Inland Revenue (Amendment) Bill 2000

Administration's Response to the Issues Raised in the Bill's Committee Meeting Held on 9 December 2003

Purpose

This paper sets out the Administration's response to issues raised by Members at the Inland Revenue (Amendment) Bill 2000 Bills Committee meeting held on 9 December 2003.

Self-education Expenses: Clause 4 of Bill and of the corresponding Committee Stage Amendments (CSAs) to amend section 12(6) of the Ordinance

2. Members asked us to clarify the following-

(a) the scope of "trade, professional or business associations" under the proposed sections 12(6)(b)(ii) and 12(6)(c)(ii);

(b) whether courses jointly provided by a trade, professional or business association or education provider with other organizations and courses accredited or recognized but not "provided" by a trade, professional or business association would be covered under the proposed section 12(6)(c)(ii);

(c) if the answer to (b) above is no, whether the Administration would consider revising section 12(6) to cover the courses mentioned;

(d) whether a taxpayer would be required to prove that the course in question relates to his current employment or to an employment which the taxpayer is likely to take up in future; and

(e) whether there is any discrepancy between the Chinese and the English versions of the proposed section 12(6)(b)(ii) and 12(6)(c),

in particular the wordings "in any employment".

3. As stated in the LegCo brief on the Bill issued back in September 2000, the proposed amendments in relation to section 12(6) of the existing Ordinance were to clarify the policy intent on self-education expense deduction under salaries tax. The policy intent has always been: all employment-related self-education expenses including examination fee which is paid by a taxpayer in taking a prescribed course of education should be covered by the self-education expense deduction and deductible from the assessable income of a person. However, according to our legal advisor, the definition of self-education expense as defined under the existing Ordinance cannot be interpreted as covering the fee for an examination taken by a taxpayer who has not taken any prescribed course of education, although the examination is to enable the taxpayer to gain or maintain qualification for use in an employment. We have therefore proposed some technical amendments in order that this policy intent is accurately reflected in the legislation.

4. The issues raised by Members in relation to self-education expenses are actually outside the scope of the current amendment exercise. Under both the existing and proposed section 12(6),

(a) "trade, professional or business association" is interpreted by reference to its literal meaning. Examples of organizations which have been regarded by the Inland Revenue Department as a "trade, professional or business association" for the purpose of section 12(6) include the following: Federation of Trade Unions, the Law Society of Hong Kong, the Hong Kong Society of Accountants etc. No disputes have occurred/difficulties been encountered regarding the interpretation of these since the enactment of the section in 1996.

(b) Courses jointly provided by a trade, professional or business association or education provider with other organizations are regarded as falling within the definition of "a course .... provided by" such association and hence the expenses expended on such courses would qualify for deduction under salaries tax. However, according to our legal advisor, courses merely

accredited or recognized by the associations cannot be construed as "courses ... provided by" them. It was also not the policy intention to allow the expenses on such courses to be deducted from salaries tax.

(c) As stated in paragraph 3 above, the objective of the current legislative exercise is to clarify the policy intent with regard to an examination fee that is not connected with a prescribed course of education. It is a technical amendment.

Revising section 12(6) to include courses accredited or recognized by trade, professional or business associations would involve a change in policy which was not contemplated when the Administration introduced the Bill. According to our preliminary research, some trade, professional and business associations may not necessarily have sufficient knowledge of or much control over the courses they accredit or recognise. If we allow not only courses provided by but all courses accredited or recognized by all such organizations to enjoy the deduction, there will be scope for abuse, considering the large number of such organizations and the very different policies on accrediting and recognising courses.

The associations consulted did not make any request to expand the scope of prescribed courses of education to accredited or recognized courses. Since the proposed amendment Bill is technical in nature and does not involve a change in policy, we prefer to deal with the suggestion to allow deductions for accredited/recognized courses separately.

(d) Expenses on courses in connection with both current employment as well as planned new employment qualify for deduction under section 12(6). This policy is stated clearly in the information pamphlet entitled "A guide to expenses of self-education – How to claim deductions under Salaries Tax" issued by the Inland Revenue Department, which says in the answer to the second question of the Q and As section that "a prescribed course of education is a course undertaken at a specified

institution to gain or maintain qualifications for use in the current employment, or a planned new employment. In other words, the course must be related either to the present job or a job in the future". The taxpayer making a self-education expense deduction claim has to show that the course in question relates to his current employment or to an employment which he is likely to take up in future. The type of proof which would be accepted by the Inland Revenue Department includes the nature of the course taken, other evidence showing that the taxpayer is seeking new employment related to the course he takes, etc. The policy intention is to encourage all kinds of employment-related education.

(e) The terms "in any employment" and "在受僱工作中" have exactly the same meaning. "Employment" has been consistently translated as "受僱工作" in the Inland Revenue Ordinance as well as other legislation. For the purpose of the existing section 12(6)(d) of the Inland Revenue Ordinance, IRD has all along interpreted the term as covering both current and future employment. This has been widely made known to taxpayers and clearly set out in IRD's pamphlet. Taxpayers should know and there should be no dispute.

Royalty Income: Clause 5 of Bill and of the corresponding CSAs to amend section 15(1)(b) of the Ordinance

5. Members asked us to set out in greater detail the justifications for not adopting the comments of the Association of Chartered Certified Accountants Hong Kong Branch (ACCA) and the Hong Kong Society of Accountants (HKSA) in relation to the proposed amendments to royalty income.

6. The main concern raised by ACCA and HKSA over the Administration's proposed changes to section 15 of the Ordinance was that the proposed changes deviated from the fundamental territorial

principle of taxation that Hong Kong adopts.

7. The Administration's views on this issue have been set out in detail in the LegCo brief on the Bill (paragraphs 3 to 9) issued in September 2000 and also in our response to deputations' comments issued on 8 December 2003. To recap briefly, the Administration has always considered that a royalty payment which is allowable as a deduction for tax purposes in the accounts of the payer for the use of or right to use a patent, design, trademark, copyright, etc is income of the recipient that arises in and is sourced from Hong Kong. They have connection with business activity in Hong Kong (it is for this reason that the payment is allowable for tax deduction in the accounts of the payer) and hence should be subject to Profits Tax here. In recommending a deeming provision for royalty payments, the Inland Revenue Ordinance Review Committee stressed in their report submitted on 14 March 1968 that "[they] were concerned to ensure that any use of deeming provisions was not employed to extend the scope of the general charge to tax and considered that they could only be justified when applied to receipts which arose from or in connection with some business activity in the Colony."[1] The existing section 15(1)(b) which gave effect to that recommendation was however ruled by the Court of Final Appeal in a case in 2000 as having a narrower interpretation. This interpretation makes the existing section 15(1)(b) incapable of covering some payments of royalty that are allowable as a tax deduction in the accounts of the payer. This was not originally intended by the Administration in enacting section 15(1)(b). Hence the current proposals amending the section to bring it in line with the policy intent. There is no question of deviating from the territorial principle of taxation.

8. ACCA also questions the "deductibility test". The Administration's view is it is necessary to keep "symmetry" between the deductibility of royalty expenses by the payer and the taxability of the receipts in the hands of the recipient in order to avoid revenue leakage through tax planning. Approaches similar to the proposed section 15(1)(ba) are widely used in other jurisdictions and can be found in the tax laws of Singapore[2], Malaysia[3], Australia[4] and New Zealand[5]. In

[1] Paragraph 87 of the Report of the Inland Revenue Ordinance Review Committee dated 14.3.1968.
[2] Singapore Income Tax Act section 12(7)

these countries, royalties paid by a local resident or which are deductible against any income accruing or derived locally are deemed to be income derived from that country. The UK's approach is to disallow deduction of any royalty payment in respect of a user of a patent in order to maintain tax symmetry[6].

Exemptions to Market Making Activities: Clause 6 of the Bill and the corresponding CSAs

9. The Administration was asked to reconsider the request forwarded by the Capital Markets Tax Committee of Asia (Hong Kong Chapter) (CMTC) and the Joint Liaison Committee on Taxation to exempt market-makers from the rule on "no interest deduction for transactions between associated companies" having regard to the actual operation of the market and the compliance burden imposed on stakeholders.

10. As we explained in our submission to the Bills Committee and during the meeting on 9 December 2003, as far as we understand, under current market operations, the issuer of debt securities should not have any difficulty in ascertaining the interest payment arising from his debt securities which are received by companies within its group – hence there should not be any compliance problem with disclosure. Also, we understand that in most cases only financial institutions would engage in market-making activities for the debt securities. Given that financial institutions [which are defined in the Inland Revenue Ordinance to mean banks and other authorized institutions within the meaning of the Banking Ordinance (Cap. 155) and their associated companies] are already listed as excepted persons under the proposed section 16(2F)(c)(ii)(D), there does not seem to be a need to provide a specific exemption for market-making activities. We also informed Members that the Securities and Futures Commission (SFC) and the Hong Kong Monetary Authority (HKMA), when they were consulted on the draft CSAs, did not consider there would be any practical difficulties with the

[3] Malaysia Income Tax Act section 15
[4] Australia ITAA 1936 section 6C
[5] New Zealand Income Tax Act section OE4(1)(r)
[6] UK ICTA 1988, s.74

operation of the relevant provisions.

11. As a follow-up to Members' request, we met with some of the largest debt security issuers, including the Transit Railway Corporation (MTRC) and the Hong Kong Mortgage Corporation (HKMC). Separately, we have also met with members of the CMTC to better understand their concern.

12. Participants advise that at the current moment, all major debt securities in Hong Kong are issued through financial institutions (as defined in the Ordinance) who are excepted persons as defined in the proposed section 16(2F) and are thus exempted from the application of the provision of the proposed section 16(2C), or by companies/corporations who would not engage in market activities involving debt securities which they themselves issue. Besides, these entities (including MTRC and HKMC) should not have any problem in ascertaining the amount of interest payment arising from their own debt securities which are received by their subsidiaries. Indeed some of the issuers have an internal policy of discouraging group companies from their debt securities to avoid apparent conflict of interest. Hence, the "compliance problem" as described by CMTC is not a concern for entities which are issuing debt securities, and the exemption for market-making activities as requested by CMTC is not necessary insofar as current market operations are concerned.

13. However, CMTC Members also advised that, given the promising development of Hong Kong's bond market, international securities-dealing firms might begin to issue their own debt securities and, if they eventually do so, it would be entirely possible that subsidiaries within their own groups might make market-dealing transactions involving debt securities issued by them. As such, they would require exemption from the rule on "no interest deduction for transactions between associated companies". CMTC Members also confirmed that by market-making activities/market-makers, they are referring to the following-

(a) Market makers are securities dealers who hold themselves out as being willing to buy or sell securities for the purpose of market-

making or liquidity-providing activities.

(b) Most of the active market makers are the financial institutions and large international securities-dealing firms who are licensed by a competent local authority to act as a securities dealer or broker.

(c) The market makers may need to keep a stock of the securities on hand to facilitate the market-making activities, but in normal cases the stock of each issue would be small. However, at the initial stage of placing the debentures to the market, the underwriter/market makers may have to hold a more substantial proportion of a debenture issue before the debentures are successfully sold to market investors.

(d) When the financial institutions or the large securities firms raise funds through debenture issuing, they may appoint the securities dealers within their group to underwrite the issue and to make a market. This may be due to their cost, risk management and operational convenience considerations.

14. CMTC also confirmed that theoretically it is possible but in practice it will be difficult and costly for the multinational giant securities-dealing and investment groups to set up a system to keep track of the dealings in the securities issued by the group conducted by its associate companies worldwide, whose normal business activities are securities dealing and market making. This is the "compliance problem" to which they have referred.

15. Having carefully considered the views of CMTC and the situations they describe, we agree, even though there are no such activities and no need for such exemption at the moment, that in terms of principle, exempting market-making activities from the operation of the restriction on interest deduction as provided in the proposed section 16(2C) is reasonable, provided that they are genuine and that there are ways to suitably ring fence the exemption. We also agree that some provisions providing for the exemption should be included in the Bill to cater for possible future scenarios.

16. We are consulting CMTC on an appropriate definition for "market-makers" for the purpose of the exemption. CMTC's latest proposal, which has incorporated the Administration's views, is given in its submission dated 16 January 2004 at ***Annex***. We are working on the necessary CSAs along the lines proposed by CMTC and will present these to Members for consideration when ready.

Financial Services and the Treasury Bureau
February 2004

Capital Markets Tax Committee Of Asia
Hong Kong Chapter

January 16, 2004

Mr Patrick Tam
Inland Revenue Department .
Revenue Tower
5 Gloucester Road
Wan Chai
Hong Kong

Dear Patrick:

Re: Inland Revenue (Amendment) Bill 2000 – Proposed Amendments

We appreciate your willingness to meet with us and discuss our concerns about the proposed amendments to the bill.

We hope that we have made clear the necessity of a market making exception to avoid impairing the Hong Kong bond markets. Market making is necessary to ensure the liquidity of debt securities. Market makers intend to earn small profits from each trade based on the bid-offer spread. Market makers are not eager to buy and hold substantial positions in securities, since profits from the bid-ask spread are not large enough to justify holding costs for long periods of time.

However, we certainly understand your concerns that this market making exception should not be abused for tax avoidance purposes. To prevent taxpayers from holding substantial positions in their own notes in order to take advantage of this concession, we propose the following for your consideration.

Interest expenses should not be disallowed with respect to securities held by a market maker in the ordinary course of its market making business.

A market maker is any person who:

a) is licensed or authorized to conduct securities activities as a securities broker or dealer by either the Securities and Futures Commission or a securities regulating authority located in a major financial centre outside Hong Kong that is approved by the Commissioner for the purposes of subsection (2)(f)(ii)(A);
b) in the ordinary course of a trade or business holds himself out as being willing to buy and sell securities;

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Capital Markets Tax Committee Of Asia
Hong Kong Chapter

c) actively makes a market in securities issued by a wide range of unrelated institutions; and

d) buys and sells the debentures or instruments described in subsection (2)(f)(i) or (ii) in the ordinary course of its trade or business for the purpose of providing liquidity in such debentures or instruments.

For the avoidance of doubt a person shall not be a market maker if, in the opinion of the Commissioner, the activities of that person are not bona fide carried out for the purpose of making a market in debentures or instruments described in subsection (2)(f)(i) or (ii) or are not consistent with the activities that a bona fide market maker would undertake.

We believe that these rules would prevent a taxpayer from abusing these rules by establishing a special purpose vehicle as a market maker. First, the exception only applies to market makers in major financial centres. Obtaining authorization as a securities dealer in any of these jurisdictions is so onerous as to prevent tax avoidance purposes. Second, a taxpayer could not create a special purpose vehicle for this purpose, since it is required to be a market maker in a wide range of securities.

We also believe that these rules would prevent a financial institution from having its offshore market making affiliate hold large long-term positions in that debt. The proposed exception only applies to the extent that the securities are held by the market maker in the ordinary course of its market making activities. For clarity, the practice note could state that in normal circumstances, long term holdings (more than three months) and substantial holdings (more than 5% of the issuance) would not be consistent with market making activities.[1]

We hope that you will not find it necessary to further qualify this market making exception by inserting a 5% threshold. As we discussed, the entire purpose of this exception is to avoid compliance burdens associated with tracking the exact ownership of offshore affiliates. To address your concerns, we have included a specific antiabuse rule in our proposal.

We appreciate your willingness to discuss our concerns. Should you wish to discuss this matter further, please feel free to contact David Sutherland on 2848-6801.

Sincerely,

Jean-Pierre Baudoux
Chairman, CMTC

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[1] There could be unusual circumstances where this general rule would be violated for legitimate business reasons (*e.g.*, bonds held for a short period of time before they are initially sold to the public, bonds that must be repurchased from the market because of a significant credit deterioration of the issuer).

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