

March 26, 2004

Dr Hon Eric LI Ka-cheung, GBS, JP
Bills Committee Inland Revenue (Amendment) Bill 2000
Legislative Council
8 Jackson Road
Central
Hong Kong

Dear Dr Li,

Inland Revenue (Amendment) Bill 2000
Section 16(2C) of the Inland Revenue Ordinance ("IRO")

The Hong Kong General Chamber of Commerce Taxation Committee would like to take this opportunity to submit our views on the captioned draft legislation. We find this clause to be unnecessarily restricting of legitimate business practices, and inadequate for addressing the concerns for which it was designed.

The proposed section would disallow a deduction for interest incurred on debentures issued by a Hong Kong taxpayer to the extent to which the debentures are held by a connected person not subject to Hong Kong profits tax on the interest received. An example would be a controlling shareholder of a listed company applies its overseas funds to acquire debentures issued by the listed company.

The proposed amendments are intended to bring tax symmetry to the treatment of interest income and payments on debentures and marketable instruments, i.e. a deduction for interest will be allowed only in so far as it is taxed in the hands of the recipient. The Administration has suggested that tax symmetry has been maintained in the United Kingdom, Australia, Japan and Singapore.

We wish to point out that the Hong Kong tax regime does not currently require complete symmetry on the tax treatment of payments made to foreigners.

Tax asymmetry (as opposed to tax symmetry) exists in the four countries identified above due to the differences between the domestic income tax rates applicable to the payers of interest and the withholding tax rates applicable to the interest received by foreigners. The rate differentials range from 5% to 22.5%.

In Singapore and the UK, in the interest of promoting the development of the local bond market, interest payment to foreigners on certain qualifying debentures is exempted from withholding tax.

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In order to forestall the potential abuses of the tax asymmetry, UK, Japan, and Australia have adopted the "thin capitalisation rules". In general terms, so long as domestic corporations observe the prescribed debt-to-equity ratios, they will not be disallowed deduction for interest payments merely because the payments are made to foreign affiliates. This is in contrast to the approach adopted by the proposed Section 16(2C), whereby interest payments to foreign connected persons will be disallowed, unless the recipient is subject to tax in Hong Kong on the interest income.

The proposed Section 16(2C) only seeks to enforce tax symmetry where a foreign person receiving the interest is connected with the Hong Kong company issuing the debentures. This has the effect of discriminating against the controlling shareholder of a Hong Kong company, who would be discouraged from reinvesting its overseas funds into Hong Kong.

We wish to point out that there are circumstances in which a controlling shareholder may wish to acquire debentures issued by its Hong Kong company, and for valid commercial reasons. For example, in a convertible bond issue, the controlling shareholder may wish to acquire the bonds in order to preserve its percentage shareholding in the company. A company intending to issue debentures may also want its controlling shareholder to underwrite the issue so as to reduce the funding cost of the issue.

It is envisaged that the enactment of the proposed Section 16(2C) would inhibit these genuine commercial activities and hence the development of the debt market in Hong Kong. This appears to be against the Government's stated policy of developing Hong Kong into a centre for financial services, as highlighted in the Chief Executive's 2004 Policy Address and the Financial Secretary's 2004-05 Budget Speech.

Further, we believe the IRD could counteract those isolated avoidance cases by way of the anti-avoidance provisions under the IRO. Indeed, the IRD has been applying Section 61A to counteract the isolated tax avoidance cases with notable success.

We hope that the above will assist you in your consideration of this amendment, and the inadvertent role it might play in hampering the development of the Hong Kong financial centre.

Sincerely Yours,

Eden Woon
CEO