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Hong Kong:
Changes to double taxation relief under DTAs

Overview

Hong Kong's Inland Revenue (Amendment) (No. 6) Bill 2017 (the "Amendment Bill"), gazetted on December 29, 2017, will amend the rules allowing double taxation relief for individuals who are liable for tax in jurisdictions that maintain double taxation arrangements (DTAs) with Hong Kong.

Although the Amendment Bill is still subject to enactment (expected within the next few months), it is likely to reduce the double taxation relief currently available to Hong Kong outbound individuals working in DTA jurisdictions, as well as introduce additional compliance requirements. Furthermore, uncertainties surrounding the Amendment Bill will likely require clarification by the Inland Revenue Department (IRD).

The current state

Section 8(1A)(c) of the Inland Revenue Ordinance (IRO) provides that income earned by an individual from the provision of services in another jurisdiction is excluded from taxable income in Hong Kong provided the income is chargeable to a tax of substantially the same nature as the Hong Kong salary tax and that the foreign tax is paid.

If the jurisdiction in which the individual performs the services maintains a DTA with Hong Kong, the taxpayer can opt to claim a foreign tax credit (FTC) on the income instead of taking the exclusion. However, as the IRD has stated in its practice notes, an income exclusion under Section 8(1A)(c) generally provides more tax relief than that provided by an FTC. An income exclusion is often the preferred option, but with limited FTC cases handled by the IRD, there does not seem to be a unified FTC calculation approach, particularly for more complex cases.

New regime

The Amendment Bill will make substantial changes to Section 8(1A)(c). A claim under this provision in the IRO will be allowed only if the foreign jurisdiction is a non-DTA jurisdiction. Individuals who are subject to tax in a DTA jurisdiction will be required to claim an FTC under the relevant DTA.

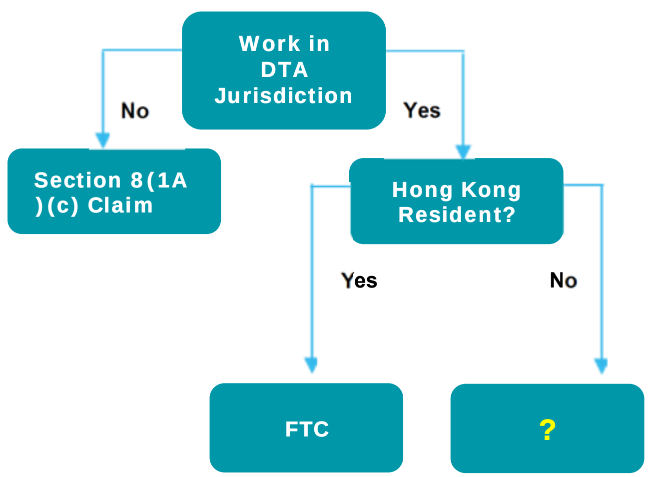
Further, the taxpayer will be required to take steps to minimize the amount of foreign tax paid before claiming an FTC. The FTC may not exceed the amount of relief that would have been granted had the taxpayer taken steps to reduce the tax. The time limit for making an FTC claim will be extended from two to six years after the end of the relevant year of assessment.

Observations

Reduced tax relief: Using the example of an FTC calculation in the IRD's practice note, we ran numerous sets of data with different income levels and travel patterns and found that the FTC does provide less tax relief than Section 8(1A)(c) claims.

However, until the IRD provides more detailed guidance on FTC calculations (e.g., whether double taxed income must be scaled down by the number of days spent in the overseas location), the extent to which an FTC is less favorable than a Section 8(1A) (c) claim will remain unclear.

Tax relief eligibility: According to Section 50(2) of the Amendment Bill, an FTC will not be allowed against Hong Kong tax unless the individual is a Hong Kong resident for the relevant year of assessment.



Using the above diagram, assume an Australian individual is employed in Hong Kong, but spent 250 days working in Mainland China (i.e., a DTA territory) and pays taxes there. The individual will not qualify as a Hong Kong temporary resident by virtue of time spent in Hong Kong.

Under current rules, the individual would be eligible to make a Section 8(1A) (c) claim. However, it is unclear whether the individual will qualify for an FTC under the Amendment Bill. While it appears that an FTC will only be available if an individual in this example qualifies as a Hong Kong resident based on family and economic ties, further clarification by the IRD is needed.

Exemption for overseas tax paid by employer: The typical approach to calculate the income exemption amount under Section 8(1A) (c) involves taking foreign taxes paid by an individual's employer as wholly attributable to the services rendered overseas and, hence, fully exempt from Hong Kong tax.

If similar treatment is not available for the FTC under the Amendment Bill, there will likely be a significant increase in the tax burden on individuals, especially those working in high tax locations.

Employers should also ensure that any foreign taxes they pay are captured in their tax returns as income (an item that can often be easily omitted). Under current rules, the penalty exposure is limited because a successful Section 8(1A)(c) claim eliminates any taxes undercharged on compensation. This may no longer be the case after the Amendment Bill becomes law.

Lump-sum or itemized compensation: The IRD provides a sample FTC calculation based on lump-sum income; however, sample calculations in which compensation is itemized would be useful, particularly when the taxability of the compensation is different in two taxing jurisdictions.

Additional obligations: The IRD expects FTC claims to be submitted only after all reasonable steps have been taken to minimize foreign tax. This may not be straight-forward for the IRD to assess, process since some tax jurisdictions are more aggressive with tax collection than others and favorable tax treatment is available only if certain compliance requirements are met. Going forward, taxpayers who do not fully utilize foreign tax minimization opportunities should revisit their overall tax filing positions and assess their impact on the FTC.

Additionally, the Amendment Bill will require a taxpayer to notify the IRD of any subsequent adjustments to the amount of foreign taxes claimed that makes the previously granted FTC excessive. This notification will need to be made within three months of the adjustment date. Failure to comply will subject the taxpayer to a penalty of up to HKD 10,000, plus the undercharged tax.

Deloitte's view

The Amendment Bill is an important step toward implementing the Organisation for Economic Cooperation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) standards. The financial impact on certain taxpayers, however, may be substantial. Twelve of Hong Kong's top 20 trading partners have DTAs with Hong Kong. The movement of workers from Hong Kong to these locations, especially to Mainland China, mean the double taxation relief measures in the Amendment Bill could have far-reaching implications.

We expect the IRD to issue additional guidance and sample calculations for unique or complex cases, such as the FTC for long-term incentive plans or the transfer of a Hong Kong employee from a DTA jurisdiction to a non-DTA jurisdiction (and vice versa). Since the above changes will take effect on April 1, 2018, taxpayers and companies sending individuals to DTA jurisdictions should closely monitor future developments.

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