New Legislation Enacted in Hong Kong Enabling a Profits Tax Deduction for Foreign Taxes

The aspirations of as Hong Kong an international hub for technology, innovation and the development of intellectual property are not perfectly matching the tax system of Hong Kong. Due to the principles of the Hong Kong tax system, there were no rules to allow for relief for foreign taxes on, for example, royalties and licence fees. Recently enacted legislation provide for a tax relief, also for countries that do not have a DTA with Hong Kong.

Hong Kong applies a territorial system of taxation whereby only income under specified heads of taxation is subject to Hong Kong Profits Tax ("Profits Tax") to the extent that it is arising in or derived from Hong Kong from a business that is carried on in Hong Kong.

Conversely a Profits Tax deduction for specified expense is only available to the extent that it is incurred in the production of profits chargeable to Profits Tax.

Given the territorial nature of the Profits Tax regime, prime facie, profits derived from outside Hong Kong would be outside the scope to taxation and any expenses incurred in connection with those profits would be non-deductible.

Foreign tax relief was not a big thing in Hong Kong, it entered into its first DTA only in 2004

However, in certain circumstances, income or profits arising in other jurisdictions that may have been taxed in that jurisdiction, for example, royalties, interest or service fees may be subject to Profits Tax in Hong Kong as a consequence of the interpretation of source in Hong Kong or the application of specific sections of the Inland Revenue Ordinance ("IRO").

Historically, Hong Kong did not have a comprehensive double tax treaty network, with its first Double Tax Agreement ("DTA") with Belgium having entered into force on 7 October 2004.

Accordingly, taxpayers subject to Profits Tax on income or profits that had been taxed overseas relied on the deduction section of the IRO, Section 16, to claim a tax deduction for overseas taxes. In particular, reliance was placed on Section 16 (1) of the IRO to claim a deduction for foreign taxes paid on profits or income, including royalties, licensing fees and service income on the ground that these were expenses of a non-capital nature incurred in the production of chargeable income.

Section 16(1) (c) provided a deduction for foreign taxes paid on certain types of income, such as specified interest, interest from inter-company financing and gains on the redemption of taxable instruments, to the extent that the taxes were paid in a jurisdiction with which Hong Kong had not entered into a DTA. In the absence of a DTA network most overseas taxes of a similar nature to Profits Tax would be deductible under this section.

However, as the Hong Kong DTA network subsequently expanded exponentially, the Inland Revenue Department ("IRD") introduced a new Section into the IRO, Section 16 (2J), and issued a revised Departmental Interpretation and Note ("DIPN") No. 28 (Revised) concerning the Deduction of Foreign Taxes in July 2019.

Section 16 (2J) which was effective from the year of assessment 2018/19 restricted the deduction available under Section 16(1) (c) of the IRO if the overseas taxes were paid in

a jurisdiction with which Hong Kong had entered into a DTA which provided for a tax resident of Hong Kong to claim a tax credit in accordance with Section 50 of the IRO.
Furthermore, the IRD clarified in DIPN No. 28 (Revised) that deductions for overseas taxes paid on profits or income such as royalties, licensing and service fees would not be deductible under Section 16 (1) of the IRO since tax on profits and income is an application of the profits and not an expense or outgoing incurred in the production of chargeable profits.
As a consequence, taxpayers in receipt of income such as royalties, licensing fees and service income which did not fall within the scope of Section 16 (1) (c) would not be able to claim a deduction for overseas taxes charged on such income if received from a jurisdiction which had not entered into a DTA with Hong Kong, resulting in double taxation. Of course, if a DTA was in place, a Hong Kong resident taxpayer would be able to claim an appropriate tax credit as provided for in the Articles of the DTA.

Bill 2021 introduces new provisions for claiming a tax deduction for overseas tax from non-DTA countries

As Hong Kong is actively promoting itself as a hub for technology, innovation and the development of intellectual property, the restriction of the tax deduction for overseas taxes paid on royalties and license fees may have severely impacted such development given that many payers of such fees may be located in developing nations which have not entered into DTAs with Hong Kong.
Accordingly, Hong Kong enacted the Inland Revenue (Amendment) (Miscellaneous Provisions) Bill 2021 ("Bill 2021") which extends Section 16 (1) (c) to include royalties and licensing fees subject to the provisions of the revised Section 16 (2J) and Section 50 of the IRO. As a consequence, taxpayers paying overseas taxes in a jurisdiction with which Hong Kong has not entered a DTA will be able to claim a deduction for such overseas tax. If the overseas tax is paid in a DTA jurisdiction they will continue to be able to claim the appropriate tax credit under the terms of the DTA.
The Bill 2021 also added Section 16(1) (ca) which effectively provides that non-residents who are subject to Profits Tax and who pay "specified tax" may claim a deduction for that overseas tax in Hong Kong subject to the provisions of Section (16) (2J) and Section 50AA of the IRO. This provision will be particularly attractive to branches of foreign companies located in Hong Kong who are in receipt of income subject to specified tax from non-DTA jurisdictions.