

Example (1)

Section 16(2)(d) - borrowing secured by a loan and not deposit

Scenario :

- **AHK Ltd**, a company carrying on business in Hong Kong, borrows \$10m (Loan X) from a Hong Kong financial institution, **BHKFI Ltd**, and uses the funds as working capital.
- **BHKFI Ltd**, the Hong Kong financial institution, has an overseas associated company (not a financial institution) called **BOS Ltd**.
- **AHK Ltd** has an overseas associated company called **AOS Ltd**.
- **AOS Ltd** lends (not a deposit) \$10m. (Loan Y) to **BOS Ltd**, to secure the repayment of Loan X (principal and interest).
- The group, and possibly even **AHK Ltd** itself, has surplus funds. **AHK Ltd** does not actually need to borrow the \$10m from outside the group.
- Through the chain of loans, the interest paid by **AHK Ltd** on Loan X is effectively received by **AOS Ltd**.
- The risk borne by the Hong Kong financial institution, **BHKFI Ltd**, is actually zero because of Loan Y placed with **BOS Ltd**.

Taxation consequences under existing section 16(2)(d)

- (a) The requirements of section 16(2)(d) have been satisfied because -
- (i) AHK Ltd borrowed the money (Loan X) from a financial institution;
 - (ii) Loan X was not secured or guaranteed by a deposit with a financial institution (or overseas financial institution) where the interest was not chargeable to Profits Tax (instead it was secured by a loan to a company which is not a financial institution, BOS Ltd).
- (b) Having satisfied the requirements of section 16(2)(d), AHK Ltd can claim a deduction for the interest payments on Loan X.
- (c) The interest received by AOS Ltd. from BOS Ltd in respect of Loan Y is offshore income and hence not chargeable to tax in Hong Kong.

Taxation consequences under proposed section 16(2)(d)

- (a) Although AHK Ltd borrowed Loan X from a financial institution, the requirements of proposed section 16(2)(d)(ii) would not be satisfied because -
- the repayment of Loan X was secured by a loan (Loan Y) made by AOS Ltd to a person (i.e. BOS Ltd) where the sums paid by way of interest on the security loan (i.e. Loan Y) are not chargeable to Profits Tax in Hong Kong.
- (b) As the requirements of proposed section 16(2)(d)(ii) would not be satisfied, the interest paid by AHK Ltd in respect of Loan X would not qualify for deduction.
- (c) The interest received by AOS Ltd. from BOS Ltd in respect of Loan Y is offshore income and hence not chargeable to tax in Hong Kong.

Example (2)

Section 16(2)(d) - Assignment or transfer of the right to receive interest

Scenario :

- **AHK Ltd**, a company carrying on business in Hong Kong, borrows \$10m from an overseas financial institution. The funds are then used as working capital.
- The overseas financial institution effectively recovers the funds lent to **AHK Ltd** by assigning, for a fee, the loan and the right to receive interest to **AOS Ltd**, an overseas associate of **AHK Ltd**. The assignment takes place outside Hong Kong.
- In reality, the \$10m obtained by **AHK Ltd** is provided by **AOS Ltd**. Indeed, **AOS Ltd's** funds may come from **AHK Ltd**, which has surplus cash. In other words, there is a circular flow of funds.
- The interest payments by **AHK Ltd** on the \$10m loan are effectively ploughed back to the group through **AOS Ltd** as a result of the assignment.
- The risk borne by the overseas financial institution is zero because of the assignment of the loan to **AOS Ltd**.

Taxation consequences under existing section 16(2)(d)

- (a) The requirements of section 16(2)(d) have been satisfied because -
 - (i) **AHK Ltd** borrowed the money from an overseas financial institution;
 - (ii) the borrowing is not secured or guaranteed against any deposit (because of the assignment of loan);
- (b) Having satisfied the requirements of section 16(2)(d), **AHK Ltd** can claim a deduction for the interest payments.
- (c) The interest received by **AOS Ltd** is offshore income and hence not chargeable to tax in Hong Kong.

Taxation consequences under proposed section 16(2)(d)

- (a) Although AHK Ltd borrowed Loan X from a financial institution, the requirements of proposed section 16(2)(d)(i)(A) would not be satisfied because -
- as a result of the assignment of the loan, an associate of the borrower (i.e. AOS Ltd) was entitled to sums payable by way of interest on the money borrowed.
- (b) As the requirements of proposed section 16(2)(d)(i)(A) would not be satisfied, the interest paid by AHK Ltd in respect of the loan would not qualify for deduction.
- (c) The interest received by AOS Ltd is offshore income and hence not chargeable to tax in Hong Kong.

Observation

The overseas financial institution may assign the loan to an affiliate outside Hong Kong which then assigns the loan to AOS Ltd. Alternatively, AHK Ltd may borrow from a Hong Kong financial institution which then assigns the loan to its overseas affiliate. The overseas affiliate would in turn assign the loan to AOS Ltd. The two-tier structure would make it much more difficult for the IRD to trace the circular flow of funds.

Example (3): Section 16(2)(e)

Scenario :

- **AHK Ltd**, a company carrying on business in Hong Kong, has surplus cash of \$10m. It deposits the sum with an overseas financial institution, **BOSFI Ltd**.
- **BOS Ltd**, an overseas associated corporation of **BOSFI Ltd**, lends \$10m to **AHK Ltd**.
- **BOS Ltd** is not an associate of **AHK Ltd**.
- The money borrowed is used by **AHK Ltd** to buy trading stock.
- The lending is secured by the deposit made by **AHK Ltd** with **BOSFI Ltd**.

Taxation consequences under existing section 16(2)(e)

- (a) The requirements of section 16(2)(e) have been satisfied because -
- (i) the money is used to buy trading stock; and
 - (ii) the lender is not an associate.
- (b) Having satisfied the requirements of section 16(2)(e), **AHK Ltd** can claim a deduction in respect of the interest paid to **BOS Ltd**.
- (c) The interest received by **AHK Ltd** from the deposit with **BOSFI Ltd** is offshore income and is not chargeable to tax in Hong Kong.

Taxation consequences under proposed section 16(2)(e)

- (a) Although the borrowed money was used by **AHK Ltd** to buy trading stock and was not borrowed from an associate, the requirements of proposed section 16(2)(e)(i)(A) would not be satisfied because -
- The repayment of the loan is secured by a deposit, made by **AHK Ltd** with **BOSFI Ltd**, where the sums paid by way of interest on the deposit were not chargeable to Profits Tax in Hong Kong.

- (b) As the requirements of proposed section 16(2)(e)(i)(A) would not be satisfied, the interest paid by AHK Ltd in respect of the loan would not qualify for deduction.
- (c) The interest received by AHK Ltd from the deposit with BOSFI Ltd is offshore income and accordingly not chargeable to tax in Hong Kong.

Observation

AHK Ltd does not actually need to borrow money to buy trading stock. It has surplus cash. By the back-to-back loan arrangement, a deduction is created whereas the corresponding interest income is not taxable. AHK Ltd therefore obtains a tax benefit.

Example (4): Section 16(2)(f)

Scenario :

- **AHK Ltd**, a company carrying on business in Hong Kong, acquires an incoming-producing asset for \$100m. The funds for the acquisition come from a debenture issue in Luxembourg.
- **AOS Ltd**, an overseas subsidiary of **AHK Ltd**, has surplus funds of \$100m.
- **AOS Ltd** acquires the debentures issued by **AHK Ltd**.

Taxation consequences under existing section 16(2)(f)

- (a) The interest paid by AHK Ltd to the holder of the debentures, its associate AOS Ltd, qualifies for deduction under section 16(2)(f)(i) as it is paid in respect of debentures (the term “debentures” is defined in section 16(2) of the Ordinance to mean “debentures listed on a stock exchange in Hong Kong or any other stock exchange recognized for the purposes of this paragraph by the Commissioner”).
- (b) The interest received by AOS Ltd from AHK Ltd is offshore income (Luxembourg) which is not chargeable to tax in Hong Kong.

Taxation consequences under proposed section 16(2)(f)

- (a) The interest paid by AHK Ltd on the debentures would not qualify for deduction as they are held by an associate, AOS Ltd (section 16(2)(f)(iii)(A)).
- (b) The interest received by AOS Ltd from AHK Ltd is offshore income (Luxembourg) which is not chargeable to tax in Hong Kong.

Observation

The group as a whole has the fund to buy the asset. If AOS Ltd were to lend the funds to AHK Ltd outside Hong Kong by way of a simple loan arrangement, the interest expenses of AHK Ltd would not be deductible because the interest income of AOS Ltd would not be taxable (section 16(2)(c)). However, by using the debenture method (instead of a simple loan arrangement), AHK Ltd aims to get the interest expenses deduction. The debentures, being listed in Luxembourg, give the impression that AHK Ltd has obtained the fund from the market, but in fact no external funds are involved.

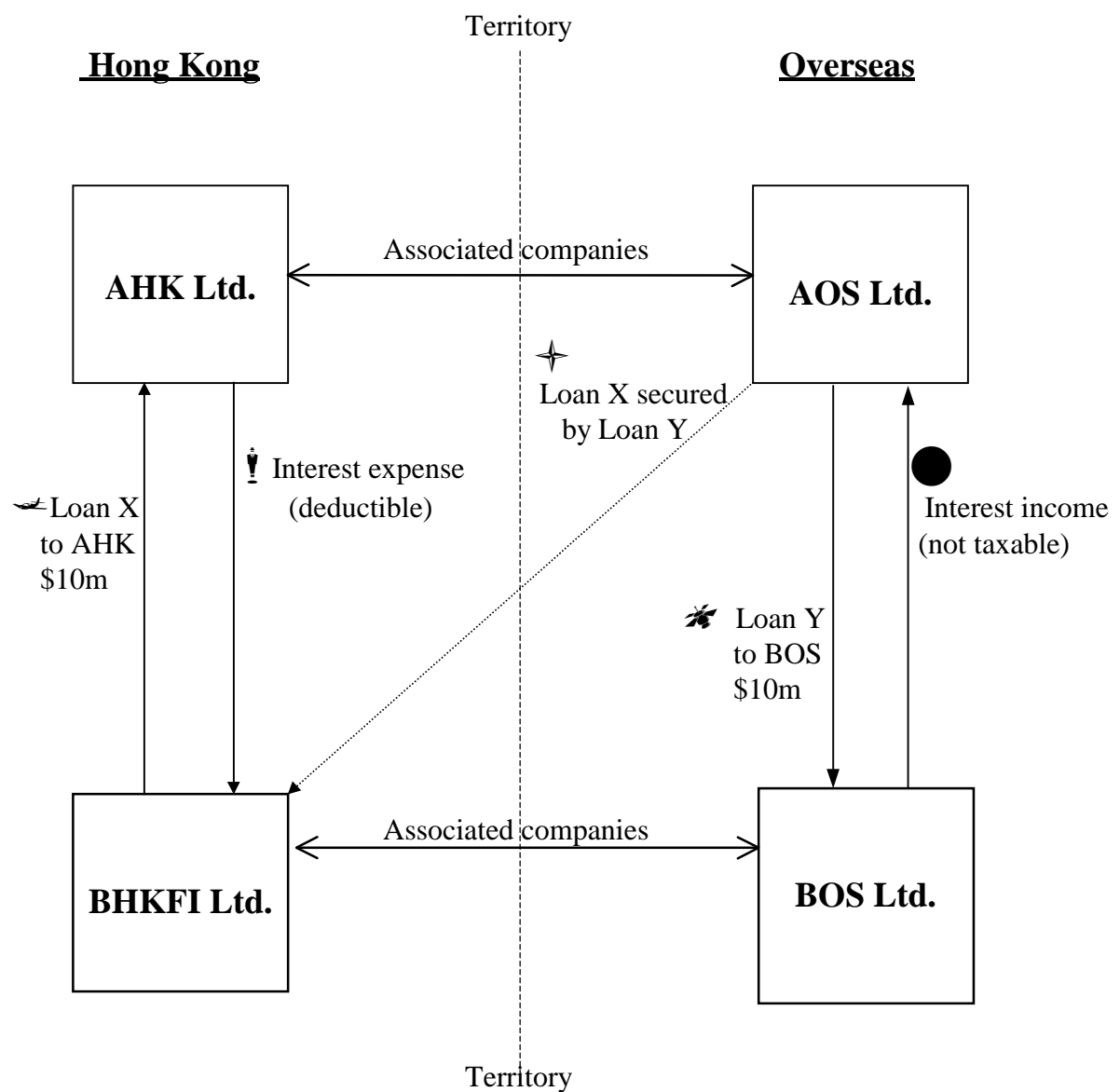
Example (1)

AHK Ltd. - a company carrying on business in Hong Kong

AOS Ltd. - an overseas associated company of **AHK Ltd.**

BHKFI Ltd. - a Hong Kong financial institution

BOS Ltd. - an overseas associated company of **BHKFI Ltd.**

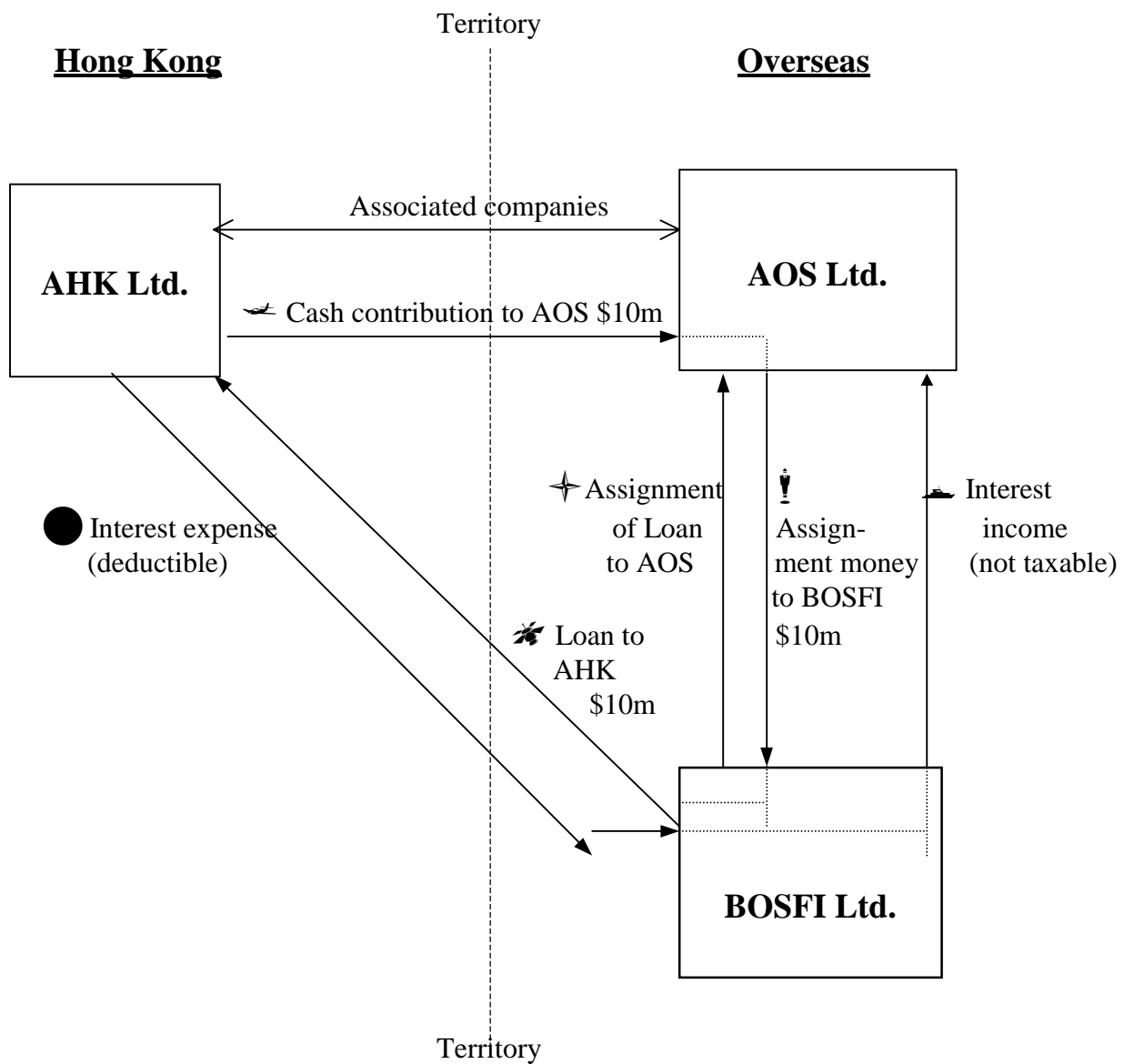


Example (2)

AHK Ltd. - a company carrying on business in Hong Kong

AOS Ltd. - an overseas associated company of **AHK Ltd.**

BOSFI Ltd. - an overseas financial institution

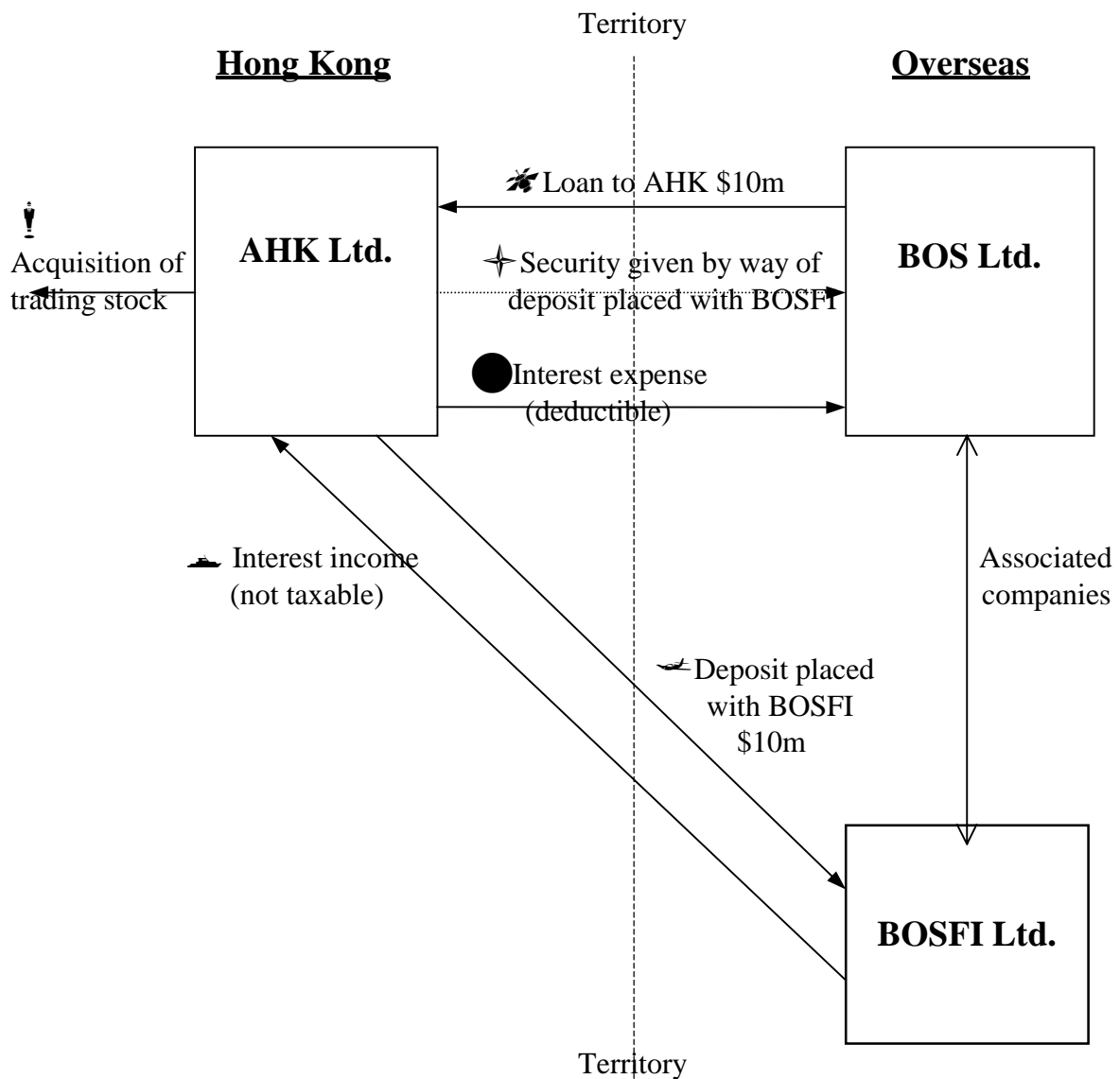


Example (3)

AHK Ltd. - a company carrying on business in Hong Kong

BOSFI Ltd. - an overseas financial institution

BOS Ltd. - an overseas associated company of **BOSFI Ltd.**



Example (4)

AHK Ltd. - a company carrying on business in Hong Kong

AOS Ltd. - an overseas associated company of **AHK Ltd.**

