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Financial Institutions: Practice versus Law and Foreign Tax Credits?

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International and foreign tax credit rules vary significantly between jurisdictions. At one end of the spectrum, there are purely territorial systems, which rarely consider tax paid in other jurisdictions, and at the other end, there are worldwide systems, which grant relief for foreign taxes paid but make such relief subject to certain conditions (e.g. relief may be granted only for foreign tax where it is strictly required to be paid under local tax law and is not allowed where the foreign "tax" is considered to be a "voluntary payment").

In the current economic climate where tax authorities are exploring every avenue to boost collection levels, increased focus is being placed on whether global financial institutions pay their fair share at home and whether relief claimed for foreign taxes paid abroad is properly claimed. This can create challenges for taxpayers, particularly in the Asia Pacific region, which has uncertain and rapidly evolving tax laws that are subject to inconsistent interpretation and enforcement by tax authorities.

In many instances, local tax officials will make an assessment based on their own internal view, which the taxpayer will decide to appeal. Rather than go to court, both parties may opt to negotiate a settlement for a lesser amount; this allows the taxpayer to avoid a costly and protracted legal dispute and appeases the tax authority. However, while the taxpayer may argue that it had little choice but to pay the tax; an agreement struck with a tax authority to pay a disputed amount still may be considered a voluntary payment of tax since the issue was not determined by the courts. There are other instances where taxpayers and tax authorities agree to pay tax on a certain basis, which actually differs from the commonly held interpretation of the law. This is a challenge for taxpayers across a majority of the Asia Pacific region; however, this article focuses specifically on the situation in Hong Kong. [1]

Areas where Hong Kong practice differs from law

Like many other Asian jurisdictions, Hong Kong is somewhat different in its approach to tax than western jurisdictions, such as the UK and the US. While Hong Kong is a common law jurisdiction and its tax legislation, the Inland Revenue Ordinance (IRO), is based on old (circa 19th century) British legislation, the IRO itself is relatively brief (the hard copy form of the IRO is no more than an inch thick). Such a small body of legislation necessarily results in gaps and areas of uncertainty, some of which are plugged by case law and some of which are plugged by Inland Revenue Department (IRD) guidance. However, interestingly, there are a number of areas where the practice of certain taxpayers diverges from the commonly held interpretation of the law and, in some cases, IRD guidance.

In these instances, the IRD may explicitly approve of the taxpayer's practice, or it may simply choose not to challenge it, perhaps on the basis that the practice is mutually beneficial to both the taxpayer and the IRD and, in fact, may result in the over-collection, rather than the under-collection, of tax. This may merely be the by-product of simple and relatively static tax legislation, which is administered in a pragmatic fashion to achieve an acceptable result. Several examples of areas where practice may diverge from the law or IRD guidance are discussed below.

Nice Cheer Investment – Fair value or realised basis

On 12 November 2013, Hong Kong's Court of Final Appeal held in *Nice Cheer Investment v. Commissioner of Inland Revenue FACV 23/2012* that certain unrealised fair value accounting gains on securities were not taxable, whereas corresponding unrealised losses were deductible for tax purposes. The IRD downplayed the significance of the decision, stating that its impact was limited to the specific facts of the case, but announced it would respect the court's decision. Some practitioners welcomed the clarification of what they always considered to be the correct technical position. However, for many in the tax community, particularly banks and securities houses, the decision represented a step change in tax law from a position of taxing securities' fair value accounting gains and losses symmetrically, to asymmetrically.

The creation of this asymmetry, from a technical perspective, was generally beneficial to taxpayers; it effectively meant the early recognition of tax deductible losses, which could be carried forward indefinitely, versus recognition of taxable profits on a realised basis. However, from a practical and operational perspective, the decision created a potential problem; following this asymmetrical basis of taxation would require systems and tax compliance process changes.

The answer to this problem was simple and practical. The IRD would respect the Court of Final Appeal's decision and accept taxpayers filing their tax returns in accordance with the decision, but the IRD would also allow taxpayers to file their tax returns on the basis that fair value gains and losses were taxable symmetrically. Filing on the latter basis, as some taxpayers chose to, may accelerate the payment of Hong Kong tax and shift profits that would have been taxable in future periods into the current period, or may increase the overall amount of Hong Kong tax payable.

Source of securities trading and brokerage profit and loss – Onshore or offshore

Hong Kong only taxes Hong Kong-sourced profits. Accordingly, the source of profits is one of Hong Kong's most hotly contested areas and is considered a question of fact to be determined on a case-by-case basis. However, since the 2007 decision of the Court of Final Appeal in *ING Baring Securities (Hong Kong) Limited v. Commissioner of Inland Revenue FACV No. 19* (ING Barings), where the IRD lost to the taxpayer, there has been authority from Hong Kong's highest court, that commission income and trading profit from a securities transaction executed on a stock exchange outside of Hong Kong, should be

[1] The issues discussed in this article are not exhaustive.

considered foreign source, and this view is supported in IRD guidance.[2] However, a number of banks and securities houses continue to file their tax returns on the basis that such profits are wholly or partly onshore (with a corresponding deduction of expenses incurred to earn those profits). As Mr Justice Bokhary stated in *ING Barings*, the source of profits is a question for which there is "room for reasonable minds to differ" and, as such, arguments have and can be constructed in support of an onshore filing position; for example, the use of the "operations test" and consideration of funding raised in Hong Kong, to argue that the activity that giving rise to the profit does not occur exclusively outside Hong Kong. However, while these arguments have been made, the technical position appears to be in favour of the treatment of those profits as offshore, and provided the taxpayer's businesses are profitable, adopting an onshore basis of taxation is likely to result in the payment of additional tax.

Hong Kong amalgamation rules – Treatment of losses

It is fairly common knowledge that Hong Kong-based bank branches, subsidiaries and securities houses have a reasonable amount of carried forward losses. Such losses may have been incurred during the global financial crisis of 2007 and subsequent years, or are simply the result of an overall drop off in brokerage income, difficult trading conditions and a static or increasing cost base, sometimes exacerbated by transfer pricing policies which, while in line with OECD standards, are not well suited to loss-making businesses.

In 2014, Hong Kong introduced new rules allowing for the court-free amalgamation of companies. The rules were initially thought to be a boon for taxpayers looking to rationalise multiple subsidiaries in an attempt to cut costs and to utilize potentially trapped losses. However, despite there being no legislation specifically released to cover the treatment of losses upon amalgamation, on 30 December 2015, the IRD issued its own guidance (updated on 16 December 2016),[3] which espoused the view that a strict (and relatively unlikely) fact pattern would need to exist before losses could be carried forward to, and effectively pooled in the new entity. The absence of specific legislation means that, for now, there is no clear answer on how losses should be treated under a court-free amalgamation, and it is reasonable to say that there are a number of competing views in the Hong Kong tax community. However, perhaps unsurprisingly, the IRD guidance that is being followed by a number of taxpayers appears to be at the less favourable end of the spectrum of possible interpretations, and may result in the forfeiture or practical inability of companies to utilise losses. Again, this may result in more tax being paid in Hong Kong than required under applicable law.

Comments

With the increasing level of information disclosure and exchange between tax authorities and scrutiny to which taxpayer's affairs are being subject, they may wish to undertake an exercise to examine whether tax paid is in accordance with, or is possibly more than that required by applicable law. This may lead to:

a) The identification of risks to FTC claims and the opportunity to address those risks either by changing the basis of filing in Hong Kong or in the parent jurisdiction
b) The opportunity to make cash tax savings in Hong Kong, by adjusting the method of filing to one which is in accordance with the local tax law and is more favourable to the taxpayer

Taxpayers may also wish to consider their tax filing position compared to applicable tax law across Asia Pacific as the issues highlighted above are not unique to Hong Kong.

Whether the issues discussed above are of concern will ultimately depend on a number of factors, including the international and foreign tax credit rules of the parent jurisdiction, the tax profile of the parent company and tax filing position of the Hong Kong branch or subsidiary.

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[2] Paragraph 45, Departmental Interpretation and Practice Notes No. 21 (Revised) – Locality of Profits.
[3] http://www.ird.gov.hk/eng/tax/bus_cfa.htm (revised 16 December 2016).

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