

Inland Revenue (Amendment) Bill 2000**Administration's Response to the Submission of the Real Estate
Developers Association (REDA) dated 5 May 2004**

At the meeting with REDA, the Administration indicated that we were prepared to consider any further justifications for and concrete proposal from REDA on special treatment regarding Profits Tax deduction for debt security interest expense on internal borrowings. However, as stated in paragraph 4 of the paper we submitted to the Bills Committee in the meeting on 29 April 2004, we would maintain that rules on tax deductibility on the interest expense on borrowings on debt securities should be consistent with other tax-related taxation arrangements in the IRO. Also, deductibility should be restricted by sufficient conditions which can effectively ring-fence the exemption, as otherwise, much revenue would be at stake and the objective of the present Bill to plug an existing loophole in section 16(2)(f) will be defeated.

2. REDA's current submission as outlined in its letter of 5 May 2004 does not provide any convincing arguments that may justify an exemption from the "tax symmetry" rule in section 16(2)(c) or from the "non-associate-lender" rule in section 16(2)(e), which apply to sole proprietors, partners or shareholders of private companies who also advance loans to their businesses for "genuine commercial reasons." It does not advance any "compliance problem" such as in the case of market makers. The grounds stated in its current submission have been covered by REDA in its numerous earlier submissions. The Administration has also provided very detailed comments on REDA's points in our earlier response.

3. As for REDA's specific proposal, Members may wish to note that **its effect is to allow interest expenses payable on internal borrowings through listed debentures and marketable debt instruments to be deducted from Profits Tax liability of the interest recipients, as long as the holding of the recipient (who may be a controlling shareholder) does not exceed 50%.** (Note: REDA

assumes that the issue of all such debentures and instruments by controlling shareholders must be for “genuine commercial reasons”).

4. The Administration’s assessment on REDA’s specific proposal is as follows-

- (i) Under the existing section 16(2)(f), interest on debentures taken up by controlling shareholders may be disallowed under section 61A if it can be proved that the arrangement aims at tax avoidance. Under REDA’s proposal, such interest will automatically get Profits Tax deduction so long as certain minor conditions are satisfied, irrespective of whether there are genuine commercial reasons. REDA’s proposal may in effect **enlarge the existing loophole by legitimising the deductability of certain borrowings from controlling shareholders**. From the tax administration point of view, REDA’s proposal is worse than the existing legislation, which already has a loophole to plug.
- (ii) It is **not equitable** nor is it consistent with other related taxation arrangements in the Inland Revenue Ordinance (IRO) because under IRO, (a) deduction in respect of interest on a loan advanced to a business concern by a controlling shareholder of a small and medium sized corporation is not allowed unless the symmetry condition is complied with (section 16(2)(c)) and (b) dividend payments to shareholders which are the pay-offs for equity injection are not deducted from Profits Tax liability.
- (iii) It would be out of line with international practice, which maintains “tax symmetry” in full scale for interest expense and especially for internal borrowings.

5. **The REDA proposal, if adopted, will tilt the level playing field in favour of certain controlling shareholders of listed companies, contributing to inequality in the tax treatment for different groups of enterprise operators, as well as enlarging the loophole for tax avoidance. It is unacceptable from both the tax policy as well as tax administration points of view. If REDA’s proposal is adopted, our tax base will be seriously eroded and much revenue (estimated to be**

of the order of billions of dollars) will be at stake.

Financial Services and the Treasury Bureau

10 May 2004