

**Capital Markets Tax Committee Of Asia**  
**Hong Kong Chapter**

1 December 2003

Clerk to the Bills Committee  
Legislative Council  
Central  
Hong Kong

Attention: Mr. Mathew Loo

Dear Sir:

Thank you for the chance to comment on Inland Revenue (Amendment) Bill 2000. The Capital Markets Tax Committee of Asia Hong Kong Chapter ("CMTC") appreciates your willingness to consider our comments.

The CMTC sympathizes with the government's motives for introducing the Bill, namely to attack certain types of tax-motivated arrangements which are being utilized by certain taxpayers to claim interest deductions through arrangements that could be regarded as abusive. We do not object to this policy. Our particular concern is to enable the government to meet its objective but at the same time to ensure that the Bill does not go so far as to impact adversely on genuine commercial (ie, non tax-abusive) note issues.

In response to our previous submissions, the Bill has been amended to accommodate most of the genuine commercial transactions that we have identified. We appreciate the government's willingness to amend the Bill to allow apportionment of interest where only a portion of the loan runs afoul of the new interest disallowance provisions. We are only aware of one additional situation that remains to be addressed.

An associate of a global financial institution may hold an issuer's notes as part of a market-making exercise in order to stimulate the demand for notes in the marketplace. This type of commerciality is usually apparent. Many third party investors will only hold bonds if they perceive those bonds as liquid investments. A financial institution will often commit that it will buy and sell certain bonds at fair market value to guarantee this liquidity. Normally, bonds acquired in the context of market making will be held for very short periods of time. Most market making activity is conducted for bonds issued by third parties. But when a financial institution issues bonds on its own behalf, it will inevitably be the market maker for its own issue instead of giving the market making responsibilities to its competitors.

Financial institutions may not be concerned with the proportional interest disallowance resulting from its market making activities, since the amounts involved should be very small. But the compliance burdens imposed by the requirement to track the ownership of its bonds in market making activities will be very difficult -- perhaps impossible. Most market making activities take place outside of Hong Kong. It is not realistic for large multinational financial institutions to track market making activities of their huge affiliates in New York and London.

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We have suggested two solutions to address this “market-making” issue. First, we believe that a deduction should be permitted if an affiliate holds bonds pursuant to an affiliate’s genuine market making activities. Notes held in market making activities would nearly always be held for very short periods of time.

The Administration rejected our suggestion<sup>1</sup>, explaining:

*“This treatment will favor the “notes” dealers and will be perceived as unfair to other non-dealer holders of notes who are associates of the notes issuer.”*

We respectfully disagree with the Administration’s assessment of this issue. We do not believe that an affiliate of a non-financial services group would have any bona fide commercial justification for acquiring notes of a Hong Kong affiliate. Only an affiliate of a financial service group would have a justification for performing market making activities. Thus, we do not believe that our suggestion would be unfair to groups that are not engaged in financial services.

Secondly, we suggested a “de minimus” or “safe harbor” rule. If the proportion of notes not qualifying for deduction constitutes 5 percent or less of the total notes on issue, a deduction should be allowed with respect to the whole of the notes issue.

In the context of this suggestion, we mentioned that in Singapore, there is a withholding tax exemption for certain bond issues. The government there was also concerned to prevent groups holding their own notes in order to take advantage of these concessions. However, for these purposes the Singapore government was content to rely upon a 50% threshold. In these circumstances, we believe that our 5% proposal is relatively benign.

The Administration rejected our suggestion<sup>2</sup>, explaining:

*“With the allowance of interest deduction in part and the use of “connected person” test in place of “associates” test in sections 16(2C), the “de minimus” rule is no more necessary.”*

We appreciate the mentioned revisions to the bill, but we do not believe that they address our compliance concerns. We believe that it will be nearly impossible for a financial services firm to track ownership of its bonds by affiliates in their market making capacity. We believe that a financial services firm should be able to demonstrate by reasonable evidence that no more than 5 percent of the issuance could have been held in market making activities. Thus, our “de minimus” suggestion addresses our concerns about compliance.

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<sup>1</sup> Ref 15, Summary of Follow-On Concerns Raised in the Second Round of Consultation and the Administration’s Response.

<sup>2</sup> Ref 17, Summary of Follow-On Concerns Raised in the Second Round of Consultation and the Administration’s Response.

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We respectfully request the Bills Committee to consider our requests for (1) an exception for market making activities, and (2) a “de minimus” exception. We believe that both of these suggestions would enhance Hong Kong’s debt capital markets with virtually no financial cost to the government.

Again, we appreciate the willingness of the Bills Committee to consider our comments.

Should you wish to discuss these matters further, please contact David Sutherland on 2848-6801

Sincerely,



Jean-Pierre Baudoux  
Chairman, CMTC



David Sutherland  
Secretary, CMTC

Cc: Mr. Frederick Ma, Secretary for Financial Services & The Treasury  
Mrs. Alice Lau, Commissioner for Inland Revenue