

2 April 2004

Clerk to the Bills Committee on the  
Inland Revenue (Amendment) Bill 2000  
Legislative Council  
Legislative Council Building  
8 Jackson Road  
Central  
Hong Kong

Dear Sir

**Proposed Amendments under the Inland Revenue (Amendment) Bill 2000**

We refer to your letter of 26 February inviting us to submit further information to illustrate the extent of the impacts of the proposed Section 16(2C) of the Inland Revenue Ordinance (“IRO”) on the development of the debt market in Hong Kong.

We now attach our detailed submission for your review. The key items of our submission are duplicated below for your reference:

1. The original intention of this type of amendment was to ‘strengthen anti-avoidance provisions in the wake of increasing incidence of aggressive tax avoidance schemes<sup>1</sup>’. However, this section is very broadly worded and will not only operate in circumstances of anti-avoidance, but will penalise many arms length debt raisings.
2. The Administration has explained that tax symmetry between the payment and receipt of interest is a key aspect of this section, and is consistent with regimes in the United Kingdom, Australia, Japan and Singapore. However, tax symmetry in relation to interest is not prevalent in these tax regimes as follows:
  - Withholding tax rates for interest are typically far lower than the income tax rate, which means the tax paid on the interest income is lower than the tax benefit derived from the interest deduction. This is not symmetrical in a revenue sense.
  - Some jurisdictions (eg. Singapore and the UK) have regimes designed to encourage local debt raisings, which exempt widely issued debt securities from interest withholding tax even if associates participate in the debt raising. Deductions continue to be available even though there is no tax in the hands of the recipient, which again is not symmetrical; and

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<sup>1</sup> Press Release, October 18, 2000 Speech by the Secretary for the Treasury, Miss Denise Yue

- Anti-avoidance aspects are usually controlled by thin capitalisation measures or general anti-avoidance provisions.

If full symmetry is pursued, this will put Hong Kong at a competitive disadvantage in relation to debt issues compared to most offshore tax regimes.

3. The Inland Revenue Ordinance currently has many instances where tax symmetry is not maintained, such as deductible service fees paid to offshore entities which are not subject to tax in Hong Kong. Introducing symmetry in relation to interest will be inconsistent with the general territorial concept of taxation in Hong Kong law.
4. We conducted a recent survey of our key members as to the implications of section 16(2C) on their commercial business. The survey results are attached in Appendix C to our submission, and the key findings were:
  - 70% of respondents envisaged commercial circumstances (described in Appendix C) in which corporate groups wish their controlling shareholders to acquire their own debentures.
  - 80% of respondents envisaged commercial circumstances (also described in Appendix C) in which controlling shareholders would want to acquire debts issued by groups they control.
  - 90% ‘strongly agree’ that the enactment of proposed section 16(2C) may impose an undue administration burden on corporate groups to ascertain whether any connected persons may have acquired their debentures.
  - 90% ‘strongly agree’ that the section will increase the cost of debt issues and 70% ‘strongly agree’ that the section may discourage corporate groups to raise funds in Hong Kong by way of debt issue.
  - 70% ‘strongly agree’ that the section would inhibit the development of the debt markets in Hong Kong. We note this is inconsistent with the Administration’s frequently stated objectives of encouraging a healthy domestic debt market.
5. The Administration has indicated that the tax revenue collected connected with bond related tax abuse is more than HK\$1billion. However, based on public statistics<sup>2</sup>, at least HK\$553billion in bond issues were made in the years 1997 to 2003.

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<sup>2</sup> Statistics are provided by Hong Kong Capital Market Association based on information extracted from the databases maintained by Thomson Financial.

Against the size of the total bond issues, we question whether the level of bond related tax abuse is as severe as the Administration might suspect. Isolated abuse cases should be adequately covered by anti-avoidance provisions under the current regime.

We would welcome the opportunity to go through the submission with you or provide any other information you may require.

Yours faithfully

Louis Loong  
Secretary General

**Submission regarding proposed Section 16(2C)  
of the Inland Revenue Ordinance**

**The Real Estate Developers Association of Hong Kong**

2 April 2004

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# 1 Background

## *Background*

The Inland Revenue (Amendment) Bill 2000 contains a proposed new Section 16(2C) of the Inland Revenue Ordinance (IRO), dealing with tax deductions for interest paid under certain debt financing arrangements.

The new section broadly seeks to disallow deductions for interest paid to connected persons, unless the interest is subject to tax in Hong Kong. The Administration has explained its intention to introduce a new concept of 'tax symmetry' into Hong Kong tax law, where interest deductions should match taxable interest in order to protect the revenue and minimise anti-avoidance concerns.

The Administration suggests this concept of 'tax symmetry' is present in various overseas jurisdictions, and has prepared a paper<sup>1</sup> illustrating tax symmetry in four overseas jurisdictions - Singapore, the United Kingdom, Australia and Japan.

## *Purpose*

The Real Estate Developers Association of Hong Kong (REDA) is concerned that the introduction of this section as currently worded will impact adversely on its members, and on the Hong Kong debt market in general. This submission outlines these concerns for consideration by the Administration.

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<sup>1</sup> CB(1)1158/03-04(01)

## 2 Submission summary

The key items of concern by the REDA in relation to the proposed section 16(2C) and the Administration's policy regarding 'tax symmetry' can be summarised as follows:

### *Beyond anti-avoidance*

1. The original intention of this type of amendment was to 'strengthen anti-avoidance provisions in the wake of increasing incidence of aggressive tax avoidance schemes<sup>2</sup>'.

However, this section is very broadly worded and will not only operate in circumstances of anti-avoidance, but will penalise many arms length debt raisings.

### *No full symmetry overseas*

2. Full tax symmetry in relation to interest is not prevalent in most overseas tax regimes, including those explored in the Administration's paper. In offshore regimes:
  - a. Withholding tax rates for interest are typically far lower than the income tax rate, which means the tax paid on the interest income is lower than the tax benefit derived from the interest deduction. This is not symmetrical in a revenue sense.
  - b. Many jurisdictions have regimes designed to encourage local debt raisings, which exempt widely issued debt securities from interest withholding tax even if associates participate in the debt raising. Deductions continue to be available even though there is no tax in the hands of the recipient, which again is not symmetrical; and
  - c. Anti-avoidance aspects are usually controlled by thin capitalisation measures or general anti-avoidance provisions.

If full symmetry is pursued, this will put Hong Kong at a competitive disadvantage in relation to debt issues compared to most offshore tax regimes.

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<sup>2</sup> Press Release, October 18, 2000 Speech by the Secretary for the Treasury, Miss Denise Yue

***Current tax position***

3. The Inland Revenue Ordinance currently has many instances where tax symmetry is not maintained, such as deductible service fees paid to offshore entities which are not subject to tax in Hong Kong.

Introducing symmetry in relation to interest will be inconsistent with the general territorial concept of taxation in Hong Kong law.

***Impact to commercial business***

4. REDA has recently conducted a survey among its key members as to the implications of section 16(2C) on their commercial business. The survey results are attached in Appendix C, and the key findings were:
  - a. 70% of respondents envisaged commercial circumstances (described in Appendix C) in which corporate groups wish their controlling shareholders to acquire their own debentures.
  - b. 80% of respondents envisaged commercial circumstances (also described in Appendix C) in which controlling shareholders would want to acquire debts issued by groups they control.
  - c. 90% 'strongly agree' that the enactment of proposed section 16(2C) may impose an undue administration burden on corporate groups to ascertain whether any connected persons may have acquired their debentures.
  - d. 90% 'strongly agree' that the section will increase the cost of debt issues and 70% 'strongly agree' that the section may discourage corporate groups to raise funds in Hong Kong by way of debt issue.
  - e. 70% 'strongly agree' that the section would inhibit the development of the debt markets in Hong Kong. We note this is inconsistent with the Administration's frequently stated objectives of encouraging a healthy domestic debt market.

Overall, the survey showed companies have genuine concerns that the introduction of this section will adversely impact on their business.

The above items are explained in more detail in the main body of this paper, read in conjunction with the Attachments.

### 3 Detailed comments

#### *Symmetry not common*

Full tax symmetry in relation to interest payments and receipts is not prevalent in most overseas tax regimes.

Each of the jurisdictions highlighted in the Administration's paper has a withholding tax regime in respect of interest payments to foreigners. A tax deduction for the local payer is generally subject to satisfactory fulfillment of the withholding requirements.

#### *Tax rate differentials*

However, in each of the four jurisdictions, the interest withholding tax rate is significantly lower than the domestic income tax rate. This is not symmetrical in a revenue sense, because there is a greater tax benefit from the interest deduction than the withholding tax collected on the income. The rate differentials range from 5% in Singapore to 22.5% in Japan, and they are all in the taxpayers favour.

#### *Widely issued debt concessions*

In some jurisdictions, the tax differential is allowed to widen even further in order to promote the development of the local bond market.

In Singapore, withholding tax is waived in respect of interest payments on debt issues that satisfy the requirements under the "Qualifying Debt Securities"<sup>3</sup> scheme. In the UK, specific provisions have been introduced to waive the withholding tax requirements for all instruments that qualify as "quoted Eurobonds"<sup>4</sup>.

The effect of these provisions is similar to Section 16(2)(f) of the IRO as it currently stands.

#### *Anti avoidance*

While each of the four jurisdictions have legislation to restrict the potential abuse of the tax rate differentials between interest income and expense, none of the jurisdictions has sought to disallow an interest deduction simply on the basis that the recipient is a foreign affiliate.

Restrictions are instead generally placed on the level of borrowing as against interest-free equity i.e. the application of "thin capitalisation" rules.

<sup>3</sup> Under the Qualifying Debt Securities ("QDS") Scheme in Singapore, the withholding tax requirements will be waived for holders of publicly offered debt securities issued in Singapore if, during the primary launch, (1) the securities are issued to not less than 4 persons, and (2) less than 50% of the issue is beneficially held or funded by parties associated with the issuer.

<sup>4</sup> The withholding tax exemption generally applies to interest received by non-UK holders of debentures or debt instruments listed in the UK or any recognised stock exchange ("quoted Eurobonds").

Generally, if the local corporation's debt-to-equity ratio is maintained within an acceptable threshold, a tax deduction will be available even if the recipient of the interest is a foreign affiliate and taxed at reduced withholding tax rates.

This approach is to be contrasted with the proposed amendments which seek to disallow all interest payments to a connected person.

Appendix A contains a summary table which compares the taxation of interest in the four jurisdictions covered in the Administrations paper.

Appendix B contains an overview of the tax treatment of interest income and interest expense on debentures in the four jurisdictions.

### ***Current Hong Kong law***

The Hong Kong tax regime does not generally require symmetry on the tax treatment of payments even to connected foreign persons. For example, service fees paid by a local corporation will generally be deductible, even if the foreign service provider is not chargeable to Hong Kong tax on the income.

In respect of interest income and expenses, the Hong Kong regime has effectively been non symmetrical since the abolition of interest tax in 1989, which was done to attract foreign capital.

Foreign corporations that do not carry on business in Hong Kong are not normally taxed on interest from Hong Kong debentures, while the Hong Kong issuer can still typically deduct the interest expense.

This differential (17.5%) will continue to apply to debt issues under proposed section 16(2C), provided payments are not made to connected persons.

### ***Survey results***

A recent survey among REDA members showed companies have genuine concerns about penalising connected persons from participating in local debt issues. They believe such a provision will adversely impact on their business. The survey results are attached in Appendix C.

Section 16(2C) as currently drafted seems to assume that connected persons only take up domestic bonds in order to avoid tax. However, this is clearly not the case. The survey respondents stated there are many commercial reasons why shareholders should be able to participate in local debt issues without being penalized by the tax regime.

For example:

1. controlling shareholders may be required to underwrite the issue
2. shows confidence to the market to have shareholders participate and increases chance of a successful launch
3. convertible bond acquisitions in order to avoid dilution of their percentage shareholding

The survey concluded that as a consequence of these and other reasons, that the section is likely to discourage corporate groups to raise funds in Hong Kong by way of debt issue, which would in turn inhibit the development of the debt markets in Hong Kong.

*Affects commercial markets*

We note this is inconsistent with the Administration's frequently stated objectives of encouraging a healthy domestic debt market.

In his 2004 Policy Address, the Chief Executive has stressed the importance of developing Hong Kong into a centre for international financial services and asset management, or the Switzerland of Asia<sup>5</sup>. This echoes the initiatives set out in the 2003/04 Budget, which stressed that Hong Kong must take advantage of the rapid accumulation of capital in the region and its established economic infrastructure to promote its status as the bond and fund management centre for Asia<sup>6</sup>.

Introducing restrictions on the tax deductibility of interest payments on debentures at this juncture is likely to cause concern among potential issuers and investors, thus hampering the growth of the local bond market.

The situation is likely to become more acute when it is compared to the environment in Singapore, one of our major competitors for capital in the region. Since the Financial Year 1998/99, the government of Singapore has introduced a package of tax incentives to encourage the growth of its local debt market, including the QDS scheme.

If the proposed amendments in Section 16(2C) were to be put through, the after-tax cost for raising capital in Hong Kong by way of debenture issues would increase. Hong Kong corporate groups may be discouraged from issuing debentures. This may contradict the objectives of the government towards developing Hong Kong into the bond and fund management centre in the region.

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<sup>5</sup> Paragraph 33 of the 2004 Policy Address refers.

<sup>6</sup> Paragraph 39 of the 2003/04 Budget refers.

### *Anti-avoidance aspects*

While the Administration has stressed the severity of abuse under the existing tax regime, no clear financial evidence has been provided in support of the case. Based on available statistics, the amount of bond issues by Hong Kong based groups (including issues made by their foreign affiliates and guaranteed by the Hong Kong parents) during the years 1997 to 2003 amounted to no less than US\$70.9 billion (i.e. HK\$553.4 billion)<sup>7</sup>. On the other hand, the Administration has indicated that the tax revenue collected by the Hong Kong Inland Revenue Department on related abuse and avoidance cases has exceeded HK\$1 billion (which is understood to be the cumulative effect for all the statutorily open tax assessment years).

Against the size of the total bond issues by Hong Kong based groups, it is possible that the Administration may have overstated the severity and level of abuse.

Besides, the Administration has stated that it had succeeded in collecting the tax revenue from the isolated abuses and avoidance cases by invoking the present anti-avoidance provisions under the IRO. This casts doubt on whether there is an imminent need for the proposed amendments to be enacted, which may have the unwanted effect of inhibiting the majority of the commercial activities.

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<sup>7</sup> Statistics are provided by Hong Kong Capital Market Association based on information extracted from the databases maintained by Thomson Financial.

## Appendix A

### **An overview of the taxation of interest income arising from and the tax deductibility of interest on debentures in Singapore, the United Kingdom, Australia and Japan\***

	<u>Singapore</u>	<u>United Kingdom</u>	<u>Australia</u>	<u>Japan</u>
Corporate tax rate	20% <sup>1</sup>	30%	30%	42% <sup>2</sup>
Interest withholding tax rate for non-residents (non-treaty country)	15%	20%	10%	20%
Treaty rates	0-5%	0% up	10%	10% up
Conditions for allowing deduction for interest expenses paid or payable to foreigners	<ul style="list-style-type: none"><li>• Interest may be subject to disallowance if a part or whole of the funds are used to finance non-income producing assets.</li><li>• Unless special tax incentives apply, withholding tax has to be properly deducted before deduction is allowed.</li></ul>	<ul style="list-style-type: none"><li>• The funds must be applied for financing its business activities, assuming the borrowing is for an “allowable purpose”.</li><li>• Thin capitalisation rules may apply to restrict the amount of deductible interest expense.</li></ul>	<ul style="list-style-type: none"><li>• There is a clear nexus between the corporation’s taxable business income and the interest expense incurred.</li><li>• Withholding tax has been properly deducted from the interest, unless specific exemptions are available.</li><li>• Thin capitalisation rules</li></ul>	<ul style="list-style-type: none"><li>• The funds are applied for financing its assessable activities.</li><li>• Thin capitalisation rules apply to restrict the level of deductible interest.</li><li>• Deduction is not subject to successful compliance with IWT requirements.</li></ul>

<sup>1</sup> With effect from YA2005.

<sup>2</sup> Current effective tax rate.

	<ul style="list-style-type: none"> <li>• There are no general thin capitalisation rules.</li> </ul>		may apply to restrict the amount of deductible interest expense.	
Acceptable debt/equity ratio under thin capitalisation regulations, if applicable	Not applicable.	No specific rules. The IR generally allows a debt/equity ratio of 1:1 provided there is also interest cover of 3:1. May depend upon facts and circumstances and need to negotiate with IR in advance if nil or reduced withholding rate is applied.	75% of net Australian assets.	3:1 for foreign related party debts only.
Tax symmetry	<ul style="list-style-type: none"> <li>• No tax symmetry if conditions under the QDS scheme are satisfied.</li> <li>• Even if the QDS scheme does not apply, there is a tax rate differential for the interest payer and the recipient of at least 5%.</li> </ul>	<ul style="list-style-type: none"> <li>• No tax symmetry if requirements for Quoted Eurobonds are met.</li> <li>• Even if the issues do not qualify as Quoted Eurobonds, there is a tax rate differential for the interest payer and the recipient of at least 10%.</li> </ul>	<ul style="list-style-type: none"> <li>• No tax symmetry if requirements under “publicly offered debentures” are met.</li> <li>• The tax incentives for publicly offered debentures are however restricted to non-affiliates.</li> <li>• Even so, there is a tax rate differential of at least 20% for payments to foreign affiliates</li> </ul>	<ul style="list-style-type: none"> <li>• Interest paid by resident corporations is taxed and the IWT rules ensure that foreign recipients are taxed on the interest income.</li> <li>• However, there is no complete tax symmetry as there is a tax rate differential for the interest payer and the recipient at 22.5%.</li> </ul>

			under the standard IWT rate for interest.	
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\* The above is intended for general information purposes and should not be relied upon as definitive advice on any specific transaction.

## **Appendix B**

### **An overview of the taxation of interest income arising from and the tax deductibility of interest incurred on debentures in Singapore, the United Kingdom, Australia and Japan**

The purpose of this paper is to explore whether or not there is tax symmetry between the deduction for interest expense incurred by a resident corporation on debentures and the taxation of such interest in the hands of the recipients in four jurisdictions, namely Singapore, the United Kingdom, Australia and Japan. In particular, attention will be drawn to the tax treatment of interest paid on debentures by a resident corporation to its foreign associate.

This paper is intended for general information purposes only and should not be relied upon as definitive advice for any specific transaction.

#### **Singapore**

##### *Deductibility of interest payment by a resident corporation*

Interest paid or accrued by a Singapore corporation is generally deductible if the funds are applied for financing its assessable activities. The Singapore tax regime does not contain thin capitalisation rules restricting the level of debt against equity finance.

##### *Specific rules applying to the deduction for interest paid to a foreign associate*

The above deduction rule applies equally to interest paid to associated and non-associated persons.

##### *Taxation of such interest income in the hands of a foreign associate*

Where a non-resident individual or corporation receives interest on such debentures, interest withholding tax (“IWT”) will generally apply at the withholding tax rate of 15%<sup>1</sup> (although the rate may be reduced to 10% or nil under certain double tax treaties). The withholding requirements are equally applicable to interest paid to foreign associates and non-associated persons, except for interest paid on debentures qualifying for exemption under the “Qualifying Debt Securities” (“QDS”) scheme<sup>2</sup>.

The QDS scheme, together with a package of other tax incentives, was introduced in the 1998/99 Budget to promote the development of an active debt market in Singapore. Under the QDS scheme, an exemption from IWT for foreign recipients is available for issues that satisfy certain conditions, including:

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<sup>1</sup> With effect from the year of assessment 2005, the corporate income tax rate for Singapore is 20%. As the non-treaty IWT rate is 15%, there is a rate differential of at least 5% between the corporate income tax rate applicable to deductible interest expense and the withholding rate applicable to interest received by non-residents.

<sup>2</sup> The exemption is set out in Section 13(11) of the Income Tax Act and Income Tax (Qualifying Debt Securities) Regulations 2001.

- The debt securities are arranged and issued in Singapore during the specified period (which has since been extended to 27 February 2008); and
- During their primary launch, the securities are issued to no less than 4 persons and less than 50% of the issues are beneficially held or funded, directly or indirectly, by related parties of the issuer.

While the scheme restricts the tax exemption to debentures that are not majority-held by the related parties of the issuers, to the extent that the 50% threshold is not breached, the tax exemption is equally available to foreign associates and non-associates.

*Is there symmetry between the deductibility and taxation of interest on debentures in Singapore?*

Under the QDS scheme, the Singapore tax regime does not require symmetry between the deductibility and taxation of interest on debentures in Singapore, so far as the specific conditions set out in the scheme rules are satisfied. Further, the scheme arrangements do not impose an added tax cost to the debenture issuer where the holder of the debenture is a foreign associate.

For debentures which do not qualify as QDS, tax asymmetry exists given the rate differential of at least 5% between the corporate income tax rate applicable to deductible interest expenses and the withholding rate applicable to interest received by non-residents.

## **United Kingdom**

*Deductibility of interest payment by a resident corporation*

Interest paid or accrued by a UK corporation is generally deductible if the funds are incurred for financing its business activities, assuming the borrowing is for an “allowable purpose”. Broadly, an allowable purpose does not include securing a tax advantage as the main purpose, or one of the main purposes.

Thin capitalisation provisions may apply to restrict the tax deductibility of interest paid or payable on non-UK related party debt and third party debt with non-UK related party guarantees. While there is no specific legislation in the UK giving a safe harbour for a debt-to-equity ratio, the Inland Revenue normally allows a debt/equity ratio of 1:1 provided there is also an interest cover of 3:1. However, this can vary from case to case depending on all the relevant facts and circumstances. Generally, an arm’s length transfer price is required on related (overseas) party transactions.

*Specific rules applying to the deduction for interest paid to a foreign associate*

Where interest is payable to a foreign associate, a further restriction may apply whereby interest may only be deductible when paid (rather than on an accrual basis) if the interest accrued is not paid within twelve months of the relevant period end (unless the recipient of the income is subject to UK corporate tax on the receipt).

### *Taxation of such interest income in the hands of a foreign associate*

Where a non-resident individual or corporation receives interest on such debentures, IWT will generally apply at withholding tax rate of 20% (although the rate may be reduced to nil under certain double tax treaties). The withholding requirements are equally applicable for interest paid to both foreign associates and non-associated persons, unless the debentures satisfy the conditions for quoted Eurobonds<sup>3</sup>. Interest on loans of less than 12 months duration do not attract IWT.

In the Budget 2000, with a view to promoting the international competitiveness of the bond market in London, the Chancellor of the Exchequer announced the abolition of interest withholding tax on all international bonds qualifying as “quoted Eurobonds”. Subject to the above transfer pricing provisions, payments of interest on all international bonds are effectively exempt from IWT, even if the recipient is a foreign associate of the issuer.

### *Is there symmetry between the deductibility and taxation of interest on debentures in the UK?*

Subject to the transfer pricing provisions set out above, the UK tax regime does not require symmetry between the deductibility and taxation of interest on debentures. It will however be necessary that the purpose or one of the main purposes of a particular borrowing is to secure a tax advantage. This typically does not require that regard to the nature of the income in the hands of the recipient is given.

## **Australia**

### *Deductibility of interest payment by a resident corporation*

Interest paid or accrued by an Australian resident corporation is generally deductible if the following key conditions are satisfied:

1. There is a clear nexus between the corporation’s taxable business income and the interest expense incurred, i.e. the interest paid or accrued by the corporation is a necessary business expense incurred in generating its Australian taxable income;
2. Tax deduction for interest is limited to the extent the total borrowing does not exceed 75% of its total Australian assets, i.e. essentially a 3:1 debt to equity ratio (thin capitalisation rules);
3. Under these rules, the loan instrument will typically be classified as “debt”, rather than “equity”, if there is an effective non-contingent obligation for the issuer to return the initial outlay to an investor; and
4. Withholding tax has been properly deducted from the interest, unless specific exemptions are available.

### *Specific rules applying to the deduction for interest paid to a foreign associate*

The above deduction rules apply equally to interest paid to associated and non-associated persons.

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<sup>3</sup> Under Section 349(3)(c) of the Income and Corporation Taxes Act, payments of interest on a quoted Eurobond are excluded from the general requirement to deduct income tax. “Quoted Eurobonds” effectively refer to all listed securities issued by companies and carrying a right to interest.

### *Taxation of such interest income in the hands of a foreign associate*

Where a non-resident individual or corporation receives interest on such debentures, IWT will generally apply at the withholding tax rate of 10%. The withholding requirements are equally applicable for interest paid to foreign associates and non-associated persons, unless the debt instruments qualify for exemption as “publicly offered debentures”<sup>4</sup>.

Under the tax legislation, an exemption from IWT is available for issues that qualify as “publicly offered debentures”. Specific provisions are however present to exclude the IWT exemption for interest paid or payable by the Australian payer in certain circumstances.

### *Is there symmetry between the deductibility and taxation of interest on debentures in Australia?*

Under the specific provisions governing the IWT exemption for “publicly offered debentures”, there is a distinction on the IWT exemption between foreign associate (which is not otherwise chargeable to tax in Australia on such interest) and non-associated person. However, there does not appear to be a complete symmetry under this regime. As one will note from the above analysis, there is a rate differential between the 30% corporate tax rate (under which the interest expense will remain deductible for tax purposes) and the 10% IWT rate (under which the interest income received by the foreign associate will be taxed).

## **Japan**

### *Deductibility of interest payment by a resident corporation*

Interest paid or accrued by a Japanese corporation is generally deductible if the funds are applied for financing its assessable activities. Under the thin capitalisation rules, the tax deductibility of interest paid to foreign associate will be limited to the acceptable debt-to-equity ratio (which stands at 3:1 whereby only foreign related party debt will be counted towards the relevant debts). Excessive interest will be disallowed as a tax deduction.

### *Specific rules applying to the deduction for interest paid to a foreign associate*

If the level of foreign related party debts is within the acceptable threshold, the legislation does not provide for special rules for the deduction of interest expense paid to a foreign associate on debentures.

### *Taxation of such interest income in the hands of a foreign associate*

Where a non-resident individual or corporation receives interest on such debentures, IWT will generally apply at the withholding tax rate of 20% (although the rate may be reduced to 10% under certain double tax treaties). The withholding requirements are equally applicable to interest paid to foreign associates and non-associated persons.

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<sup>4</sup> The exemption is set out in Section 128F(1) of the Income Tax Assessment Act 1936.

*Is there symmetry between the deductibility and taxation of interest on debentures in Japan?*

One can possibly contend that there is some degree of symmetry between the deductibility and taxation of interest on debentures in Japan, as interest paid or payable to a foreign party (even if the party is not associated to the Japanese issuer) will be subject to IWT. However, the symmetry under this regime is again not a complete one. As one will note from the above analysis, there is a potential 22.5%-32.5%<sup>5</sup> rate differential under the Japanese tax regime on debenture interest paid or payable to a foreign party. While the thin capitalisation rules in Japan only seek to restrict the tax deduction for interest expense paid or payable to foreign associates, to the extent that the acceptable threshold is not exceeded, the Japanese tax regime does not seek to disallow the interest deduction to the debenture issuer simply because the holder of the debentures is a foreign associate.

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<sup>5</sup> The current effective corporate tax rate in Japan is 42.5%. As the IWT rate ranges from 10%-20%, there is a potential rate differential of 22.5%-32.5%.

**Survey on Inland Revenue (Amendment) Bill 2000**  
**Concerning the issue of debenture by Hong Kong taxpayers**

**Appendix C**

<b>Questions</b>	<b>Answers</b>	<b>Remarks</b>
<p>1. Have you issued any debentures or other marketable debt instruments (such as bonds, convertible bonds, fixed/floating rate notes, etc) that remained outstanding at any time during the last 7 years?</p> <p><input type="checkbox"/> Yes</p> <p><input type="checkbox"/> No (please go direct to question 5)</p>	<p style="text-align: center;"><b>90%</b></p> <p style="text-align: center;"><b>10%</b></p>	
<p>2. What kind of debt instruments have you issued?</p> <p><input type="checkbox"/> Straight bonds</p> <p><input type="checkbox"/> Convertible bonds</p> <p><input type="checkbox"/> Others (Please specify_____)</p>	<p style="text-align: center;"><b>56%</b></p> <p style="text-align: center;"><b>67%</b></p> <p style="text-align: center;"><b>11%</b></p>	<b>Perpetual capital securities</b>
<p>3. Were the issues listed on a stock exchange? You may choose more than one answer.</p> <p><input type="checkbox"/> No (please go direct to question 5)</p> <p><input type="checkbox"/> Yes, in Hong Kong (please go direct to question 5)</p> <p><input type="checkbox"/> Yes, outside Hong Kong (please specify the jurisdiction _____)</p>	<p style="text-align: center;"><b>0%</b></p> <p style="text-align: center;"><b>22%</b></p> <p style="text-align: center;"><b>100%</b></p>	<b>Luxembourg x 8, Europe x 1</b>
<p>4. Why did you have the issues listed outside Hong Kong? You may choose more than one answer.  <i>(degree of the relevance of the consideration, ranging from 1 to 5 with 1 = very relevant and 5 = very irrelevant)</i></p> <p><input type="checkbox"/> Costs of issue [ ]</p> <p><input type="checkbox"/> Availability of tax incentives [ ]</p> <p><input type="checkbox"/> Availability of investors [ ]</p> <p><input type="checkbox"/> Liquidity of market [ ]</p> <p><input type="checkbox"/> Market regulations [ ]</p> <p><input type="checkbox"/> Others (please specify_____)</p>	<p style="text-align: center;"><b>89%</b></p> <p style="text-align: center;"><b>67%</b></p> <p style="text-align: center;"><b>89%</b></p> <p style="text-align: center;"><b>89%</b></p> <p style="text-align: center;"><b>89%</b></p> <p style="text-align: center;"><b>89%</b></p> <p style="text-align: center;"><b>11%</b></p>	<p><b>Average relevance</b></p> <p style="text-align: right;"><b>1.625</b></p> <p style="text-align: right;"><b>2.0</b></p> <p style="text-align: right;"><b>2.0</b></p> <p style="text-align: right;"><b>2.625</b></p> <p style="text-align: right;"><b>1.75</b></p> <p style="text-align: right;"><b>3.0</b></p>

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<p>5. Will you consider raising funds in future by way of issuing debentures or other marketable debt instruments?</p> <p><input type="checkbox"/> Yes</p> <p><input type="checkbox"/> No</p>	<p style="text-align: center;"><b>90%</b> <b>10%</b></p>	
<p>6. Do you envisage any circumstances in which corporate groups may wish their controlling shareholders to acquire their own debentures or other marketable debt instruments issued?</p> <p><input type="checkbox"/> Yes (please specify the circumstances, e.g. the controlling shareholder may be required to underwrite the issue, etc. _____)</p> <p><input type="checkbox"/> No</p>	<p style="text-align: center;"><b>70%</b> <b>30%</b></p>	<p style="text-align: center;"><b>Refer to List A for the circumstances</b></p>
<p>7. Do you envisage any circumstances in which the controlling shareholders may wish to acquire the debts issued by the corporate groups that they control?</p> <p><input type="checkbox"/> Yes (please specify the circumstances, e.g. in a convertible issue, the controlling shareholder may wish to acquire part of the issue to preserve its shareholding in the corporate group, etc. _____)</p> <p><input type="checkbox"/> No</p>	<p style="text-align: center;"><b>80%</b> <b>20%</b></p>	<p style="text-align: center;"><b>Refer to List B for the circumstances</b></p>
<p>8. Do you agree that the enactment of the proposed Section 16(2C) of the IRO may impose an undue administration burden on the corporate groups to ascertain whether any connected persons may have acquired their debentures and, if so, whether such persons are subject to tax in Hong Kong in respect of the interest on the debentures?</p> <p><input type="checkbox"/> Strongly agree</p> <p><input type="checkbox"/> Agree</p> <p><input type="checkbox"/> Neutral</p> <p><input type="checkbox"/> Disagree</p> <p><input type="checkbox"/> Strongly disagree</p>	<p style="text-align: center;"><b>90%</b> <b>10%</b></p>	<p style="text-align: center;"><b>All respondents agree/strongly agree</b></p>

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<p>9. Do you agree that the enactment of the proposed Section 16(2C) of the IRO may increase the costs of debt issues, e.g. the after tax interest cost and administration cost?</p> <p><input type="checkbox"/> Strongly agree  <input type="checkbox"/> Agree  <input type="checkbox"/> Neutral  <input type="checkbox"/> Disagree  <input type="checkbox"/> Strongly disagree</p>	<p><b>90%</b> <b>10%</b></p>	<p><b>All respondents agree/strongly agree</b></p>
<p>10. Do you agree that the enactment of the proposed Section 16(2C) of the IRO may discourage the corporate groups in Hong Kong to raise funds by means of debt issues?</p> <p><input type="checkbox"/> Strongly agree  <input type="checkbox"/> Agree  <input type="checkbox"/> Neutral  <input type="checkbox"/> Disagree  <input type="checkbox"/> Strongly disagree</p>	<p><b>70%</b> <b>30%</b></p>	<p><b>All respondents agree/strongly agree</b></p>
<p>11. Do you agree that the enactment of the proposed Section 16(2C) of the IRO would inhibit the development of the debts market in Hong Kong?</p> <p><input type="checkbox"/> Strongly agree  <input type="checkbox"/> Agree  <input type="checkbox"/> Neutral  <input type="checkbox"/> Disagree  <input type="checkbox"/> Strongly disagree</p>	<p><b>70%</b> <b>30%</b></p>	<p><b>All respondents agree/strongly agree</b></p>

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<b>List A (Circumstances for Question 6)</b>	<b>List B (Circumstances for Question 7)</b>
<ol style="list-style-type: none"> <li>1. The controlling shareholder may be required to underwrite the issue.</li> <li>2. During financial crisis, it may be difficult and costly to borrow. The controlling shareholder is likely to be the source of the most cost efficient finance. Financial support from controlling shareholder in the form of acquiring the group's debenture is, of course, welcomed.</li> <li>3. To avoid dilution of shareholders' interest / To preserve its shareholding in the group</li> <li>4. To show shareholders' confidence in the group / Vote of confidence to the group</li> <li>5. Support from controlling shareholder may increase the chance of a successful launch.</li> <li>6. To lower the cost of borrowing and to increase attractiveness of the debentures to outsiders</li> </ol>	<ol style="list-style-type: none"> <li>1. In the case of convertible bonds, the controlling shareholders may wish to acquire the bonds to avoid dilution of their shareholding in the group/ to preserve the shareholding in the group.</li> <li>2. During financial crisis when the group has difficulties in borrowing from other sources, the controlling shareholder is likely to provide financial support because they will benefit as a result of the group's survival in financial crisis.</li> <li>3. If the pricing of the bonds is attractive, just like any other investors, the controlling shareholder would, of course, wish to acquire the bonds. It is unreasonable to discriminate the controlling shareholder by the proposed amendment bill. It is also unfair for the group to be penalized as a result of independent investment decisions of the controlling shareholders.</li> <li>4. In pursuit of higher return than bank deposit interest. It is a fundamental underlying principle that shareholders are distinct from their investee companies. Shareholders will act in accordance with their best interest.</li> <li>5. Invest for a good yield in a company where the controlling shareholder has full knowledge and complete confidence.</li> <li>6. Out of personal investment decision of the controlling shareholders.</li> <li>7. The borrowing company can reduce its borrowing cost.</li> </ol>