

HONG KONG BAR ASSOCIATION'S COMMENTS ON
INLAND REVENUE (AMENDMENT) BILL 2000

The guiding principle when considering the Inland Revenue Ordinance should be maintenance of the integrity of the source principle and the simplicity which characterises the Hong Kong taxation system. These characteristics are widely acknowledged to have made an important contribution to the continuing resilience of the Hong Kong economy.

A. Royalty income

1. The amendments are conceived as an attempt to plug a perceived gap in the Hong Kong profits tax system arising from the outcome of the *Emerson* case in the Court of Final Appeal. The facts of the *Emerson* case, which are set out in the LegCo Brief, do not suggest deliberate avoidance of Hong Kong tax but rather to reflect the taxpayer company's commercial and manufacturing arrangements.
2. The Inland Revenue Department anticipates a loss of revenue of \$200 million per annum. Statistics which might form the basis upon which to question this estimate are not available but soundings among tax practitioners suggest this may be an overstatement. The Department should be asked the basis upon which the estimate is made.
3. Underlying the changes appears to be a desire for 'symmetry', that is a desire to ensure that where a tax deduction is given there should be a corresponding assessment upon taxable income. Apart from the legal aphorism that 'there is no equity in a taxing statute' the pursuit of symmetry is misguided. There many examples which demonstrate that 'symmetry' is an entirely inappropriate concept. One example would be that the proceeds of sale of an asset might be a capital receipt in the hands of the seller but a revenue expense (eg acquisition of trading stock) in the hands of the purchaser; or vice versa. The test should remain whether the payments are made in the production of assessable income. The introduction of changes based upon 'symmetry' is to be resisted as setting an undesirable precedent for further changes to the Ordinance.
4. An aim of government is to develop Hong Kong as centre of technology and design. A parallel development has been the emergence of Hong Kong as a service centre. Such developments seek, and do, act to develop local expertise

and intellectual property rights. Nonetheless the development of Hong Kong must involve licensing of overseas technology and other intellectual property rights. The proposal would deter the use of technology, is likely to impede Hong Kong's rôle as a service centre and runs counter to policy aims.

5. The proposal overlooks the international aspects. Where a company pays a royalty to an overseas person in respect of intellectual property the foreign person frequently will be subject to overseas taxation upon the royalties received. Where payments are made between group companies this disbaring of relief may well have the effect of giving rise to double taxation, the subsidiary receiving no relief while the parent or sister company would be assessed upon the income. This is not only undesirable *per se* but is likely to create an impetus to structure operations to avoid the use of Hong Kong, to the detriment of the economy.
6. In conclusion, the proposal appears to commence from the flawed premise of a search for 'symmetry', its effect may be to cause multinational companies to restructure operations to the detriment of Hong Kong.

B. Revisions to Anti-avoidance Provisions on Deduction of Interest Expenses

(a) Money borrowed from a financial institution

No comment on the proposal to amend section 16(2)(d) which is focussed upon tax avoidance practices involving the assignment of income streams.

(b) Money borrowed from a non- financial institution

The present draft of 16(2)(f) debars deduction even where only one of the holders of the debentures or instruments is an associate (16(2)(f)(iii)(A)(B)(C)). If only one holder is an associate all deduction is lost. Some provision for apportionment should be made in order to avoid the section operating in a penal manner.

(c) Interest payments on debentures and financial instruments

1. The proposed changes would cause particular problems for market makers who would find considerable difficulty in avoiding completely the involvement of associates. As stated at (b) above, all deduction would be lost where even one associate is a debenture holder.
2. Apportionment should be available where the debenture holders comprise both associates and non-associates. It is considered that this could be done on a pro rata basis without creating drafting difficulties.

3. It is noted that there are no transitional provisions. The section bites where the '*deduction claimed is in respect of interest payable by that corporation*' Interest accrued prior to the commencement of the amendments and becoming payable after commencement would be caught thereby giving the section retrospective effect. As it is undesirable for taxation changes to have a retrospective effect, transitional provisions are required.
4. As a general point, the Department has not found the use of Section 61A to prevent avoidance through debt instruments entirely satisfactory because it has to be applied on a case-to-case basis and success is not guaranteed in each individual case. It is submitted that section 61A has generally been effective against tax avoidance arrangements which have no commercial purpose. Further it would be unrealistic to expect that 'success' would be obtained in each case not least because the arrangements in question may have been commercially motivated.
5. The lament that success is not guaranteed progresses from the assumption that the Department is correct in every case which, with respect to the undoubted professionalism of the Department, would not always be the case. It would be better to retain relative simplicity in the legislation and to rely upon the general anti-avoidance principles (and the *Ramsay* principle) to control avoidance. This briefing point serves rather to support retention of the present approach than to support the proposed changes.

(C) Revisions Relating to Depreciation of Industrial and Commercial Buildings

No comment upon the proposals.

(D) Revisions to Remedy Some Irregularities and to Clarify the Legislative Intent

The revisions are welcomed.

(E) Revisions Relating to Costs and Fees

The amendments are practical and reflect an approach adopted elsewhere in the Laws of Hong Kong.

(F) Conclusion

It is advisable that wider consultation to be carried out in the commercial sector as to whether or not the proposals are acceptable.

Hong Kong Bar Association
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