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Hong Kong Tax Newsflash: Tax Reserve Certificate for Tax in Dispute

In a recent judicial review (*Dairyfarm Establishment and The Dairy Farm Company, Limited v. CIR [2018] HKCFI 2245)*, the Court of First Instance held that tax reserve certificate (TRC) may be purchased and used as security for the payment of tax in dispute under multiple assessments raised on the same profits but on an alternative mutually exclusive basis. The Court also clarified the power of the Inland Revenue Department (IRD) on tax administration, including issuance of tax assessments.

Background

A Hong Kong entity paid royalties to its overseas group entity for the use of registered trademarks in Hong Kong. The taxpayer considered that the royalties should be chargeable to profits tax pursuant to Sections 15(1)(b), 20B and 21A of the Inland Revenue Ordinance (IRO) at an effective tax rate of 4.95%. However, such position was challenged by the IRD.

Conditional holdover by TRCs

The IRD issued multiple assessments, on an alternative basis, in respect of the same royalties pursuant to Section 14 and Section 21 of the IRO. The IRD also disallowed the deduction claim on the relevant royalty payments pursuant to Sections 16, 61 and 61A of the IRO.

The IRD and the taxpayer understood that the assessments under Section 14 (S14 Assessments) and the assessments under Section 21A (S21A Assessments) are alternative assessments. One set of the Assessments will be annulled upon the finalization of the tax dispute.

While the taxpayer lodged objection against the assessments, the IRD ordered the taxpayer to purchase TRCs for both S14 and S21A Assessments as conditional holdover.

Taxpayer's proposals & the IRD's stance

The taxpayer made several proposals to the IRD aiming to avoid purchasing excessive TRCs. Under all these proposals, the IRD would not suffer from any financial prejudice. However, all these proposals were rejected by the IRD.

The total amount of TRCs purchased by the taxpayer was HK$505 million for all the years concerned. The taxpayer considered it was unfair and applied for judicial review.

The Court's decision

Annulment of assessment The taxpayer proposed the IRD to annul certain alternative assessments for the time being (without prejudice to them being reissued before time bar). The IRD rejected on the grounds that assessments cannot be annulled once they have been validly issued. The Court held that the IRD's view is incorrect.

Postponement of the tax payment due dates The taxpayer proposed the IRD to postpone the payment due dates of certain alternative assessments after the finalization of the tax dispute. The IRD considered that payment due dates cannot be amended once they have been specified in the assessments and rejected such proposal. In addition, tax payment due date must be a fixed date. The Court also held that the IRD's view is incorrect.

Purchasing TRCs to cover multiple assessments The taxpayer proposed to purchase one set of TRCs for S14 Assessments (the assessments involving larger sums) as security for both the S14 and S21 Assessments. The IRD rejected the proposal on the grounds that the TRCs purchased for a specific assessment cannot be accepted as security for another assessment. The Court held that a TRC may be purchased and lawfully used as security for multiple assessments provided that the tax is assessed on the same profits, on mutually exclusive basis, under alternative assessments.

The Court held that the IRD erred in law in rejecting the proposals and remitted the matter to the IRD for fresh consideration.

Our observation

When there is a tax dispute, it is not uncommon for the IRD to issue more than one assessments on an alternative basis in order to preserve its rights. Although taxpayer may not need to pay the tax under all the alternative assessments ultimately, the IRD is empowered to order the taxpayer to purchase TRCs for all the alternative assessments before the tax dispute is resolved. This may create a cash flow problem for the taxpayer if the tax appeal procedures last for years.

In this case, the IRD took a rigid stance and refused to accept the taxpayer's proposals which would not result in the IRD suffering from financial prejudice though. The Court clarified that the IRD erred in law in rejecting these proposals. In particular, it is held that where the IRD has issued two sets of assessments charging tax on the same profits but on an alternative, mutually exclusive, basis, a TRC (in the higher amount of the two assessments) may be purchased and lawfully used as security for both assessments.

With reference to this case, taxpayers who face similar assessment practice of the IRD may consult professionals and seek a more reasonable solution when negotiating with the IRD.

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