

**立法會**  
**Legislative Council**

LC Paper No. CB(1) 345/00-01

(These minutes have been seen  
by the Administration)

Ref: CB1/BC/1/00/2

**Bills Committee on  
Inland Revenue (Amendment) Bill 2000**

**Minutes of meeting  
held on Monday, 6 November 2000, at 4:30 pm  
in Conference Room A of the Legislative Council Building**

- Members present** : Hon Eric LI Ka-cheung, JP (Chairman)  
Hon CHAN Kam-lam  
Hon SIN Chung-kai  
Hon Mrs Miriam LAU Kin-yee, JP  
Hon Ambrose LAU Hon-chuen, JP
- Member absent** : Hon Cyd HO Sau-lan
- Public officers attending** : Mr E C D'SOUZA  
Acting Commissioner of Inland Revenue
- Miss Esther LEUNG  
Principal Assistant Secretary for the Treasury
- Mr SO Chau-chuen  
Acting Assistant Commissioner of Inland Revenue
- Mr J G A GRADY  
Senior Assessor, Inland Revenue Department
- Miss Maisie CHAN  
Assistant Secretary for the Treasury
- Clerk in attendance** : Ms LEUNG Siu-kum  
Chief Assistant Secretary (1)4

**Staff in attendance** : Ms Bernice WONG  
Assistant Legal Adviser 1

Ms Rosalind MA  
Senior Assistant Secretary (1)6

---

## **I Election of Chairman**

Mr Eric LI Ka-cheung was elected Chairman of the Bills Committee.

## **II Meeting with the Administration**

### Briefing by the Administration on the Inland Revenue (Amendment) Bill 2000 (the Bill)

2. The Principal Assistant Secretary for the Treasury (PAS/T) referred members to the Legislative Council Brief of the Bill (Ref.: FIN CR 1/2306/00) and said that this was a composite bill seeking to amend a number of provisions in the Inland Revenue Ordinance (the Ordinance). She briefed members on the following areas where amendments to the Ordinance were proposed:

- (i) To amend the provisions relating to profits tax on royalty income for revenue protection reasons. The need for this amendment stemmed from a recent decision of the Court of Final Appeal (CFA) over a case submitted before it. In that case, CFA ruled that only that part of the royalty income relating to goods manufactured in Hong Kong should be chargeable to profits tax. However, this decision deviated from the long standing practice adopted by the Inland Revenue Department (IRD) under which royalty income had been charged to profits tax where the trademark had been used by a Hong Kong business entity in producing assessable profits. The place where the goods were manufactured or sold was not a matter of concern under this practice. Given that a substantial part of Hong Kong's manufacturing activities had been relocated elsewhere, this decision might give rise to significant loss of profits tax revenue. The proposed amendment enabled IRD to continue with its long standing assessing practice, which had been widely accepted by taxpayers.
- (ii) To strengthen the anti-avoidance provisions on deduction of interest expenses. It was considered necessary to tighten the existing anti-avoidance provisions in the wake of increasing incidence of aggressive tax avoidance schemes which could not readily be caught by such provisions. These involved schemes making use of various tax planning tools, such as alienation of interest income, artificial

public issue of debentures in overseas stock exchanges, and the use of trusts to disguise associate relationships between borrowers and lenders. These schemes generally had the common purpose of engineering artificial interest payment situations through circular flows of funds within companies in a group, without any genuine external borrowing which required real interest expenses. The proposed amendments would restrict more stringently the conditions governing deduction of interest payments to ensure that deduction would only be allowed if the payments were genuine interest expenses which had been made to non-associated parties.

- (iii) To amend some provisions relating to depreciation allowances for capital expenditure on industrial and commercial buildings under profits tax. Under the existing provisions, if the use of a building had been changed any time prior to its disposal, that is, from industrial to commercial or *vice versa*, all the allowances granted in respect of its previous use would not be taken into account in the calculation of the balancing allowance or balancing charge. This was not the policy intention. As it was now quite common for industrial buildings to be converted into commercial buildings, the existing provisions were vulnerable to abuse through deliberate tax planning. The proposed amendments sought to enhance the existing provisions so that all the depreciation allowances that had been granted both under a building's past or current usage could be taken into account when calculating the balancing allowance or charge at the time of the building's disposal.
- (iv) To make a number of miscellaneous amendments which could be classified into three categories: one seeking to remedy irregularities so as to clarify legislative intent, another aimed to streamline the legislative procedures regarding revision of costs and fees relating to tax appeal cases, and the third sought to repeal a number of spent provisions.

Concerns raised by the Legal Service Division  
(LC Paper No CB(1) 129/00-01(03))

*Clause 8 Home loan interest*

3. Assistant Legal Adviser 1 (ALA 1) sought clarification on the issue of fairness resulting from the retrospective application of the proposed amendments in clause 8 of the Bill in relation to home loan interest. She noted the Administration's explanation that cases where taxpayers did not apply for home loan interest deductions because of the fact that their car parking spaces had not been valued together with their dwellings as single tenements could seek remedy under section 70A of the Ordinance. Nevertheless, she considered it legally unjustified to treat the non-application for home loan interest deductions as errors or omissions to be corrected under section 70A. In addition, taxpayers who became eligible for the

interest deductions with the retrospective effect of the amendments might not know the proper means to apply for correction of their assessments under section 70A. She suggested that a clear savings provision stating a specified period for these eligible taxpayers to apply for the deduction with retrospective effect could be provided to avoid any confusion on the part of these taxpayers. The Chairman shared ALA 1's view that it would be fairer to the affected taxpayers if a clear provision in the legislation was provided for them to apply for the home loan interest deductions within a specified period.

4. The Acting Commissioner of Inland Revenue (CIR(Atg)) explained that in accordance with section 26E(8) of the Ordinance, a car parking space had to be valued together with the dwelling concerned as a single tenement by the Rating and Valuation Department in order to qualify for mortgage loan interest deduction. This had resulted in many taxpayers applying to the Commissioner of Rating and Valuation (CRV) to consolidate separate assessments of the flats and car parking spaces into joint assessments and thus posed considerable inconvenience to taxpayers as well as additional workload for CRV. The proposed amendments sought to improve the situation by removing the mandatory requirement for a single rating assessment so that a car parking space would qualify for home loan interest deduction as long as the car parking space was purchased with the same mortgage loan as the dwelling. The Administration did not anticipate that the retrospective application of the amendment would give rise to any unfairness. According to the legal advice of the Department of Justice, the arrangement for taxpayers to apply for revision of their tax assessments under section 70A to claim their eligible home loan interest deductions with retrospective effect was appropriate. A separate provision to allow for the application for such deductions was not considered necessary. However, he would consider ALA 1's suggestion if members considered that a special provision for the application for such deductions was more appropriate. PAS/T added that the suggestion was practicable in principle subject to further discussion with the Department of Justice.

Admin

#### *Clause 5 Royalty Income*

5. While noting the policy intent of the new proposed section 15(1)(b) and 15(1)(ba) was to enable CIR to continue with the established assessing practice, ALA 1 questioned why the proposed section 15(1)(b) did not contain the condition specified in the proposed section 15(1)(ba) that those sums referred to for the use of or right to use intellectual property in Hong Kong were to be deductible as expenses incurred in deriving assessable profits arising in or derived in Hong Kong.

6. CIR(Atg) explained that the proposed section 15(1)(b) was almost identical to the present section 15(1)(b) except for some minor improvement in drafting. The addition of the proposed section 15(1)(ba) was to restore the long standing assessing practice which had been widely accepted by taxpayers who had organized their affairs accordingly.

## Discussion with members

### *Revisions relating to depreciation of industrial and commercial buildings*

7. Mr SIN Chung-kai sought information on the rationale behind the proposed amendments relating to depreciation of industrial and commercial buildings. He also asked the Administration to illustrate to members the difference between the existing and the proposed provisions in the calculation of the balancing allowance or balancing charge of a building at its disposal.

8. CIR(Atg) explained that under the existing provisions, when an industrial or commercial building was disposed of, the difference between the disposal price and the written down value of the building would either be granted as a balancing allowance to the taxpayer or imposed as a balancing charge on the taxpayer, depending on whether the disposal price was lower or higher than the written down value. However, the existing calculation of the balancing allowance or charge only took into account the depreciation allowances granted in respect of the current use of the building at the time of its disposal. As a result, if there was a change in the use of a building any time prior to its disposal, the allowances granted under the previous use could not be taken into account in accordance with the existing legislation. This was not the policy intention. With the increasing trend for industrial buildings to be converted into commercial buildings, the existing provisions had become vulnerable to abuse through deliberate tax planning. The proposed amendments were thus considered necessary to enable the aggregation of all the depreciation allowances granted to a building under its current and previous uses for calculation of the balancing allowance or charge at its disposal.

9. The Acting Assistant Commissioner of Inland Revenue (ACIR(Atg)) illustrated the differences between the calculation of the balancing allowance or charge with an example of an industrial building with the purchase price of \$1 million. With the 20 % initial depreciation allowance and 4 % annual allowance, its written down value would be below \$1million. If the building was converted into a commercial building afterwards and disposed of under its commercial use, the depreciation allowances granted during its previous use as an industrial building would not be taken into account in accordance with the existing provisions, resulting in a higher written down value at disposal and thus giving a higher balancing allowance to or a lower balancing charge on the taxpayer compared with the amount calculated had the use of the building not been changed prior to its disposal.

10. In response to Mr SIN Chung-kai's question on the required procedures for the conversion of the use of a building from industrial to commercial and *vice versa*, ACIR(Atg) said that the definition of industrial buildings was clearly given under section 40 of the Ordinance. Changes in the use of an industrial building deviating from the stated definition would mean that the building concerned had been changed to commercial use and no formal procedure would be required for the conversion. The definition on the use of the building under the Ordinance was for the purpose of tax assessment only. He took the example of the changes in use of some industrial buildings in San Po Kong from manufacturing to storage as a result of the removal of

the manufacturing industry to the Mainland in recent years. These buildings would be classified as commercial ones under the Ordinance.

11. Mr SIN Chung-kai doubted whether the inconsistency in the definitions of industrial and commercial buildings between different ordinances would cause any confusion to the public. ACIR(Atg) said that the definition under section 40 of the Ordinance had been in use for many years. There had not been any dispute in this regard. As far as revenue collection was concerned, no confusion or problem had been detected.

*Revisions relating to anti-avoidance provisions on deduction of interest expenses*

12. The Chairman raised concern about the possible problems arising from the proposed amendments to section 16(2) to tighten the existing anti-avoidance provisions. He pointed out that if government-owned organizations such as the Mass Transit Railway Corporation (MTRC) issued debentures to raise funds in the market and part of the debentures were acquired by government funded or related organizations, the interest expenses of MTRC in relation to all the debentures issued would become non-deductible under the proposed provisions. The same problem would also be faced by large international corporations with hundreds of overseas subsidiaries. These corporations might easily fall into the trap of having all the interest expenses on debentures non-deductible because any one of their acquired subsidiaries might have acquired a portion of the debentures they issued, disregard the amount, and it could be without the knowledge of the corporations. He said that tax practitioners and chief financial officers of big corporations had particular concern on the impact of the proposed provisions on the deductibility of interest expenses. He warned that the proposed provisions might turn out to be imposing penalty on big corporations, especially those based overseas.

13. CIR(Atg) replied that the purpose of the proposed amendments to section 16(2) was to add restrictions on the deductibility of interest expenses to strengthen the anti-avoidance provisions. The problem which organizations like MTRC might encounter could be resolved if the interests received by the associated corporations were taxable under other provisions of the Ordinance. The interest expenses of MTRC would be tax deductible under such circumstances. Nevertheless, he agreed that the Administration had to consider further the consequences in cases where the interest-receiving associates of the corporations concerned were non-taxable organizations.

14. CIR(Atg) fully appreciated the possible impact of the proposed amendments on large international corporations with subsidiaries worldwide. However, this would be a problem for the corporations concerned to resolve on their own. The policy intention of the proposed amendments was that tax deduction should not be granted if interest expenses were not really incurred in the group context of the corporations concerned. He considered that a corporate group could formulate its own business policy to impose restrictions on its individual corporation as to what suitable stocks and debentures they should subscribe for.

15. The Chairman further raised two points for clarification relating to the drafting. He pointed out that the wordings used in relation to debentures in the proposed section 16(2)(f) seemed to depart from the increasingly popular corporate practice in the certification of debentures. Moreover, the use of the word "payable" in the proposed section 16 seemed to imply retrospective application of the proposed restrictions of tax deductibility, which he believed should not be the intention in drafting. CIR(Atg) responded that the Administration would further look into the definition of debentures and the drafting of the proposed section 16 in relation to the Chairman's concern.

Admin

16. Mr SIN Chung-kai expressed concern about the impact of the proposed amendments to section 16(2). He said that there were public concern on these amendments. To facilitate members' understanding of the proposals, he requested the Administration to give a briefing on the comparison between the existing and the proposed legislation relating to anti-avoidance provisions on deduction of interest expenses. Mrs Miriam LAU shared his view and suggested that examples should be given to illustrate how the proposed provisions could combat tax avoidance schemes more effectively than the existing ones.

17. CIR(Atg) appreciated members' concern over the proposed amendments to section 16(2)(f). Nevertheless, he pointed out that though these proposals seemed to be the most contentious ones among others in the Bill, they were in fact not matters of wide public concern. The number of known groups was in fact less than ten, yet the amount of tax involved was well in excess of \$ 2 billion. As regards the briefing requested by members on section 16(2), he undertook to arrange it in two weeks' time so that members could have a better understanding of the Bill before considering submissions from the public.

*Revisions relating to royalty income*

18. The Chairman expressed concern about the rationale behind changing the territorial rule in the taxability of royalty income with the introduction of the proposed section 15(1)(ba). He said that it had been the practice under the existing legislation to allow for taxing only a proportion of the royalty income in cases where the territorial issue was too ambiguous to resolve. However, the proposed provision would bring all royalty income or receipts which were currently tax deductible expenses of the paying company in Hong Kong chargeable to Profits Tax.

19. CIR(Atg) explained that in practice, IRD would accept taxing a proportion of the royalty income in appropriate circumstances. Such an arrangement would only be made where the profits were shared in proportion. This would still be allowed after the proposed amendment to section 15(1) was enacted.

*Public consultation and the way forward*

20. Noting that no public consultation had been carried out on the Bill, Mrs Miriam LAU expressed concern over the need for a proper consultation, especially with those affected parties such as the tax practitioners and the business corporations.

21. CIR(Atg) said that the Administration had consulted the Joint Liaison Committee on Taxation (JLCT) regarding the legislative intention of the proposed amendments before the bill was gazetted on 5 October. The Administration did not seek the views of JLCT on the detail drafting of the amendments as it was considered more appropriate to leave the work of drafting to the Administration. The Administration was willing to take on board any comments, criticisms and recommendations the tax paying community might have on the proposed amendments.

22. The Chairman said that as the Bill was a rather complicated and technical piece of draft legislation, members might need some time to digest its content and issues involved. This meeting would only serve as a kick-off to reveal some of the problems and concerns relating to the Bill. The Bills Committee should allow some time for the concerned parties to prepare their submissions before inviting deputations to make their presentations to the Bills Committee. He suggested and members agreed that instead of sending written invitations to different organizations for submissions, the Bills Committee would make an electronic invitation for submissions through the Legislative Council web site. Members agreed that two weeks should be allowed for the public to give their submissions to the Bills Committee and a meeting should be arranged in early December 2000 to receive deputations.

*(Post-meeting note: An invitation for submissions to the Bill was put on the Legislative Council web site on 7 November 2000, with the closing date for submissions on 21 November 2000.)*

### Date of future meetings

23. Members agreed that the second meeting of the Bills Committee would be held on Monday, 20 November 2000 for detailed explanation on the proposals in the Bill by the Administration. The third meeting was scheduled for Monday, 4 December 2000 at 4:30 pm to receive deputations.

*(Post-meeting note: The second meeting scheduled for 20 November 2000 would be held at 9:00 am instead of 10:45 am as originally proposed.)*

### **III Any other business**

24. There being no other business, the meeting ended at 5:50 pm.

Legislative Council Secretariat  
30 November 2000