DUTIABLE COMMODITIES (AMENDMENT) (NO. 2) BILL 1984

THE FINANCIAL SECRETARY moved the second reading of:—'A bill to amend the Dutiable Commodities Ordinance'.

He said:—Sir, I move that the Dutiable Commodities (Amendment) (No. 2) Bill 1984 be read for the second time.

The Bill seeks to amend the minimum required strength for whisky and rum from 43% to 42% of ethyl alcohol by volume, so as to correct a technical error following the metrication of the Dutiable Commodities Ordinance.

The amendment will have no financial and little other implications. (*laughter*)

Sir, I move that the debate on the motion be now adjourned.

Motion made. That the debate on the second reading of the Bill be adjourned—THE FINANCIAL SECRETARY.

Question put and agreed to.

INLAND REVENUE (AMENDMENT) BILL 1984

THE FINANCIAL SECRETARY moved the second reading of:—'A bill to amend the Inland Revenue Ordinance'.

He said:—Sir, I move that the Inland Revenue (Amendment) Bill 1984 be read the second time.

This Bill seeks to give legislative effect to the proposals made in paragraphs 136 to 140 of this year's budget speech—

firstly, to increase, with effect from the year of assessment 1984–85, the standard rate of tax from 15% to 17% and the profits tax rate applicable to corporations from 16½% to 18½%;

secondly, to provide, with effect from 1 April 1984, measures to minimize potential losses of profits tax revenue (following the removal of the interest tax charge from interest on deposits with financial institutions), by stipulating the conditions which must henceforth be complied with in order to qualify interest payments as deductible expenses in the computation of assessable business profits; and

thirdly, again with effect from 1 April 1984, to bring to charge to profits tax sums received by or accruing by way of interest to businesses carried on in Hong Kong which had previously escaped the tax net, either because the deposits were denominated in a non-Hong Kong currency, or because of the application of the artificial 'provision of credit' test.

These proposals were the subject of a Revenue Protection Order, signed on 30 March 1984. They have been exhaustively debated in this Council. I do not therefore again intend to expand on them. Following publication of the Order, they have been the subject of several representations by various interested person and institutions to the UMELCO Office and to the Administration. Some have been entirely reasonable. The Bill now tabled before this Council reflects changes which the Administration has agreed should be made to the Bill. They have emanated from most helpful discussions which have taken place with a Legislative Council *Ad Hoc* Group, with whom agreement has been reached on the acceptability of various representations, while retaining the overall philosophy of my proposals. I believe that the changes proposed will meet with the approval of the business community in particular, and the general public at large. They seem to me to be fair. Specifically, the refinements contained in the Bill—

(i) make clear that the new provisions will apply only to interest payable or receivable on or after 1 April 1984;

(ii) provide that the relief presently available to financial institutions in respect of foreign taxes suffered on interest income brought to charge to tax will be available to all other corporations managed and controlled here and to all other persons who carry on business here;

(iii) ensure that those who purchase machinery or plant or stock-in-trade on credit terms will receive a full deduction for any related interest payments, provided that the transactions involved are at arms length with persons who are not closely connected to the taxpayer; and

(iv) lastly, refine the definition of an 'overseas financial institution' to provide the Commissioner of Inland Revenue with powers to refuse to recognize any such institution if he is of the opinion that it is not adequately supervised by a supervisory authority.

Since these changes were agreed two further issues have surfaced. Firstly, the point has been made that interest payments in relation to publicly listed Bonds, issued prior to 1 April 1984, ought not to be subject to the new conditions for deductibility. Secondly, it has been suggested that interest income received by authorized unit trusts should not be subject to the extended charge to tax on such income on the ground that this would inhibit the growth of the unit trust industry in Hong Kong, to the detriment of Hong Kong's position as an international financial centre. I have been advised that Unofficial Members may comment in these two specific areas. It thus seems wise for me to await their views. Committee stage amendments are of course still possible. The Government is always responsive to constructive criticism.

Sir, I move that the debate on this motion be now adjourned.

Motion made. That the debate on the second reading of the Bill be adjourned—THE FINANCIAL SECRETARY.

Question put and agreed to.

DUTIABLE COMMODITIES (AMENDMENT) (NO. 2) BILL 1984

Resumption of debate on second reading (30 May 1984)

Question proposed.

Question put and agreed to.

Bill read the second time.

Bill committed to a committee of the whole Council pursuant to Standing Order 43(1).

INLAND REVENUE (AMENDMENT) BILL 1984

Resumption of debate on second reading (30 May 1984)

Question proposed.

MR. BROWN:—Sir, this Bill has a number of unique features, not least of which is the amount of adverse criticism it attracted prior to being written.

During the budget debate on 29 March I admitted to being a cautious man and suggested it would be more appropriate to study this legislation once it had seen the light of day. My colleagues and I have done just that, and we have examined it closely bearing in mind the very many representations received both prior and susequent to the publication of the Bill.

Although this Bill was initially studied by the Legislative Council Monetary Policy Group, it was decided to expand the membership of that Group into a special *Ad-hoc* Group so that the many issues raised by both professional bodies and ordinary members of the public could be considered by a wider spectrum of experience. Sir, I speak as its Convener.

Representations received from the public ranged from the general to the particular. Whilst the former were interesting—and indeed on occasions, I might say, as colourful as the public responses they elicited from the Financial Secretary—the *Ad-hoc* Group concentrated its attention on the facts.

It is a fact—an undisputed one as far as I am aware—that retrospective taxation is bad in principle. It is a fact that the Bill, as originally published together with the Public Revenue Protection (Inland Revenue) Order on 30 March, contained provisions which were retrospective in that certain items were newly brought to charge with effect from a date prior to 1 April 1984. This has been accepted as a valid criticism by the Administration, and I am happy to

record, as a matter of fact, that the refinements to the original draft of this Bill to remedy this particular issue are accepted as being entirely satisfactory to Unofficial Members.

Another issue, regarding which the facts are not in dispute, is the desirability of making provision for foreign tax relief. This is not a matter of principle, but most jurisdictions do make such provision and, given Hong Kong's status in the international financial arena, it is desirable that we do likewise. The Administration has accepted this point of view and again the refinement to the Bill to achieve this objective is also applauded.

A matter which caused more difficulty was the undeniable fact that in throwing out the water dirtied by tax avoidance measures, the Bill, in its original form, also threw out the baby of genuine business transactions. Unofficials are of like mind with the Official Members of this Council regarding the need to preserve the yield from profits tax, and this was amply demonstrated, I think, in the budget debate speeches.

The result of much heartsearching over the need to support the principles on which we are all agreed, and the need to accommodate the very genuine fears that the measures as proposed would be detrimental to economic growth, is reflected in further significant refinements of the Bill. Although these amendments will not please everyone, they do remove most genuine business transaction from the ambit of the new proposals. Unofficial Members believe the refinements are a sensible solution to the problems highlighted by public debate, and they therefore support them. However, I feel sure that the Financial Secretary would agree with me that in legislation of this nature actual experience of its working will probably reveal the need for further fine tuning, and indeed it is clear from the remarks he made when introducing this Bill on 30 May that the Administration remains responsive to sensible suggestions to remedy any unforeseen effects which may result from the Bill's application. One area that I believe will require watching is the possible impact of the decision to disallow for tax relief interest paid by a Hong Kong subsidiary or associated company to an overseas parent. Many multi-national corporations finance their subsidiaries from a central treasury and whilst, therefore, clause 4(*e*) is a welcome refinement to the original proposals the provisions detailed under (B) and (C) of this clause may require reconsideration in the light of experience.

Sir, in the Budget Debate I made reference to the need to spell out in clear and precise terms what is meant by 'carrying on business in Hong Kong' in the context of tax legislation. Alas, I appear to have asked for the impossible. It would seem that a precise definition is beyond the ability of the English language, at least in its legal usage, and I assume incidentally the same applies to Chinese. The worries expressed in this connection therefore remain, but Unofficial Members have been given an undertaking that a 'Departmental Interpretation and Practising Note' will be issued so that the public will be aware of the Inland Revenue Department's current interpretation of this simple

phrase—a phrase that has such crucial importance as to whether tax is or is not payable. I understand that this Note will be issued shortly after this Bill has been enacted—assuming that it reaches the statute book as now intended.

Turning to the subject of the territorial source concept Unofficials have already made their position clear on the need not to compromise this corner stone of our tax legislation. We were most satisfied by the unequivocal undertaking given by the Financial Secretary in this Council on 25 April 1984 when he reiterated that the Government remained wedded to the principle that taxation should only be applied to income arising from Hong Kong. Never the one to mince his words, the Financial Secretary underlined this commitment by stating categorically that no proposals made by him to Executive Council would include changes to the basic territorial source criterion. I mention this this afternoon partly to underline the importance of the undertaking made, and partly because it does answer—and answer most satisfactorily—many representations we received on this key issue.

Whilst considerable changes were made to the original draft of this Bill before it was presented to us for its first reading—and such changes cover the most important issues considered by the *Ad-hoc* Committee—a number of other matters have subsequently arisen which have deserved careful deliberation. The *Ad-hoc* Committee believes that two of these merit amendments to the Bill at the committee stage. My Colleagues Messrs. Peter C. WONG and Peter POON will move these amendments, which I understand are acceptable to the Administration, and they will explain the reasons for them in their own speeches later in this debate.

Sir, it is the right of Government to introduce legislation to counter tax avoidance, and indeed it is its duty to do so. It is the duty of this Council to ensure that measures of this nature achieve their objective in a manner that is fair, and is seen to be fair, to all tax payers. The *Ad-hoc* Group is satisfied, subject to the agreed amendments to be passed at the committee stage, that the Bill now meets this criteria.

It follows, Sir, that I support the Motion.

MR. PETER C. WONG:—Sir, Mr. BROWN has covered fairly exhaustively the various aspects of the Bill, public reactions and representations, deliberations by Unofficial Members and discussions with the Administration.

I shall confine my remarks to the amendment relating to unit trusts which I will move at the committee stage.

With effect from 1 April 1984, the Bill proposes to bring to charge to profits tax sums received by or accruing by way of interest to businesses carried on in Hong Kong, notwithstanding that the funds in respect of which the interest arises are made available to the borrowers off-shore, and irrespective of the currency in respect of which the transaction is denominated.

The unit trust industry has put forward powerful arguments that in the interests of Hong Kong as a financial centre, certain concession should be made so that it would be viable for the industry to continue to operate in Hong Kong. The *Ad-hoc* Group has carefully studied the industry's representation, and after consultation with the Administration, come to the conclusion that having regard to the unique circumstances of the unit trust industry, it appears that it would be desirable to grant some measure of relief. To put the matter in perspective, it would be helpful to review the events of the past two years.

In 1982 the unit trust industry sought exemption from profits tax in respect of gains accruing to unit trusts from the purchase and sale of securities. The industry argued that the threat of liability to profits tax continued to inhibit its growth potential, to the economic disadvantage of Hong Kong at large.

In practice, unit trusts, with a few exceptions, do not engage in trading in securities to any significant extent; transactions in securities undertaken by unit trusts are generally in the nature of capital investment transactions. The revenue implications of exemption from profits tax in respect of gains derived from disposal of securities by unit trusts would therefore be minimal.

Members will recall that as a result of the enactment of the Inland Revenue (Amendment) (No. 2) Bill in 1983, the potential liability to profits tax on gains derived from the disposal of securities of a unit trust was removed (s. 26A(1A)). This amendment, however, did not cover tax on interest income. Nevertheless, it was a recognition of the unique position of unit trusts.

When the present Bill was published the industry made further representation emphasizing that if the potential liability of Hong Kong unit trusts to tax on interest income remains, the future of Hong Kong's unit trust industry will be diminished, to the disadvantage of the financial sector as a whole.

It is not difficult to envisage that unless some concession is made in this area, it is likely that new funds will not be established in Hong Kong and many existing funds will be forced to relocate out of Hong Kong. This can be accomplished by simply changing the Hong Kong Trustee to an overseas Trustee.

There is merit in the arguments put forward by the industry. Bearing in mind that the revenue implications of exemption from profits tax in respect of unit trust interest income would be minimal, and the useful part which the industry plays in relation to Hong Kong's position as an international financial centre, the *Ad-hoc* Group has recommended to the Government that there is a case for some concession to be made.

Sir, I am happy to report that Government has acceded to our request and accordingly I will be moving an amendment to the Bill by the insertion of a new clause 4A which would have the effect of exempting unit trusts from tax liability in respect of sums received or accrued by way of interest.

Sir, subject to the agreed amendments, I support the Bill.

MRS. FAN:—Sir, I am in favour of any anti-tax-avoidance measures to protect the Government's revenue; and at this point in time, we are all painfully aware of the need to generate more revenue in order to offset our deficit as far as possible. However, I, for one, would place priority on the maintenance of Hong Kong as a major financial centre, and would jealously guard our simple and comparatively low tax system as a means to achieve the latter objective.

In its present form, the Inland Revenue (Amendment) Bill 1984 has no doubt improved considerably on its first draft which was issued together with the Revenue Protection Order signed on 30 March 1984. The reservation which I raised during the budget debate on 29 March 1984, however, has not been totally alleviated. I refer to the extension of our territorial concept in taxation to include off-shore interest in the tax net, and the growing complexity of our tax system, particularly relating to the imposing of restrictions on the treatment of interest payments.

In the taxing of off-shore interest, many have expressed their views that this represents a departure from our territorial tax concept. It is argued that if a company placed its surplus fund on overseas deposits, even though that the moneys originally arose from net profit derived from carrying on business in Hong Kong, there is insufficient justification to tax the interest gain from that deposit in view of the fact that firstly it is derived from off-shore and secondly it is not related to but merely results from the carrying on of a business in Hong Kong. The Financial Secretary, however, assured this Council on 25 April 1984, that 'The Government remains wedded to the principle that taxation should only be applied to income arising in or derived from Hong Kong.' The Commissioner of Inland Revenue also assured his audience in a tax seminar on 31 May 1984 that 'This is not the first step in a sinister move to bring world-wide profits to charge.' The question remains whether the decision to tax off-shore interest will affect business in Hong Kong. In this, I tend to be more pessimistic than the Commissioner of Inland Revenue, who confidently said in the same seminar, 'As to the claim that business will be driven away, I can only say that those who go are probably not making a great economic contribution to Hong Kong anyway—and Hong Kong does not flourish on "hot money".'

At this junction, it may be petinent to note that paragraph 133 of the Report of the Third Inland Revenue Ordinance Review Committee, suggested that 'if such a surplus is invested abroad we do not regard the interest as part of the profits in the manner described in paragraph 131.' (*The full text of paragrpahs 131 and 133 was tabled for Members' reference*). While I can see a certain justification for taxing off-shore interest earned by financial institutions, I cannot see any rationale of including off-shore interest income derived by non-financial institutions in our tax net, except to generate more revenue.

The Financial Secretary expressed regret toward the growing complication of tax law but felt this was inevitable. I share his regrets. The simplicity of our tax legislation and our relatively low tax rate have enabled businessmen here to conduct their operations free from tax considerations, and this accounts for one of Hong Kong's attractiveness as a financial centre. The proposed Bill, which imposes restrictions on the treatment of interest payment, will no doubt create complications to our tax system, especially for companies both carrying on onshore as well as off-shore business activities in Hong Kong. The growing complexity may well prompt Hong Kong businessmen, who in the past have not been interested in tax avoidance, to find it necessary to consider tax planning, in order to prevent this normal commercial transactions from being caught unexpectedly by the new Bill. Again, whether this will have any detrimental effect on Hong Kong's economy and the inland revenue system remains to be seen.

The main purpose of taxing off-shore interest is to increase revenue, and the 'heavily discounted estimate' is $350 million according to the Commissioner of Inland Revenue. I sincerely hope that this will be the case, although I am afraid that the financial benefits generated may well be offset by the costs of implementing the legislation as well as the likely unfavourable economic and financial ramifications.

With these reservations on the Bill, Sir, I shall abstain from voting on the motion.

MR. POON:—Sir, the Financial Secretary's tax proposals in his Budget Speech on 29 February 1984 involve some important changes in the Inland Revenue Ordinance. Inevitably, there was a lot of controversy. The business circle and the legal and accounting professions were alarmed at the possible implications of such proposals. Numerous representations were made to UMELCO and they have all been carefully considered. The Bill before us will meet many of the constructive suggestions and criticisms.

No anti-tax avoidance legislation is perfect. We would have happily hoped that we can turn the clock back and re-introduce tax on interest income which would render most of the controversial new amendments unnecessary. For a variety of reasons, this cannot be and it is imperative that legislation be enacted as soon as possible to plug the tax loophole caused by the abolition of tax on certain interest income.

The Textile and Clothing Industry was concerned as to whether interest paid to financial institutions on loans backed by foreign currency deposits of its own business would be allowed as a tax deduction. The Commissioner of Inland Revenue has confirmed that such interest will be deductible and will not be caught under the new s. 16(2)(*d*), as the interest on such foreign currency deposits is chargeable to Hong Kong tax. To put it simply, there will not be double taxation in such a case.

The amendments to allow interest paid to persons other than financial institutions on money borrowed wholly and exclusively to finance capital expenditure on plant and machinery ranking for depreciation under the Inland

Revenue Ordinance and for purchase of trading stock used by the borrower in the production of profits chargeable under the said Ordinance will cater for genuine business transactions and cover most of the cases deserving relief. It may well be that other categories of interest ought to be considered for relief but we must wait and see how the new laws operate and learn from experience. If it is later found that there is genuine hardship in such cases, Government ought to consider further amendments.

There have been some vigorous but useful debates on whether the new tax legislation will be detrimental to business in Hong Kong in general and Hong Kong as a financial centre in particular. The Bill in its present form will remove a lot of doubts and fears but there are still certain matters of concern which cannot be entirely dismissed.

The new laws are arbitrary and complicated. There will be considerable administrative problems and difficulties. It is still difficult to know what the Inland Revenue Department will consider to be 'carrying on business' in Hong Kong. The family investment holding company in Hong Kong earning only passive interest overseas may have to pay profits tax. There is no provision for apportionment of interest for tax deduction purpose if only part of the loan from a person other than a financial institution is backed by a deposit of a closely-connected person. The de facto rejection of the so called 'provision of credit' test as a major criterion for determining the source of interest is still regarded by some to be an erosion of the territorial concept despite the assurance by the Financial Secretary that it is not Government's intention to extend the ambit of tax beyond the 'territorial basis'.

No law can cover all conceivable situations. Therefore many cases will have to be determined on their own merits and there are bound to be some inequities. We must also expect that the Inland Revenue Department will apply the new laws in a sensible and reasonable manner. Nevertheless, it is the uncertainly that worries businessmen and their advisers. Businessmen should be able to understand clearly what their tax liability would be if they were to engage in particular transactions. In their regard, it is most essential that properly detailed clarifications be made in the Practice Notes to be issued by the Commissioner of Inland Revenue on the new amendments. As these amendments will affect transactions entered into on or after to 1 April 1984, such Practice Notes should be made available as soon as possible.

On the whole, I am reasonably satisfied that the new Bill with the amendments to be proposed, will achieve to a great extent its purpose to counter tax avoidance. To the prophets who predict that entirely new tax avoidance schemes will emerge, the Financial Secretary has already drawn their attention to the strong House of Lords decision in *Furniss V Dawson* which greatly reinforces Inland Revenue's power to challenge the substance of tax avoidance

schemes. It has also been indicated that, if necessary, Government might also look at appropriate amendments to expand the present Section 61 of the Inland Revenue Ordinance which empowers an Assessor to disregard certain artificial tax avoidance transactions.

Finally, I share the view that the interest payment in relation to publicly listed debentures issued prior to 1 April 1984 should be allowed as a tax deduction. This is only fair as such debentures were issued for commercial purpose and without knowledge of Government's attention to disallow such interest. I shall propose the necessary amendment later.

With these remarks, Sir, I support the motion.

THE FINANCIAL SECRETARY:—Sir, very helpful discussions have taken place with the LegCo *Ad-hoc* Group and the Legislative Scrutiny Group respectively before and after the Bill was published. I am grateful to the knowledgeable Unofficial Members who participated and have given wise advice on the Bill. I am grateful also for the support, comments and indeed reservations of Mr. BROWN, Mr. WONG, Mr. POON and Mrs. FAN this afternoon.

Mr. BROWN has rightly pointed out that it is the duty of Government to introduce legislation to counter tax avoidance. Mrs. FAN agrees. I am determined to do this; and I am sure that the Bill will in part help to achieve this objective without hindering genuine business borrowings or dampening the interest of potential foreign investors in Hong Kong. It is worth bearing in mind that complicated law arises only from the need to counteract byzantine avoidance measures.

I note the concern that has been expressed over the phrase 'carrying on a business in Hong Kong'. This is a technical expression well known in taxation law which, however, is unfortunately not capable of precise definition. The question as to whether a person is or is not carrying on a business in Hong Kong can only be determined by taking into account all the relevant facts of that situation. However, I can assure honourable Members that the Commissioner of Inland Revenue will, as usual, examine each case carefully. He will also issue a Departmental Interpretation and Practice Note giving guidance on this matter after the Bill is enacted. I confirm also that the Admistration will remain open to further representations if unforeseen problems arise.

Mr. Peter C. WONG and Mr. Peter POON will move two amendments to the Bill at the committee stage. They have explained them in detail. I am happy to confirm that the Administration accepts the proposed amendments in their entirety.

Sir, I beg to move.

Question put and agreed to.