Bill on tax deduction for spectrum utilisation fees gazetted

4 December 2023
Issue 19

In brief

Following the announcement by the Financial Secretary in Hong Kong's 2023/24 Budget in February 2023, the Inland Revenue (Amendment) (Tax Deductions for Spectrum Utilization Fees) Bill 2023 (Bill) was gazetted on 1 December 2023 to provide for tax deductions for spectrum utilisation fees (SUF) to be paid by future assignees of radio spectrum[1]. The deduction will be spread over the spectrum assignment term, which is generally 15 years. The Government has, however, rejected the industry's call to extend the proposed deduction to cover SUF paid or to be paid in respect of radio spectrum obtained from past auctions. Such SUF will continue to be regarded by the Inland Revenue Department (IRD) as capital in nature and non-deductible.

Subject to the enactment by the Legislative Council (LegCo), the tax deductions for SUF will apply to SUF derived in auctions conducted on or after the commencement of the amendment ordinance.

This news flash summarises the features of the proposed tax deductions for SUF and our comments thereon.

In detail

Background

Radio spectrum is a scarce and valuable public resource essential for the provision of stable, advanced and innovative communications services. Under the current auction model, mobile network operators (MNOs) are required to make either a one-off lump sum payment upfront or annual instalments for the SUF covering the entire assignment period[2]. Such SUF (whether payable in a one-off lump sum or by annual instalments) are regarded by the IRD as capital in nature and not tax deductible, and legal challenges by one of the MNOs, in *China Mobile Hong Kong Company Limited v Commissioner of Inland Revenue (China Mobile* case*)*[3], were unsuccessful. Given the substantial amount of the SUF, the non-deductibility of the SUF is an industry-wide issue and has led to repeated calls to the Government to revisit this position.

In light of the growing importance of telecommunications development to support the overall economic and smart city development in Hong Kong, the Bill proposes to provide tax deductions for the SUF to be paid by successful bidders in future spectrum auctions.

Features of the proposed tax deductions for SUF

- Capital expenditures that are SUF will be deductible to the extent that they are incurred by the taxpayer for the use of the radio spectrum in the production of its assessable profits. However, the deduction will not apply to SUF that are reimbursed by any grant, subsidy or similar financial assistance.

- The deduction for SUF will be spread over the spectrum assignment term (which is generally 15 years). Depending on the payment method of the SUF, the deduction allowable for a year of assessment (YOA) will generally be as follows:

SUF payable:	Deduction allowable for a YOA
By annual instalments	The instalment payable in that YOA
Other than by annual instalments	Total SUF payable divided by the number of eligible YOAs[4] (Annual Amount) (i.e. one-off lump sum payment ÷ 15 years, in the case of a one-off lump sum payment for a 15-year assignment term)

- Special rules apply to the following situations:

(1) The taxpayer only begins to use the radio spectrum after the YOA in which the assignment term of the radio spectrum begins (Assignment YOA)

The tax deduction will begin in the YOA in which the spectrum is first in use (First Use YOA), and the amount allowable in that YOA will be the aggregate of the instalments payable or the Annual Amounts (as the case may be) from the Assignment YOA to the First Use YOA. The deduction allowable for the subsequent YOAs will follow the general deduction rule for SUF as mentioned above. For instance, if the taxpayer only begins to use the spectrum in the YOA after the Assignment YOA, assuming the annual instalment or Annual Amount is $100, the taxpayer will claim $200 in the First Use YOA and $100 in each of the subsequent YOAs.

(2) The taxpayer's use of the radio spectrum is pursuant to a unilateral transfer of such use[5&7]

The deduction rule will vary depending on the payment method of the SUF:

(i) SUF payable by annual instalments

The transferee begins to use the radio spectrum:	Deduction allowable to the transferee
In the YOA in which the transfer is effected (Transfer YOA)	Follow the general deduction rule for SUF
After the Transfer YOA	Similar to the special rule under Situation (1) above, except that the Assignment YOA will be replaced with the Transfer YOA

(ii) SUF payable other than by annual instalments

In the case where the SUF is payable other than by annual instalments by the transferor, the transferee will be deemed to incur on the date of transfer SUF for the transferee's use of the radio spectrum, which will be calculated as follows:

SUF paid by the transferor before the transfer *Less:* Total deduction for SUF that has been / would have been allowed to the transferor before the transfer

The transferee will be allowed a deduction for the deemed SUF for the remaining eligible YOAs (i.e. the eligible YOAs other than those in which a deduction is / would have been allowable to the transferor) as follows:

The transferee begins to use the radio spectrum:	Deduction allowable to the transferee for a YOA
In the Transfer YOA	Deemed SUF divided by the number of remaining eligible YOAs (Deemed Annual Amount)
After the Transfer YOA	Similar to the special rule under Situation (1) above, except that the deduction allowable will be determined based on the Deemed Annual Amount and the number of remaining eligible YOAs

No deduction will be allowable to the transferor for any YOA that begins after the date of the transfer.

Our observation: *The provisions in the Bill appear to deal with whole years only. It is not immediately clear how the deduction should be claimed by the transferor and the transferee during the Transfer YOA if the transfer takes place in the middle of the basis period, for instance whether a partial deduction for the annual instalment/Annual Amount should be claimed by each of the transferor and the transferee.*

- Deduction for SUF is not affected by a transfer of frequency bands on a swap[6&7], i.e. the use of the radio spectrum by the persons in a swap is taken to remain the same one throughout the assignment term as if the transfer had never occurred.

- If a taxpayer has claimed deduction for SUF but its liability to pay the SUF is subsequently released, the released amount will generally be treated as a taxable trading receipt accruing at the time of the release.

Legislative timetable and effective date

The Bill will be introduced to the LegCo on 6 December 2023. It is proposed that the tax deduction will only apply to the SUF derived in auctions conducted on or after the commencement of the amendment ordinance, with no retrospective effect. In other words, SUF paid or to be paid in respect of spectrum obtained from all past auctions will continue to be regarded by the IRD as capital in nature and non-deductible, unless the Court of Appeal decision in the *China Mobile* case is overturned.

The takeaway

We welcome the introduction of the proposed tax deduction for SUF, which will resolve on a prospective basis the long-standing industry-wide issue and provide more incentive to the MNOs to enhance their telecommunications services. However, the deductibility of SUF derived in all past auctions will remain a dispute between the MNOs and the IRD to the extent that MNOs do not agree with the IRD's current view.

Apart from the SUF, there are other 'black hole' expenditures, such as payment for acquiring indefeasible right of use in relation to communication systems and upfront payment for acquiring a franchise or licence in relation to intellectual property rights, which are essential for the conduct of business in certain industries but are not tax deductible. We urge the Government to consider providing tax deductions for other 'black hole' expenditures so long as they are incurred in producing profits chargeable to tax in Hong Kong. It is unlikely that such rights acquired will be sold for a non-taxable capital gain, and where this does happen, the inclusion of claw-back and reasonable restriction provisions should be sufficient to prevent any potential abuse. A more business friendly tax environment will encourage more investments in the relevant business sectors, including but not limited to the telecommunications industry.

If you have any questions regarding the Bill, or its impact on your operations, please do not hesitate to reach out to us.

Endnotes

1. The Bill and the Legislative Council Brief on the Bill can be accessed via these links:
   https://www.legco.gov.hk/yr2023/english/bills/b202312012.pdf
   https://www.legco.gov.hk/yr2023/english/brief/cedb815511c_20231129a-e.pdf

2. Prior to 2007, SUF were calculated based on an annual royalty method, which were considered a revenue expenditure incurred in the production of chargeable profits and tax deductible. In 2007, a one-off lump sum payment method was introduced to replace the annual royalty payment method, and an annual payment method was further introduced in 2018 as an alternative.

3. Our news flash on *China Mobile Hong Kong Company Limited v Commissioner of Inland Revenue* can be accessed via this link:
   https://www.pwchk.com/en/hk-tax-news/2022q4/hongkongtax-news-dec2022-16.pdf

4. In general, the eligible YOAs refer to the YOAs from the Assignment YOA until the YOA that ends on or before the last date of the assignment term.

5. The use of the radio spectrum that falls within a frequency band assigned to a person (Person A) is 'unilaterally transferred' to another person (Person B) if:

   (i) Person B replaces Person A as the assignee of the use of the frequency band; and

(ii) Person A does not replace Person B as the assignee of the use of any other frequency band of the radio spectrum.

6. The use of the radio spectrum that falls within a frequency band assigned to Person A is transferred to Person B on a swap if:

   (i) Person B replaces Person A as the assignee of the use of the frequency band;
   (ii) Person A replaces Person B as the assignee of the use of another frequency band of the radio spectrum; and
   (iii) despite the replacements:
      (a) the assignment term for Person A's and Person B's respective use of the radio spectrum that falls within the original frequency band (Original Use) continues to apply for their use of the radio spectrum that falls within the changed frequency band (Changed Use); and
      (b) the respective SUF payable by Person A and Person B for the Original Use continues to be so payable for the Changed Use.

7. A 'replacement' in notes 5 and 6 refers to one that occurs pursuant to the Communications Authority's exercise of a power under the Telecommunications Ordinance (Cap. 106), but does not include a sale and purchase between the persons for the use of the radio spectrum that falls within the frequency band.

Let's talk

For a deeper discussion of how this impacts your business, please contact:

PwC's Corporate Tax Leaders based in Hong Kong

Charles Lee
+852 2289 8899
charles.lee@cn.pwc.com

Jeremy Ngai
+852 2289 5616
jeremy.cm.ngai@hk.pwc.com

Jeremy Choi
+852 2289 3608
jeremy.choi@hk.pwc.com

Rex Ho
+852 2289 3026
rex.ho@hk.pwc.com

Cecilia Lee
+852 2289 5690
cecilia.sk.lee@hk.pwc.com

Jenny Tsao
+852 2289 3617
jenny.np.tsao@hk.pwc.com

Kenneth Wong
+852 2289 3822
kenneth.wong@hk.pwc.com

In the context of this News Flash, China, Mainland China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

The information contained in this publication is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. Before taking any action, please ensure that you obtain advice specific to your circumstances from your usual PwC's client service team or your other tax advisers. The materials contained in this publication were assembled on 4 December 2023 and were based on the law enforceable and information available at that time.

This News Flash is issued by **PwC's National Tax Policy Services** in Mainland China and Hong Kong, which comprises a team of experienced professionals dedicated to monitoring, studying and analysing the existing and evolving policies in taxation and other business regulations in Mainland China, Hong Kong, Singapore and Taiwan. They support PwC's partners and staff in their provision of quality professional services to businesses and maintain thought-leadership by sharing knowledge with the relevant tax and other regulatory authorities, academies, business communities, professionals and other interested parties.

For more information, please contact:

Long Ma
+86 (10) 6533 3103
long.ma@cn.pwc.com

Gwenda Ho
+852 2289 3857
gwenda.kw.ho@hk.pwc.com

Please visit PwC's websites at http://www.pwccn.com (China Home) or http://www.pwchk.com (Hong Kong Home) for practical insights and professional solutions to current and emerging business issues.

www.pwchk.com