KPMG

HONG KONG TAX ALERT

April 2021 | Issue 3

The Hong Kong SAR Government eases the rules on foreign taxes paid

Summary

The Hong Kong SAR Government has published its bill to amend the law relating to deductions for tax paid overseas. Under the proposals:

1. Section 16(1)(c) will be expanded to cover a wider range of overseas tax charged on a gross, withholding basis;
2. The deduction under that section will be available to non-Hong Kong resident enterprises who are subject to tax on that income in Hong Kong even where a double tax agreement is in place with the other jurisdiction, subject to relief not being available for the tax suffered in the jurisdiction of residence.

Background

As a jurisdiction taxing only locally sourced income, Hong Kong has traditionally offered little in the way of double tax relief. The proliferation of double tax agreements ("DTA") over the last fifteen years has changed that for jurisdictions with which there is an agreement in place, but Hong Kong continues not to offer unilateral tax relief where no DTA is in place. There were, however, two important exceptions to this principle:

1. It was generally accepted that tax arising on a gross basis qualified for a deduction under the general principles of Section 16 as a payment not dependent on profits and necessary in order to generate the related income. This principle was upheld in the Board of Review (Case D43/91), which remains the leading precedential case law on the matter in Hong Kong.
2. Section 16(1)(c) specifically allowed a deduction for taxes of a similar nature to Hong Kong profits tax arising on a limited number of items deemed to be taxable under Section 15 (broadly interest and gains on certificates of deposit).

When the law was revised in 2019, section 16(1)(c) was changed such that it only applied when the relevant tax arose in a jurisdiction with which Hong Kong did not have a DTA (on the basis that the company should claim a credit under the DTA instead where such a provision is in place). No amendment was made to the basic principles of deductibility under section 16.

In July and August of 2019 the IRD issued two revised versions of DIPN 28, updating their position to reflect the new legislation. Their views represented a significant change from accepted practice and were decidedly controversial. In particular, the IRD argued that no deduction was available under general principles for withholding taxes, even if charged on a gross basis. A deduction would only be available under section 16(1)(c), which could only apply where no DTA was in place. A fuller account of the technical background can be found in our Hong Kong tax alert from October 2019 (DIPN 28 – Changing the landscape – Disallowing deductions for foreign taxes).

The IRD's volte-face had important consequences for a number of taxpayers, in particular those operating through branches in Hong Kong, although there might be a treaty with the jurisdiction in which the tax arose, as non-Hong Kong residents were unable to take advantage of it. It also cast doubt over the position of payments other than interest that had suffered overseas withholding tax as it was hard to see how these fitted into the IRD's analysis.

The new law effectively seeks to deal with both these difficulties.

KPMG observations

The proposed changes should make clear that a deduction is available for overseas withholding taxes suffered on income chargeable to Hong Kong profits tax. It also addresses the anomalous situation in which a non-resident company was previously unable to get any relief on tax suffered in jurisdiction with which Hong Kong has a DTA. These changes will both be widely welcomed by the business community.

However, it should be noted that the mechanism by which we will return to the status quo ante still potentially leaves a question mark over how overseas tax suffered between April 2019 and the effective date of the new law will be treated. It would be hoped that the IRD would accept the same treatment should apply in that period and drop any outstanding queries on the matter - we understand that a moratorium is currently in place regarding such queries. Clearly any taxpayers who have already accepted the IRD's position might find themselves disadvantaged.

It is also worth noting that Hong Kong's rules on double tax relief remain restrictive by international standards. A deduction for overseas taxation still results in double taxation, albeit at a lower rate, and many other international centres offer a unilateral credit for overseas taxation suffered and a deduction is effectively only a fallback position where a credit cannot be applied (for example because of an overall loss position). Cases of effective double taxation may become more significant as Hong Kong adopts its laws to deal with the impact of BEPS 2.0.

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