

## Tax

Issue H102/2021 – 23 March 2021

# Hong Kong Tax Analysis

## Return of the Withholding Tax Deduction May the Relief be with you

### 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 Inland Revenue Ordinance (IRO). However, in mid-2019, the IRD amended this guidance and through revisions to Department Interpretation and Practice Notes No. 28 (DIPN 28), changed their published 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.

Firstly, the relief was available only in respect of interest and gains on certain debt instruments that were taxable by virtue of section 15(1) of the IRO.

Secondly, the relief granted under section 16(1)(c) was limited by section 16(2J) of the IRO, the limitation provided that section 16(1)(c) would be dis-applied where a treaty existed.

Section 16(2J) was not an issue for Hong Kong tax residents that could take advantage of Hong Kong's treaties. However, it was problematic for non-residents, who themselves could not benefit from double tax relief under Hong Kong's treaties.

Accordingly, and perhaps counterintuitively, this meant that branches had more avenues to relieve double taxation when dealing with jurisdictions with which Hong Kong had not concluded a treaty, as opposed to those where Hong Kong had concluded a comprehensive double tax treaty.

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The change in tax authority guidance, together with the previous method of operation of section 16(1)(c) was particularly problematic to the banking sector which primarily operates in Hong Kong through branch structures for the purposes of capital efficiency. The banking industry also clearly earns significant interest income, service fee income and certain other incomes types that are subject to foreign withholding tax.

Following the change in DIPN 28, we have worked closely with the Capital Markets Tax Committee of Asia and the IRD in order to bring about legislative change broadly consistent with the position outlined in the previous DIPN 28 under which withholding tax on payments was generally deductible. We therefore welcome the changes proposed in the Inland Revenue (Amendment) (Miscellaneous Provisions) Bill 2021 (Bill). We have set out below the key features of the Bill and our current observations. While the Bill is a step forward, there are also areas which could be clarified throughout the legislative process.

## Objectives of the Bill?

The changes proposed in the Bill broadly aim to provide relief to both Hong Kong tax residents and branches in respect of withholding tax suffered on any type of payment, provided the withholding tax is charged in a manner essentially consistent with international practice.

### Residents

The relief will only be available to Hong Kong tax residents where Hong Kong has not concluded a treaty with the jurisdiction imposing the foreign tax. Accordingly, where a treaty does exist, if the taxpayer wishes to claim double tax relief, it must do so through the provisions of the treaty and cannot use the domestic provisions included in the Bill.

Theoretically, this is unlikely to disadvantage taxpayers, as Hong Kong treaties typically provide for credit relief which is more beneficial than relief by way of deduction. However, as a practical matter, we understand some taxpayers may still have a preference for claiming deductions and so this limitation could prove to be problematic if not addressed.

### Non-residents operating through branches

The relief will be available to non-residents irrespective of whether Hong Kong has concluded a treaty with the jurisdiction imposing the foreign tax. However, the amount of the relief will be limited to the difference between the foreign tax imposed, and the foreign tax eligible for relief in the jurisdiction of residence. By way of example, if \$100 of income is earned by the Hong Kong branch of a United Kingdom company and \$20 of withholding tax is levied, if credit relief of \$20 were claimed in the United Kingdom, then no withholding could be deducted in Hong Kong. Whereas, if no relief were available in the United Kingdom, the full \$20 could be deducted in Hong Kong. Please see below further discussion of these provisions.

## How does the Bill operate?

The key provisions of the Bill amend section 16(1)(c) and introduce the new section 16(1)(ca) to the IRO.

### Amendment to section 16(1)(c)

Section 16(1)(c) is a double tax relief provision which is relatively limited in its application. It only applies in respect of certain interest income and gains on debt instruments that are deemed taxable under section 15(1). Over the last few years various subsections have been added to section 15(1) to cater for the introduction of the corporate treasury centre incentive and the regulatory capital securities provisions. Section 16(1)(c) had not previously been updated for these changes and the Financial Services and the Treasury Bureau has taken this opportunity to include these categories of deemed income within section 16(1)(c). Accordingly, the changes to section 16(1)(c) are updates and do not change the fundamental operation of section 16(1)(c).

### Introduction of section 16(1)(ca)

The most important change in the Bill is the introduction of section 16(1)(ca), which will essentially provide relief for "specified tax". Specified taxes are essentially withholding taxes in respect of any payment, provided that the withholding tax is calculated as a percentage of gross income, without the deduction of expenses.

While not all withholding taxes are levied on this basis, the drafting of section 16(1)(ca) should apply to the vast majority of withholding taxes levied including in respect of interest, service fees, rents, royalties and dividends to the extent they represent chargeable income. Accordingly, only in very exceptional circumstances will a tax that is withheld on a payment not be within the scope of section 16(1)(ca).

The definition of specified taxes specifically prevents relief from being provided by section 16(1)(ca) that could be provided for under section 16(1)(c). Accordingly, there is no overlap between the two provisions, and no possibility of claiming the same deduction under both, or choosing under which provision to claim a particular deduction.

Between the application of section 16(1)(c) and section 16(1)(ca) we anticipate that the majority of withholding taxes will be eligible for deduction. However, the Bill has also introduced certain limitations on both provisions to ensure that relief is not provided in circumstances where treaty relief can be claimed, or in the case of branches, where relief is available in the branch's jurisdiction of residence.

### Limitations on relief – amendment to section 50AA

Section 50AA provides Hong Kong's general provisions on relief from double taxation and has been amended to provide a limitation in respect of the application of both sections 16(1)(c) and 16(1)(ca).

This limitation has already been discussed above and applies only to non-residents. It compares the foreign tax that is actually levied against the foreign tax that is eligible for relief in the jurisdiction of residence (i.e. in the branch's head office location) and only allows a deduction for the unrelieved amount of foreign tax (i.e. foreign tax suffered minus foreign tax eligible for relief = amount eligible for deduction).

This limitation was not present in the previous DIPN 28, but represents a policy decision of the IRD, that relief should only be provided by Hong Kong where it cannot be obtained elsewhere.

### Foreign tax minimization steps

Similar to existing foreign tax minimization provisions within section 50AA, it will be necessary for all reasonable steps to be taken to minimize the amount of foreign tax suffered in the first instance. This is particularly the case in respect of claims made by branches in Hong Kong and will involve ensuring that any remedies available to them under both the laws of their jurisdiction of residence and the relevant treaty are taken advantage of prior to claiming relief in Hong Kong. This will include utilizing reliefs, deductions, reductions or allowances and making any elections for tax purposes.

## **Transitional provisions**

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.

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