Bills Committee on Inland Revenue (Amendment) Bill 2000

Summary of views submitted to the Bills Committee and the Administration's response upon re-activation of the Bill

(as at 23 February 2004)

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
General comments	Capital Markets Tax Committee of Asia (Hong Kong Chapter) (CMTC)	CMTC does not object to the objective of the Bill to attack certain types of tax-motivated arrangements to claim interest deductions through arrangements that could be regarded as abusive.	Noted.
	Capital Markets Tax Committee of Asia (Hong Kong Chapter) Joint Liaison Committee on Taxation	Most of the previous concerns have been addressed by the proposed amendments.	Noted.
	The Taxation Institute of Hong Kong (TIHK)	TIHK has no further comment on the direction and the general principles set out in the Bill, and only raises certain drafting and technical issues.	Noted.

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 4 - *Adjustments to accessible income*	The Taxation Institute of Hong Kong	<u>Expenses of self-education</u> The Administration should consider removing the reference to "any employment" in **sections 12(6)(b)(ii) and 12(6)(c)(ii)**. If such wordings are retained, the Commissioner of Inland Revenue (the Commissioner) should issue a Departmental Interpretation & Practice Note to clarify how "any employment" should be interpreted to include future employment.	If the reference to “any employment” in sections 12(6)(b)(ii) and 12(6)(c)(ii) is removed, taxpayers may claim deduction of expenses incurred in attending any course which may not be related to any employment that the taxpayer may seek to take up. This is not the policy intention of the Administration. The Commissioner agrees to issue a Departmental Interpretation & Practice Note to clarify that “any employment” should be interpreted to include future employment.

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 5 - *Certain amounts deemed trading receipts*	The Association of Chartered Certified Accountants Hong Kong (ACCA)	<u>Royalty income</u> The Administration's position towards the proposed **section 15(1)(ba)** is essentially: (a) to clarify the words "for use or right to use in Hong Kong" should cover "use in the economic sense"; and (b) to apply the "deductibility test" to demonstrate a substantial link to economic use in Hong Kong. ACCA does not subscribe to the "economic use" interpretation, as the Emerson case rejected the interpretation and it does not reconcile with section 15(1)(a) to which no amendment is proposed. Given that the actual taxpayers in respect of royalty income under section 15 (1)(ba) are the non-resident recipients, ACCA does not subscribe to the application of the "deductibility test", as the test hinges on the economic activities of other parties, instead of the taxpayers themselves or the location of use (in the conventional sense) of the taxpayers' assets. **Proposed section 15(1)(ba)** deviates from the fundamental territorial principle of taxation and is inconsistent with other provisions in section 15.	Section 15(1)(a) and (b) were enacted by the Inland Revenue (Amendment) Ordinance 1971 to implement recommendations of the Second Inland Revenue Ordinance Review Committee. In its report, the Committee recommended to bring into the charge to Profits Tax, by way of a deeming provision, receipts from the use of patents, trademarks, etc. It was stressed by the Committee that "[they] were concerned to ensure that the use of the provisions was not employed to extend the scope of 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***" (paragraph 87 of the Report of the Inland Revenue Ordinance Review Committee dated 14 March 1968). The Committee agrees with the then Commissioner of Inland Revenue's proposal of adding the deeming provisions for use of patents, trademarks etc. as "[they] were satisfied that the deeming provisions were justified and, since ***the originating source of the receipts was in the Colony***, that they were appropriate in view of the difficulty in determining chargeability in these cases under the general charge.

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 5 - *Certain amounts deemed trading receipts (Cont'd)*	ACCA *(Cont'd)*	Royalty income *(Cont'd)* The increase in the rate of deeming assessable profits for royalties from 10% to 30%, which took effect on 1 April 2003, is already a disincentive for creative and high-tech industries. The provision of section 15(1)(ba) will further harm Hong Kong's competitiveness.	It is clear that the intention of the deeming provisions introduced under section 15(1)(a) and (b) was to capture those ***receipts originated from Hong Kong that arose from or in connection with some business activity in Hong Kong***. Thus the Administration believes that the original intention of enacting section 15(1)(b) should cover the royalty payment that is paid by a Hong Kong business and is used by that business for the purpose of producing its profits chargeable to Hong Kong Profits Tax, and can thus be claimed as a tax deduction by the payer. This is what we referred to as the "economic use" of the trademark etc. The deductibility of the royalty payment in the tax computation of the payer is evidence of the fact that the royalty payment arose from or was in connection with some business activity in Hong Kong (otherwise the deduction would not be allowed). Thus the Administration considers that the "deductibility test" conforms to the original legislative intention of introducing section 15(1)(b). Furthermore, the tax symmetry to be achieved accords with international taxation practice (see United Nations Model Double Taxation Convention 2001, Article 12). Countries in the Asia – Pacific region like Singapore and Malaysia also adopt this principle.

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 5 - *Certain amounts deemed trading receipts (Cont'd)*	ACCA *(Cont'd)*		Even after increasing the charging rate on royalty income to 30%, the effective tax rate on royalty income, at the current corporation rate of 17.5%, is still only 5.25%. This effective rate is low when compared with other jurisdictions, such as Singapore (which charges withholding tax at 22% on royalty income derived by a non-resident from a trade carried on in Singapore) and the UK (which charges withholding tax at 22% for royalty payments to non-residents). In comparative terms, the increase in charging rate and the introduction of the proposed section 15(1)(ba) will thus not blunt our competitive edge.

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 5 - *Certain amounts deemed trading receipts (Cont'd)*	Hong Kong Society of Accountants (HKSA)	*Submission dated 8 December 2003* HKSA does not support the introduction of the proposed **section 15(1)(ba)**, which is not consistent with the "source principle" under the Hong Kong tax regime. HKSA does not agree to the Administration's argument that the proposed **section 15(1)(ba)** merely reinstates the position which had been widely accepted by taxpayers prior to the Emerson case. HKSA also queries the introduction of a principle of "symmetry" between the deductibility of an expense by the payer of the royalty and the taxability of the receipts in the hands of the payee. To achieve such "symmetry" by taxing an entity that may conduct no business and have no place of business in Hong Kong is inappropriate and contrary to the source principle. *Submission dated 4 February 2004* HKSA continues to have concerns in relation to clause 5 of the Bill and do not consider that these concerns have been resolved by the Administration's explanation.	The Administration's responses to concerns raised by ACCA on royalty income on pages 3 to 5 are relevant. The Administration stresses that the addition of section 15(1)(ba) is meant to uphold the original intention of introducing section 15(1)(b), which was to capture those receipts originated from Hong Kong that arose from or in connection with some business activity in Hong Kong. See Administration's response to HKSA's submission dated 8 December 2003 above.

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 6 - *Ascertainment of chargeable profits*	HKSA *(Cont'd)*	New section 16(2)(f) *Submission dated 8 December 2003* HKSA considers that the term "any other stock exchange recognized by the Commissioner for the purpose of this subparagraph" under new **section 16(2)(f)** should be more clearly defined, i.e. by reference to a list to be published in an appropriate location. Submission dated 4 February 2004 The proposed new section 16(2)(f) added by the Bill refers only to *"any other stock exchange recognised by the Commissioner for the purpose of this subparagraph"*. HKSA considers that making specific reference to the location where a list will be published (e.g. on the IRD website) would provide greater certainty.	In the 2002 annual meeting between the HKSA and the Commissioner, it was agreed that the Commissioner would publish the list of recognized stock exchanges on the web site of the IRD. The list has indeed been published on the web site since October 2002. The Administration thinks that the current arrangement can serve this purpose. The Administration considers that the existing arrangement of publishing the overseas stock exchanges recognised by the Commissioner for the purpose of the existing section 16(2)(f) on the website of the IRD is well known to the public and works smoothly and should be applicable to the new section 16(2)(f). It seems not necessary to fix the mode of publishing the information in the legislation, which may restrict the mode of communication between the IRD and the public. Furthermore, there are other similar provisions in the IRO (such as sections 16B(1)(a), 16C(1) etc.) which make reference to organisations approved by the Commissioner but do not contain a specific reference of location of publishing the list as suggested by the Society. There is no reason why section 16(2)(f) should be dealt with differently.

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Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	Joint Liaison Committee on Taxation (JLCT)	Section 16(2A) The provisions could give rise to a loss of deductions for interests paid to a bank where the taxpayer holds separate deposits with a bank. A bank technically has a common law right to offset the taxpayer's liability under the loan against the amount held for the taxpayer on deposit under the Bill. As the Commissioner will issue a Departmental Interpretation & Practice Note to clarify that interest may continue to be deducted so long as the taxpayer had the ability to lift the deposit at any time (thus "de-linking" the loan from the deposit), JLCT accepts that no further amendment to address this particular issue is required.	The legal adviser of the Administration has advised that set-off is in the nature of a cross-action. The mere fact that there is in existence a deposit held by the borrower with a financial institution so that the principal or interest on the loan may be recovered from it by the financial institution through the exercise of its rights to set-off does not mean that the payment of principal or interest on the loan is "secured" by the deposit, since such deposit is liable to be cancelled or withdrawn by the borrower at any time. The position will, of course, be different if there is put in place such an arrangement that the deposit must be maintained during the currency of the loan in which case the repayment of the principal or interest may then be said to be "secured". The Commissioner would make this view clear in a Departmental Interpretation & Practice Note after the Bill is enacted.
	The Association of Chartered Certified Accountants Hong Kong	**Proposed section 16(2A)(b)** provides for interest deduction to be calculated on such basis as is most reasonable and appropriate in the circumstances of the case. A Departmental Interpretation & Practice Note should be issued to show the details of the possible calculation bases with examples of calculations for interest deduction under **section 16(2A)(b)**.	The Commissioner agrees to show the details of the possible calculation bases with examples in a Departmental Interpretation & Practice Note.

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	The Hong Kong Association of Banks (HKAB)	HKAB notes the proposed amendments to **section 16(2A)(b)**, and has no further comment to make.	Noted.
	Capital Markets Tax Committee of Asia (Hong Kong Chapter) Joint Liaison Committee on Taxation	<u>Sections 16(2C) and 16(2F)</u> In the case of large groups, particularly multinational groups which carry on financial services, it is almost inevitable that affiliates will from time to time buy debentures or marketed notes issued by their group's companies in the course of their normal trading or market-making activities. It would be incredibly complicated, and in many cases probably impossible, for such groups to monitor the activities of all their worldwide affiliates, particularly where such debentures or marketed notes are bought and sold within a short time frame in the course of short-term trading activities.	The Administration does not favour providing exemption to a holding of debentures or notes by an affiliate where the holding is pursuant to the affiliate's genuine market making activities because of the following reasons – (a) If we adopt the principle that interest deduction should be disallowed if it flows back in some ways to the borrower or an affiliate of the borrower, there is no reason why this principle should not apply to a financial services group, a member of which is engaged in market making activities on the note issued by the group company. The non-financial services groups may consider such an exemption discriminatory to them. (b) There will be difficulties in defining "market makers" and "market making activities" in granting the exemption since there are as yet no generally accepted definitions of these terms.

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Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	Capital Markets Tax Committee of Asia (Hong Kong Chapter) Joint Liaison Committee on Taxation *(Cont'd)*	<u>Sections 16(2C) and 16(2F) *(Cont'd)*</u> Hence, the following additional exemptions (*"safe harbour" or "de minimis" exemption*) from the interest disallowance provisions are suggested - (a) a holding by an affiliate where the holding is pursuant to the affiliate's genuine market-making activities; and (b) a threshold whereby up to 5% of the debentures or notes on issue could be held by affiliate without triggering any interest disallowance. Another alternative suggested by JLCT is to give the Commissioner a statutory discretion to ignore small holdings where she is satisfied that the holding arises from genuine trading or market-making activities.	Following the discussions in the Bills Committee meeting held on 9 December 2003, the Administration has further consulted some major debt instrument issuers and the CMTC on the suggestion to provide for exemption to the market making activities. Having regard to the views collected, the Administration agrees, even though there are not such activities and no need for the exemption at the moment, that in terms of principle, exemption genuine market-making activities from the operation of the restriction on interest deduction provision is reasonable, provided that there are ways to ring fence the exemption. It agrees that some provisions providing for the exemption should be included in the Bill to cater for possible future scenarios. Details of the development are set out in the paper "Administration's Response to the Issues Raised in the Bill's Committee Meeting Held on 9 December 2003", CB(1)921/03-04(01)

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	The Real Estate Developers Association of Hong Kong	<u>Importance of a simple tax system to Hong Kong</u> <u>*Submission dated 1 December 2003*</u> The proposed amendments to **section 16(2)** are very complicated. Introducing so many complications to the interest deduction legislation will hinder genuine fund-raising activities. The lengthy proposed anti-avoidance provisions are unnecessary and the **existing section 61A** of the Inland Revenue Ordinance (Cap. 112) is already an effective tool in handling tax avoidance cases. The proposed provisions would damage the simplicity of Hong Kong's existing tax system. Given the complexity of the provisions in the Bill, there is a very genuine risk of the Bill discouraging investment activities in Hong Kong.	The Administration values Hong Kong's simple tax system. However, it is also important to ensure the fairness and integrity of our tax system and to avoid, as far as possible, exploitations and abuses of our tax system. Anti-avoidance provisions are therefore necessary. At the same time, we have to minimise possible inconvenience caused by anti-avoidance provisions to genuine commercial activities. The provisions now proposed strike a balance between maintaining a simple tax system and avoiding abuse. Invoking general anti-avoidance provisions such as the existing section 61A and resolving disputes on assessments raised under the general anti-avoidance provisions are complicated and time-consuming. It is considered better to both taxpayers and the Administration to provide more explicit rules to ensure greater certainty in making interest deduction claims.

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Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	The Real Estate Developers Association of Hong Kong *(Cont'd)*	<u>Importance of a simple tax system to Hong Kong *(Cont'd)*</u> <u>*Submission dated 23 December 2003*</u> Raising funds genuinely from controlling shareholders and/or directors should not be considered as tax avoidance arrangement. The **existing section 61A** allows flexibility to examine the commercial reasons for such arrangement to determine whether it is a tax avoidance case; but this flexibility will be disallowed under the proposed amendments.	As we reiterated in our replies to the earlier submissions of the REDA, the purpose of the Bill is to counteract the exploitations and abuses on the existing law. The application of the existing 61A, in some cases, creates uncertainty both to the taxpayer and the Administration and may not effectively counteract all the abuses, particularly those under the disguise of some commercial purposes. The proposed amendments provide clearer and more explicit rules for the taxpayers to follow, notwithstanding that they do not give consideration to whether any commercial element exists in the transaction. They are welcomed by some of the professionals who have made representations on the Bill.

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	The Real Estate Developers Association of Hong Kong *(Cont'd)*	<u>Importance of financial support from controlling shareholders and directors</u> <u>*Submission dated 1 December 2003*</u> Financial support from controlling shareholders and/or directors is a genuine commercial transaction and there is no reason for the borrower to be penalized simply because it chooses to borrow from a connected person. Such support would most likely take the form of controlling shareholders and/or directors underwriting and/or subscribing for shares or debt securities issued by their company or an associated company. The Bill will completely destroy the cost-effectiveness of such arrangements.	Under the existing section 16(2)(c), interest on a loan from a controlling shareholder and/or director is not allowable for deduction if the interest is not chargeable to tax in the hands of the controlling shareholder and/or director. The aim of adding the proposed anti-avoidance provisions by the Bill and the CSAs is to tackle the avoidance schemes which would enable deduction of the interest payments that should be denied if the scheme were not in place. Thus the denying of deduction of interest payable to controlling shareholders and/or directors who are not taxed on the interest income is in line with the existing policy, intention and provision of the legislation.

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Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	The Real Estate Developers Association of Hong Kong *(Cont'd)*	<u>Importance of financial support from controlling shareholders and directors</u> *(Cont'd)* <u>*Submission dated 23 December 2003*</u> Deduction of interest is currently allowed under other provisions such as existing **section 16(2)(f)** even if the interest is not chargeable to tax in the hands of controlling shareholders and/or directors. The Administration has presumed that genuine fund raising activities from controlling shareholders or directors are avoidance schemes. Under the proposed amendments, interest is deductible on funding raised by debentures from overseas non-related lenders even if it is not taxable in the hands of the recipients. However, should funding be raised from overseas controlling shareholders or directors through the same arrangement, interest deduction is disallowed. The existing law, including section 16(2)(c), does not distinguish the tax treatment of interest on money borrowed from controlling shareholders and/or directors from the tax treatment of interest on money borrowed from the others. The new distinction is introduced in proposed sections 16(2B), 16(2C) and 16(3B). This arrangement can hardly be in line with the existing policy, intention and provision of the legislation.	The main purpose of seeking a symmetry in the taxing and allowing deduction of interest payment is explicitly spelt out in section 16(2)(c). Thus a borrowing from the controlling shareholders or directors of a company would be deprived of interest deduction if the interest paid to the shareholders or directors are not taxable in their hands. The law allows deduction of interest in other cases, such as borrowing from the bank (s.16(2)(d)), borrowing for specified purposes and under some specific conditions (s.16(2)(e), in which borrowing from an associate of the borrower is not allowed) and from issuing debentures and marketable debt instruments which are listed on a stock exchange or marketed in a financial centre (s.16(2)(f)), without insisting on the taxing of the same amount of interest in the hands of the recipients. The rationale for the deduction under these cases is to allow interest deduction on borrowings made in ordinary course of a taxpayer's business from a financial institution or from a properly regulated debt market, or for a specified purpose (in the latter case borrowing from associates is not allowed). However, the availability of these alternative routes of interest deduction has enabled some taxpayers to abuse the interest deduction scheme such that interest, which would otherwise not be deductible under the law, is arranged to be claimed under the provisions that are provided for other types of loans. For example, an arrangement may be set up in which deduction of

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Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	The Real Estate Developers Association of Hong Kong *(Cont'd)*		interest on bonds issued in an overseas stock market is claimed under section 16(2)(f), while the whole or the major part of the issue was subscribed by an offshore associated company of the borrower. The whole scheme is set up to bypass the operation of section 16(2)(c), which would otherwise disallow deduction of the interest payable to the associated company that is not chargeable to tax in respect of the interest received. It is obviously not the intention of the legislation to allow that section being by-passed in such a way. The Administration takes the view that section 16(2)(f) is intended to allow deduction of interest on money borrowed from external sources through issuing debentures and debt instruments. Loans that are internal to the group should be governed by the tax symmetry test laid down under the existing section 16(2)(c). The proposed new section 16(2C) is meant to ensure that the test of section 16(2)(c) would not be bypassed. Genuine transactions, which are not disguised borrowings from related parties, will not be affected by the proposed amendments.

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Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	The Real Estate Developers Association of Hong Kong *(Cont'd)*		The existing section 16(2)(e) disallows deduction of interest if the money is borrowed from an associate of the borrower, which includes an associated company, a controlling shareholder or director (see the definition of "associate" in section 16(3)). In addition, section 16(2)(c) disallows deduction of interest payable to associated companies, controlling shareholders and directors who are not financial institutions, if they are not chargeable to tax in respect of the interest they receive. Although interest deductions under section 16(2)(d) and (f) in respect of borrowings from financial institutions and from issue of debentures and debt instruments do not distinguish the tax treatment of interest from money borrowed from controlling shareholders and directors from money borrowed from others, these provisions apparently aim to cater for bona fide external borrowings. Raising of funds internally in a group by routing through borrowings from financial institutions or through issuing of debentures aiming to gain tax deduction of the interest concern is an abuse of these provisions. It is clear that the proposed amendments are in line with the policy intent of the existing law – that interest payable to associates should not be allowable for deduction if it is not chargeable to tax in the hands of the recipients.

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	The Real Estate Developers Association of Hong Kong *(Cont'd)*	<u>Importance of financial support from controlling shareholders and directors</u> *(Cont'd)* <u>*Submission dated 23 December 2003*</u> Under the new arrangement, controlling shareholders and/or directors will keep their funds overseas, and the borrowers will be forced to borrow at less cost-efficient pricing to maintain the interest deduction. The Association advocates for a level playing field and that the discriminatory provisions to controlling shareholders and/or directors should be dropped from the Bill.	As said above, under the existing law interest cost of borrowing from controlling shareholders or directors who are not chargeable to tax in respect of the interest is not tax deductible, if it is not disguised as other loans. Different jurisdictions have different controls over allowing deduction of interest payable to shareholders or directors. Some nations such as Japan and Australia adopt the thin capitalization rule, which limits the deduction of interest by reference to the proportion of debt to equity of a company. In Hong Kong we adopt tax symmetry as a control. The control of interest deduction is particularly important in maintaining the integrity of the taxation scheme in Hong Kong since the repealing of interest tax in Hong Kong has created an imbalanced tax treatment on interest payments that can be and indeed has been seriously exploited, resulting in a heavy drain on our tax revenue.

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Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	The Real Estate Developers Association of Hong Kong *(Cont'd)*	*Submission dated 1 December 2003* Since debentures may be acquired ex-interest or cum-interest for a particular interest payment, there may be situations where in the year of acquisition or disposal, certain interest is disallowed in the hands of taxpayer in accordance with the apportionment formula set out in **section 16(2C)** while none of the associated interest is received by the taxpayer or any of its associated companies. *Submission dated 23 December 2003* In the year of acquisition or disposal of debenture, if the amount of interest ultimately received by the taxpayer or its associated companies is made known to the taxpayer, it would be appropriate to disallow the same amount, instead of arriving at the disallowable amount by means of the apportionment formula stated in proposed section 16(2C).	When a debenture or note is sold, the seller's entitlement to the accrued interest on the debenture or note will normally be reflected in the selling price of the debt instrument. Thus the apportionment formula of section 16(2C) (which bases on the time of holding the debenture by the debenture holder) is a fair basis that reflects the commercial practice. The Administration considers that the apportionment formula stated in the proposed section 16(2C), which apportions the accrued interest between the old and new holders of the debenture by reference to the respective time of holding the debentures, provides a fairer basis of apportionment in the year of acquisition and disposal. Should the proposed basis of REDA be used in a case where an associated company of the borrower acquires the debentures cum interest shortly before interest is payable, the full amount of interest payable to the associated company on interest payment day will be disallowed notwithstanding that the amount in question includes the interest accrued for the period prior to the acquisition of the debenture by the associated company.

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Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	The Real Estate Developers Association of Hong Kong *(Cont'd)*	*Submission dated 1 December 2003* Regarding the bases for determining whether "a corporation shall be regarded as being controlled by a shareholder" as provided under **section 16(3A)(a)**, it is not clear as to what extent this proposed section is to apply.	The test of a person's control over a corporation is spelt out under the definition of "control" under existing section 16(3). The Bill only proposes to recast the existing provision by grouping them under the new section 16(3A)(a). The test has been working smoothly for a long time and there is little dispute on this issue in the past. Whether a company is controlled by a shareholder by means of holding of shares or the possession of voting power; or any power by the articles of association or any other document regulating the corporation is a matter of fact which the company itself should be in a position to know. A holding of over 50% of the issued share capital of the company is obviously an evidence of control. For holdings below this percentage, the judgement has to rely on the facts of the particular case.
		Submission from 23 December 2003 A clear guidance on the definition of "control" in the form of a Departmental Interpretation and Practice Note would be helpful.	The term "control" is defined in the proposed amendments to section 16(3). The Administration agrees to provide guidance on the definition by way of a Departmental Interpretation and Practice Notes after the Bill is enacted.

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Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	The Real Estate Developers Association of Hong Kong *(Cont'd)*	*Submission dated 1 December 2003* Controlling shareholders will be regarded as "connected persons" under **sections 16(3A) and (3B)**, and hence interest deduction will be disallowed. Such provisions will discourage business from seeking financial support from controlling shareholders.	For the issue of disallowing deduction of interest paid to controlling shareholders, see the Administration's response to REDA's view on general comments of the Bill on page 13 on importance of financial support from controlling shareholders and directors.
	The Taxation Institute of Hong Kong (TIHK)	The term "arrangements are in place" is used in **sections 16(2B)(b) and (2C)(b)**. Given this drafting, the interest deduction restriction will be invoked even when "on paper arrangements" are in place and where the passing of interest has not actually occurred. The Administration should consider whether the restriction on interest deduction under **sections 16(2B)(b) and (2C)(b)** should be restricted to cases where the passing of interest has actually occurred. The term "interposed person" used in **sections 16(2B)(b) and (2C)(b)** should either be defined in the Ordinance or elaborated in a Departmental Interpretation & Practice Note.	It is intended that the provision for restricting interest deduction will be invoked even when "on paper arrangements" are in place where the passing of interest has not actually occurred. Restricting the application of the provision to cases where the passing of interest actually occurred may be vulnerable to abuses. After all, it would be quite peculiar to have such an arrangement on paper that would not be performed by the parties. Such "on paper arrangement" has the flavour of tax avoidance and should not be encouraged. The Commissioner agrees to elaborate the meaning of "interposed person" in a Departmental Interpretation & Practice Note.

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Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	The Taxation Institute of Hong Kong (TIHK) *(Cont'd)*	TIHK requests the Administration to simplify the drafting language and style to benefit both laymen and professionals.	The Administration and the Law Draftsman have strived to make the provisions as simple as possible. However, given the complexity of the anti-avoidance scheme, the provisions are necessarily somewhat complicated.
	Hong Kong Society of Accountants (HKSA)	*Submission dated 8 December 2003* HKSA welcomes the efforts of the Administration to define more clearly the scope of anti-avoidance provisions under **section 16** through the proposed CSAs.	Noted.

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Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	HKSA *(Cont'd)*	New section 16(5A) (grandfathering provisions) *Submission dated 8 December 2003* HKSA supports the introduction of "grandfathering" provisions in proposed **section 16(5A)** to exclude, from the operation of the new provisions, sums which are the subject of an application to the Commissioner for advance clearance or an application under section 88A *(Advance rulings)* of the Ordinance and where the Commissioner has expressed the opinion that the transaction or arrangement would not fall within section 61A (*Transactions designed to avoid liability for tax).* HKSA suggests that consideration be given to extend the relevant provisions in a conceptually similar way to pre-existing sums or applications made under section 22B(4) *(Limited partner loss relief).*	The Administration considers that the grandfathering provisions set out in the proposed section 16(5A) are adequate for the current purposes. The grandfathering provisions under section 22B(4) are of a wider scope, and are so required to cater for the specific situations in enacting section 22B – (a) Section 22B was enacted by the Inland Revenue (Amendment) Ordinance 1992 to introduce a new basis of sharing losses incurred by a limited partnership to its limited partners. To safeguard against the loss of revenue, section 22B was given retrospective effect to cover losses incurred on transactions entered into on or after 15 November 1990.

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	HKSA *(Cont'd)*		(b) Section 22B(4) provides that the section applies to the years of assessment commencing on or after 1 April 1991. As far as the year of assessment 1991/92 is concerned, the basis period of this year might cover a period earlier than 15 November 1990. One of the purposes of the grandfathering provision under section 22B(4) was to exclude the loss incurred by the transactions entered into before 15 November 1990 from the application of section 22B(4), if they were of the type that did not fall within the terms of section 61A. (c) In addition, the grandfathering provisions under section 22B(4) also operated to exclude from the operation of section 22B the transactions that were entered after 15 November 1990, where an application for advance clearance was lodged with the Commissioner of Inland Revenue before that date and that the Commissioner had given an earlier advance clearance (which might be made before or after 15 November 1990), which was necessarily based on the old law (the new legislation was enacted on 13 March 1992).

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	HKSA *(Cont'd)*		The situations and the purposes of making grandfathering provisions for the provisions relating to interest deduction under the Inland Revenue (Amendment) Bill 2000 are different from those of the 1992 Amendment Ordinance – (a) Section 16(5A)(1) of the Bill 2000 proposes that the new provisions do not apply to interest that were incurred before the commencement of the amendment ordinance. Unlike the 1992 amendments which enabled section 22B to apply to a year of assessment (the basis period of which would be different for different taxpayers) and to losses incurred under a transaction which occurred before the amendment ordinance was enacted, the date of application of the interest deduction provisions proposed by the Bill 2000 is precise, clear and non-retrospective, as it would not bring any interest incurred before the enactment under the scrutiny of the new legislation. (b) Interest generated from a loan that was advanced before the commencement of the amendment ordinance will be subject to the new law if it is incurred after the commencement. However, the taxpayer is not necessarily prejudiced by the legislative change since in most cases they are free to pay off or restructure the loan to satisfy the new conditions. Thus there is no justification to grandfather all the loans drawn before the commencement of the new legislation.

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	HKSA *(Cont'd)*		(c) The only purpose of making grandfathering provisions under the proposed section 16(5A) is to reflect the concerns, raised by some of the parties who have made representations to the Bills Committee and to the Administration, about some financing transactions that had been completed, were not abusive, and had received advanced clearance or advanced rulings from the Commissioner. Such cases generally involved leasing and asset financing transactions, which would be very difficult to restructure if affected adversely by the legislation. The grandfathering provisions are targeted at this type of cases only. (d) The grandfathering provision is extended to cover the cases where an application for advance ruling is made and the Commissioner has granted a favourable ruling before the commencement of the amendment ordinance. It is not appropriate to extend the provision further to cover the cases in which the Commissioner gives an advance ruling after the commencement of the new legislation since after that date, the Commissioner will be obliged to give a ruling in accordance with the new legislation. [The term "that date" in "before or after that date" in section 22B(4) refers to 15 November 1990, rather than the date of enactment of the 1992 Amendment Ordinance.]

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	HKSA *(Cont'd)*		Hence the Administration considers that the extension of scope of the grandfathering provision suggested by the HKSA does not suit the current situations and objectives.

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 6 - *Ascertainment of chargeable profits (Cont'd)*	HKSA *(Cont'd)*	<u>New section 16(5A) (grandfathering provisions)</u> *(Cont'd)* <u>*Submission dated 4 February 2003*</u> Notwithstanding the Administration's explanation of the difference in the underlying objectives between clause 6 of the Bill and the provisions of section 22B, HKSA believes that the grandfathering provisions should be extended to any genuine financing transactions that have not been the subject of an advance ruling application, if the Commissioner of Inland Revenue (CIR) is of the opinion that the transaction would not have been regarded as falling within the terms of section 61A if an advance ruling or clearance had been sought. The discretion is considered necessary to enable CIR to allow for "grandfathering" at the request of taxpayers on a case-by-case basis. Otherwise, taxpayers who, prior to the passage of the legislation, have in place genuine financing arrangements that are subsequently affected by the new legislation but who had not sought an advance ruling or clearance at the time of raising the funding, would be unfairly prejudiced. Furthermore, in cases where taxpayers choose to pay off or restructure the loan, the costs involved could be significant.	The Administration does not support extending the grandfathering provision as suggested by the HKSA on the following grounds – ➢ The new anti-avoidance provisions in section 16 will only affect interest incurred after the enactment, and therefore does not have retrospective effect as section 22B did (which affects the losses made in transactions occurred before its enactment). ➢ Section 22B affects the treatment of losses incurred by transactions, which occurred before the specified date (15 November 1990) and are irreversible. Although a financing arrangement that occurred before the enactment of this Bill may be affected, the arrangement is reversible. ➢ HKSA's proposal will give rise to uncertainty to both taxpayers and CIR - Leasing and asset-financing cases are what sections 22B and 39E were designed to deal with. A Departmental Interpretation and Practice Note was published as early as in 1986 to set out the guidelines under which such transaction might be structured without a risk of being challenged by the CIR under the general anti-avoidance provision in section 61A. After

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			several years of operation, it was decided that the law should be amended to tighten the control on this type of transactions. Accordingly section 22B was introduced and section 39E amended in the 1991 amendment exercise. In other words, long before the legislative change, there were already guidelines on what is an acceptable and what is not an acceptable arrangement. These guidelines were published and well known to the public. In such circumstances, it is not difficult to know whether an application would have been acceptable to the CIR before the legislative change. The grandfathering provisions in section 22B(4) and 39E(6), as regards cases of "non-application", are therefore workable. However, cases of interest deduction claims under section 16(2) have to be decided on the merits of each individual case (i.e. a case-by-case approach is adopted). It is very difficult to ascertain whether a particular case is or is not "the same type as any in relation to which, in the circumstances prevailing before the commencement of the Amendment Ordinance (i.e. the Inland Revenue (Amendment) Bill 2000), the CIR would have expressed the opinion that the arrangement would not fall within the terms of section 61A" [per HKSA's suggestion in its letter dated 8 December 2003]. Taxpayers cannot refer to a set of published

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			guidelines to ascertain whether CIR would give a favourable ruling in a particular situation because such guidelines do not exist. Such grandfathering provision is bound to create disputes between the taxpayers and the CIR as regards whether the CIR would have expressed the opinion that the arrangement in question would not have fallen within the terms of section 61A.

Council Business Division 1
Legislative Council Secretariat
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