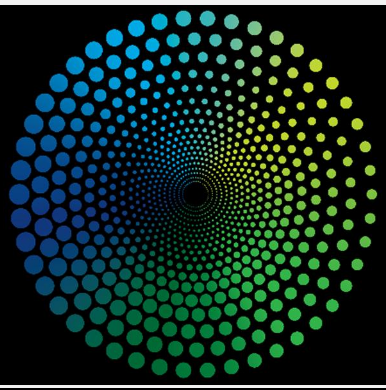
Hong Kong | Tax & Business Advisory | 19 March 2021 | Issue 138



Hong Kong Tax Newsflash

New Bill on deduction of foreign tax, court-free amalgamation and electronic filing of tax return

The Inland Revenue (Amendment) (Miscellaneous Provisions) Bill 2021 (Bill) which seeks to implement various amendments to the Inland Revenue Ordinance (IRO) is gazetted today and will be introduced into the Legislative Council on 24 March 2021.

This article will highlight the key features of the proposed amendments. We will provide detailed analysis and more insights of each area in separate articles.

1. Foreign tax deduction regime

Background

Prior to 2019, the Inland Revenue Department's (IRD's) published position in guidance was that foreign withholding tax on payments, such as interest and royalties etc, was deductible under section 16(1) of the IRO. However, in mid-2019, the IRD amended this guidance and through Department Interpretation and Practice Notes No. 28 (DIPN 28), changed this position, creating uncertainty with regard to the availability of such deductions.

While some relief for withholding tax on interest was available under section 16(1)(c) of the IRO, this was limited in several ways. In particular, it only provided relief where Hong Kong had not concluded a treaty with the taxing jurisdiction and it did not provide relief to branches, notwithstanding branches were themselves not entitled to the benefit of credit relief under Hong Kong's treaties.

In other words, the type of relief was limited predominantly to interest withholding tax, and branches were disadvantaged in certain scenarios.

This was particularly problematic to the banking sector which largely operates in Hong Kong through branch structures for the purposes of capital efficiency.

Following the change in DIPN 28, we have worked closely with industry participants and the IRD in order to bring about legislative change broadly consistent with the position outlined in the pre-2019 DIPN 28. We therefore welcome the changes proposed in this Bill.

Key features

The changes proposed in the Bill will achieve the following:

- Broaden the types of tax for which relief may be granted, based on a new "specified tax" definition, which essentially refers to tax charged upon gross income. This should be broad enough to cover the majority of withholding taxes suffered by Hong Kong taxpayers.

- Provide relief to both Hong Kong tax residents and branches, but only to the extent that the person is not eligible to claim treaty relief in Hong Kong or double tax relief in their jurisdiction of residence and only where tax minimisation steps have been taken. This is consistent with the IRD's position that double tax relief should first be provided under a treaty, then by the jurisdiction in which a taxpayer is resident and if that is not available, by Hong Kong.

These proposed changes should be effective from the year of assessment 2021/22. The industry had requested a retrospective application of these provisions and while the Government does not appear to have catered to this request in the Bill, we would suggest that the IRD do not direct enforcement resources towards any cases identified in the interim period between the change in DIPN 28 and year of assessment 2021/22.

2. Tax treatment for court-free amalgamation of companies

Background

Since March 2014, the Companies Ordinance (CO) has provided the legal framework for two or more companies within a group to amalgamate and continue as one company without the involvement of the courts. At present, the IRD makes assessments on court-free amalgamation cases in accordance with guidelines published on its website. The Bill seeks to codify this assessing practice into the IRO.

Key features

As a starting point, the amalgamating company[1] will be treated as having ceased business on the date immediately before the date of amalgamation for profits tax purposes.

An irrevocable election may then be made to provide for a special tax treatment in respect of the amalgamating/amalgamated company. The special tax treatment includes the following key elements:

Succession of business and assets – The amalgamated company[1] in a qualifying amalgamation would generally be treated as having acquired the assets on the date on which the amalgamating company acquired them and for the amount that was incurred by the amalgamating company, unless there is reclassification of assets. As a result, the amalgamated company would be allowed to claim the balance of deductions and annual allowances of certain assets e.g. commercial / industrial buildings, plant or machinery, refurbished buildings, prescribed fixed assets and environment protection facilities etc.

Trading stock – There are differing tax treatments under different scenarios where the amalgamated company succeeds to the trading stock of the amalgamating company. Under certain circumstances, the amalgamated company would be deemed to have acquired the trading stock at the carrying amount immediately before the date of amalgamation, while in certain other cases, the amalgamating company would be deemed to have disposed of the trading stock at the value as reflected in the financial accounts of the amalgamated company on the date of amalgamation. Any profit arising from the deemed disposal will be treated as chargeable for the amalgamating company for the year of cessation.

Tax losses – The set off of pre-amalgamation losses of the amalgamating/amalgamated company would be allowed subject to certain restrictions and conditions.

<u>Pre-amalgamation losses of amalgamating companies</u>

Tax losses of the amalgamating company can only be used to set off the assessable profits of the amalgamated company if the following tests are fulfilled:

- Post entry test – Losses must be incurred after the amalgamating company and the amalgamated company had become wholly owned subsidiaries of the same company, or the amalgamating company had become a wholly owned subsidiary of the amalgamated company.
- Same trade test – Losses must be from the same trade or business succeeded from the amalgamating company.
- Anti-avoidance test – Avoidance of tax is not the main purpose, or one of the main purposes, of carrying out the amalgamation.

<u>Pre-amalgamation losses of amalgamated companies</u>

Tax losses brought forward in the amalgamated company can be used to set off the assessable profits of the trade or business succeeded from the amalgamating company if the following conditions are satisfied:

- Financial resources condition – The amalgamated company has adequate financial resources to purchase the trade or business of the amalgamating company.
- Trade continuation condition – The amalgamated company continues to carry on a trade or business since the qualifying loss was incurred up to the date of amalgamation.
- Post entry test
- Anti-avoidance test

Other provisions included within the election – The Bill also covers a range of other tax matters in respect of amalgamations including the cancellation of shares, deductions for special payments under an approved retirement scheme, refunds from retirement schemes, bad debts and income derived after amalgamation etc.

3. Transfer or succession of certain capital assets without an election

In addition to the special tax treatment for amalgamations upon election, the Bill also specifies the tax treatment in relation to transfer or succession of "specified assets" without sale under certain circumstances, including a qualifying amalgamations whereby the amalgamated company does not elect for the special tax treatment. "Specified assets" generally refers to capital assets such as plant or machinery, prescribed fixed assets, patent rights, know-how, specified intellectual property rights, building, etc., as well as rights generated from research and development (R&D) activities. Such transfer or succession will be deemed as a sale at the lower of the open market value of the asset and the capital expenditure incurred or deductions allowed under section 16B of the IRO for R&D expenditures. As such, the relevant claw back provisions may apply accordingly.

Our comments

The introduction of the Bill, which will codify the tax treatments on amalgamation into the IRO, can provide clarity and improve certainty for taxpayers. However, we observe that the default assumption in the proposed amendments to the IRO appears to deviate from the fundamental concepts of amalgamation in the CO. According to the CO, the amalgamating company does not cease to exist pursuant to an amalgamation and continues as part of the amalgamated company, on this basis fiscal attributes of each company should continue to be present in the amalgamated company. In contrast, the starting point of the Bill deems the amalgamating company, pursuant to the amalgamation, to have ceased its trade or business with the implication that the amalgamated company would not be regarded as having automatically succeeded to the fiscal attributes of the amalgamating company. Arguably therefore, the Bill may put taxpayers in a worse position with regard to amalgamations than at present.

This Bill does not cover the treatment of stamp duty under amalgamations. We suggest that the IRD may consider making the necessary amendments to the Stamp Duty Ordinance as well for the sake of clarity and certainty.

The proposed provisions regarding amalgamations are lengthy and will be discussed in more detail in future articles.

4. Statutory framework for the furnishing of tax returns

Background

The IRD is undertaking a project for the electronic filing of profits tax returns. The Bill seeks to amend the IRO to provide the statutory framework for the filing of tax returns electronically. The proposed amendments will provide legislative backing to the IRD's plans to enable more businesses to voluntarily e-file profits tax returns and financial statements in 2023, with the ultimate goal of implementing e-filing of profits tax returns through the newly developed Business Tax Portal in 2025.

Key features

The amendments include new provisions which

- allow an alternative way of using a template to furnish a return in addition to using a printed form;
- empower the Commissioner to require a tax return to be furnished in the form of an electronic record;
- allow a taxpayer to engage a service provider to furnish the tax return for or on behalf of the taxpayer;
- require a service provider to obtain and retain written confirmation from the taxpayer.

The Bill contains specific provisions to clarify that the engagement of a service provider to furnish a tax return will not relieve the taxpayer from the obligation of furnishing the tax return. On the other hand, the Bill also proposes new penal provisions against service providers for certain acts without reasonable excuse, e.g. failure to furnish returns and filing incorrect returns.

Our comments

We generally welcome the introduction of the new mechanism for the filing of tax returns, which keeps abreast of IT trends. However, service providers may have concerns in respect to the proposed penal provisions.

We will provide detailed analysis and more insights on the above issues in separate Tax Analysis. Please stay tuned for our upcoming publication.

Note:

1 The company whose shares are not cancelled upon amalgamation is the amalgamated company whereas the company whose shares are cancelled upon amalgamation is the amalgamating company.

If you have any questions, please contact our professionals:

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