

Bills Committee on Inland Revenue (Amendment) Bill 2000

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

(as at 8 December 2003)

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
General comments on the Bill	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
General comments on the Bill (Cont'd)	The Real Estate Developers Association of Hong Kong	<p><u>Importance of a simple tax system to Hong Kong</u></p> <p>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.</p> <p>Given the complexity of the provisions in the Bill, there is a very genuine risk of the Bill discouraging investment activities in Hong Kong.</p>	<p>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.</p> <p>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.</p>

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
General comments on the Bill (Cont'd)	The Real Estate Developers Association of Hong Kong (Cont'd)	<p><u>Importance of financial support from controlling shareholders and directors</u></p> <p>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.</p> <p>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.</p>	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.
Clause 4 - <i>Adjustments to accessible income</i>	The Taxation Institute of Hong Kong	<p><u>Expenses of self-education</u></p> <p>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.</p>	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 - <i>Certain amounts deemed trading receipts</i>	The Association of Chartered Certified Accountants Hong Kong (ACCA)	<p><u>Royalty income</u></p> <p>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.</p> <p>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.</p> <p>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.</p> <p>Proposed section 15(1)(ba) deviates from the fundamental territorial principle of taxation and is inconsistent with other provisions in section 15.</p>	<p>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 <i>they could only be justified when applied to receipts which arose from or in connection with some business activity in the Colony</i>" (paragraph 87 of the Report of the Inland Revenue Ordinance Review Committee dated 14 March 1968).</p> <p>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 <i>the originating source of the receipts was in the Colony</i>, that they were appropriate in view of the difficulty in determining chargeability in these cases under the general charge.</p>

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<p>Clause 5 - <i>Certain amounts deemed trading receipts</i> (Cont'd)</p>	<p>The Association of Chartered Certified Accountants Hong Kong (ACCA) (Cont'd)</p>	<p>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.</p>	<p>It is clear that the intention of the deeming provisions introduced under section 15(1)(a) and (b) was to capture those <i>receipts originated from Hong Kong that arose from or in connection with some business activity in Hong Kong.</i> 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.</p> <p>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).</p> <p>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.</p>

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Clause 5 - <i>Certain amounts deemed trading receipts</i> <i>(Cont'd)</i>	The Association of Chartered Certified Accountants Hong Kong (ACCA) <i>(Cont'd)</i>		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.

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<p>Clause 5 - <i>Certain amounts deemed trading receipts (Cont'd)</i></p>	<p>Hong Kong Society of Accountants (HKSA)</p>	<p>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.</p> <p>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.</p>	<p>Reply awaited.</p>

Clause No. / Subject	Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Clause 6 - <i>Ascertainment of chargeable profits</i>	Joint Liaison Committee on Taxation (JLCT)	<p><u>Section 16(2A)</u></p> <p>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.</p> <p>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.</p>	<p>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".</p> <p>The Commissioner would make this view clear in a Departmental Interpretation & Practice Note after the Bill is enacted.</p>
	The Association of Chartered Certified Accountants Hong Kong	<p>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.</p> <p>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).</p>	<p>The Commissioner agrees to show the details of the possible calculation bases with examples in a Departmental Interpretation & Practice Note.</p>

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Clause 6 - <i>Ascertainment of chargeable profits (Cont'd)</i>	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.

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<p>Clause 6 - <i>Ascertainment of chargeable profits (Cont'd)</i></p>	<p>Capital Markets Tax Committee of Asia (Hong Kong Chapter) Joint Liaison Committee on Taxation <i>(Cont'd)</i></p>	<p><u>Sections 16(2C) and 16(2F)</u></p> <p>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.</p> <p>Hence, the following additional exemptions ("<i>safe harbour</i>" or "<i>de minimis</i>" exemption) from the interest disallowance provisions are suggested -</p> <p>(a) a holding by an affiliate where the holding is pursuant to the affiliate's genuine market-making activities; and</p> <p>(b) a threshold whereby up to 5% of the debentures or notes on issue could be held by affiliate without triggering any interest disallowance.</p> <p>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.</p>	<p>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 –</p> <p>(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.</p> <p>(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.</p> <p>The Administration does not support the proposal of implementing a “de minimis” rule because of the following –</p> <p>(a) Since the provisions for apportionment of interest deduction are now proposed in the CSAs, there is no need for a de minimis exemption.</p>

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<p>Clause 6 - <i>Ascertainment of chargeable profits</i> <i>(Cont'd)</i></p>	<p>Capital Markets Tax Committee of Asia (Hong Kong Chapter)</p> <p>Joint Liaison Committee on Taxation <i>(Cont'd)</i></p>		<p>(b) With the modification of the definition of connected parties, the issuer of debt securities should have no difficulty in knowing what portion of the interest payment, if any, would ultimately be received by a person connected with him.</p> <p>(c) The anti-avoidance provision under subsection (2C) will have no application if interest is paid to a market maker who is not connected with the borrower, or who is chargeable to tax on the income concerned.</p> <p>(d) If the market maker is connected with the borrower, there should be no difficulty for the borrower to identify the part of interest payable to the market maker and to be excluded from the deduction claim.</p>

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Clause 6 - <i>Ascertainment of chargeable profits</i> <i>(Cont'd)</i>	Capital Markets Tax Committee of Asia (Hong Kong Chapter) Joint Liaison Committee on Taxation <i>(Cont'd)</i>		(e) As pointed out by CMTC in its letter to the Bill's Committee dated 1 December 2003, only the financial services group would be involved in market making activities on bonds and notes. It should not be difficult for a financial service firm involved in buying and selling of bonds and notes issued by its affiliates for market making purposes to track the activity details and report to the issuer accordingly. The Administration believes that in general the group should have a special company or vehicle to carry out the market making activity and it should not be difficult for that entity to keep records of its own activities.
	The Real Estate Developers Association of Hong Kong (REDA)	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.	See the Administration's response to REDA's view on general comments of the Bill in page 2 on importance of a simple tax system to Hong Kong.

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<p>Clause 6 - <i>Ascertainment of chargeable profits</i> <i>(Cont'd)</i></p>	<p>The Real Estate Developers Association of Hong Kong (REDA) <i>(Cont'd)</i></p>	<p>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.</p> <p>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.</p>	<p>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.</p> <p>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.</p> <p>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 judgment has to rely on the facts of the particular case.</p>

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Clause 6 - <i>Ascertainment of chargeable profits (Cont'd)</i>	The Real Estate Developers Association of Hong Kong (REDA) (Cont'd)	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 3 on importance of financial support from controlling shareholders and directors.
	The Taxation Institute of Hong Kong (TIHK)	<p>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.</p> <p>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.</p> <p>TIHK requests the Administration to simplify the drafting language and style to benefit both laymen and professionals.</p>	<p>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.</p> <p>The Commissioner agrees to elaborate the meaning of "interposed person" in a Departmental Interpretation & Practice Note.</p> <p>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.</p>

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<p>Clause 6 - <i>Ascertainment of chargeable profits (Cont'd)</i></p>	<p>Hong Kong Society of Accountants (HKSA)</p>	<p>HKSA welcomes the efforts of the Administration to define more clearly the scope of anti-avoidance provisions under section 16 through the proposed CSAs.</p> <p>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 (<i>Advance rulings</i>) of the Ordinance and where the Commissioner has expressed the opinion that the transaction or arrangement would not fall within section 61A (<i>Transactions designed to avoid liability for tax</i>). 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) (<i>Limited partner loss relief</i>).</p> <p>HKSA also 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.</p>	<p>Reply awaited.</p>