a profit is made. As the tax is not an appropriation of the profits, a deduction is allowable under section 16(1). Typically such foreign taxes will take the form of a withholding tax on income derived by way of interest or royalties. To be allowable as a deduction, the foreign tax in question must be one that is charged on the gross amount of the earnings that are themselves chargeable to Hong Kong profits tax"*.

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