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2020/21 Hong Kong Budget Commentary

Overview

On 26th February, 2020, Mr. Paul M Chan, the Financial Secretary of Hong Kong, delivered his fourth budget speech at the Legislative Council.

During the US-China trade conflicts last year, both the US and China have imposed additional tariffs on hundreds of billions of dollars' worth of one another's goods, which deeply affects the economic atmosphere in the world. In Hong Kong, local social incidents took a heavy toll on inbound tourism and consumption-related activities, and thus, Hong Kong economy has deteriorated with a GDP real growth of -1.2% for the year 2019 as a whole, which was the first year-on-year decline in a decade. Subject to the direct impacts of the social unrest on the labour intensive sectors such as retail, catering and hotel, the seasonally adjusted unemployment rate had risen visibly from 2.8% to 3.4%. Upon the outbreak of African Swine Fever, decrease in supply of fresh pork leading to a surge in pork price, causing the inflation rate to increase significantly from 2.6% for 2018 to 3.0% for 2019.

In addition, the outbreak of the Novel Coronavirus Pneumonia has led to a significant decrease in the number of tourists and significantly affected the willingness of spending of local residents, which posed a further damage to the inbound tourism and consumption-related activities of Hong Kong. It is expected that the epidemic would deal a heavy blow to Hong Kong's economic atmosphere.

The budget deficit of 2019/20 is HKD37.8 billion, which is HKD54.6 billion less than the original estimated budget surplus of HKD16.8 billion and this is the first time for the Hong Kong Government to run a fiscal deficit in the recent 15 years. As mentioned in the blog of the financial secretary, the Government will continue to adopt an expansionary fiscal stance and introduce counter-cyclical measures to "stimulate the economy, support enterprises, safeguard jobs, and smoothen livelihoods". As such, the budget has proposed the following relief measures:-

Highlights

	Proposed fiscal/ tax measures
1	Reduce profits tax for 2019/20 by 100 percent, subject to a ceiling of HKD20,000
2	Reduce salaries tax and tax under personal assessment for 2019/20 by 100 percent, subject to a ceiling of HKD20,000
3	Waive rates for residential properties for four quarters of 2020/21, subject to a ceiling of HKD1,500 per quarter
4	Waive rates for non-residential properties for four quarters of 2020/21, subject to a ceiling of $5,000 per quarter in the first two quarters and a ceiling of $1,500 per quarter in the remaining two quarters
5	Waive the business registration fees for 2020/21
6	Waive the registration fees for all annual returns for two years
7	Provide a subsidy to cover 75 percent of monthly billed electricity charges payable by non-domestic households for four extra months, subject to a monthly cap of $5,000 per account.
8	Waive 75 percent of water and sewage charges payable by non-domestic households for four extra months, subject to a monthly cap of $20,000 and $12,500 respectively per household
9	Disburse $10,000 to Hong Kong permanent residents aged 18 or above
10	Offer a profits tax exemption to qualifying ship lessors and a half-rate profits tax concession to qualifying ship leasing managers
11	Offer a 50 percent profits tax concession to the marine insurance industry and other eligible insurance businesses

	Policies for long-term development
1	Expansion of the express air cargo terminal, development of a premium logistics centre and redevelopment of the Air Mail Centre at the Hong Kong International Airport so as to foster cross-border logistics and trading activities
2	Waive the stamp duty on stock transfers paid by Exchange Traded Fund ("ETF") market makers in the course of creating and redeeming ETF units listed in Hong Kong in order to reduce the transaction cost of ETFs listed and spur the development of the ETF market in Hong Kong

Changes in law and practice on foreign taxes deduction

On 19th July, 2019, the Inland Revenue Department ("the IRD") issued a revised Departmental Interpretation and Practices Notes No. 28 – Profits Tax: Deduction of Foreign Taxes due to the amendment of the Inland Revenue Ordinance ("IRO").

Before the amendment

Before the amendment of the IRO, only foreign taxes imposed on profits were treated as non-deductible and subject to tax credit claim under Section 50 of the IRO. While foreign withholding taxes imposed on gross income such as interest and royalties were treated as deductible under Section 16(1) of the IRO on the basis that the taxes on gross income could be regarded as an outgoing expense of the taxpayer.

After the amendment

After the amendment of the IRO, the IRD takes the view that foreign tax on income is also an appropriation of profit and thus not an outgoing expense deductible under Section 16(1) of the IRO. Starting from the year of assessment 2018/19, both foreign taxes on profits and foreign withholding taxes on income should be treated as non-deductible and lodge a tax credit claim for the foreign tax paid. Only foreign taxes fulfils the following criteria stated in Section 16(2J) could be treated as deductible under Section 16(1)(c) of the IRO:-

(i) The territory is not a territory with double taxation agreement with Hong Kong ("DTA territory") and a tax credit claim is applicable under Section 50 of the IRO;
(ii) The foreign tax is substantially the same nature as tax imposed under the IRO; and
(iii) Where the income or gain is deemed assessable under specific deeming provisions in Section 15, which mainly includes certain interest income and gains from disposal / maturity of a certificate of deposit, bill of exchange or regulatory capital security in certain circumstances.

Impact of the amendment

In summary, starting from the year of assessment 2018/19, foreign taxes on profits and foreign withholding taxes on income should be treated as non-deductible and lodge a tax credit claim for the foreign tax paid. Only foreign taxes with similar nature as profits tax on interest income or gain from disposal / maturity of a certificate of deposit or bill of exchange paid to Non-DTA territory is deductible under Section 16(1)(c) of the IRO, which is applicable to very limited situations. Companies should review their business operations and check if this amendment on foreign tax deduction would affect the tax position of the company.

On the other hand, foreign taxes and duties not in the nature of profits or income tax, such as value added tax, goods and services tax, duties on commodities, etc. will continue to be deductible under section 16(1) if they are incurred in the production of chargeable profits.

The Fifth Protocol to the Mainland / Hong Kong Double Taxation Arrangement

The Fifth Protocol to the Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income ("the Fifth Protocol to the DTA") entered into force in December 2019.

The Fifth Protocol mainly introduces changes to the following two areas:-

(i) Providing tax relief to qualified teachers and researchers; and
(ii) Incorporating some recommendations in the Base Erosion and Profit Shifting ("BEPS") package promulgated by the Organisation for Economic Co-operation and Development ("OECD"), such as Resident, Permanent Establishment, and Anti-Tax Treaty Abuse Provisions, so as to align with the international standards.

Tax relief to teachers and researchers

Under the new article of the Fifth Protocol, a teacher or researcher, who is employed by the qualified education or research institution in Hong Kong or the Mainland, and engages in teaching or research activities for public interests for qualified education or research institution on the other side, is exempt from tax on that other side in respect of the remuneration derived from the above activities for a period of three years, provided that the relevant income has been subject to tax on the side where the teacher or researcher is employed.

Incorporation of BEPS recommendations

(1) Article 4 – Resident

Before the launch of the Fifth Protocol, a person other than an individual (e.g. corporation) with residency in both sides shall be deemed to be a resident only of the side in which its place of effective management is situated. The above tie-breaker rule has been replaced with a mutual agreement approach, which means that the residency of the person should be determined by the mutual agreement between the competent authorities of Hong Kong and the Mainland on a case-by-case basis by considering factors such as place of effective management and place of incorporation. No tax relief or exemptions would be granted to such person under the DTA if place of residence of the person was not mutually agreed by the competent authorities of both sides.

(2) Article 5 – Permanent Establishment

Previously, an enterprise of one side is deemed to have a permanent establishment in the other side if a person is acting as a dependent agent of the enterprise and habitually exercising an authority to conclude contracts in the other side in the name of the enterprise.

However, under the Fifth Protocol, the scope of the situation has been expended. If a dependent agent habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are:-

(i) in the names of the enterprise; or
(ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by the enterprise or that the enterprise has the right to use; or
(iii) for the provision of services by the enterprise,

that enterprise shall be deemed to have a permanent establishment in that one side in respect of any activities which that person undertakes for the enterprise.

In addition, the Fifth Protocol also broadens the circumstance under which an agent will be considered as a dependent agent, where a person acts exclusively or almost exclusively on behalf of one or more enterprises to which the agent is closely related to, that person shall not be automatically considered as an independent agent. In this circumstance, “closely related” refers to having more than 50% of direct or indirect controlling power over the enterprise.

(3) Article 13 – Capital Gain

Before the launch of the Fifth Protocol, gains derived from the alienation of shares in a company in which the assets are comprised of not less than 50% of immovable property situated in one side at any time within 3 years before the alienation of shares may be taxed in that side. The Fifth Protocol extends the taxing right from shares only to shares and other comparable interest in other entities such as partnership and trusts. Also, the Fifth Protocol has updated the quantum of “not less than 50%” to “more than 50%”.

(4) Article 24(A) – Entitlement to Benefits

As mentioned in the revised introductory statement, the intention of the DTA is not to create opportunities for non-taxation or reduced taxation through tax evasion or avoidance. As such, the

Principal Purpose Test which was previously applicable to interest, royalties, dividends and capital gains is now applicable to the entire DTA so as to avoid treaty shopping or treaty abuse.

Impact of the Fifth Protocol

After the launch of the Fifth Protocol, the extension of scope of the Principal Purpose Test shall deny the treaty benefits to be claimed under the DTA if the main purpose or one of the main purposes of the taxpayers is to take advantage of the DTA.

In addition, as the definition of dependent agent was amended to cover the agent who exclusively or almost exclusively negotiates contracts (instead of concludes contract) in the other side on behalf of a closely related enterprise in one side, the risk of being deemed to have a permanent establishment in the other side becomes higher. The tax authority in the other side may impose tax on the profits earned through this agent as the enterprise is deemed to have a permanent establishment in the other side. However, no interpretation or administration guidance in this regard has been released by the tax authorities of both sides, thus there are many uncertainties on the application of this change in practice. Companies with cross-border businesses should review their business operations and check if the Fifth Protocol would affect the tax position of the companies in Hong Kong and the Mainland.

Should you need further explanation on the above matters, please kindly contact us at (852) 3929-4800 to seek our professional advice.

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The Aoba & Hopkins Group consists of CPA firms and full service consulting firms located in Hong Kong, Guangzhou and Beijing that have been providing quality and efficient professional services to our valued clients aboard and at home since 1989.

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