

5 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

Proposed Amendments under the Inland Revenue (Amendment) Bill 2000

On 20 April 2004 we met with the Secretary for Financial Services and Treasury Mr. Frederick Ma Si-Hang, together with representatives from the IRD and key business leaders to discuss the captioned Bill.

The meeting was quite constructive. Both the Administration and REDA seemed to equally agree that the proposed amendments should not attack or inhibit genuine commercial dealings.

The Administration explained that they would consider inserting some new criteria into the revised Bill, which would enable taxpayers to deduct interest before profits tax in circumstances where:

1. Interest is paid on debentures listed on an approved exchange,
2. The debt raising is arranged by approved dealers,
3. A controlling shareholder does not own more than a certain maximum percentage of the debentures on issue, and
4. The IRD may review the subscribers and screen for potential avoidance practices before the debt raising is concluded.

We understand the above criteria are intended to apply to debentures and other debt instruments issued by companies listed on an approved exchange and their subsidiaries.

Having regard to the above and various other matters discussed in that meeting, we were asked to provide some follow up comments to our earlier detailed submission, which we now outline below.

Key point - general

In our view, interest on debentures and other marketable debt instruments should be clearly distinguished from shareholder or bank loans in the proposed Bill. These instruments are typically highly regulated, publicly traded, and are less susceptible to avoidance practices.

Interest on these instruments should be broadly tax deductible, even if paid to a controlling shareholder, because they are genuine commercial dealings, commonly employed by large groups of companies to manage and regulate their debt and treasury operations.

Item 1 – Listing requirement

We believe any concessions granted in relation to debentures should apply equally to other marketable debt instruments, even if they are not listed. This is consistent with existing provisions in the Inland Revenue Ordinance (“IRO”), and reflects the fact that commercially similar instruments should be treated the same way for tax purposes.

For example, section 16(2)(f) extends concessions available on debentures to the ‘holder of any instrument issued bona fide and in the course of carrying on business and which is marketable in Hong Kong or in a major financial centre outside Hong Kong...’

Item 2 – Approved arranger

We have no issue with this requirement, on the basis that debenture issues typically involve reputable arrangers in any event.

Item 3 – Maximum threshold

The Administration made the point during the meeting that 100% subscriptions of debentures by connected parties would trigger avoidance concerns. We note that 100% subscriptions by connected parties are by no means necessarily driven by avoidance.

For instance, it is not uncommon for marketable debt to be created which is in the first instance owned ‘in house’ but intended for subsequent sale to raise funds as where market conditions make it attractive to do so. This is a normal commercial tool of treasury management.

However, we would be prepared to agree to some form of threshold ownership test prescribed in the law, to minimise avoidance risks.

50% threshold

We would be prepared to accept 50% as an appropriate controlling shareholder threshold for Hong Kong debt markets. That is, provided a controlling shareholder owns not more than 50% of the issued debentures, interest paid on these instruments should generally be tax deductible.

We note that this level is consistent with Singapore, where debenture interest would qualify for tax exemption provided less than 50% of the securities issued are beneficially held or funded by related parties of the issuer. This 50% threshold test is applied during their primary launch. Perhaps this policy could be replicated for Hong Kong debt markets.

Compensating adjustments

If a 50% threshold is considered appropriate by the Administration, we believe there should be compensating concessions in the law to reflect the fact that a controlling shareholder might need to breach such a threshold for genuine commercial reasons.

For example, under Main Board listing rule 8.08, the minimum public ownership requirement for a listed company is 25% of the issued share capital at the time of listing. A 75% controlling shareholder might need to subscribe for convertible notes sufficient to ensure his interest is not diluted from the debt raising. This is a genuine commercial imperative and the shareholder should not, in our view, be penalised as a consequence.

In this instance, tax deductions should only be denied on the amount reflecting the excess - the law should contain a pro rata formula for equitable reasons. That is, a 51% ownership holding for commercial reasons should not cause all interest deductions to be denied. It is more equitable to merely deny the interest on the 1% excess.

Preferred threshold 75%

We note that our preferred threshold is 75%, on the basis that the listing rule above means there are circumstances where a controlling shareholder might own 75% of a public company. In our view, the rules associated with interest deductions on debentures should track the listing requirements for equity for commercial reasons. However, we are prepared to accept a lower threshold of 50% for administrative convenience.

Item 4 – IRD scrutiny

The Administration mentioned that they may consider involving the IRD at the subscription phase of debenture issues in order to screen potential subscribers and determine whether there is a potential avoidance concern.

We believe this additional level of administration will inhibit an efficient debt market, by causing additional compliance burdens and costs to borrowers. Moreover, debt issues usually occur quickly and a government screening process will likely cause prohibitive time delays.

We also understand that subscriber information is not generally made available by agents or arrangers to the issuers of debentures or debt instruments.

Alternative

If this requirement is considered critical by the Administration, perhaps it could be modified so that IRD approval is not required prior to issuing the debentures. Rather, the taxpayer could make a special declaration as part of the profits tax return that interest on these instruments satisfies the controlling shareholder ownership threshold during their primary launch.

Tax symmetry

The Administration has explained that the proposed amendments are intended to bring tax symmetry to the treatment of interest income and payments on debentures and marketable instruments. Our detailed comments on this point were outlined in our earlier submission. We would like to reiterate that a) the IRO currently has many instances where tax symmetry is not maintained, b) tax symmetry in relation to interest is not prevalent in most overseas tax regimes, and c) under the terms of the current amendment Bill, it will continue to be the case that tax symmetry will not be required in the case of debt instruments held by independent investors.

We believe it is discriminatory to treat investors who are controlling shareholders differently to normal investors. In an open market, listed companies should not be penalised simply because their controlling shareholders wish to invest in their debentures or otherwise lend financial support to them. Indeed, such investment activities could be seen as conducive to the stability and growth of the Hong Kong financial market, rather than to its detriment.

Perceived level of abuse

The Administration has cited the fact that over \$1 billion in tax attributable to avoidance schemes on debenture interest has been assessed as a reason for such stringent proposals. On the other hand, the Administration has also noted that a major part of the tax assessed is still under objection or appeal. It is therefore yet to be seen the extent to which the amount may indeed be related to avoidance schemes. We would however observe that there are no reported cases involving debenture interest which have been decided by the Board of Review or courts in Hong Kong to be motivated by avoidance. In any event, we believe the criteria discussed in this letter would effectively screen out the perceived avoidance cases.

Listed issuers

We understand the concession criteria are intended to apply to companies listed on an approved exchange and their subsidiaries. We believe this is appropriate given the level of regulation and supervision of listed companies – i.e. transactions of listed companies have much greater transparency and hence the scope for abuses is much more restricted.

Amendment guidelines

We believe amendments to reflect the above can be accomplished by the introduction of a new subsection 16(2I), with limited consequential amendments to the remainder of the Bill. Subsection (2I) could state that subsection (2C) will not apply where certain criteria is satisfied.

Without pre-empting how this or another section might be drafted, subsection (2I) should include the following concepts as discussed in this paper:

- The debentures or instruments concerned are issued by a company listed on an approved exchange or an associate controlled by the company.
- The interest payable on the debentures or instruments concerned is payable to connected persons who are not controlled by the listed company, and such connected persons do not directly or indirectly hold more than 50% of the debentures or instruments concerned. If they do hold more than 50%, then only the interest on the excess is denied, and
- The issue of the debentures or instruments is arranged by an “authorised arranger” (perhaps also defined in the revised Bill as appropriate).

Simple tax system

We note that it is of paramount importance to Hong Kong to maintain its simple tax system and not to cast unnecessary inhibitions on commercial transactions. The Bill as currently drafted is reasonably complex. We would hope that the final version could be simplified to the extent possible.

We hope the Administration looks favourably on our submission and we would be pleased to discuss any aspect of this or our earlier submission at your convenience.

Yours sincerely

Mr Louis Loong
Secretary General