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HONG KONG TAX ALERT

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DIPN 28 - Changing the landscape - Disallowing deductions for foreign taxes

Summary

In a recently released DIPN, the IRD expressed the view that foreign income taxes imposed on gross income (e.g. WHT imposed on gross royalties, service fees and management fees) are no longer be deductible under the general deductibility rules of section 16(1).

On 19 July 2019 the Hong Kong Inland Revenue Department ("IRD") released a revised Departmental Interpretation and Practice Notes No. 28 – Profits Tax: Deduction of Foreign Taxes ("DIPN 28"). Whilst being one of the shortest IRD practice notes, at only 5 pages long, the IRD's interpretation is highly contentious and represents a significant deviation from long standing law and practice.

In particular, the IRD expressed the view that foreign income taxes imposed on gross income (e.g. WHT imposed on gross royalties, service fees and management fees) are no longer be deductible under the general deductibility rules of section 16(1). Interestingly, the first version of the revised DIPN 28 was issued on 19 July 2019, this was subsequently updated a month later by the IRD to amend the second paragraph to explicitly state withholding tax is not deductible.

Pre July 2019 – A little bit of history

As a general rule, a deduction for profits tax paid or similar foreign taxes is not available under the IRO (section 17(1)(b) and section 17(1)(g)). Section 16(1)(c) allows a deduction for foreign taxes (where they are substantially similar to Hong Kong profits tax – i.e. tax on profits not tax on gross income) imposed on sums which are assessable to profits tax pursuant to specified deeming provisions.

In 1991, the Board of Review held in D43/91 that taxes on gross receipts were outgoings or expenses incurred in the production of profits within the meaning of section 16(1) and such deduction should not be excluded under section 17(1)(b) of the Inland Revenue Ordinance ("IRO").

This view of the law is supported by the Hong Kong Financial Secretary in the 1997-1998 budget speech:

"...deduction [for foreign withholding taxes] would not be available to overseas companies operating a branch here [in Hong Kong]. However, a judicial decision has indicated that foreign withholding tax charged on income or turnover is a legitimate expense, which should be deductible in determining assessable profits whatever the residency status of the company concerned. The Inland Revenue Department is following the judicial decision in its practice….This will, I hope, offer another inducement to encourage overseas companies to set up branch operations in Hong Kong, thereby strengthening our status as an international financial centre."

The original DIPN 28 was consistent with this view and made it clear that where an amount of foreign tax does not qualify for deductions under Section 16(1)(c), it may still be deductible pursuant to the general deductibility rules in Section 16(1), but only where the tax is an expense which must be borne regardless of whether or not a profit is derived and is not an appropriation of profit.

Hong Kong's long standing practice on foreign withholding taxes

Prior to the revision of DIPN 28 and consistent with D43/91, foreign withholding taxes imposed on gross income such as management fees, interest and royalties were deductible. The long established principle for foreign withholding taxes means that[1]:

(i) Foreign withholding taxes imposed by countries which have a double tax agreement ("**DTA**") with Hong Kong would be entitled to a credit offset against their profits tax liability for the foreign withholding tax suffered, but would be denied a tax deduction for the withholding tax suffered.

(ii) Foreign withholding taxes imposed by countries which do not have a DTA with Hong Kong would be allowed a tax deduction for the foreign withholding tax suffered but not a credit offset to their Hong Kong profits tax liability.

Recent Law Change

In 2018, Section 16(1)(c) was revised and Section 16(2J) was introduced. The effect of these amendments was that Section 16(1)(c) (i.e. the deduction for profits tax type foreign taxes) is not available where the tax is paid in a jurisdiction where Hong Kong has entered into a DTA with. This is a reasonable amendment to the IRO.

What are the key changes causing concern?

Change in long standing practice

— The revised DIPN 28 states the following:

> *Paragraph 1: "Since a tax on profits **or income** is an application of the profits and not an outgoing or expense incurred in producing chargeable profits, the tax is not deductible. The assessable profits of a trade, profession or business are the profits before, and not after, deduction of profits tax" (emphasis added)*

— The revised DIPN 28 also removes the comment:

> *"…tax can properly be described as a charge on earnings (rather than on profits) that is payable regardless of whether or not a profit is made. As the tax is not an appropriation of the profits, a deduction is allowable under section 16(1). Typically such foreign taxes will take the form of a withholding tax on income derived by way of interest or royalties…"*

Potential Impact

For multinational groups with their global or regional head offices situated in Hong Kong, or groups with service centres or intellectual property holdings in Hong Kong, to even a simple service providers in Hong Kong, the revised policy may have a significant adverse impact and increase in the overall cost of doing business in Hong Kong.

Clarification on the types of income deductible within section 16(1)(c)

> *Paragraph 2: "…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."*

Potential Impact

In of itself, the impact could be argued as minimal at most. Section 16(1)(c) provides a deduction for foreign profits tax where two specific tests are satisfied:

[1] Both (i) and (ii) are on the assumption that the relevant income is subject to Hong Kong profits tax.

(i) The foreign tax is substantially the same nature as tax imposed under the IRO (i.e. tax is applied on profits and not on gross income); and

(ii) Where the income is deemed assessable under specific deeming provisions in Section 15. Specifically, these are:

Deeming Provision	Income to which deeming provision is applicable to
Section 15(1)(f)	Interest
Section 15(1)(g)	Interest
Section 15(1)(j)	Gains from disposal / maturity of a certificate of deposit or bill of exchange
Section 15(1)(k)	Gains from disposal / maturity of a certificate of deposit or bill of exchange
Section 15(1)(l)	Gains from disposal / maturity of a certificate of deposit or bill of exchange

There is a very narrow scope for the application Section 16(1)(c), its operation is limited to foreign taxes which are taxed substantially the same as profits tax (i.e. tax on profits and not on gross receipts) and income will need to arise from “interest” and related debt securities where the income is not taxed under the general charging provisions in Section 14.

Based on the above, the scope of application of Section 16(1)(c) has never and could never cover royalties, licensing fees, service fees and management fees as such it could be argued that the commentary included within paragraph 2 is largely irrelevant.

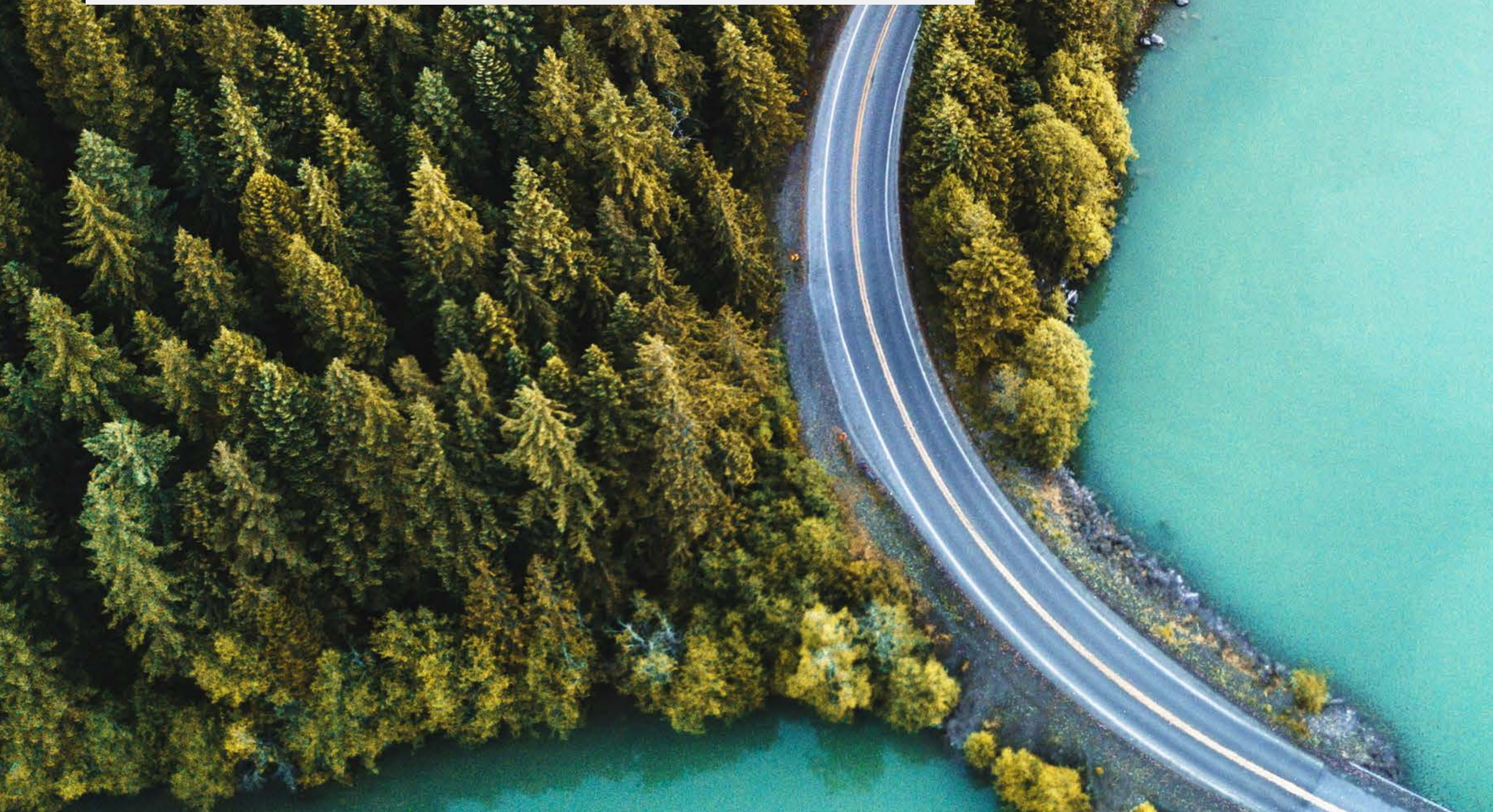
KPMG observations

We view the revised DIPN 28 as being a significant departure from current practice. This arises predominantly from a change in how the IRD interpret the application of section 16(1) for foreign taxes on foreign income which is subject to HKPT. This departure has significant impacts for taxpayers across a variety of industries and groups. If it is in fact correct it takes effect from 1 April 2018, so we recommend that you review your transactions and prior year tax computations to determine whether this impacts you.

How the IRD interpret deductibility of foreign taxes in the revised DIPN 28 is perplexing to say the least. Section 16(2J) is clearly intended to operate to deny a deduction under Section 16(1)(c) which as stated above, has limited application. It is not clear how these paragraphs extend the wider principle of withholding and other taxes on gross income.

We strongly recommend that at a minimum, the IRD reinstates the first version of the revised DIPN 28 (as released in July 2019) or better yet, revert back to the previous long standing practice.

As a final note, DIPN’s are *issued for the information and guidance for taxpayers. They have **no** binding force and do not affect a person’s right of objection or appeal to the Commissioner, the board of Review or the Courts.*



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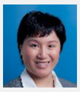

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