HONG KONG

A Critical Assessment of the Hong Kong Inland Revenue Department's Revised Departmental Interpretation and Practice Note No. 28 on the Deductibility of Foreign Tax

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I. Introduction

As a general rule, the well-informed Hong Kong tax practitioner tends to anticipate developments in Inland Revenue Department (IRD) departmental interpretation and practice notes (DIPNs) with a sense of dread and stoic resignation. In our well-worn cynicism, we assume there will be something wrong with the positions of laws pronounced on behalf of the Commissioner, *ex cathedra*; the question is only just how wrong the guidance will be and what sort of impact it will have on our clients. The August 2019 revision of DIPN No. 28 on the deductibility of foreign taxes under section 16(1) of the Inland Revenue Ordinance (IRO),[2] however, presented the long-suffering tax practitioner with a piece of technical analysis so patently wrong and ill-informed that it can only, as I have written in the past in regard to the carry-forward of losses pursuant to an amalgamation,[3] have been impelled by practical concerns, rather than technical purism. At least, one would very much hope that to be the case. Put simply, the historic guidance on section 16(1) first published in 1997 took the (correct) view that, when overseas withholding taxes were levied by a foreign revenue authority on certain gross receipts (which were in turn taxable in Hong Kong), such amounts would, in principle, be allowable as a good section 16 deduction in computing the assessable amount of that sum upon receipt in Hong Kong.[4] The reasoning behind this policy was, put shortly, that, while a foreign tax on profits could not be regarded as an expenditure or outgoing incurred in the production of taxable profits, because such a tax would by definition be levied on the profits themselves and was therefore *posterior* to the ascertainment of profits, a withholding tax was an expense that had to be borne regardless of whether or not a profit had been derived; it was a necessary incident of earning the amount subject to the overseas withholding tax and the tax itself was to be charged on the gross amount, not some measure of profit, howsoever computed.

This historic position had the advantage of being both a workable statement of policy that provided a degree of legal certainty to tax advisors and their clients, and one that aligned with the purposive intent of section 16(1). In July 2019, the IRD issued an update to DIPN 28, which was swiftly superseded the following month by a further update. At the date of this article, this is the current version of that publication. In that regard, it is somewhat curious that the new DIPN 28 remains marked as having been updated in July 2019, despite comprising a version made public on August 2019 in reality. The current version of the guidance, however, categorically excludes most foreign withholding taxes from being good deductions under the general deduction provision in section 16(1),[5] though it accepts, as it must, that the specific deduction provisions under section 16(1)(c)[6] for certain interest and interest-like payments that have borne foreign tax are good deductions.[7] Setting aside the way in which the new policy is wholly unfounded in law, this change is startling because it amounts to the adoption of a policy position that is diametrically opposed to the prevailing consensus of over two decades, and all this without a single relevant change in the governing legislation. In other words, section 16(1) has not, in substance, changed, either in its drafting or in its judicial interpretation, but IRD guidance has.

II. The Case of Section 16(1)(c)

As a prior point, section 16(1) is an uncommonly generous deduction provision by common law revenue standards. Unlike the United Kingdom tax code, it does not require that expenditure be laid out wholly and exclusively for the purposes of trade in order for it to be deductible.[8] Instead, it is sufficient that the expenditure or outgoing in question be incurred, in some causal sense, in the production of those profits, and there is no criterion of totality or exclusivity in that regard.[9] When one considers the extensive British jurisprudence on the deductibility of expenditure one must bear in mind that those disputes in general turned on the more restrictive wording of the British statute, which is a critical distinction in applying that case law to the analogous provisions in the IRO. Turning now to the specific words of the IRO, the necessary starting point is section 16(1), which relevantly provides that:

"In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period, including […]

(c) subject to subsection (2J) and section 50AA, tax of substantially the same nature as tax imposed under this Ordinance, proved to the satisfaction of the Commissioner to have been paid elsewhere, whether by deduction or otherwise, by any corporation or by a person other than a corporation who carries on a trade, profession or business in Hong Kong, during the basis period for the year of assessment in respect of profits chargeable to tax by virtue of section 15(1)(f), (g), (i), (ia), (j), (k), (l) or (la) […]".

If read plainly, section 16(1) formulates the general rule on deductibility: If one incurs outgoings or expenditure in the production of assessable profits, such sums are deductible. The various paragraphs under subsection (1) are specific cases in which a deduction is expressly granted, but that does not evidently preclude other sums from being deductible. Here, the key term is "including", which establishes this section as open-ended. Thus, provided that an overseas tax falls within the parameters of section 16(1) and is not barred from deduction by virtue of anything in section 17, it should, in principle, be deductible. Paragraph (c) is illustrative in that regard because it provides an example of a self-contained code allowing for the deduction of foreign tax, albeit specifically in the context of interest and similar receipts deemed to be taxable under certain section 15(1) deeming provisions. Section 16(1)(c), as a fully-developed deduction regime, therefore provides structural and conceptual guidance in understanding how section 16(1) may operate generally to allow the deduction of foreign taxes not specifically addressed in the statute.

Section 16(1)(c) was enacted by the Inland Revenue (No. 3) Ordinance 1978[10] at the same time as section 15(1)(i).[11] Section 15(1)(i) is a deeming provision, which charges to profits tax interest received by or accruing to a financial institution exercising that trade in Hong Kong. Its purposive intent is evidently to prevent such financial institutions, which will in general be taxable in Hong Kong on interest received irrespective of its source, from being unduly penalised by overseas tax leakage borne on interest sourced in other jurisdictions. In that ambit, the purpose of paragraph (c) is apparent: It specifically provides for a deduction in the computation of profits tax for foreign tax(es) paid by the taxpayer of substantially the same nature as tax imposed under the IRO (e.g., taxes on business profits analogous to section 14, and taxes on gross income analogous to the various deeming provisions in section 15),[12] with respect to certain receipts taxable under the listed paragraphs of section 15(1). Such paragraphs are, in substance, related to interest receipts[13] and gains from the disposal or maturity of a certificate of deposit or bill of exchange. [14] The scope of deduction under paragraph (c) is therefore limited; it does not amount to a general deduction for taxes of any kind whatsoever paid abroad. Thus, and by way of illustration, if Company A carrying on a trade in Hong Kong has the right to receive, under a loan agreement, 100 of Hong Kong source interest from Company B resident in Singapore, and in fact receives 85 net of Singaporean withholding tax levied at 15 per cent,[15] all other things being equal, the amount accruing to or received by Company A for the purposes of section 15(1)(f) would be 85. That accrual or receipt of 85, as the case may be, would by operation of section 16(1)(c) be subject to a further deduction of 15 on account of Singaporean withholding tax, leading to a taxable fund of 70. Assuming that 70 were taxed at the full current corporate rate of profits tax of 16.5 per cent, the end result would be a liability to profits tax of 11.55, *plus* a liability to Singaporean tax of 15, leading to an aggregate tax of 26.55 on the interest payment. That is considerably more than the 16.5 that would have been payable had only Hong Kong tax been levied on the interest payment, but it is still preferable to the net sum being assessed in regard to Hong Kong tax, absent a deduction for Singaporean withholding tax. Section 16(1)(c) is, therefore, not quite as desirable as a unilateral tax credit as it provides, in effect, for a reduction in the value of the taxable receipt, rather than for a tax credit once liability to Hong Kong tax is computed, but it does go some way to preventing a Hong Kong taxpayer from being unduly penalised by foreign tax.

Paragraph (c) is to be read cumulatively with sub-section (1). This means that the starting point in applying that provision is to ascertain whether a sum was an expenditure or outgoing incurred in the production of profits chargeable to profits tax; if and only if that initial condition is satisfied does one turn to the various specifically allowed deductions enumerated in paragraphs (a) – (h), of which paragraph (c) on the deductibility of foreign tax is the focus of this article.[16] Deductibility under paragraph (c) is expressly limited by the operation of sub-section (2J), as follows:

" Subsection (1)(c) does not apply in relation to any tax paid in a territory by a person in respect of profits referred to in that subsection if—

(a) the territory is a DTA territory (as defined by section 48A); and

(b) under section 50, tax payable in the territory by a Hong Kong resident person in respect of the profits is to be allowed as a credit against tax payable in Hong Kong by the Hong Kong resident person in respect of the profits."

The purpose of subsection (2J) is apparent: The provisions of a DTA in effect trump the operation of section 16(1)(c). This is consistent with the general approach adopted in the IRO: Sections 49(1) and 49(1C) together require that the provisions of a DTA apply notwithstanding any provisions to the contrary in the IRO when it comes to determining, among other things, the income, profits, or gains taxable in Hong Kong. Section 16(2J) is thus, in substance, for the benefit of both the government, which must comply with its *pacta sunt servanda* public international law obligations, while preserving the integrity of its tax base, and for the taxpayer, who has a legal certainty of accessing the more desirable tax credit relief afforded under a DTA. The allocation of taxing rights under a DTA is not, consequently, disturbed by anything in section 16. On the contrary, and returning to the aforementioned example, assuming that Company B resided in Japan, being a jurisdiction with which Hong Kong has a DTA, and Company A were the beneficial owner of the interest, Article 11 of the DTA would allocate taxing rights both to Japan and Hong Kong, limiting withholding tax to 10 per cent, with a credit, as opposed to a mere deduction available to Company A with respect to that withholding tax by virtue of Article 22(1) and section 50. The net result of this would be that Company A should, in principle, pay no more than 16.5 per cent aggregate tax [17] in respect of the interest receipt, with taxing rights allocated between Japan and Hong Kong, in accordance with the DTA. This would ordinarily constitute a marked improvement in Company A's position relative to section 16(1)(c).

III. The Deductibility of Foreign Tax Outside of Section 16(1)(c)

The correct technical position under section 16(1)(c), as articulated in the old DIPN 28, is therefore settled and affirmed in the new DIPN 28. While the scope of deductions under section 16(1)(c) is limited, it is instructive as to how a deduction for a withholding tax levied on a receipt *other* than interest would be treated under the general deduction provisions in section 16(1). Precisely the same methodology summarised above would apply in ascertaining the taxable receipt in Hong Kong, and the net effect of a deduction would likewise in any event be less desirable than a tax credit under an applicable DTA. In any exercise of statutory construction, where the legislation speaks and where it is silent can provide a compelling indication as to what the purposive intent of a provision is. Thus, section 17(1)(g) prohibits any deduction for any tax paid or payable under the IRO, other than salaries tax paid in respect of employees' remuneration. That an express provision was thought necessary by the draughtsman to exclude the deductibility of other taxes under the Ordinance suggests that such sums would, but for section 17(1)(g), arguably be deductible under section 16(1). There is, it would follow, no general principle in the schema of the IRO itself excluding the deductibility of other taxes for the purposes of section 16(1), unless such sums were expressly excluded from deductibility by some enactment, or by case law. While it is likewise true that there is an express provision in section 16(1)(c) governing the deductibility of foreign taxes borne on certain taxable interest receipts, the sums enumerated in sub-section (1) are comprised in an inclusive list; that is, this provision contains a non-exhaustive list of deductions that *are* in any event classed as allowable deductions. Conversely, section 17 is a closed and exhaustive list. If a deduction falls within section 16(1) and is not otherwise barred under a specific paragraph of section 17(1), it *is* thereby allowable as a deduction.

Prior to the introduction of the new DIPN 28, the consensus was that withholding taxes were deductible within the meaning of section 16(1) and not excluded by virtue of any express prohibition in section 17. Thus, and for example, a person chargeable to profits tax in Hong Kong with respect to royalty payments received from overseas under section 14 – perhaps because the relevant sub-licensing agreements under which the royalties are payable was made and took effect in Hong Kong[18] – would have been able to deduct the amount of withholding tax paid in the jurisdiction of source in computing its liability to Hong Kong profits tax. This goes some way toward mitigating the harshness of what would otherwise amount to double taxation – that is, the same sum would be taxed first in the jurisdiction of source by way of the application of a foreign withholding tax and subsequently upon receipt in Hong Kong.

The proper starting point of an inquiry into the general deductibility of withholding taxes should be whether or not the withholding tax in question was incurred in the production of profits assessable to tax in Hong Kong. The IRD, in its new guidance, answers this question in the negative. The new DIPN 28 states:

"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."[19]

To be clear, the IRD now understands such tax on profits and income to *include* withholding taxes, since such taxes are in effect income taxes.[20] That leaves, in the IRD's view, as deductible under section 16, a limited number of incidental imposts, such as rates levied on properties, vehicle licence fees, excise duties, and foreign taxes, including value added tax and goods and services tax not levied by reference to profits or income.[21] Two decisions made by the House of Lords are cited as authorities in regard to the change in IRD policy;[22] neither judgment was cited in the old DIPN 28. Both warrant some consideration.

In AG v Ashton Gas Company [1906] AC 10,[23] the dispute turned on whether a dividend to be declared to shareholders in a gas company established by statute, which was under that statute limited to 10 per cent of corporate profits, should be computed on the basis of pre or post-tax profits. Unsurprisingly, the Judicial Committee held that the 10 per cent cap was to be applied to the post-tax retained profits, a conclusion that will be apparent to an observer with any familiarity of corporate law. By definition, profits tax (or in the case of the Ashton Gas Company, income tax on corporations) can only be applied once the taxable profits of the taxpayer have been ascertained. The amount available for distribution must therefore be the post-tax profits retained by the company. To be clear, although the tax payable was denominated "income tax", it was, in substance, a tax on profits.

In IRC v Dowdall, O'Mahoney & Co Ltd [1952] AC 401, the taxpayer argued that tax payable in the Republic of Ireland on its trading profits arising in the United Kingdom in two branches should be allowable as a deduction in computing its liability to United Kingdom excess profits tax.[24] Specifically, the taxpayer was chargeable to Irish tax on its worldwide profits, but in regard to its British tax liability for profits sourced in that jurisdiction sought some relief, in the form of a deduction, from the double taxation that had arisen – that is, the same profit would have been taxed twice, in the Republic of Ireland and in the United Kingdom. The Court found for the Revenue, holding that the relevant test as established by British legislation was whether Irish income tax had been wholly and exclusively laid out or expended for the purposes of the taxpayer's trade. Logically, the Court reasoned, that could not be the case because British income tax under Schedule D[25] was charged on profits *subsequent* to their generation as a commercial matter, and not as an incident thereof.[26] Profits, as computed in accordance with the relevant charging provisions, are causally prior to the imposition of a tax on profits, as no tax may be attached to a fund that does not (yet) meet the statutory definition of an assessable profit.[27] Even if the same fund of profits attracted direct taxation on a different basis in two separate jurisdictions (for example, by virtue of there being different rules in each such jurisdiction for the computation of assessable profits), one incidence of taxation cannot be said to have been incurred in the production of the other; they are both in effect simultaneous impositions on the same fund, albeit collected by different jurisdictions and on the basis of different computational rules.

The IRD is consequently correct, to the extent that it considers that a deduction under section 16(1) ought not to be allowed for most forms of direct taxation on business profits – that is, taxes in substance analogous to profits tax. If such amounts were deductible as a matter of course, the drafting in section 16(1)(c), deeming direct taxation of substantially the same nature as profits tax incurred in the narrow context of interest income to be deductible, would be otiose, as would the words "by deduction or otherwise". This latter phrase clarifies that, irrespective of the means by which the tax is charged, its quantum is deductible. Withholding tax, however, is distinct from a profits tax or analogous income tax. It is, generally speaking, a tax on the gross sum of a payment of passive income, such as royalties, dividends, or interest, which is charged by the jurisdiction of source irrespective of whether or not the payee makes a profit. In other words, it is a necessary incident to the payment; it becomes chargeable as and when the income on which it is charged arises. By way of illustration, in Hong Kong, only one major withholding tax is currently levied[28] on royalties that are deemed to be taxable under sections 15(1)(a) – (bb) by virtue of section 20B, though an analogous withholding mechanism was historically applied to interest payments sourced in Hong Kong.[29] This is a paradigmatic withholding tax, in that it charges gross receipts to profits tax, irrespective of whether or not the payee has realised a profit. In that regard, section 21A is an imperative computational section deeming the assessable profits arising to the payee of royalties charged to profits tax under section 15(1)(a) – (ba) to be, variously, 100 or 30 per cent of the gross sum, thereby expressly excluding deductions one would in the ordinary course expect to apply in the computation of an assessable fund of business profits.

The character of a withholding tax is thus distinguishable from a tax on corporate profits. In Dowdall, the reason given by the House of Lords for excluding the deduction of Irish tax was that Irish tax charged was a profits tax analogous to the British excess profits tax with respect to which a deduction was claimed by the taxpayer. This ratio, however, cannot tenably apply to a withholding tax, because the economic cost of a withholding tax is by definition *anterior* to the computation of assessable profits. In order for assessable profits to be computed in Hong Kong, one must first take the aggregate of profits chargeable within section 14 and then deduct, among other things, expenditure incurred that falls within the parameters of deductibility established in section 16(1). This logical sequence was made clear in Lo & Lo.[30] A withholding tax, however, has the economic effect of reducing the funds of income from which assessable profits are to be computed and is therefore *prior* to the computation of the pool of Hong Kong assessable profits. Put simply, the taxpayer does not receive the gross sum, but a sum net of withholding tax. The payment of an overseas withholding tax is a necessary precondition to the taxpayer lawfully receiving the income, which would then subsequently be used as a starting point for ascertaining that taxpayer's liability to profits tax in Hong Kong. Consequently, withholding tax is not a tax on profits because it is charged irrespective of whether or not the payee makes a profit.

The only published decision in Hong Kong relating to the deductibility of foreign taxes was the Board of Review decision in D43/91 (1991) 1 HKRC ¶80-154,[31] which was, unfortunately for present purposes, decided in the context of the discrete regime for the taxation of shipping profits in section 23B. Relevantly, however, the dispute turned on whether certain foreign taxes would fall within the general deductibility provisions in section 16(1) as outgoings or expenditure incurred in the production of taxable profits. The taxpayer had been subject to tax in the Philippines, Australia, and Taiwan in the course of shipping operations, and sought to claim amounts paid by way of foreign tax as deductions in computing taxable shipping profits. The Board allowed the appeal to the extent that the overseas taxes were charged on gross receipts and not on net income or profits, holding that such sums were deductible within the meaning of section 16(1) and were not excluded by virtue of section 17(1)(b), which prohibits a deduction (now subject to the provisions of section 16AA) for any disbursements or expenditure not actually expended for the purposes of producing taxable profits. Based on the evidence before it, the Board concluded that the Taiwanese and Filipino taxes were charged on turnover or gross income and were therefore allowable as deductions, and that Australian tax was deductible to the extent that it was incurred under a statutory provision that required tax to be paid as a fixed and invariable percentage of the gross income derived by the taxpayer from the carriage of cargo or passengers in Australia.[32] In so doing, the Board recognised and approved the general principle, as articulated by Buckley LJ in the English Court of Appeal in AG v Ashton [1904] 2 Ch 621[33] at 624, that: "a sum which is an expense which must be borne whether profits are earned or not, may no doubt be deducted before arriving at profit". There could hardly be a less ambiguous statement.

In D43/91, the chief distinguishing factor in establishing the deductibility of foreign tax was the nature of the fund on which that tax was assessed. If it is a profits tax, then it is not deductible, following the reasoning established in Dowdall;[34] if, however, it is charged on gross receipts, it is deductible, following the reasoning of the Chancery Division in Ashton. Consider, further, the decision of the English Court of Appeal in Harrods (Buenos Aires) v Taylor-Gooby 41 TC 450, where the taxpayer was the Buenos Aires branch of a well-known London department store. In setting up business in Argentina, it was required as a matter of Argentine tax law to pay a fixed amount per annum by way of "substitute tax" that was charged on non-Argentine companies carrying on a business in Argentina. It claimed sums paid by way of such substitute tax as deductible in computing its liability to British income tax on business profits under Schedule D. The Court of Appeal held that the sums so incurred were deductible. Willmer LJ opined:

"Liability to pay the [Argentine] tax was incurred as soon as the Company established its *'empresa estable'* [i.e., a fixed place of business in Argentina] and quite regardless of whether the trade thereof resulted in a profit. The tax paid in respect of any given year is a payment necessarily made in order to ensure that trading will be allowed to continue during the next and succeeding years. In this respect the payment of the tax is clearly made for the purpose of earning profit from the continuance of trading".[35]

As the Board did in D43/91, the Court of Appeal asserted a fundamental distinction between taxes on profits, which are not deductible, and taxes that are charged irrespective of whether or not profits arise, which are deductible. Here, it is apposite to specify that the deduction provisions in section 16(1) are drafted more broadly than the relevant deduction provisions in the British Income Tax Acts, not just when it comes to the question of the "wholly and exclusively" criterion. In Hong Kong, it is sufficient that the outgoing or expenditure in question be incurred in the production of assessable profits. Conversely, the British statute required – and today still requires – that it be wholly and exclusively for the purposes of profit-making trade. Though, in practice, the two concepts likely overlap to a significant degree, the question of whether or not an outlay is for the purposes of a trade is a moot point in Hong Kong, since the true issue to be canvassed in ascertaining the deductibility of a sum is whether or not, causally speaking, it was incurred in the production of assessable profits.

Thus, it is helpful to return to the specific drafting in section 16(1), which refers to expenditure or outgoings incurred in the production of assessable profits. Withholding tax is evidently an outgoing; it is a fixed amount that must be paid as a necessary incident of receiving a given income stream. In that respect, and economically speaking, it is no different from a fixed cost. Likewise, a withholding tax is incurred in the production of assessable profits to the extent that the income stream in question is chargeable under section 14. All "incurred" means is to encounter, or, literally, if one were to gloss its Latin etymology, to run into; where a withholding tax is charged, it is incurred by the taxpayer because it is perceived from that taxpayer's perspective as a deduction from the gross amount contractually due to it. On this basis, its assessable profits in Hong Kong would be computed, assuming, of course, that there is no gross-up clause in the relevant agreement.[36] Parenthetically, if there were a gross-up provision governing the payment of income, subject to withholding tax, the withholding tax in question would be deductible under section 16(1) from the grossed-up sum, to the extent that sum were a taxable receipt within the meaning of sections 14 and/or 15. The new DIPN 28 asserts that, without citing any authority, withholding taxes are in each case taxes on "profits or income" and are therefore, on the *rationes decidendi* of Harrods and Dowdall, barred from being deductible.[37] This, however, is a rather spurious piece of semantic obfuscation. It is correct to say that a withholding tax is, in a general sense, a tax on *income*. By definition, it is levied by reference to a stream of income received by a taxpayer, with the machinery for assessing and recovering the tax applied to the payor instead of the payee, usually as a matter of administrative convenience.[38] However, for the reasons outlined in detail above and those reported in the *very same cases* the IRD cites in support of its position as articulated in the new DIPN 28, such taxes are categorically *not* taxes on profit because they are chargeable irrespective of whether or not the taxpayer has obtained a profit. Harrods and Dowdall, among others, are authorities for the proposition that taxes on profits are not deductible, but they are univocal in regard to the way in which foreign taxes that are not taxes on profit are, in principle, deductible to the extent that they are incurred for the purposes of taxable trade (in Hong Kong, that should be read as "in the production of assessable profits"), *regardless* of whether they are by nature income taxes or otherwise. It would follow that the conclusion in DIPN 28 on the character of withholding taxes is apparently inconsistent with the otherwise authoritative jurisprudence cited.

As a final observation, there is no equivalent to section 16(2J) for withholding taxes generally, as opposed to those charged on interest. Section 49 subordinates the provisions of the IRO to any DTA having effect specifically as regards the matters enumerated in section 49(1C), including, among other things, the computation of income taxable in Hong Kong. One may therefore infer that the Commissioner's volte-face in DIPN 28 arose from the IRD's concern that a taxpayer may first claim a deduction for overseas withholding tax under section 16(1) and further claim a tax credit by virtue of section 50 and the relevant treaty arrangements. This objection, however, appears to be unsustainable, in that section 50(5)(a) expressly excludes deductions for foreign tax being taken into account in the computation of the foreign-taxed income, with respect to the way in which a credit is to be allowed. This thereby excludes any risk of aggressive tax planning or loss of tax revenue by way of a taxpayer claiming both a deduction and a credit with respect to the same income that would otherwise be subject to tax both abroad and in Hong Kong.

IV. Some Final Observations

It is trite to observe that DIPNs are not legally binding. The new DIPN 28, however, is an unwelcome indication of the IRD's increasingly idiosyncratic and unilateral approach to construing the IRO. If nothing else, the unannounced reversal of a longstanding pragmatic consensus between tax professionals, taxpayers, and the Commissioner is questionable as a matter of administrative best practice. It would, at a minimum, have been desirable if the Commissioner had sought to consult with stakeholders prior to revising DIPN 28, which he did not, in fact, do. Hong Kong does not have a double taxation agreement with some of its most important trading parties, such as the United States of America and Germany. To deny a section 16(1) deduction for withholding tax borne in those jurisdictions will, therefore, in practice render investments by a person chargeable to profits tax in those jurisdictions more fiscally onerous than it should be. I understand that a number of highly experienced practitioners have made submissions to the Commissioner encouraging him to reconsider the current version of DIPN 28; however, in view of the IRD's apparent reluctance to engage in meaningful consultation exercises, the most realistic prospect for the taxpayer is that the Board of Review or, preferably, a higher Court comes to the contrary conclusion and so establishes a binding precedent regarding the deductibility of foreign withholding taxes. I have had the opportunity to review a number of written responses signed on behalf of the Commissioner to such letters of inquiry, and their contents was uniformly disappointing. The Commissioner in substance concluded that it is "trite law that income tax or profits tax is not generally deductible but for specific provisions in *(sic)* tax statute", whilst the authorities discussed in detail above make clear that taxes on gross income are distinct from taxes on profits.

On a strictly technical level, the new DIPN 28 is thus unfounded in law. It is not apparent to me why the Commissioner would have resolved, suddenly and with no apparent warning, to resile from the long-established understanding between the Revenue and practitioners in regard to the deductibility of foreign withholding taxes. His responses to the various questions put to him in writing on that point have been, as far as I have been able to ascertain, unconvincing. Not only is the reasoning behind the new guidance erroneous, but the very authorities cited by the IRD as a juristic fig-leaf to shore up its untenable position in reality militate *against* its conclusions Put simply, they say the very opposite of what the IRD represents them as saying. In short, insofar as it purports to disallow deductions for foreign withholding taxes not relieved or credited by a DTA in force, the new guidance is on very tenuous technical ground and ought therefore to be challenged as such by taxpayers and practitioners.

Endnotes

1. The author is grateful to Mr John Timpany of KPMG for his invaluable analysis and insight. An alternative and illuminating critique of the practice notes has been published by KPMG: 'DIPN 28 – Changing the landscape – Disallowing deductions for foreign taxes' (2 October 2019), accessible at: tax-alert-9-hk-dipn-28-changing-the-landscape-disallowing-deductions-for-foreign-taxes.

2. All statutory references in this article are references to the Inland Revenue Ordinance.

3. 'A critical assessment of the Inland Revenue Department's revised and updated guidance on the tax consequences of company amalgamations', *Asia*

Pacific Journal of Taxation, 2017, Vol. 21, No. 1.

4. DIPN No. 28 (1997), paragraph [5].

5. DIPN No. 28 (2019), paragraphs [1] – [3].

6. Enacted by section 4 of the Inland Revenue (Amendment) (No. 3) Ordinance 1978.

7. *Supra* 5, paragraph [4].

8. *See* section 34 of the Income Tax (Trading and Other Income) Act 2005.

9. *See*, for example, So Kai Tong, Stanley v CIR [2004] 2 HKLRD 416.

10. Section 4 of the Inland Revenue (No. 3) Amendment Ordinance 1978, noting that the deduction was originally limited to financial institutions. When interest tax was abolished in 1989, the benefit of a section 16(1)(c) deduction was extended to other taxpayers.

11. Section 3 of the Inland Revenue (No. 3) Amendment Ordinance 1978.

12. As regards the question of whether the tax is of substantially the same nature as taxes imposed under the IRO, it has been suggested that because the IRO technically speaking only taxes profits, income from employment, and property income, withholding taxes on gross income do not actually fall within the scope of paragraph (c). That view, however, would ignore both the fact that gross interest and royalty receipts are indeed chargeable under section 15, and that it was evidently the legislative intent of section 16(1)(c) to apply to foreign withholding taxes on interest. Further note that at the time that section 16(1)(c) was enacted, Hong Kong source interest was generally subject to withholding tax.

13. Sections 15(1)(f) – (ia).

14. Sections 15(1)(j) – (la).

15. *See* sections 12(6), and 45 – 45A of the Singapore Income Tax Act.

16. This is trite, but *see*, for example, CIR v Lo & Lo [1984] STC 366, at 369 – 370, per Lord Brightman.

17. A detailed accounting treatment of the tax credit provisions in section 50 are beyond the scope of this article.

18. Following the ratio in CIR v HK-TVB International Ltd [1992] 2 AC 397.

19. *Supra* 5, paragraph [1].

20. *Supra* 5, paragraph [2].

21. *Supra* 5, paragraph [5].

22. *Supra* 5, paragraph [3].

23. Ironically, the Chancery Division judgment affirmed by the House of Lords in this decision contains a proposition militating *against* the IRD's views as articulated in the new DIPN 28; for more information about this, *see* further below.

24. In summary, excess profits tax is a tax raised generally to fund wartime activity or otherwise in a national emergency. It is levied on profits considered to be in excess of "normal" (e.g., peacetime) profits.

In Dowdall, the relevant taxing statute was the Finance Act (No. 2) 1939, which was evidently enacted in contemplation of the Second World War.

25. Broadly speaking, equivalent to Hong Kong profits tax in that it is charged on, among other things, the profits of a trade, profession or vocation exercised in the United Kingdom.

26. At 418 – 419, per Lord Reid.

27. Nice Cheer Investment Ltd v CIR [2013] HKCU 2611 and, in particular, the discussion by Millett NPJ at [15] – [23] on the nature of a "profit" in the juristic sense, as well as the relationship between that concept and the application of the charging provisions of a revenue statute.

28. Section 20A(3) charging to profits tax on gross payments made by sales agents at a rate of 1 per cent of gross sales is technically a withholding tax, though, with the enactment of a comprehensive doctrine of permanent establishment under Schedule 17G, the practical application of this provision is likely now limited.

29. Part V (now repealed and replaced) of the Inland Revenue Ordinance. Prior to the abolition of interest tax, section 28 charged interest tax on, broadly speaking, interest sourced in Hong Kong. *See* section 7 of the Inland Revenue (Amendment) (No. 2) Ordinance 1989.

30. At 370, per Lord Brightman.

31. *See* the "unreported board case" identified in the Board's decision (at [10]), where it was apparently held that Indian freight tax and Cuban Government tax were deductible in ascertaining the chargeable profits of a shipping company.

32. At [17].

33. Affirmed by the House of Lords in [1906] AC 10.

34. *See* also Smith's Potato Estates v Bolland [1948] AC 508, where legal and accountancy expenses incurred by a trader in contesting an assessment raised by the British Revenue was held not to be allowable as a deduction, as they were incurred to determine the current amount of tax payable by the taxpayer, and not to generate profits.

35. At 467.

36. As a technical matter, and depending on the drafting of such gross-up clauses, amounts payable to the taxpayer on account of foreign withholding tax may be treated as sums payable under an indemnity to compensate the taxpayer for foreign withholding tax; section 17(1)(e) would operate to treat the withholding tax in question as barred from deduction under section 16(1).

37. *Supra* 5, paragraph [2].

38. For example, where the payee is a non-resident and the tax laws of the jurisdiction are enforceable against the payee only with difficulty, if at all. T