

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

**Minutes of meeting
held on Monday, 4 December 2000, at 4:30 p.m.
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-ye, JP
Hon Ambrose LAU Hon-chuen, JP
- Public officers attending** : Ms Esther LEUNG
Principal Assistant Secretary for the Treasury
- Miss Maisie CHAN
Assistant Secretary for the Treasury
- Mr E C D' SOUZA
Acting Commissioner of Inland Revenue
- Mr Patrick TAM
Assistant Commissioner of Inland Revenue
- Mr J G A GRADY
Senior Assessor, Inland Revenue Department
- Mr TAM Tai-pang
Senior Assessor, Inland Revenue Department
- Ms Betty CHOI
Senior Government Counsel

- Attendance by invitation** : PricewaterhouseCoopers Ltd.
Mr Rod HOUNG-LEE
Partner, PricewaterhouseCoopers Ltd.
- The Association of Chartered Certified Accountants Hong Kong
Mr Jimmy CHUNG
Chairman of Budget & Tax Sub-committee
- Mr Alex WONG
Member of Budget & Tax Sub-committee Immediate Past Chairman
- The Taxation Institute of Hong Kong
Mr Thomas LEE
President, Taxation Institute of Hong Kong
- Mr LI Man-fai
Vice-President, Taxation Institute of Hong Kong
- Mr Marcellus WONG
Council Member, Taxation Institute of Hong Kong and Convenor, Taxation Review Committee
- Hong Kong Society of Accountants
Mr Tim LUI
Chairman of Taxation Committee, HKSA
- Mr David SMITH
Member of Taxation Committee, HKSA
- Mr Peter TISMAN
Deputy Director (Professional Practices), HKSA
- Clerk in attendance** : Ms LEUNG Siu-kum
Chief Assistant Secretary (1)4

Staff in attendance : Ms Bernice WONG
Assistant Legal Adviser 1

Mrs Florence LAM
Chief Assistant Secretary (3)2

Mrs Queenie YU
Senior Assistant Secretary (1)6 (Des)

I Meeting with deputations

The Chairman briefed members that the purpose of the meeting was to listen to views of four attending deputations on the Bill. He said that two other deputations namely, the Hong Kong General Chamber of Commerce, and WOO, KWAN, LEE & LO Solicitors sent in their written submissions before the meeting which had already been issued to members. Some deputations had indicated that they would provide their submissions in due course and the Administration was in the process of consulting relevant organization such as the Hong Kong Monetary Authority.

2. The Chairman welcomed representatives of the Administration and four deputations to the meeting. He then invited representatives of each of the attending deputations to give their views on the Bill.

(i) PricewaterhouseCoopers Ltd
(LC Paper Nos. CB(1) 248/00-01(01) and CB(1) 273/00-01(03))

3. Mr Rod HOUNG-LEE of PricewaterhouseCoopers Ltd. (Pricewaterhouse) said that the proposed section 15(1)(ba) extended too far the traditional source concept in Hong Kong tax regime. It brought into Hong Kong profits tax net, a person who received sums for the use or the right to use certain intellectual property outside Hong Kong, which were currently deductible in ascertaining the Hong Kong assessable profits of the payer. The Administration's rationale for the proposed amendment was based on the assumption that tax symmetry was good and lack of tax symmetry was bad. Nevertheless, he pointed out that such symmetry did not apply to many types of businesses. For example, a Hong Kong company might have to seek advice from overseas companies in undertaking a project on a regional basis, whilst the company claimed a tax deduction for such service payment in Hong Kong, the payment made to the overseas company was not taxable in Hong Kong. This was common especially in international retailing business or companies providing professional services in accounting, architectural, engineering, advertising field etc. Pricewaterhouse believed that if the proposed amendment was passed, it would send a strong negative signal that the Government was now prepared to deviate from the time honoured source concept in its tax regime. It would create

uncertainty for businesses in Hong Kong and overseas as to whether their profits derived from outside Hong Kong might one day be deemed to be taxable in Hong Kong. To minimize the loss of revenue arising from tax on royalty income, Mr Rod HOUNG-LEE suggested that the Administration should review the general application of the anti-avoidance provisions or the arrangement for the basic transfer pricing rule.

4. Referring to the proposed section 16(2)(d) of the Bill, Mr ROD HOUNG-LEE expressed concern on the effects of the proposed amendment under the way it was currently drafted. He appreciated that the objective of the proposed section 16(2)(d) was to ensure that any person who was entitled to interest payment on the money borrowed by a taxpayer from a financial institution or an overseas financial institution would not be the borrower or an associate of the borrower. However, he was opposed to the arrangement that the whole sum of interest payment would not be tax deductible even if only part of the loan was secured by another loan or a deposit. He cited as an example, if there was \$100 of interest, \$2 of that sum was received by a person who was an associate of the borrower, the whole sum of interest would be technically not tax deductible. Similarly, he referred to the proposed section 16(2)(f) which disallowed the deductions for whole of interest payment on debentures or other financial instruments even if one of the holders of the debentures or instrument was the taxpaying corporation itself or its associate.

5. With the aid of a chart tabled by Pricewaterhouse at the meeting, Mr Rod HOUNG-LEE explained the mechanism of a typical securitisation structure for on-going commercial transactions such as, corporate loans or mortgage loans. He illustrated how an issuer raised funds from the international market or institutional investors and acquired a legal ownership of loan from the originator or servicer. He said that the issuer had to get a tax deduction on the debt it raised either in Hong Kong or internationally to finance the acquisition of the loans, otherwise the securitisation would not be feasible. He envisaged that the proposed section 16(2) would have a detrimental impact on many genuine business transactions. It would also create an undue administrative burden for Hong Kong companies that borrowed money in the ordinary course of business and hinder the attempts of the Government to promote a debt capital market in Hong Kong.

6. Referring to the table prepared by Pricewaterhouse on marketable security, Mr Rod HOUNG-LEE illustrated the following two situations relating to section 16(2)(f) :

- (a) Even if an associate of the Hong Kong borrower paid Hong Kong tax, the whole of interest of the debentures or marketable financial instruments bought by the associate would become not tax deductible; and

- (b) If an associate of the Hong Kong borrower bought, say, only 5% of the debentures or marketable financial instruments, 100% of the interest payment on the debentures of marketable financial instruments of the Hong Kong borrower would be disallowed for tax deduction.

7. Mr Rod HOUNG-LEE said that the proposed amendments of sections 16(2)(d) and 16(2)(f) would hinder underwriters and issuers of marketable securities of Hong Kong from promoting debenture markets or marketable financial instruments.

- (ii) The Taxation Institute of Hong Kong
(LC Paper No. CB(1) 248/00-01 (03))

8. Mr Marcellus WONG of the Taxation Institute of Hong Kong (TIHK) briefed members on the concerns detailed in their submission. The gist of which was highlighted in the following paragraphs.

9. Referring to the proposed section 12(6)(c) of the Bill, Mr Marcellus WONG said that the necessary conditions for taxpayers to claim expenses of self-education were too restrictive. For taxpayers who were proactive to invest their time and effort in upgrading themselves in new areas, it might be difficult for them to satisfy or prove at the point of time when they incurred the expenses that the qualifications gained were “for use in any employment”. This was against the promotion of life-long learning culture by the Government. He also said that in the proposed amendment, a prescribed course of education included a training or development course provided by a trade, professional or business association for its members. TIHK considered that the term “members” was too general and might create confusion, it should be clearly spelled out in the definition that “members” should include student members and non-voting members of a trade, professional or business association.

10. Referring to the proposed section 15(1)(ba) on royalty income, Mr Marcellus WONG said that whilst TIHK appreciated the Administration’s concern on the potential loss of revenue, it shared the view of Pricewaterhouse that the proposed amendment would set a bad precedent of explicitly violating the territorial based taxation principle of Hong Kong tax system. He further brought members through the two examples set out in their submission which illustrated how the new section 15(1)(ba) might create unfair tax treatments for some taxpayers. TIHK considered that the problem should be better dealt with under section 17(1) to disallow tax deduction for the royalty payments if the income was not subject to Hong Kong tax.

11. As regards the proposed amendments to section 16(2), Mr Marcellus WONG appreciated that the purpose of the amendments was to counteract various tax-avoidance arrangements which were currently dealt with under the general anti-avoidance provision under section 61A on a case-by-case bases. TIHK however shared the views presented by Pricewaterhouse and believed that the proposed amendments would unnecessarily hinder genuine business transactions, create

unnecessary hardships for businesses to consider cost effective sources of finance and significantly reduce Hong Kong's attractiveness to be a debt capital market. More specifically, he said that the definition of "associate" was so wide that it might trap genuine lending and borrowing transactions with the result that the related interest expenses were not qualified for deduction because of the restrictions of the new section 16(2) without the awareness of such consequences by both the lender and the borrower. He then brought members through the two examples and some potential problems detailed in paragraphs 10 and 11 of their submission on how the proposed amendments might discourage underwriters from entering into financial transactions.

12. Referring to the proposed section 16(2)(f)(iii)(A) which suggested that existence of one related holder of the financial instruments at any one time, even if there were thousands of genuine holders, would render the whole of the interest costs of the debt issue non-deductible, Mr Marcellus WONG said that the absence of a mechanism of apportionment of interest expenses for deduction purposes would be very unfair to the taxpayers. He also pointed out that the word "entitled" under the proposed sections 16(2)(d)(i), 16(2)(e)(ii)(c) and 16(2)(f)(iii)(c) should be clarified as whether it was the legal or beneficial interest in the interest sum that the sections were referring to.

13. Mr Marcellus WONG said that if the Government believed that the current section 61A was not sufficient to achieve the purpose of combating tax-avoidance practices, an inclusion of a "motive" or "purpose" test in the relevant provisions to combat tax-avoidance arrangements could be considered. Alternatively, a discretionary power could be given to the Commissioner of Inland Revenue to disregard the operative provisions, such as the one in section 9A, to avoid the denial of interest expenses incurred under genuine commercial loans or financing transactions. He stressed that genuine business transactions should not be affected only because someone had abused the system.

(iii) The Association of Chartered Certified Accountants Hong Kong
(LC Paper No. CB(1) 248/00-01(02))

14. Mr Alex WONG of the Association of Chartered Certified Accountants Hong Kong (ACCA) briefed members that they shared similar views with the other deputations on the proposed section 15(1)(ba). He also pointed out that it was not clear whether the expenses attributable to offshore income were regarded as non-deductible or merely excluded from the calculation of assessable profits as a concession particularly, in the case of 50/50 claim for the Mainland's processing arrangement and, in consequence, whether the expenses were within the scope of section 15(1)(ba).

15. Mr Alex WONG appreciated that the proposed amendment on section 26E would allow home loan interest deduction be extended to car parking spaces which were not valued together with dwellings. However, he noted that the amendment if passed would apply with effect from assessment year of 1998-99 and expressed

concern that this should not set a precedent to introduce retrospective legislation in the future. In addition, he said that under the existing provisions of section 26E, a married couple who jointly owned a property were entitled to a tax deduction of \$50 000 which was the same amount granted to a single person who owned a property. He suggested that the Administration should take the opportunity to remedy this unfairness and raise the tax deduction ceiling for married couples to \$100 000.

16. Mr Jimmy CHUNG of ACCA also briefed members on ACCA's views on proposed amendments for section 16(2) as detailed in their submission which were consistent with the views expressed by the other deputations. He also referred to the proposed section 16(2)(e)(D) which disallowed interest expense deduction on any borrowing specific for the acquisition of plant and machinery or trading stock where the borrowing was, directly or indirectly and in part or whole, secured by a non-taxable deposit or loan. He said that the proposal ignored the commercial practice that banks generally required a credit line be secured by an acceptable form of securities. As regards the proposed section 16(2)(f), he pointed out that the proposal ignored the fact that most of the issues of debentures or instruments were for genuine fund raising and financial management purposes. He said that either the issuer or an associated person might from time to time acquire part of the issue, for example, when it was cheaper to borrow from the market instead of paying interest at the rate pre-determined by the issue or when there was a perceived need of using the instruments to secure ownership control of the issuer or an associated company.

(iv) Hong Kong Society of Accountants
(LC Paper No. CB(1) 248/00-01(04))

17. Mr Tim LUI of Hong Kong Society of Accountants (HKSA) briefed members on their submission on the proposed section 15. HKSA agreed with the views of the other deputations. He said that the principle of tax symmetry between taxability and deductibility which was introduced explicitly by the Bill, did not currently constitute part of Hong Kong's framework of taxation. The proposal would represent a policy change that should be brought out into the open and fully debated.

18. Referring to the proposed section 16(2)(f), Mr David SMITH of HKSA briefed members that sometimes it would be beyond an issuer's control to prevent an associate acquiring debentures. In addition to the examples cited by the previous speakers, he said that the breadth of the definition of "associate" would mean, for example, if any bonds issued by the Mass Transit Railway Corporation were acquired by the Kowloon Canton Railway Corporation, the entire interest paid on the whole of the bond issue would strictly become non-deductible. He said that the Bill needed to be amended in the following ways:

- (a) There should be a de minimis exemption for the provision. Any interest disallowance should only apply where more than, say, 5% of the issue was in the hands of associates;
- (b) The disallowance should apply only in respect of that interest actually paid to associates, leaving the interest paid to non-associates deductible;
- (c) The definition of “debenture” and “instrument” in the proposed section 16(2)(f) to be extended to tradable interests in global notes to reflect the current situation in financial markets; and
- (d) To clearly define in what sense the money borrowed in the situations described in sections 16(2)(d)(ii) and 16(2)(e) could be said to be secured by a loan.

Questions from members

19. Referring to the comment made by Mr Marcellus WONG of TIHK that the definition of “associate” was too broad, the Chairman asked whether TIHK wished to make any proposed amendments to give a narrower definition to the term in the existing legislation. Mr Marcellus WONG clarified that TIHK wished to caution the Administration that the application of the broad definition of “associate” might result in extensive unforeseen circumstances which would cause serious hardship to lenders and borrowers in entering commercial undertakings. He said that TIHK was of the view that section 16(2) was too harsh and it would be more appropriate for the Administration to tighten the existing anti-avoidance provisions in section 61A. The Chairman opined that it would defeat the purpose of the proposed amendments if section 61A was to continue to be used. Mr Marcellus WONG said that it would be the ideal outcome, otherwise, the Administration could consider alternative suggestions put forward by the deputations to reduce the adverse impact of the proposed section 16(2).

20. Referring to the comment made by Mr Alex WONG of ACCA that the proposed section 15(1)(ba) seemed to change the current arrangement of allowing apportionment of expenses attributable to offshore income tax-deductible, the Chairman opined that the proposed section 15(1)(ba) did not specify that this arrangement would no longer be allowed. Mr Alex WONG explained that the apportionment arrangement was not incorporated in the existing Inland Revenue Ordinance, it was a current administrative arrangement. Nevertheless, the proposed section 15(1)(ba) provided that all sums payable for the use of intellectual property, which were deductible expenses of the payer in ascertaining his assessable profits were chargeable to tax in Hong Kong. In other words, all expenses would be taxable under the proposed amendments to section 15(1)(ba). To avoid uncertainty, relevant amendments would have to be made to the Inland Revenue Ordinance to specify that the apportionment arrangement was allowed.

21. Referring to the suggestion put forward by Mr David SMITH of HKSA that a 5% de minimis exemption should be provided in the proposed section 16(2)(f), the Chairman asked whether similar suggestion was appropriate for section 16(2)(d). Mr David SMITH replied that it was not appropriate to apply a de minimis exemption to section 16(2)(d). Instead, HKSA was more concerned about the amount of tax deduction allowed for the interest expenses if the loan was only secured in part.

22. Referring to the suggestion by the deputations that the Administration should deal with tax avoidance cases by using the existing anti-avoidance provisions under section 61A of the Inland Revenue Ordinance, Mrs Miriam LAU asked whether section 61A could be strengthened to address the anti-avoidance situations encountered by the Administration. Mr David SMITH clarified that section 61A comprised a very wide range of provisions which could not be strengthened any further. He explained that the current provisions in a nutshell provided that when a taxpayer benefited from a transaction and would be concluded that the sole dominant purpose of doing the transaction was to get a tax benefit, then the tax benefit would be taken from the taxpayer. In his opinion, it would be an impossible task for the Administration to codify accepted or not accepted cases. He recommended that the Administration should not proceed with the proposed amendments in section 16(2)(f).

23. The Chairman referred members to the wordings of section 61A. He said that in deciding whether a case involved a genuine commercial scheme or tax avoidance scheme, the court would look at the whole of the circumstances and interpret the fact and the motive of the transaction. On the other hand, the new anti-avoidance clause worked very mechanically which would just look at hard facts to prove or disprove a case. It could therefore bring some unexpected results.

II Meeting with the Administration (LC Paper No. CB(1) 248/00-01(07))

24. At the invitation of the Chairman, the Acting Commissioner of Inland Revenue (CIR(Atg)) made the following responses to the deputations' views:

- (a) The wide definition of self-education expenses would not be a problem in its interpretation. For examples, if a senior partner of a company claimed expenses for driving lessons, there would be queries from the Administration whereas if he took a course on putonghua, the claim would be accepted;
- (b) The Administration would take on board the views of the deputations on section 26E. The Administration had no intention to introduce retrospective legislation in any way. It was only a concession made to the taxpayers;

- (c) The Administration would definitely take on board the serious concern raised by the deputations on section 15 that the territorial source concept was breached. He said that the words "the use of or right to use intellectual property in Hong Kong" could be interpreted in two ways. The narrower way would be to look at the terms of the relevant agreement to determine the source of income as in the recent Emerson court case. The Administration had been adopting a wider interpretation since 1971, i.e., if a Hong Kong business incurred royalty expenses to earn Hong Kong sourced profits, there was a use of the intellectual property concerned in Hong Kong. The Administration anticipated that there would be a significant erosion of revenue if the proposal to remedy tax-avoidance was not to be considered; and
- (d) The Administration would take on board the views of the deputations on section 16(2) and arrange meetings to discuss their concerns, and see how best these could be resolved. Whilst appreciating the views and suggestions to overcome the difficulties anticipated by the deputations, the Administration considered that there would be significant problems in monitoring and administering their suggestions and that there would still be potential scope for abuse.

Admin

25. Mr SIN Chung-kai opined that given there were divided views on the basic principles of the proposed amendments of the Bill, it might not be worth discussing in detail the technical aspects of the Bill at the present stage. He proposed the following approaches on the way forward for the Administration to consider:

- (a) To continue processing only those proposed sections of the Bill which were not controversial;
- (b) To withdraw the Bill by the Administration; and
- (c) To consult the trade further with a view to resolving major differences and come up with CSA for the Bills Committee to reconsider when available.

26. Mrs Miriam LAU Kin-yee shared Mr SIN's view. She said that the worries expressed by the attending deputations were serious as the proposed amendments contravened the basic taxation principle and would have adverse impact on genuine commercial dealings to a large extent. Mr CHAN Kam-lam also agreed and said that the Administration should strike a balance in improving the anti-avoidance provisions whilst maintaining genuine commercial undertakings. The Chairman said that the Administration should take full advantage of the present opportunity to consult the public on the anti-avoidance provisions.

27. The Principal Assistant Secretary for the Treasury (PAS(T)) responded that sections 15 and 16 were the major parts of the proposed amendments of the Bill. She opined that there was no point to push ahead the other minor amendments which

were considered less controversial. The Administration was prepared to examine all the submissions from the deputations for detailed analysis with a view to improving the proposed amendments of the Bill. She stressed the need to strike a balance in protecting revenue whilst ensuring that genuine commercial transactions would not be adversely affected. She agreed that the existing section 61A was not an effective provision to tackle anti-avoidance cases. Referring to Mr SIN's options on the way forward, PAS(T) said that the Administration was prepared to take option (c).

The
Chairman

28. The Chairman said that in the circumstance he would liaise with the Administration for the best time to resume the next meeting date. In the meantime, if further submissions were received by the Bills Committee, members would assess the need to hold further meetings to receive different views. Mrs Miriam LAU referred members to the discussion on Inland Revenue (Amendment) Bill 1984 recorded in the Hansard, she said that other than the accounting trade, concerns were also raised by the textiles and clothing industries. She opined that the Bills Committee should also listen to views from other trade or industries. The Chairman responded that submissions from the commerce and legal sector had been received. Mr SIN reminded the meeting that the Bills Committee placed an invitation for submissions on the Bill on the web site in November. He suggested that the Administration should consult different trade or industries in working out their proposals.

III Any other business

29. There being no other business, the meeting ended at 6:30 p.m.

Legislative Council Secretariat

6 February 2001