Hong Kong Tax Alert

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IRD changes its assessing practice to deny deductions under section 16(1) of the IRO for foreign withholding taxes charged on gross receipts of all types of income[1]

As a result of this change in the assessing practice, effective from 2018/19, only foreign taxes on certain interest-type income suffered in a jurisdiction that does not have a comprehensive avoidance of double taxation arrangement with Hong Kong (i.e., a non-CDTA jurisdiction), would be tax deductible under the recently amended terms of the specific provision of section 16(1)(c) of the Inland Revenue Ordinance (IRO).

Foreign withholding taxes suffered in a non-CDTA jurisdiction charged on gross receipts of all other types of income e.g., royalties, management or service fees would no longer be tax deductible under section 16(1) of the IRO, i.e., no unilateral tax relief in Hong Kong.

Relief for double taxation in Hong Kong for foreign taxes suffered in a CDTA jurisdiction would only be granted by way of a tax credit under the CDTA between Hong Kong and the jurisdiction concerned.

1. The IRD first issued revised DIPN 28 on 19 July 2019. Subsequently, in mid-August 2019, the IRD replaced the July 2019 version (July version) with another version (August version). In the August version, there are two key changes:
   i. "Tax on profits" is replaced by "Tax on profits or income"; and
   ii. "Foreign taxes on profits or income (e.g. withholding tax on royalties, licensing fees, service fees and management fees), subject to the provisions in section 16(1)(c), are not deductible." is newly added.

Recent change in the assessing practice of the Inland Revenue Department (IRD)

A board of review decision D43/91 held in 1991 that foreign taxes charged based on gross income or turnover which must be borne regardless of whether a profit was made, was not an appropriation of profit. As such, D43/91 held that where the gross income concerned was also chargeable to tax in Hong Kong, the foreign taxes suffered were outgoings and expenses incurred in the production of the gross income and were, therefore, deductible under the general deduction provision contained in section 16(1) of the IRO.

The IRD had previously accepted this judicial decision and indicated in its practice note (DIPN 28) issued in July 1997 that foreign taxes in the form of withholding tax (WHT) charged based on gross income derived by way of interest or royalties were deductible

The above long-established legal position and assessing practice meant that foreign WHT suffered in a non-CDTA jurisdiction, whilst not eligible for a tax credit under a CDTA, could be claimed as tax deductible in Hong Kong. In other words, absent a CDTA, taxpayers in such circumstances could nonetheless obtain some form of unilateral relief for the double taxation suffered, by way of a tax deduction of the foreign WHT under section 16(1) of the IRO in Hong Kong.

However, last month the IRD issued a revised DIPN 28 superseding that issued in July 1997. In the revised DIPN 28, the IRD states generally that a tax on profits **or income** is an appropriation of profits and, therefore, is not an outgoing or expense allowable for deduction under section 16(1) of the IRO. Specifically, revised DIPN 28 states that "foreign taxes on profits or income (e.g., withholding tax on royalties, licensing fees, service fees and management fees), subject to the provisions in section 16(1)(c), are not deductible."[2].

Recent legislative amendment to section 16(1)(c)

Previously, foreign taxes charged on specified interest (or similar gains) deemed assessable in Hong Kong under specified deeming provisions of the IRO were all tax deductible in Hong Kong under section 16(1)(c) of the IRO, regardless of whether the foreign taxes were paid in a CDTA or non-CDTA jurisdiction.

In other words, if the foreign taxes were suffered in a CDTA jurisdiction, taxpayers would previously have a choice of either claiming the foreign taxes paid (i) as a tax credit in Hong Kong under the CDTA concerned, or (ii) as a tax deduction under sections 16(1)(c) of the IRO.

However, effective from the year of assessment 2018/19, the newly added provision contained in section 16(2J) of the IRO dictates that only foreign taxes on interest-type income referred to above suffered in a non-CDTA jurisdiction are tax deductible under section 16(1)(c) of the IRO.

For foreign taxes suffered in a CDTA jurisdiction, taxpayers can now only claim the foreign taxes paid as a tax credit in Hong Kong under the relevant CDTA.

The IRD explained that the international practice is that where a CDTA is in place, relief from double taxation should be allowed under the CDTA only to the extent contemplated by the CDTA. Given the tax credit approach adopted in all Hong Kong's existing CDTAs, section 16(2J) is therefore added to restrict the application of the unilateral relief from double taxation, by way of a tax deduction under section 16(1)(c), to only those foreign taxes paid in non-CDTA jurisdictions.

Practical impact of the above changes

Foreign taxes on interest-type income

As shown in the example below, the recent amendment to section 16(1)(c) of the IRO could adversely affect the tax position of foreign banks operating a branch in Hong Kong.

Example

The Hong Kong branch of a German bank lends money to a Chinese borrower and suffers WHT in mainland China on its interest income earned from the Chinese borrower. The interest income would also likely be chargeable to tax in Hong Kong under the deeming provisions of the IRO referred to above.

Under the recent change in the IRD's assessing practice and the amended terms of section 16(1)(c), the Hong Kong branch can no longer claim the WHT suffered in mainland China as a tax deduction under section 16(1)(c) of the IRO. This would be the case because mainland China is a CDTA jurisdiction of Hong Kong for the purposes of the now amended terms of section 16(1)(c) of the IRO.

Furthermore, the German Bank, of which the Hong Kong branch is a part, would unlikely qualify as a tax resident of Hong Kong. As such, neither can the Hong Kong branch claim the WHT suffered in mainland China as a tax credit in Hong Kong under the CDTA between mainland China and Hong Kong.

2. Revised DIPN 28 nonetheless also states that the following types of duties or taxes which are not calculated by reference to profits or income may be considered for tax deduction:
   - rates levied on properties;
   - vehicle license fee;
   - duties on commodities;
   - taxes/duties on paid-in capital
   - goods and services tax; and
   - value added tax

In this case, in respect of the WHT suffered in mainland China, the German bank can only seek either (i) a unilateral tax relief in Germany (if available) or (ii) a bilateral tax relief under the CDTA between mainland China and Germany. However, if the income of the Hong Kong branch of the German Bank is tax exempt in Germany, conceivably no unilateral or bilateral tax relief could be obtained in Germany. As such, the Hong Kong branch of the German Bank would now have no relief in respect of the double taxation it suffered in mainland China and Hong Kong.

In respect of foreign WHT suffered in a CDTA jurisdiction by a Hong Kong resident local bank, the bank will now not have the option of claiming the WHT paid as a tax deduction under section 16(1)(c). Instead, the bank will have to go through the more complicated process including providing evidential proof of the foreign WHT paid to claim a tax credit in Hong Kong.

Foreign taxes on non-interest type income

Under the IRD's new assessing practice as explained above, taxpayers can no longer claim a tax deduction under section 16(1) of the IRO for foreign WHT on non-interest type income which is charged based on gross receipts regardless of whether a profit is made. As such, where such foreign WHT is suffered in a non-CDTA jurisdiction, taxpayers can neither claim the foreign WHT as a tax credit nor a tax deduction in Hong Kong.

For foreign taxes (withholding or otherwise) suffered in a CDTA jurisdiction on income which is also chargeable to tax in Hong Kong, taxpayers can now only seek relief from double taxation in Hong Kong by way of a tax credit under the CDTA between Hong Kong and the jurisdiction concerned.

It should however also be noted that if a Hong Kong taxpayer suffers a loss in the year in which the foreign WHT is paid in a CDTA jurisdiction, under the new assessing practice, that taxpayer will be unable to avail themselves of any tax relief for the foreign WHT. In contrast, under the IRD's previous assessing practice, such foreign WHT could at least have been claimed as tax deductible under section 16(1) of the IRO, thus increasing the tax losses of the taxpayer that could be carried forward.

Commentary

The CDTA network of Hong Kong is currently not wide enough to cover many of Hong Kong's major trading partners e.g., Australia, Germany, Singapore and the United States are all non-CDTA jurisdictions.

As such, the lack of unilateral tax relief in the form of a tax deduction under section 16(1) of the IRO for WHT suffered in non-CDTA jurisdictions on royalty and service fee income might make Hong Kong less attractive as a hub for international licensing and regional headquarters activities.

While quoting some overseas case-law authorities in support of the IRD's change in interpretation of the law and assessing practice, revised DIPN 28 has not referred to the case D43/91 and explained why the IRD no longer follows the decision in D43/91. The overseas cases quoted in revised DIPN 28 all seem to relate to tax on profits rather than on gross income, and, as such, may not be persuasive enough to justify the IRD's new position.

To minimize any possible future tax disputes, and given the potential impact on the tax competitiveness of Hong Kong, it would be advisable for the IRD to elaborate the legal basis as well as the policy considerations behind its change in assessing practice.

Taxpayers who would like to understand in more detail how the above changes may impact their operations and structure should seek professional advice where necessary.

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