香港稅務學會
THE TAXATION INSTITUTE OF HONG KONG
(Incorporated in Hong Kong as a company limited by guarantee)

Your Ref: CB1/BC/1/00
Our Ref: MW/CWC/512T40/0Ncwc-IRB2000

BY EMAIL AND FOLLOWED BY FAX

November 28, 2000

Clerk To Bills Committee
Bills Committee on
Inland Revenue (Amendment) Bill 2000
Legislative Council
No. 8 Jackson Road
Central
Hong Kong

Dear Madam,

Inland Revenue (Amendment) Bill 2000 (the "Bill")

Thank you for your letter dated 20 November 2000. We are pleased to submit below our comments on the Bill for the Bills Committee's consideration:

(A) Expenses of Self Education

1. While we welcome the Government's proposal to expand the scope of the definition of "expenses of self-education" in section 12(6)(c) of the Inland Revenue Ordinance ("IRO") to include examination fees for any examination set by a provider of a prescribed course of education and undertaken by the taxpayer to gain or maintain qualification for use in any employment, we consider there are still a few areas in the provisions which need further expansion or clarification in order to bring out the policy intent of this legislation.

2. One of the necessary conditions to claim such expense is either a prescribed course of education or an examination undertaken by the taxpayer **to gain or maintain qualifications for use in any employment**. Such requirement is understandable as the deduction rule currently is under section 12(1)(e) which requires a nexus of the expenses with employment. However, without elaboration, the phrase 'in any employment' may be interpreted as 'in the present employment'. For taxpayers who have foresight and are proactive to invest their time and effort in upgrading themselves in new areas in order to prepare for future challenges that are foreseeable but could not be certain, it may be difficult for them to satisfy or prove "for use in any employment' at the point of time when they incurred the expenses. This is against

the promotion of 'life-long' learning culture by the HKSAR Government. It is suggested that this relief could be moved to Part IVA of the IRO as a concessionary deduction and a relaxation on the nexus with employment as a requirement so as to cultivate the 'life-long' learning attitude of people Hong Kong, if this is the real intention of the HKSAR Government. Note that similar to other concessionary deductions, the upper limitation (currently $30,000) would effectively prevent abuse and a great loss of revenue by granting such relief.

3. Secondly, in the proposed amendment, a 'prescribed course of education' includes a training or development course provided by a trade, professional or business association **for its members**. Also, an examination includes examination set by a trade, professional or business association **for its members**. The reality is that most professional examinations are set by the relevant professional associations for their student members to take in order to qualify for membership and that training or development courses are conducted for both members and student members or even non-members to update their relevant knowledge. Without an elaboration on the word "members", it may create confusion. Ideally, it should include student members and non-voting members of a trade, professional or business association.

4. Finally, it is quite common for a participant of a professional examination to pay fees to attend intensive revision courses run by the professional body or by an 'education provider'. The proposed amendment allows deduction, subject to the clarification of the definition of "members" above, in respect of the examination fees. However, the related fees in respect of the revision courses are not being taken care of as such revision courses may not be said to 'gain or maintain qualifications for use in any employment'.

(B) Royalty Income

5. The Bill proposes to amend section 15(1)(b), which deems certain sums for the use of intellectual property to be trading receipts. We fully appreciate the Government's intent to protect revenue in the light of the Final Court of Appeal's decision in the Emerson case. However, we do not agree with the addition of section 15(1)(ba) which effectively levies tax on persons earning income not having a Hong Kong source. The proposed new section 15(1)(ba) will set a bad precedent of explicitly violating the territorial based taxation principle of our tax system.

6. Hong Kong tax system has long been based on a territorial or source concept. By adopting the proposed amendment in section 15(1)(b), it is sending a very negative signal to the business community. They may begin to wonder whether the Government is considering to deviate from the territorial concept and whether the Government will one day start deeming other offshore income as taxable in Hong Kong. The new section 15(1)(ba) may create unfair tax treatments for some taxpayers. The following are two examples:

Example (1):

The subject matter is royalties in respect of the use of "trademark" relating to sales of goods. The taxpayer's sales are effected outside Hong Kong but the purchases are effected in Hong Kong. The IRD may, as per DIPN 21, assess the taxpayer's trading profits as sourced in Hong Kong. Though it is contentious (as in the Magna case), the taxpayer decided not to appeal for costs and benefits reason. In addition to the profits tax liability on its trading profits, this taxpayer will further suffer the deemed tax liability in respect of the royalties income for the recipient.

Example (2):

The subject matter is royalties in respect of 'patent right' used in the production process by a Hong Kong manufacturer in the PRC. The taxpayer, for commercial reasons, enters into a processing or assembly arrangement with a Mainland entity under which the goods are required to be exported to places outside the Mainland. According to DIPN 21, the taxpayer's manufacturing profits are likely to be qualified for the 50:50 apportionment of taxation. As a result, only 50% of the taxpayer's profits are considered to be Hong Kong sourced and assessable to Hong Kong tax. The other 50% of the taxpayer's profits are not liable to profits tax and the related expenses would also not be deductible. However, the royalties income will by virtue of the new section 15(1)(ba) be 100% taxable.

7. The place where an intellectual property is used is a matter of fact and cannot be changed just because it has been used for producing profits chargeable to Hong Kong tax. According to paragraph 7 of the Legislative Council Brief, the reason for this proposed amendment is that the CIR considered that where a Hong Kong business would be said to have incurred royalty expenses in producing its Hong Kong sourced profits, the intellectual property concerned must have been used in Hong Kong and thus the royalty income for the use of the intellectual property should be taxable in Hong Kong. We submit that this logic is wrong.

8. If the intention is to match the deduction of royalties in respect of the relevant intellectual properties in the hands of the payers with the taxation of the same royalties in the hands of the recipients, we submit that it would **do less harm** to put the legislation under section 17(1) to disallow the deduction for the royalty payments if the income is not subject to Hong Kong tax. The importance of our source jurisdiction is highlighted by The Honourable Donald Tsang in its "Incentive for Enterprises" published in February 1998 as "We adopt a territorial source principle. Only income which has a source in Hong Kong is taxable here. Income sourced elsewhere, even if remitted to Hong Kong, is not subject to Hong Kong profits tax at all." (p.3 item 2).

(C) Deduction of Interest Expenses

9. We understand that the proposed amendments to section 16(2) is to counteract various tax-avoidance arrangements which are currently being dealth with under the general anti-avoidance provision under section 61A on a case-by-case basis. As this general provision does not guarantee success in each individual case, specific amendments to section 16(2) are therefore proposed to restrict more stringently the deduction for interest payable to non-associated persons.

10. However, we believe the proposed amendments will not only stop the perceived abuse in the tax-avoidance arrangements, but also unnecessarily hinder genuine business transactions and create unnecessary hardships for businesses to consider cost effective sources of finance. The proposed amendments will also significantly reduce Hong Kong's attractiveness to be a debt capital market. Under the proposed amendments, there will be significant restrictions as to the persons who can participate in debt instruments issued by Hong Kong businesses and this will increase their financing costs. The definition of 'associate' is so wide that it may trap genuine lending and borrowing transactions with the result that the related interest expenses are not qualified for deduction because of the new section 16(2) restrictions without the awareness of such consequences by both the lender and the borrower. The following are some examples:

Example (1):

A financial institution in Hong Kong grants a loan under prevailing market terms to a borrower which carries on business in Hong Kong taking the shares in the company as security. By reason of the size of the borrowing, the borrowed funds are participated by an overseas associated company of the financial institution which may or may not a financial institution itself. Both the financial institution in Hong Kong and its overseas associated company are not related or associated to/with the borrower. One year later, the borrower runs into financial difficulty and fails to meet its obligations under the loan agreement. The financial institution agrees with the majority shareholders of the borrower company to foreclose the security shares as partial repayment of the original principal or as security for further loan advances from the financial institution and its overseas associated company. As a result, the borrower becomes associated with the financial institution in Hong Kong and its overseas associated company. Under the circumstance, interest expenses payable by the borrower after the financial institution which has become its shareholder will no longer be deductible under section 16(2)(d)(i)(A).

Example (2):

A Ltd, a company carrying on business in Hong Kong raises funds in the debt capital market by way of issue of secured notes which are tradable in the global market through an associated corporation. The interest payable by A Ltd to the associated corporation for meeting its interest obligations to the noteholders are deductible under the existing provisions in section 16(2)(f)(iii). However, if some of the notes are subsequently purchased by a genuine overseas investor, B Ltd, in the global market, which happens to be an "associate" of

the A Ltd because, for example, a director of B Ltd is a relative of a director of A Ltd. This will arguably render all of the interest payable by A Ltd to its associated association to the noteholders not qualified for deduction under the new section 16(2)(f)(iii)(A).

11. Other potential problems derived from Example 2 above include:

- A Ltd will not be able to trade the debt instrument even if it wants to create trading transactions on the market for the debt instrument or to support its market price;

- if a relative of a director of A Ltd invests in a mutual fund trust operated by an insurance company and the trust invests in the A Ltd's debt instrument, the whole interest expense of A Ltd may be disallowed; and

- an associate of A Ltd accidentally invested in the A Ltd's debt instrument for a short period and disposed of the debt instrument after holding it for a short period of, say, less than one week, technically, the whole of the debt interest is non-deductible.

12. We submit that such harsh anti-abuse catch all provisions should not be made as part of the specific provision governing interest deduction. If the Government believes that the current Section 61A is not sufficient to achieve the purpose, we suggest that specific terms similar to the current proposed amendments may be incorporated into Section 61A. It is essential that genuine business transactions should not be affected only because someone has abused the system. To combat these arranged tax-avoidance transactions, the weapon should be an inclusion of a "motive" or "purpose" test in the relevant provisions.

13. Alternatively, a discretion power can be given to the Commissioner to disregard the operative provisions, such as the one in section 9A, to avoid the denial of interest expenses incurred under genuine commercial loan or financing transactions.

14. Furthermore, the provision in the proposed section 16(2)(f)(iii)(A) that "none of the holders of the debentures or instruments.." suggests that existence of one related holder at any one time, even if there were thousands of genuine holders of the instruments, will render the whole of the interest costs of the debt issue non-deductible. We consider that the absence of a mechanism of apportionment of interest expenses for deduction purpose to deal with the situation that it is partially qualified as in Example (2) above will be very unfair to the taxpayer. In addition, it is doubtful how the IRD can enforce or how the taxpayer can obtain information in order to ensure compliance of the new law. With the broad definition of an associate, the taxpayer will find it extremely difficult to keep track and ensure that no associate has had at any point in time been entitled to any sum payable by way of interest from any loan instrument issued.

15. Finally, we consider that the word "entitled" under the proposed section 16(2)(d)(i), section 16(2)(e)(ii)(C) and section 16(2)(f)(iii)(C) should be clarified as whether it is the legal or beneficial interest in the interest sum that the sections are referring to. Other unclear drafting

such as which period's interest will be disallowed for an offside event that happened in the past etc. are creating significant uncertainty for the proposed amendments.

We hope the Bills Committee will find our above comments useful. We will be pleased to attend the Bills Committee meeting on December 4, 2000 to explain our above submission to the Bills Committee, if required. In the mean time, please feel free to contact the undersigned if you have any questions.

Yours faithfully
For and on behalf of
The Taxation Institute of Hong Kong

Marcellus Wong
Convenor, Taxation Review Committee on
Inland Revenue (Amendment) Bill 2000