

14 May 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

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

We regret to note that the Administration Response has failed to address the valid concerns raised by the business community¹ in relation to the proposed amendments on the deduction of interest incurred on debt securities. We also regret to note that the Administration's Response is exaggerating, and could also be misleading.

We find it necessary to further clarify REDA's position and respond to the Administration Response as follows:

1. We appreciate the determination of the Administration to combat tax avoidance. Equally, we support the Government's long established and stated policy of not casting unnecessary inhibitions on genuine commercial transactions², which was echoed by the Secretary for Financial Services and Treasury Mr Frederick Ma Si-Hang during our recent meeting on 20 April 2004.
2. We regret to note that the Administration has repeatedly described the purchase by a controlling shareholder of debt securities issued by a listed company as "internal borrowing". The Administration seems to have ignored the fact that transactions between a listed company and its controlling shareholder are subject to most stringent regulatory supervision and public scrutiny. The funds provided by the controlling shareholder would generally be sourced from external funds outside the listed group. The Administration also seems to have ignored the fact that in an open market, the funds provided by the controlling shareholder are as genuine as the funds provided by the general public. They should not be differentiated such that the listed company is penalised by a disallowance of interest deduction where the funds are provided by the controlling shareholder.

¹ For example, refer to the earlier submissions made by the Hong Kong General Chamber of Commerce and REDA.

² Refer to the speech of the then Financial Secretary at the Legislative Council on 12 March 1986 relating to Inland Revenue (Amendment) Bill 1986, and the Departmental Interpretation and Practice Notes No. 15 issued by the Inland Revenue Department.

3. It is discriminatory to treat investors who are controlling shareholders differently to normal investors.
4. As detailed in the submission of the Hong Kong General Chamber of Commerce dated 26 March 2004 and our submission dated 2 April 2004, there are many circumstances in which controlling shareholders may wish to acquire debt securities issued by their listed companies for valid commercial reasons. On the other hand, the participation of controlling shareholders in the debt securities issued by their listed companies will enhance the stability and growth of the Hong Kong financial market. This is of the utmost importance to the development of Hong Kong's bond market, thus strengthening Hong Kong's position as a financial centre.
5. In the Administration Response, the Administration observed that, under REDA's proposal, the relevant interest will "automatically get Profits Tax deduction so long as certain minor conditions are satisfied, irrespective of whether there are genuine commercial reasons", and the proposal may "in effect enlarge the existing loophole by legitimising the deductibility of certain borrowings from controlling shareholders". We regret that the Administration has made these observations. First, the conditions as we have proposed are generally in line with the criteria articulated by the Secretary for Financial Services and Treasury Mr Frederick Ma during our meeting on 20 April 2004. Secondly, it is inconceivable that the imposition of additional conditions as we have proposed would enlarge, rather than restrict, any perceived loophole. Thirdly, we believe that our proposal should be sufficiently effective to combat the sort of perceived avoidance situations with which the Administration identified the HK\$1 billion of tax revenue. Last and certainly not the least, REDA's proposal has not precluded the Inland Revenue Department from invoking the general anti-avoidance provisions under Section 61A to combat non-genuine tax avoidance transactions where circumstances justify.
6. We appreciate that the application of the anti-avoidance provisions under Section 61A may take some time and effort, as it may take time and effort to maintain the check and balance of any system. This should not be an excuse for amending the law to penalise genuine commercial transactions by affording them the same treatment as non-genuine commercial transactions from the outset, and the tax net should not be cast unreasonably wide.
7. The Administration has repeatedly stated how the tax symmetry rule in Section 16(2)(c) may apply to disallow interest deductions to private companies where loans are made by their controlling shareholders to the companies for genuine commercial reasons. This may be inequitable to the private companies. However, the inequity is not to be addressed by imposing the same inequity onto the listed companies. In this regard, we note that it is a commercial reality recognised by the tax legislation of many countries that a business could be

funded by a mix of capital and debt (including debt from related parties). Accordingly, their tax legislation would allow a commercially acceptable financial gearing to exist without resulting in a tax penalty, typically through the use of “thin capitalisation” rules to regulate the debt to equity ratio.

8. The Administration Response maintains that international practice maintains tax symmetry in full scale for interest expense. This assertion is simply not correct. As detailed in the submission of the Hong Kong General Chamber of Commerce dated 26 March 2004 and our submission dated 2 April 2004, tax symmetry is not prevalent in other countries, nor has it been a standard feature of Hong Kong’s tax legislation. Even under the Administration’s current proposal, tax symmetry will not be maintained in that unrelated parties can continue to earn tax free interest income on debt securities while the issuer companies can deduct the interest for profits tax purposes.

We hope the above will help to clarify our position on this matter.

Yours sincerely

Louis Loong
Secretary General