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Report of the Bills Committee on
Inland Revenue (Amendment) Bill 2000

Purpose

This paper reports on the deliberations of the Bills Committee on Inland Revenue (Amendment) Bill 2000.

The Bill

2. The Bill seeks to amend the Inland Revenue Ordinance (Cap. 112) (the Ordinance) to -

(a) amend the definition of 'expenses of self-education' to include fees paid in respect of certain specified examinations;

(b) revise the provisions relating to royalty income, in the light of a ruling of the Court of Final Appeal (CFA), for revenue protection purposes;

(c) strengthen the anti-avoidance provisions on deduction of interest expenses from chargeable profits;

(d) revise the method of computation of annual allowances and the determination of balancing allowances and charges in respect of commercial and industrial buildings and structures;

(e) allow deduction of interest paid on the portion of a home loan in respect of a car parking space if such portion of the loan has been applied for the acquisition of the car parking space;

(f) empower the Board of Review to extend the time for lodging notice of appeal against the assessment to additional tax;

(g) provide for certain costs and fees to be specified in a Schedule to the Ordinance and empower the Secretary for Financial Services and the Treasury to vary the amounts by order; and

(h) make technical amendments.

The Bills Committee

3. At the meeting of the House Committee on 20 October 2000, members agreed to form a Bills Committee to study the Bill. Under the chairmanship of Dr Hon Eric LI, the Bills Committee has held 11 meetings. The membership list of the Bills Committee is at **Appendix I**. Apart from examining the Bill with the Administration, the Bills Committee has also invited views from the related sectors and the public. 13 organizations have made written submissions and/or oral representation to the Bills Committee. A list of these organizations is at **Appendix II**.

4. The Bills Committee commenced its deliberation in November 2000 and invited views from professional bodies and the trades concerned. At its meeting on 4 December 2000, the Bills Committee noted the grave concerns expressed by deputations on the effects of the some proposals in the Bill, in particular those proposals relating to royalty income and deduction of interest expenses for profits tax purposes. The Bills Committee considered that the concerns warranted a critical review of the proposals in the Bill by the Administration and thus requested the Administration to further consult the industry, professional bodies and other relevant organizations and, where appropriate, come up with draft Committee Stage amendments (CSAs) for the Bills Committee's further consideration.

5. In early 2001, the Administration indicated that it needed some time to conduct the consultation before it could revert to the Bills Committee. The Bills Committee reported the situation to the House Committee on 2 March 2001 and it was then decided that the consideration of the Bill should be held in abeyance pending the outcome of the Administration's further study of the Bill and the submission of the draft CSAs.

6. At its meeting on 24 October 2003, the House Committee noted that the Administration was ready to resume the work on the Bill with the Bills Committee after two rounds of extensive consultation with deputations and having drafted a substantive set of CSAs and thus agreed that the work on the Bill should be re-activated. Since then, the Bills Committee has held eight meetings. Upon re-activation of the scrutiny of the Bill, the Bills Committee further invited public views on the Bill and the draft CSAs proposed by the Administration. The Bills Committee also invited those organizations which had previously submitted views to the Bills Committee to give views on the draft CSAs and on certain specific policy issues related to the Bill.

Deliberations of the Bills Committee

Deduction of self-education expenses from the assessable income for salaries tax

7. Section 12(1)(e) of the Ordinance permits self-education expenses to be deducted from the assessable income for salaries tax, while the scope of self-education expenses qualified for the deduction is prescribed in section 12(6) of the Ordinance. The policy intent is that all employment-related self-education expenses should be deductible from the assessable income of a person for any year of assessment. Problem has arisen as to whether a taxpayer who merely sits for the examination and pays only the examination fee, should be regarded as having paid expenses in respect of a 'prescribed course of education'. Clause 4 of the Bill proposes to expand the scope of the definition of 'expenses of self-education' in section 12(6) to include examination fees for any examination set by a provider of a prescribed course of education and undertaken by the taxpayer to gain or maintain qualifications for use in any employment.

8. Under the proposed amendments, the term 'prescribed course of education' covers a training or development course provided by a trade, professional or business association 'for its members'. During its consultation on the Bill, the Administration received views that the meaning of 'members' required clarification. The Administration therefore proposes CSAs to delete the words 'for its members' from the proposed provisions in section 12(6). The effects of proposed the CSAs are as follows -

(a) Fees in respect of an examination set by a trade, professional or business association, and undertaken by any taxpayer (whether he is an existing member of the association or not) to gain or maintain qualifications for use in any employment can be deducted for salaries tax purposes; and

(b) Fees in connection with a training or development course provided by a trade, professional or business association, and undertaken by any taxpayer (whether he is an existing member of the association or not) can be deducted for salaries tax purposes.

9. The Bills Committee also notes that under both the existing provisions and the proposed provisions, for the tuition and examination fees to be qualified for deduction from a taxpayer's assessable income, the 'prescribed course of education' undertaken by the taxpayer shall be for the purpose of gaining or maintaining qualifications for use 'in any employment'. The Bills Committee has sought clarification on the expression of 'any employment', and on whether a taxpayer would be required to prove that the course in question relates to his current employment or to an employment which the taxpayer is likely to take up in future. The Administration confirms that expenses on courses in connection with both current employment as well as planned new employment are qualified expenses for the purpose of tax

deduction under section 12(6). The taxpayer making a self-education expense deduction claim has to show that the course in question relates to his current employment or to an employment which he is likely to take up in future. The type of proof which would be accepted by the Inland Revenue Department (IRD) includes the nature of the course taken, other evidence showing that the taxpayer is seeking new employment related to the course he takes, etc. The Administration has undertaken to issue a Departmental Interpretation & Practice Note (DI&PN) to clarify that 'any employment' should be interpreted to include future employment.

10. The Bills Committee also notes that the term 'prescribed course of education' under the existing and proposed provisions of section 12(6) covers only education courses 'provided by' an education provider and training or development courses 'provided by' a trade, professional or business association. In the light of the varied modes of provision/operation of education courses nowadays, the Bills Committee considers that the scope of courses eligible for salaries tax deduction under section 12(6) is too narrow and falls short of recognizing some education courses which are subject to strict quality control and are recognized or accredited but not provided by trade, professional and business associations. After review of 22 relevant ordinances and consultation with the relevant bureaux and departments, the Administration has agreed to propose CSAs to the effect of extending the scope of the self-education expenses deduction to cover fees paid in respect of courses accredited or recognised by -

(a) 35 institutions that have a role in the registration and recognition of professional or occupational qualifications or status, or the granting of permits or licences for practising in the professions, trades or occupations under 22 ordinances; and

(b) institutions which are statutory organisations established to, amongst other things, establish standards of skill to be achieved and award certificates of competence in any particular trade or in work involving/in connection with the construction industry. Currently, the Vocational Training Council and the Construction Industry Training Authority fall under this category.

11. The relevant institutions and the respective ordinances will be set out in a new schedule (Schedule 13) to the Ordinance. To facilitate updating of the list, the Administration proposes that the Secretary for Financial Services and the Treasury be empowered to amend the schedule by order by way of subsidiary legislation.

12. The Administration has also confirmed that courses jointly provided by a trade, professional or business association or education provider with other organizations are regarded as falling within the scope of education courses under section 12(6).

13. The Bills Committee supports the proposed extension of the scope of education courses for the purposes of deduction of self-education expenses from the assessable income for salaries tax and the other amendments under clause 4 of the Bill.

Royalty income

14. Clause 5 of the Bill proposes to amend section 15(1) of the Ordinance. Currently, section 15(1)(b) deems certain sums received for the use of or right to use of a patent, design, trademark, copyright, etc. (referred to as 'intellectual property' hereafter) in Hong Kong to be trading receipts. The proposed amendment is made for revenue protection purposes in the light of a CFA decision in the case of Commissioner of Inland Revenue and Emerson Radio Corp in 1999. The CFA ruled that only the royalty income attributable to the sale of goods manufactured in Hong Kong could be deemed to be profits arising from the use of the parent's trademark in Hong Kong for the purpose of levying profits tax. The royalty payments attributable to goods manufactured elsewhere should not be taxable in Hong Kong.

15. According to the Administration, this court ruling on the interpretation of section 15(1)(b) deviates from the Commissioner for Inland Revenue (CIR)'s long-standing assessing practice. Prior to the ruling and ever since section 15(1)(b) was enacted in 1971, CIR had maintained that this section had the effect of subjecting royalty income to profits tax in cases where the payer (a business entity in Hong Kong) was allowed a deduction as an expense incurred in deriving assessable profits arising in or derived from Hong Kong. CIR considered that where a Hong Kong business could be said to have incurred royalty expenses in producing its Hong Kong sourced profits, the intellectual property concerned must have been used in Hong Kong, and the royalty income for the use of the intellectual property should be taxable in Hong Kong.

16. The Administration considers that if this policy intent is not clearly reflected in the legislation, the CFA ruling would lead to a substantial loss of revenue from profits tax. The estimated revenue loss is in the order of $200 million a year, and may increase in multiples as and when more enterprises are aware of this ruling and take advantage of it to reduce their tax liability, given that most of Hong Kong's manufacturing base has been relocated outside Hong Kong. The Bill proposes to add a new section 15(1)(ba) to deem income or receipts for the use of, or right to use intellectual property outside Hong Kong to be trading receipts, so long as they are deductible expenses of the payer in ascertaining its profits.

17. The Bills Committee notes the following major concerns raised by associations from the accounting profession and the Hong Kong Bar Association -

(a) The proposed section 15(1)(ba) deems a person to have taxable profits which is derived outside Hong Kong. This violates the territorial source principle of Hong Kong's tax system;

(b) The place where an intellectual property is used is a matter of fact which cannot be changed just because it has been used for producing profits chargeable to Hong Kong tax;

(c) The principle of 'symmetry' between taxability and deductibility, which is introduced explicitly by the Bill, does not currently constitute part of Hong Kong's framework of taxation. This would represent a policy change and would create uncertainty amongst Hong Kong and non-Hong Kong companies;

(d) The direct linkage between taxability and deductibility, even if accepted, is not being applied consistently in section 15. Under section 15(1)(b) no reference is made to deductibility. It offends against simplicity and logic to introduce two alternative and inconsistent approaches to taxability;

(e) The pursuit of symmetry is misguided. The test should remain whether the payments are made in the production of assessable income; and

(f) The increase in the rate of deeming assessable profits for royalty payments to non-resident persons 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.

18. According to the Administration, section 15(1)(b) was enacted by the Inland Revenue (Amendment) Ordinance 1971 to implement recommendations of the Second Inland Revenue Ordinance Review Committee. With reference to the Committee's deliberations, the Administration considers it clear that the original intention of enacting section 15(1)(b) should cover the royalty payment 'which arose from or in connection with some business activities in [Hong Kong]' (per paragraph 87 of the Report of the Inland Revenue Ordinance Review Committee dated 14 March 1968) 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. The Administration also points out that the Committee was satisfied that the deeming provision was justified and appropriate since 'the originating source of the receipts was in [Hong Kong]'. The CFA ruling in the Emerson case makes the existing section 15(1)(b) incapable of covering some payments of royalty that are allowable as a tax deduction in the accounts of the payer. The implications are that royalty payments will not be subject to tax in Hong Kong so long as the process of applying the trademark to the goods or the packaging is done outside Hong Kong even if the goods are manufactured in Hong Kong. Tax avoidance can be easily achieved by changing the manufacturing process. This was not the original intention of the Administration in enacting section 15(1)(b). Hence the current proposals amending

the section to bring it in line with the policy intent. There is no question of deviating from the territorial source principle of taxation.

19. On the 'deductibility test' under proposed section 15(1)(ba), the Administration's position is that it is necessary to keep 'symmetry' between the deductibility of royalty expenses by the payer and the taxability of the receipts in the hands of the recipient in order to avoid revenue leakage through tax planning. Approaches similar to proposed section 15(1)(ba) are widely used in other jurisdictions and can be found in the tax laws of Singapore, Malaysia, Australia and New Zealand. The approach in the United Kingdom (UK) is to disallow deduction of any royalty payment in respect of a user of a patent in order to maintain tax symmetry.

20. In response to the Bills Committee's invitation for views upon re-activation of the scrutiny of the Bill, the Association of Chartered Certified Accountants Hong Kong (ACCA) and the Hong Kong Society of Accountants (HKSA) have reiterated their concern that proposed section 15(1)(ba) deviates from the fundamental territorial source principle of taxation that Hong Kong adopts. They do not subscribe to the Administration's argument that proposed section 15(1)(ba) merely reinstates the position which had been widely accepted by taxpayers prior to the Emerson case. They also do not agree 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. In the light of the strong views of these associations, the Bills Committee has requested the Administration to review the proposed amendments under Clause 5. After consideration of the views of ACCA and HKSA, the Administration remains of the view that the proposed amendment is consistent with the original policy intent as well as the territorial principle of taxation and is in line with international practice. It is of the view that the proposed amendment is appropriate.

21. The Bills Committee has sought information on whether there are other existing provisions in the Ordinance which involve 'departure' from the territorial source principle, and if so, whether the provisions were introduced for the purpose of maintaining tax 'symmetry'. The Administration has cited the examples of section 15(1)(c) which aims to clarify where the source of an income (by way of grant, subsidy or similar financial assistance) may not be easily ascertained; and subsections (i) and (l) of section 15(1) which were introduced as an anti-avoidance tool to counteract arrangements of offshore lending by financial institutions. The Administration considers that whilst 'tax symmetry' (in terms of matching deductibility with taxability) was not explicitly considered when introducing the provisions, such was maintained in effect with the enactment of the provisions. In addition, the Administration has also quoted as examples of departure from the territorial source principle section 23C(2) and (2A) (which regards sums which are derived from carriage shipped in the territory of a treaty country as earned by an owner of aircraft carrying on business in Hong Kong for profits tax purposes) which were introduced to avoid 'double non-taxation'.

22. The Bills Committee has raised concern over the possible impact of proposed section 15(1)(ba) on investments in Hong Kong. The Administration stresses that the proposed addition of section 15(1)(ba) is only meant to reverse the tax treatment to the position before the Emerson case. The question of the 'change' causing significant impact on investments in Hong Kong should therefore not arise. The Administration has informed the Bills Committee that at the existing corporate profits tax rate of 17.5%, the effective tax rate on royalty income is only 5.25% (30% x 17.5%) in Hong Kong. (The assessable profits deeming rate for payments to non-resident persons is 30% with effect from 1 April 2003.) This tax rate is highly competitive among other jurisdictions as illustrated in the table below.

Jurisdiction	**Effective withholding tax rate on royalty payments to non-resident company**
Australia	30% (lower rate for treaties countries)
The UK	22%
Japan	20%
Indonesia	20%
New Zealand	15% (lower rate for treaties countries)
Singapore	15% (22% if the royalty income is derived from a trade carried on in Singapore)
Thailand	15% (Final withholding tax on non-residents not carrying on business in Thailand)
Malaysia	10%
China	10%
Hong Kong	**5.25%**

23. The Bills Committee has not taken a position on the proposed amendments in clause 5. Dr Hon Eric LI, Chairman of the Bills Committee, has indicated that he does not support the proposed amendments.

<u>Rules governing deduction of interest expenses from chargeable profits</u>

24. According to the Administration, while interest payable by a person upon any money borrowed by him for the purpose of producing taxable profits is one of the allowable deductions, in order to prevent abuse and to be in line with the principle that equity contributed by owners may not be deducted from profits tax liability, interest expense has to satisfy the conditions for anti-avoidance purposes which are set out under section 16(2) of the Ordinance. The Administration holds the view that interest expense must either meet the ‘tax symmetry’ rule or the 'non-associate/external borrowing' rule before it may be deducted from profits tax liability (except where the loan is made by a financial institution). In other words, interest

expenses are not deductible for profits tax purposes even for genuine commercial purposes, if the interest income in the hands of the recipients is not chargeable to profits tax. Where this 'tax symmetry' rule cannot be applied strictly lest business activities will be disrupted, exemption from the rule is provided but another condition – 'non-associate borrowing/external borrowing' is applied. This 'tax symmetry' rule is stated very clearly in section 16(2)(c) (loans from non-financial institutions), section 16(2)(d) (loans from financial institutions) and section 16(2)(e) (loans from non-financial institutions for financing purchase of machinery or plant, or trading stock). As for section 16(2)(f), it was added in 1986 following some representations that argued that the application of 'tax symmetry' rule would inhibit commercial activities of corporations who legitimately seek to raise loan capital by public subscription. In such cases, it would not be possible for the loan raisers to achieve 'tax symmetry' before they may claim profits tax deduction for the interest expense because the subscribers are members of the public unrelated to the corporate loan raisers and the public subscribers may not be chargeable to tax on their interest income due to the abolition of interest tax. As a result, the Administration agreed to extend the interest deduction to new issues of listed debentures and marketable commercial papers.

25. According to the Administration, aggressive tax avoidance schemes began to emerge several years after the enactment of sections 16(2)(d) to (f), whereby tax savings may be achieved simply by creating artificial allowable interest deduction, through the use of various tax planning tools such as trust, alienation of interest income, and the artificial issue of debentures in overseas stock exchanges, where the corresponding interest income is not taxable. Tax-avoidance arrangements are currently tackled by a general anti-avoidance provision under section 61A on a case-by-case basis. According to the Administration, this general provision does not guarantee success in each individual case and is far from effective - under section 61A, it is required that only transactions the sole or dominant purpose of which is to avoid tax may be caught. The Administration advises that the lack of an effective basis to combat anti-avoidance relating to section 16 is worrying and has led to serious tax leakages.

26. In addition, according to the Administration, the lack of an effective basis to uphold the rule that there should not be any profits tax deduction for borrowings between associates has led to an anomaly in the tax law. Under the Ordinance, deduction in respect of interest on a loan advanced to a business concern by any shareholder of a small, medium and large sized corporation is not allowed, unless the ‘tax symmetry’ rule is complied with. Also, dividend payments to shareholders which are the pay-offs for equity injection are not deductible from profits tax liability. It would be an anomaly to allow deduction of interest expenses for associate borrowings through a debenture issue which is equivalent to an equity injection.

27. The Bill therefore seeks to amend section 16(2)(d) and section 16(2)(e) by adding in technical provisions explicitly disallowing interest deduction involving

more indirect interest flow back such as through setting up under circumstances of trust and trustee or alienation of interest. The purpose is to prevent abuse of interest deduction when 'tax symmetry' is absent in respect of borrowings from financial institutions and borrowings raised for specified commercial purposes. The Bill also seeks to amend section 16(2)(f) such that either the 'tax symmetry' rule or the 'non-associate borrowing' rule is stated explicitly and shall apply to debenture and financial instrument interest expenses, so as to ensure that companies can no longer make use of this concession to gain interest deduction benefits by creating artificial interest expense streams through issuing debentures or commercial papers and then subscribing them back through their associates.

28. In the light of the views received during the two extensive rounds of consultations with the professional and business sectors conducted during the course of 2001 and 2002, the Administration agrees to provide major concessions in order not to disrupt market operations but which at the same time can still strengthen the provisions to combat tax avoidance activities and close the existing loopholes effectively. The Administration proposes CSAs to the following effect -

(a) Deduction of interest on loans borrowed from non-financial institutions (subsection (c) loans), borrowed from financial institutions (subsection (d) loans) or borrowed for specified purposes (subsection (e) loans) will all be subject to two additional tests -

(i) the loan is not secured by a deposit or loan made by the borrower or an associate of the borrower with or to the lender, a financial institution, an overseas financial institution or an associate of any of these parties, where the interest generated by such deposit or loan is not taxable (new section 16(2A) proposed in the CSAs); and

(ii) there is no arrangement in place such that the interest payment is ultimately paid back to the borrower or to a person connected with the borrower (the interest flow-back test, new section 16(2B) proposed in the CSAs).

(b) Deduction of interest on debentures or debt instruments will be subject to the interest flow-back test (new section 16(2C) proposed in the CSAs).

(c) Partial deduction of interest payment is permissible -

(i) where the loan is partly secured by 'tax-free deposits or loans', interest deduction will be apportioned on a most reasonable and appropriate basis (new section 16(2A) proposed in the CSAs);

(ii) where part of the interest payment flows back to the borrower or to a connected person, apportionment is allowed by reference to -

(A) the portion of the loan assigned to or sub-participated by the borrower or the connected person that generates the interest flowed back to the borrower or the connected person; and

(B) the length of time in which such arrangement is in place (new section 16(2B) and (2C) proposed in the CSAs).

(d) When determining whether interest flows back to a person related to the borrower, a more restricted 'connected person' test is used in place of the 'associate' test originally proposed in the Bill (new section 16(2B) and (2C) proposed in the CSAs).

(e) 'A person connected with the borrower' is defined to mean -

(i) an associated corporation of the borrower; or

(ii) a person who controls the borrower, who is controlled by the borrower or who is under the control of the same person as the borrower (new section 16(3A) and (3B) proposed in the CSAs).

(f) Explicit provisions are added to deal with loan participation cases to clarify the doubt on 'person entitling the interest' (new section 16(2E)(a) and (2F)(a) proposed in the CSAs).

(g) Provisions are made to address the situations concerning trusts (new section 16(2D), (2E)(b) and (2F)(b) proposed in the CSAs).

(h) The interest flow-back test will not apply if the interest is ultimately paid to an excepted person as defined in the proposed section 16(2E)(c) and (2F)(c) proposed in the CSAs. Such provisions are meant to avoid the application of the test in the case where the interest is payable to a financial institution or an overseas financial institution (the operation of which is expected to be monitored by the local or overseas monetary authorities) and to account for the following situations in which the denial of interest deduction is considered undesirable -

(i) where part of the interest is paid to a retirement fund or a collective investment fund in which the borrower or any of its associates has interest;

(ii) where interest is payable to an associate of the borrower who acts merely as a bare trustee for a trust which is not related to the borrower;

(iii) interest payable on debentures issued by a Government owned corporation will be denied if part of the debentures issued is held by another Government owned corporation.

(i) A grand fathering provision is added to exempt from the application of the new law the interest on a loan that is covered by a favourable advance ruling or advance clearance given by the Commissioner of the Inland Revenue before the enactment of the Bill (new section 16(5A) proposed in the CSAs).

Exemption of market making activities on debt instruments from the restriction on interest deduction

29. Proposed amendments to section 16(2)(f) and the proposed new section 16(2C) would have the effect of disallowing deduction from chargeable profits of interest expenses on marketable debt instruments issued by a Hong Kong taxpayer to the extent to which the marketable debt instruments are held by a connected person, not subject to Hong Kong profits tax on the interests received. Interest expenses on the debt instruments held by small shareholders and other persons other than a connected person of the issuing corporation however would continue to qualify for the tax deduction.

30. Concern has been raised by the Capital Markets Tax Committee of Asia (Hong Kong Chapter) (CMTC) and the Joint Liaison Committee on Taxation (JLCT) that 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. These multinational groups would therefore face a compliance problem when they are required to complete the annual tax returns.

31. The Bills Committee shares the concern about the compliance difficulties in the above situations. The Administration, after further consultation with some major debt instrument issuers and the CMTC, has reported to the Bills Committee that currently, all major debt securities in Hong Kong are issued through financial institutions or issued by companies/corporations who would not engage in market-making activities involving debt securities which they themselves issue. Financial institutions are excepted persons as defined in the proposed section 16(2F) and are thus exempted from the application of the deduction disallowance provisions

under proposed section 16(2C). Therefore, the compliance problem is not a concern insofar as current market operations are concerned. However, in light of the future development of Hong Kong's bond market, the Administration agrees that in principle, exempting market-making activities from the restriction on interest deduction is reasonable, provided that they have genuine compliance problems and that there are ways to suitably ring fence the exemption.

32. The Bills Committee notes that in the relevant CSAs (proposed section 16(2G) and 16(2H)) subsequently proposed by the Administration, the exemption is confined to the market-making activities of 'market makers' as defined in proposed section 16(2H), which in effect covers registered securities dealers actively involved in the securities dealing business. On the concern that the exemption only applies to 'market makers' but not 'market-making activities' of other persons and hence may be too restrictive, the Bills Committee has invited views from the relevant industry and professional bodies. In response, three bodies, namely CMTC, JLCT and the Taxation Institute of Hong Kong (TIHK) have provided views. CMTC and JLCT consider that the scope of the exemption under the proposed CSAs is sufficient to cover genuine market making activities. They concur with the Administration's concern that extending the exemption to cover persons who are not market makers in the strict sense, but who merely perform sporadic market making activities, could open the avenue to tax avoidance. TIHK considers that the exemption may be extended to genuine market making activities provided that the term 'market making activities' is clearly defined in the Ordinance, for example, by means of a percentage threshold and the length of holding.

33. The Administration holds the view that the same compliance issue is not relevant in cases not involving securities dealing market makers. The definition of 'market making' deployed in the proposed CSAs is appropriate and in line with international practices. Widening the market marker definition to accommodate exemption for trading/underwriting transactions by non-market-maker corporates would retain and possibly enlarge the loophole for tax avoidance. It is also inconsistent with the general ‘tax symmetry’ principle on internal borrowings.

<u>Deduction of interest expenses on debt instruments held by a controlling shareholder of the issuing corporation</u>

Concerns raised by the Real Estate Developers Association of Hong Kong and the Hong Kong General Chamber of Commerce

34. The Real Estate Developers Association of Hong Kong (REDA) has raised strong reservation about the need and justifiability of the proposed provisions to disallow deduction from chargeable profits of interest expenses on debt instruments held by a controlling shareholder of the issuing corporation. Hong Kong General Chamber of Commerce (HKGCC) also shared the view that the proposed section 16(2C) unnecessarily restricts legitimate business practices. They point out that

there are genuine commercial reasons for controlling shareholders to participate in their corporations' local debt issues. Examples of these circumstances are -

(a) the controlling shareholder is required to underwrite the issue;

(b) the controlling shareholder's participation in the debt issue would show confidence to the market and increase chance of a successful launch; and

(c) the controlling shareholder needs to acquire convertible bonds issued by his corporation in order to avoid dilution of his percentage shareholding.

35. In the view of REDA and HKGCC, proposed section 16(2C) will have the effect of discriminating against the controlling shareholder of a Hong Kong company by treating them differently to normal investors. Controlling investors would be discouraged from reinvesting its overseas funds into Hong Kong. They are of the view that if the section is put through, the after-tax cost for raising capital in Hong Kong by way of debenture issues would increase. Hong Kong corporation groups may be discouraged from issuing debentures.

36. REDA and HKGCC also point out that isolated abuse cases can be adequately covered by the existing anti-avoidance provisions, and indeed IRD has been applying section 61A of the Ordinance to counteract isolated tax avoidance cases with notable success. REDA notes that whilst the application of the anti-avoidance provisions under section 61A may take some time and effort, 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.

The Administration's position regarding Profits Tax deductibility of loan interest

37. According to the Administration, the policy intent of the proposed anti-avoidance provisions is to reinstate the 'symmetry' principle and 'non-associate/external borrowing' rule enshrined in section 16(2)(c), (d) and (e). Where strict or pure 'tax symmetry' may not be applicable in view of market operation, loans that are internal to a corporation or corporate group should be governed by the symmetry test. The existing anti-avoidance provisions in section 61A of the Ordinance are far from effective in combating tax avoidance schemes because of its highly restricted scope of application. In particular, the provisions only apply where the transaction or arrangement in question is carried out with the sole or dominant purpose of obtaining a tax benefit.

38. The Administration explains that although no express reference to either the 'tax symmetry' or the 'non-associate/external borrowing' rule has been laid down in section 16(2)(f), it restricts the deduction to instruments issued to the public only with

the intention that the deduction and exemption from the general 'tax symmetry' rule only applies to genuine public issues of debentures and financial instruments. The assumption behind was that these would not involve associate borrowings. The proposed amendments simply seek to reflect more clearly the policy intent.

Situation of tax avoidance taking advantage of the loophole under section 16(2)(f)

39. The Administration advises that tax avoidance cases in relation to interest expenses are far from isolated and the situation is worrying. If the loophole is not plugged, much revenue will be at stake. According to the Administration, for the period from 1997 to 31 March 2004 alone, the back tax on the tax avoidance schemes involving interest expense (section 16 abuse) that the Government has assessed by invoking the general anti-avoidance provision of section 61A has exceeded $6.7 billion. Those involving debentures specifically exceeded $1 billion and are in relation to seven cases. All debenture avoidance cases concern a particular sector in the economy. A breakdown of these figures are shown in the table below -

	Finalised Cases [1]		Cases still in progress		Total	
	No. of cases	Tax amount ($ million)	No. of cases	Tax amount ($ million)	No. of cases	Tax amount ($ million)
Debenture Cases	4	250	3	880	7	1,130
Other Cases	17	400	49	5,150	66	5,550
Total	21	650	52	6,030	73	6,680

The Administration advises that The tax leakage in respect of section 16 is very significant in the total scheme of things: the amount of tax recovered by IRD's whole Field Audit and Investigation Unit in a year is only $2 billion. The above figures only partly reflect the real situation, because there are avoidance plans still under investigation and plans that are more sophisticated and which IRD is not adequately empowered to tackle relying on the existing general anti-avoidance provisions.

Comparison with overseas jurisdictions on tax treatment of interest income and payments

40. As to how the tax treatment of interest income and expenses in Hong Kong compares with other major tax jurisdictions, the Administration has provided the information on Singapore, the United Kingdom, Australia and Japan as suggested by

[1] Finalised Cases refer to cases that have become final and conclusive under the Inland Revenue Ordinance, i.e. cases that are no longer under objection or appeal.

the Bills Committee. According to the Administration, in all these four tax jurisdictions, interest paid by local residents/companies both to residents and non-residents is generally treated as taxable income without regard to the place in which the loan that generates interest was drawn. This wide scope of taxing interest income in these jurisdictions ensures symmetry. All the four jurisdictions maintain a withholding tax system on interest payable to non-resident persons to ensure collection of tax on interest income. In addition to the application of withholding tax system, most of the places studied impose other specific conditions that have to be met before the corresponding loan interest expense incurred by the borrower may be deducted. In Australia, Japan and UK, interest expense paid to non-residents must meet the 'thin capitalization rules' before it may be fully deducted from the borrower's income tax assessment. The 'thin capitalization rules', which require that the debt-to-equity ratio of the borrower must not exceed the prescribed ratio (generally 3 to 1), are designed as a tool, additional to tax symmetry, to limit the amount of interest deduction to the specified ratio if the loan borrowed is excessive. The Administration considers that the tax treatment of interest deduction in Hong Kong is generally much more favourable than the jurisdictions studied.

41. REDA and HKGCC however point out that full tax symmetry in relation to interest is not prevalent in most overseas tax regimes. In UK, Australia, Singapore and Japan, the interest withholding tax rate is significantly lower than the domestic income tax rate and they are all in the taxpayers favour. None of the jurisdictions has sought to disallow an interest deduction simply on the basis that the recipient is a foreign affiliate.

42. On the point raised by REDA and HKGCC, the Administration emphasises that 'tax symmetry' is the prevalent rule governing deduction of interest expense in other tax jurisdictions. It informs the Bills Committee that the withholding rates in the four places are 20% in the UK (vis-à-vis corporation tax rates of 10% – 30%), 20% in Japan (vis-à-vis corporation tax rates of 22% – 37.5%), 15% in Singapore (vis-à-vis corporation tax rate of 22%), and 10% in Australia (vis-à-vis income tax rate of 30%). The Administration's analysis is that while the rates under the withholding system may be lower than the income tax rates in these jurisdictions, there is no doubt that an important purpose of it is to maintain symmetry in derivation of tax benefits and payment of tax in order to prevent abuse.

43. The Administration further highlights that Hong Kong's treatment of debt security interest expense even after the enactment of the Administration's proposed section 16(2)(f) and 16(2C) which has the following characteristics, will still be generally more favourable compared to the four overseas places specifically studied:

(a) interest expense incurred from public issues of debt securities (i.e. external borrowings) is allowed to be deducted from the borrower's tax liability even when the lender does not pay Hong Kong tax on the payment received and there is no 'thin capitalization rule' to restrict such deduction; and

(b) interest expense incurred from private issues of debt securities subscribed by connected parties (associated companies and shareholders having control over the company), i.e. internal borrowings, may be deducted from the borrower's tax liability without having to meet other specified conditions such as those applicable elsewhere in relation to the equity to debt ratio ('thin capitalisation rules') or the interest rate, so long as the lender pays Hong Kong tax on the corresponding interest income.

Relationship between the proposed 16(2)(f) and 16(2C) and the development of the bond market in Hong Kong

44. The Administration's assessment is that the development of the local bond market will not be adversely affected by the proposed anti-avoidance provisions. This is because the proposal will not change the tax treatment of debentures which are genuinely issued to the public and the 'tax symmetry' condition will continually not be applicable to such issues. In addition, the Administration points out that with the proposed interest deduction apportionment concession, interest deduction will be allowed in respect of the portion of debentures previously held by controlling shareholders but which have already been released to the public. The amendments will only disallow deduction of interest expenses on debentures subscribed by controlling shareholders and remove the current unintended tax benefits for arranging debentures overseas compared with local issues, thus arguably bringing back to Hong Kong those issues which might have gone overseas under the existing legislation.

45. The Administration advises that among the bonds issued locally by Hong Kong corporates, which include financial institutions, statutory bodies, and Government-owned corporations and other businesses entities, between 1998 and 2003, only 13% were issued by business entities which were neither financial institutions nor statutory bodies/Government-owned corporations, whereas 67% of the bonds issued overseas by Hong Kong corporates were issued by such business entities. Fictitious debenture issues (which are represented as issues to the public but would in fact be transferred to the hands of some overseas set-ups of associated companies of the loan raisers soon after issue) do not contribute to the healthy development of Hong Kong's bond market, as they do not increase the diversification, deepening or liquidity of the market. In addition, since these debt securities are generally not offered for trading in the stock exchange and do not need to be cleared through the Central Money markets Unit, they would not have any positive impact on our infrastructure development. These products are not particularly innovative either.

Proposal from REDA in respect of interest deduction for debentures held by controlling shareholders

46. In early May 2004, REDA submitted a proposal in respect of interest deduction for debentures held by controlling shareholders of the issuing corporations after a meeting with the Administration. According to REDA's understanding obtained at the meeting, the Administration is prepared to consider amending the Bill to enable taxpayers to deduct interest before profits tax in the circumstances where -

(a) interest is paid on debentures listed on an approved exchange;

(b) the debt raising is arranged by approved dealers;

(c) a controlling shareholder does not own more than a certain maximum percentage of the debentures on issue; and

(d) IRD may review the subscribers and screen for potential avoidance practices before the debt raising is concluded.

47. In gist, REDA's proposal include the following features -

(a) Tax deductions should be allowed if a controlling shareholder does not own more than 50% of the debentures on issue (75% is REDA's preferred threshold but it is prepared to accept 50% as the threshold);

(b) If there is a genuine commercial imperative for a controlling shareholder to hold a percentage of the debenture issue in excessive of the threshold, tax deductions should only be denied on the amount reflecting the excess;

(c) The tax concession granted in relation to debentures should apply equally to other marketable debt instruments, even it they are not listed; and

(d) REDA agrees to the condition that only debt issues arranged by approved dealers are eligible for the tax deduction.

48. The Administration's response is that REDA's proposal 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.' The proposal also does not advance any 'compliance problem' such as in the case of market makers. The Administration holds the view that it is not equitable nor is it consistent with other related taxation arrangements under the Ordinance and that it would be out of

line with international practice, which maintains 'tax symmetry' on a full scale for interest expense and especially for internal borrowings.

49. The Administration also explains that 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 obtain profits tax deduction so long as certain minor conditions are satisfied, irrespective of whether there are genuine commercial reasons. REDA's proposal will in effect enlarge the existing loophole by legitimising the deductibility of certain borrowings from controlling shareholders. The Administration concludes that if REDA's proposal is adopted, the tax base will be seriously eroded and much revenue (estimated to be of the order of billions of dollars) will be at stake.

50. In response to the Administration's position set out above, REDA has made a further submission to the Bills Committee to clarify its position. REDA further points out that in describing the purchase by a controlling shareholder of debt securities issued by a listed company as 'internal borrowings', 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 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.

51. REDA also criticises that the Administration's assertion that international practice maintains tax symmetry in full scale for interest expense is simply not correct. REDA's understanding is that tax symmetry is <u>not</u> prevalent in other countries, nor has it been a standard feature of Hong Kong’s tax legislation. On the other hand, it is commercial reality recognized 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 legislation would allow a commercially acceptable financial gearing to exist without resulting in a tax penalty, typically through the use of 'thin capitalization' rules to regulate the debt to equity ratio.

52. The Administration responds that many of the points in REDA's submission were incorrect and misleading. It is very sure that the prevailing international practice is to maintain 'tax symmetry' on interest payments, and that Hong Kong is already more generous than other jurisdictions on interest deduction even after the Administration's proposed amendments.

<u>Members' views and concerns upon deliberation of the issues relating to interest expense on marketable debt instruments</u>

53. The Bills Committee has thoroughly deliberated the views of the Administration and those of the REDA and HKGCC in respect of the deductibility of interest expense on marketable debt instruments held by controlling shareholders of

the issuing corporations. The Bills Committee has not reached a consensus view on the issue.

54. Hon SIN Chung-kai has indicated his support for the Administration's present proposal. He concurs with the Administration's assessment that the proposed anti-avoidance provisions would not adversely affect the local debt market. Other members of the Bills Committee have not indicated their position to the Bills Committee. Most of them have indicated that they need more time to examine the possible implications of the Administration's proposal and that they are not yet convinced that the Administration's proposal should be supported.

55. Some members have raised the concern that the approach adopted by the Administration may be abrasive, merely for the purpose of imposing the 'tax symmetry' rule to protect revenue but giving no regard to the genuine commercial elements in the holding of debentures by controlling shareholders. The proposed amendments if enacted may cause significant disincentives to local corporations in raising funds through public issue of debt instruments and hence the development of the local debt market may be seriously affected. Such a possible scenario warrants particular concern when the local debt market is still at the budding stage of development and when the Government has pronounced its commitment to promote the development of Hong Kong's debt market.

56. Some members have queried that the anti-avoidance provisions presently proposed involve a change of policy. Whilst the Administration has repeatedly stressed that the 'tax symmetry' rule has all along been a fundamental principle of Hong Kong's taxation regime, some members observe that this rule has in fact been applied to different extents at different times by the Government having regard to the then prevailing economic circumstances and monetary considerations. Moreover, the Administration has not been able to produce relevant official records that would precisely substantiate its position.

57. In connection with the 'policy intent' issue, the Bills Committee notes that in the 1986 amendment exercise when the general anti-avoidance provisions under sections 61A and 61B were introduced, the then Financial Secretary made it clear that the anti-avoidance provisions "would only be used to strike down blatant and contrived schemes where there is a clear and dominant tax avoidance purpose. It is not the intention to use the law to penalise genuine commercial transactions.". Some members of the Bills Committee consider that the then Financial Secretary's reference to avoiding any unnecessary inhibitions on genuine commercial transactions is relevant to the proposed amendments to section 16(2) which is also concerned with counteracting tax avoidance schemes. The plausible policy intent of the Administration in the past may thus be: anti-avoidance provisions should target at those transactions the sole and dominant purpose of which is to obtain tax benefits, and should not inhibit genuine commercial transactions.

58. In response, the Administration points out that the then Financial Secretary's reference relates only to the general anti-avoidance provisions of sections 61A and 61B, and is not relevant to section 16(2)(f), or otherwise it would be contrary to the 'tax symmetry' rule explicitly stated in section 16(2)(c), (d) and (e), and would be an anomaly inequitable vis-à-vis other related taxation arrangements in the Ordinance.

59. On the Administration's argument that the proposed amendments are more equitable as interest deduction is not allowed for internal borrowings by small and medium sized corporations, which do not have the capacity of raising funds through arranging debenture issues, the Bills Committee have reservation on this discourse as it is based on the assumption that subscription of debentures by controlling shareholders is no different from internal borrowings. It has been pointed out by REDA that the funds provided by the controlling shareholder would generally be sourced from external funds outside the listed group, and in an open market, such funds are as genuine as the funds provided by the general public.

60. In view of the controversies raised and the strong concerns from the business sector, a majority of the Bills Committee members consider that it would be advisable for the Administration to further discuss the issue with the business sector, in particular REDA and HKGCC, with a view to working out an alternative proposal which would safeguard government revenue from deliberate tax avoidance schemes and would not cause unnecessary inhibition to genuine commercial transactions.

61. Towards the conclusion of the Bills Committee's deliberation, the Administration has re-affirmed the need to maintain equality by reinstating the ‘tax symmetry’ rule in section 16(2)(f) and the need to plug the existing section 16(2)(f) loophole, stressing the inherent inequity and anomaly in REDA’s proposal and the serious tax leakage consequences. It made clear that the Administration would not pursue the proposal of REDA or any modified version of the proposal such as a lower threshold for the debenture holding by controlling shareholders because all such proposals would enlarge existing loopholes.

Mortgage loan interest deduction for car parking space

62. Section 26E(8) provides that where a home loan is applied to the purchase of both a home and a car parking space, the parking space must be valued together with the home as a single tenement in order for the car parking space to qualify for mortgage loan interest deduction under salaries tax. This has induced many taxpayers to apply to the Commissioner of Rating and Valuation (CRV) to consolidate the separate assessments of the flat and car parking space into a joint assessment. This has posed considerable inconvenience to taxpayers and additional workload for the CRV. The Bill proposes to remove the mandatory requirement for a single rating assessment so that a car parking space will qualify for the concession, as long as the same home loan is applied also for the acquisition of the car parking space.

63. Concern has been raised as to whether the retrospective application of the proposed amendment to section 26E(8) would be sufficient to allow the amendment of tax assessments where interest in respect of a car parking space has not been claimed, or has been disallowed on the basis of the present terms of the law. The Bills Committee suggests that a saving provision be made stating a specified period for eligible taxpayers to apply for the deduction. The Administration agrees to propose CSAs (section 70AA) to introduce a saving provision in respect of application for deduction of home loan interest (clause 8) in relation to the year of assessment 1998/99 and subsequent years. The saving provision also covers the application for deduction of self-education expenses (clause 4) in relation to the year of assessment 2000/01 and subsequent years.

Initial and annual allowances for commercial and industrial buildings and structures

64. Under the existing law, where a commercial building previously used as an industrial building is sold, only the allowances granted in respect of the building's use as a commercial building are taken into account in determining the balancing allowance or charge. The industrial building allowances previously granted are ignored. The same position applies when an industrial building previously used as a commercial building is sold. The Administration advises that this arrangement is not its policy intention. As it is now quite common for industrial buildings to be converted into commercial buildings, the existing provisions are vulnerable to abuse through deliberate tax planning. Accordingly, the Bill proposes to amend the Ordinance to the effect that any initial, annual and balancing allowances granted, and balancing charges made, whether for industrial or commercial building, will be taken into account in deriving the balancing allowance or balancing charge when a building asset is disposed of.

65. Concern has been raised as to whether the definitions of commercial and industrial buildings and structures under the Ordinance were consistent with those adopted in other legislation. The Administration advises that the definitions of commercial buildings and structures and industrial buildings and structures defined in section 40 of the Ordinance are for tax purposes only, and are determined by the nature of the trade or business carried on by the person who uses the building or structure. The permitted use of the building or structure as provided for under the relevant government lease and other covenants on the land or building, as well as other legislation are not relevant. Neither will the actual use to which a building or structure is put be a decisive factor.

66. Whilst the Bills Committee considers it not entirely satisfactory that the definitions of commercial and industrial buildings and structures under the Ordinance should be read in isolation from other legislation and from the relevant government leases or other covenants, it accepts clauses 9 to 13 of the Bill and the proposed technical amendments to those clauses.

Committee Stage amendments

67. A set of CSAs proposed by the Administration as the date of this report is at **Appendix III**. The Bills Committee has not proposed any CSAs.

68. The Bills Committee has agreed that separate voting for the following clauses at the Committee Stage of the whole Council should be arranged -

(a) Clause 5 together with the relevant consequential amendment in Clause 7; and

(b) Clause 6 together with the relevant consequential amendment in Clause 23.

Recommendation

69. The Bills Committee recommends the resumption of the Second Reading debate on the Bill.

Consultation with the House Committee

70. The House Committee at its meeting on 28 May 2004 supported the recommendation of the Bills Committee to resume the Second Reading debate on the Bill and noted that the Administration had given notice to resume the Second Reading debate on 16 June 2004.

Council Business Division 1
Legislative Council Secretariat
11 June 2004

Appendix I

Bills Committee on
Inland Revenue (Amendment) Bill 2000

Membership list

Chairman	Dr Hon Eric LI Ka-cheung, GBS, JP
Members	Hon CHAN Kam-lam, JP
	Hon HO Sau-lan, Cyd (up to 19/11/2000)
	Hon SIN Chung-kai
	Hon Miriam LAU Kin-yee, JP
	Hon Ambrose LAU Hon-chuen, GBS, JP
	Hon Audrey EU Yuet-mee, SC, JP (from 2/1/2001)
	(Total : 7 Members)
Clerk	Ms Anita SIT
Legal Adviser	Ms Bernice WONG

Appendix II

Bills Committee on
Inland Revenue (Amendment) Bill 2000

Organizations which have submitted views
to the Bills Committee

1. Capital Markets Tax Committee of Asia (Hong Kong Chapter)
2. Hong Kong Bar Association
3. Hong Kong General Chamber of Commerce
4. Hong Kong Society of Accountants
5. Joint Liaison Committee on Taxation
6. PricewaterhouseCoopers Ltd.
7. The Association of Chartered Certified Accountants Hong Kong
8. The Chinese General Chamber of Commerce
9. The Hong Kong Association of Banks
10. The Real Estate Developers Association of Hong Kong
11. The Taxation Institute of Hong Kong
12. WOO, KWAN, LEE & LO

Appendix III

INLAND REVENUE (AMENDMENT) BILL 2000

COMMITTEE STAGE

Amendments to be moved by the Secretary for Financial Services and the Treasury

INLAND REVENUE (AMENDMENT) BILL 2000

COMMITTEE STAGE

Amendments to be moved by the Secretary for Financial Services and the Treasury

Clause	Amendment Proposed
2	(a) In subclause (1), by deleting "Section" and substituting "Subject to subsection (4), section".
	(b) In subclause (3), by deleting "2001/02" and substituting "2004/05".
	(c) By adding –
	"(4) Section 4 (in so far as it relates to section 12(6)(c)(iii) and (f) of the Inland Revenue Ordinance (Cap. 112)) applies in relation to the year of assessment 2004/05 and to all subsequent years of assessment.
	(5) Section 20A –
	(a) subject to paragraph (b), applies in relation to the year of assessment 2004/05 and to all subsequent years of assessment;
	(b) in so far as it relates to item 17 of Schedule 13 to the Inland Revenue Ordinance (Cap. 112), applies in relation to the year of assessment in which section 5(1)(e) of the Legal Practitioners (Amendment) Ordinance 1998 (27 of 1998) comes into operation and to all subsequent years of assessment.".
4	In the proposed section 12(6)-
	(a) by deleting paragraph (b)(ii) and substituting –
	"(ii) fees in respect of an examination set by an education provider or a trade, professional or business association, and undertaken by the taxpayer to gain or maintain qualifications for use in any employment,";
	(b) in paragraph (c) –
	(i) in subparagraph (i), by deleting "or";
	(ii) in subparagraph (ii), by deleting "for its members;" and substituting "; or";
	(iii) by adding –

"(iii)a training or development course accredited or recognized by an institution specified in Schedule 13;";

(c) in paragraph (e), by deleting the full stop and substituting a semicolon;

(d) by adding –

"(f) the Secretary for Financial Services and the Treasury may by order amend Schedule 13.".

6 By deleting the clause and substituting –

"**6. Ascertainment of chargeable profits**

Section 16 is amended –

(a) in subsection (1)(a) –

(i) by repealing "the conditions set out in subsection (2) are satisfied" and substituting "the condition for the application of this paragraph is satisfied under subsection (2), and subject to subsections (2A), (2B) and (2C)";

(ii) by repealing "upon" and substituting "on";

(b) in subsection (2) –

(i) by repealing "conditions referred to in subsection (1)(a) are that –" and substituting "condition for the application of subsection (1)(a) is satisfied if –";

(ii) by repealing paragraphs (d), (e) and (f) and substituting –

"(d) the money has been borrowed from a financial institution or an overseas financial institution;

(e) the money has been borrowed wholly and exclusively to finance –

(i) capital expenditure on the provision of machinery or plant incurred by

the borrower, where such expenditure qualifies for an allowance under Part VI; or

(ii) the purchase of trading stock by the borrower, where the trading stock purchased is used by the borrower in the production of profits chargeable to tax under this Part,

and –

(iii) the lender is not an associate of the borrower; and

(iv) where the lender is a trustee of a trust estate or a corporation controlled by such a trustee, neither the trustee nor the corporation nor any beneficiary under the trust is the borrower or an associate of the borrower; or

(f) the borrower is a corporation and the deduction claimed is in respect of interest payable by it –

(i) on debentures listed on a stock exchange in Hong Kong or on any other stock exchange recognized by the Commissioner for the purposes of this subparagraph;

(ii) on instruments (other than debentures described in subparagraph (i)) –

(A) issued bona fide and in the course of carrying on business and marketed in Hong Kong or in a major financial centre outside Hong Kong recognized by the Commissioner for the purposes of this sub-subparagraph; or

(B) issued pursuant to any agreement or arrangements, where the issue of an advertisement, invitation or document in respect of the agreement or arrangements has been authorized by the Securities and Futures Commission under section

105 of the Securities and Futures Ordinance (Cap. 571), and the advertisement, invitation or document has been issued to the public; or

(iii) on money borrowed from an associated corporation of the borrower, where the money borrowed in the hands of the associated corporation arises entirely from the proceeds of an issue by the associated corporation of debentures described in subparagraph (i) or of instruments described in subparagraph (ii), in an amount not exceeding the interest payable by the associated corporation to the holders of such debentures or instruments.";

(c) by adding –

"(2A) Where –

(a) the condition for the application of subsection (1)(a) is satisfied under subsection (2)(c), (d) or (e);

(b) at any time during the basis period of the borrower for the year of assessment concerned, the payment of any sum payable by way of principal or interest in respect of the money borrowed is secured or guaranteed, whether wholly or in part and whether directly or indirectly, by a deposit or loan made by the borrower or an associate of the borrower with or to –

(i) the lender or an associate of the lender;

(ii) a financial institution or an associate of a financial institution; or

(iii) an overseas financial institution or an associate of an overseas financial

institution; and

(c) any sum payable by way of interest on the deposit or loan is not chargeable to tax under this Ordinance,

the amount of the deduction which, but for this subsection and subsections (2B) and (2C), would have been allowed under subsection (1)(a) for the year of assessment concerned in respect of sums payable by the borrower by way of interest on the money borrowed shall be reduced, having regard to the sum payable by way of interest on the deposit or loan, by an amount calculated on such basis as is most reasonable and appropriate in the circumstances of the case.

(2B) Where –

(a) the condition for the application of subsection (1)(a) is satisfied under subsection (2)(c), (d) or (e); and

(b) at any time during the basis period of the borrower for the year of assessment concerned, arrangements are in place, whether between the borrower and the lender or otherwise, whereby any sum payable by way of interest on the money borrowed or on any part of the money borrowed is payable, whether directly or through any interposed person, to the borrower or to a person (other than the lender) who is connected with the borrower and in either case the borrower or the person, as the case may be, is not an excepted person as defined in subsection (2E)(c),

the amount of the deduction which, but for this subsection and subsections (2A) and (2C), would have been allowed under subsection (1)(a) for the year of assessment concerned in respect of sums payable by the borrower by way of interest on the money borrowed or on the relevant part of the money borrowed, as the case may be, shall be reduced by an amount calculated in accordance with the following formula –

$$\frac{A}{B} \times C$$

where: A means the total number of days during the basis period of the borrower for the year of assessment concerned, at the end of each of which the principal in respect of the money borrowed or in respect of the relevant part of the money borrowed, as the case may be, is outstanding and

the arrangements are in place;

B means the total number of days during the basis period of the borrower for the year of assessment concerned, at the end of each of which the principal in respect of the money borrowed or in respect of the relevant part of the money borrowed, as the case may be, is outstanding; and

C means the total amount of sums payable by the borrower by way of interest on the money borrowed or on the relevant part of the money borrowed, as the case may be, which, but for this subsection and subsections (2A) and (2C), would have been deductible under subsection (1)(a) for the year of assessment concerned.

(2C) Subject to subsection (2G), where –

(a) the condition for the application of subsection (1)(a) is satisfied under subsection (2)(f); and

(b) at any time during the basis period of the borrower for the year of assessment concerned, arrangements are in place, whether between the borrower and the holders of the debentures or instruments concerned or otherwise, whereby any sum payable by way of interest on the debentures or instruments concerned or on any interest in the debentures or instruments concerned is payable, whether directly or through any interposed person, to the borrower or to a person who is connected with the borrower and in either case the borrower or the person, as the case may be, is not an excepted person as defined in subsection (2F)(c),

the amount of the deduction which, but for this subsection and subsections (2A) and (2B), would have been allowed under subsection (1)(a) for the year of assessment concerned in respect of –

(c) (where the condition for the application of subsection (1)(a) is satisfied under subsection (2)(f)(i) or (ii)) the sum payable by the borrower by way of interest on the debentures or instruments concerned or on the relevant interest in the debentures or instruments concerned, as the case may be; or

(d) (where the condition for the application of

subsection (1)(a) is satisfied under subsection (2)(f)(iii)) the sum payable by the borrower by way of interest on money borrowed from the associated corporation, being money arising entirely from the proceeds of the issue of the debentures or instruments concerned or of the relevant interest in the debentures or instruments concerned, as the case may be,

shall be reduced by an amount calculated in accordance with the following formula –

$$\frac{X}{Y} \times Z$$

where: X means the total number of days during the basis period of the borrower for the year of assessment concerned, at the end of each of which the principal in respect of the debentures or instruments concerned or in respect of the relevant interest in the debentures or instruments concerned, as the case may be, is outstanding and the arrangements are in place;

Y means the total number of days during the basis period of the borrower for the year of assessment concerned, at the end of each of which the principal in respect of the debentures or instruments concerned or in respect of the relevant interest in the debentures or instruments concerned, as the case may be, is outstanding; and

Z means the total amount of sums referred to in paragraph (c) or (d), as the case may be, which, but for this subsection and subsections (2A) and (2B), would have been deductible under subsection (1)(a) for the year of assessment concerned.

(2D) For the purposes of subsection (2A), if a deposit or loan is made by a trustee of a trust estate or a corporation controlled by such a trustee, the deposit or loan shall be deemed to have been made by each of the trustee, the corporation and the beneficiary under the trust.

(2E) For the purposes of subsection (2B) –

(a) any reference in that subsection to any sum payable by way of interest on the money borrowed or on any part of the money borrowed, however described, shall be construed as including a reference to any sum payable by way of principal or interest in respect of any other loan, where the

payment of such sum is -

(i) secured or guaranteed, whether wholly or in part and whether directly or indirectly, by any sum payable by way of principal or interest in respect of the money borrowed or in respect of any part of the money borrowed; or

(ii) conditional, whether wholly or in part and whether directly or indirectly, on the payment of any sum payable by way of principal or interest in respect of the money borrowed or in respect of any part of the money borrowed;

(b) if any sum payable by way of interest on the money borrowed or on any part of the money borrowed, as construed in accordance with paragraph (a), is payable, whether directly or through any interposed person, to a trustee of a trust estate or a corporation controlled by such a trustee, such sum shall be deemed to be so payable to each of the trustee, the corporation and the beneficiary under the trust; and

(c) "excepted person" (除外人士) means –

(i) a person who is chargeable to tax under this Ordinance in respect of any sum payable by way of interest on the money borrowed or on any part of the money borrowed, as construed in accordance with paragraph (a);

(ii) in the case of a person (other than the lender) who is connected with the borrower –

(A) a person who is entitled to any sum referred to in subparagraph (i) in the capacity of –

(I) a person acting as a trustee of a trust estate or holding property belonging to others pursuant to the terms of a contract, where the person is not

beneficially entitled to the sum in question;

(II) a beneficiary of a unit trust to which section 26A(1A)(a)(i) or (ii) applies, where the sum in question is payable to a trustee of the unit trust in respect of a specified investment scheme referred to in section 26A(1A)(b); or

(III) a member of a retirement scheme which is either a recognized retirement scheme or a substantially similar retirement scheme established outside Hong Kong, where the Commissioner is satisfied that the latter scheme complies with the requirements of a supervisory authority within an acceptable regulatory regime;

(B) a public body;

(C) a body corporate, where the Government owns beneficially more than half in nominal value of the issued share capital of that body corporate for the time being; or

(D) a financial institution or an overseas financial institution.

(2F) For the purposes of subsection (2C) –

(a) any reference in that subsection to any sum payable by way of interest on the debentures or instruments concerned or on any interest in the debentures or instruments concerned, however described, shall be construed as including a reference to any sum payable by way of principal or interest in respect of any other loan, where

the payment of such sum is –

(i) secured or guaranteed, whether wholly or in part and whether directly or indirectly, by any sum payable by way of principal or interest in respect of the debentures or instruments concerned or in respect of any interest in the debentures or instruments concerned; or

(ii) conditional, whether wholly or in part and whether directly or indirectly, on the payment of any sum payable by way of principal or interest in respect of the debentures or instruments concerned or in respect of any interest in the debentures or instruments concerned;

(b) if any sum payable by way of interest on the debentures or instruments concerned or on any interest in the debentures or instruments concerned, as construed in accordance with paragraph (a), is payable, whether directly or through any interposed person, to a trustee of a trust estate or a corporation controlled by such a trustee, such sum shall be deemed to be so payable to each of the trustee, the corporation and the beneficiary under the trust; and

(c) "excepted person" (除外人士) means –

(i) a person who is chargeable to tax under this Ordinance in respect of any sum payable by way of interest on the debentures or instruments concerned or on any interest in the debentures or instruments concerned, as construed in accordance with paragraph (a);

(ii) in the case of a person who is connected with the borrower –

(A) a person who is entitled to any sum referred to in subparagraph (i) in the capacity of –

(I) a person acting as a trustee of a trust estate

or holding property belonging to others pursuant to the terms of a contract, where the person is not beneficially entitled to the sum in question;

(II) a beneficiary of a unit trust to which section 26A(1A)(a)(i) or (ii) applies, where the sum in question is payable to a trustee of the unit trust in respect of a specified investment scheme referred to in section 26A(1A)(b); or

(III) a member of a retirement scheme which is either a recognized retirement scheme or a substantially similar retirement scheme established outside Hong Kong, where the Commissioner is satisfied that the latter scheme complies with the requirements of a supervisory authority within an acceptable regulatory regime;

(B) a public body;

(C) a body corporate, where the Government owns beneficially more than half in nominal value of the issued share capital of that body corporate for the time being; or

(D) a financial institution or an overseas financial institution.

(2G) Subsection (2C) shall not apply where under the relevant arrangements, the relevant sum payable by way of interest on the debentures or

instruments concerned or on any interest in the debentures or instruments concerned is payable to a market maker who, in the ordinary course of conduct of his trade, profession or business in respect of market making, holds such debentures or instruments or such interest for the purpose of providing liquidity thereof.

(2H)In subsection (2G), "market maker" (市場莊家) means a person who –

(a) is licensed or registered for dealing in securities under the Securities and Futures Ordinance (Cap. 571) or authorized to do so by a regulatory authority in a major financial centre outside Hong Kong recognized by the Commissioner for the purposes of subsection (2)(f)(ii)(A);

(b) in the ordinary course of conduct of his trade, profession or business in respect of market making holds himself out as being willing to buy and sell securities for his own account and on a regular basis; and

(c) is actively involved in market making in securities issued by a wide range of unrelated institutions.";

(d) in subsection (3) –

(i) by repealing "subsection (2) and this subsection" and substituting "this section";

(ii) by repealing the definitions of "control" and "debentures";

(iii) in the definition of "overseas financial institution", by repealing "subsection (2)" and substituting "this section";

(e) by adding –

"(3A) In this section –

(a) a corporation shall be regarded as being controlled by a person if the person has the power to secure –

(i) by means of the holding of shares or the possession of voting power in or in relation to that or any other corporation; or

(ii) by virtue of any power conferred by the articles of association or any other document regulating that or any other corporation,

that the affairs of the first-mentioned corporation are conducted in accordance with his wishes; and

(b) a person (other than a corporation) shall be regarded as being controlled by another person if the first-mentioned person is accustomed or under an obligation, whether express or implied, and whether or not enforceable or intended to be enforceable by legal proceedings, to act, in relation to his investment or business affairs, in accordance with the directions, instructions or wishes of that other person.

(3B) In this section, a person shall be regarded as being connected with a borrower if the person is -

(a) an associated corporation of the borrower;

(b) a person (other than a corporation) –

(i) who controls the borrower;

(ii) who is controlled by the borrower; or

(iii) who is under the control of the same person as is the borrower.";

(f) in subsection (4), by repealing "subsection (2)" and substituting "this section";

(g) by adding –

"(5A) The amendments made to this section by section 6(a), (b), (c), (d), (e) and (f) of the Inland Revenue (Amendment) Ordinance 2004 (of 2004) ("the Amendment Ordinance") do not apply to sums described in subsection (1)(a) which were incurred –

(a) before the commencement of the Amendment Ordinance;

(b) under a transaction which was the subject of an application for advance clearance made to the Commissioner before 1 April 1998, and the Commissioner has before the commencement of the Amendment

Ordinance expressed the opinion that the transaction would not fall within the terms of section 61A; or

(c) under an arrangement which was the subject of an application made to the Commissioner under section 88A, and the Commissioner has before the commencement of the Amendment Ordinance made a ruling under that section that the arrangement would not fall within the terms of section 61A.".".

9 (a) In paragraph (b) –

(i) in subparagraph (ii), by deleting the full stop at the end and substituting a semicolon;

(ii) by adding –

"(iii) in paragraph (b)(i), by repealing "in which this section commences" and substituting "commencing on 1 April 1998";".

(b) By adding –

"(c) in subsection (4), by repealing "commencement of this section" and substituting "commencement of the Inland Revenue (Amendment)(No. 2) Ordinance 1998 (32 of 1998)".".

13 (a) By deleting paragraph (a)(i) and substituting –

"(i) by repealing everything after "in relation to" and before the proviso and substituting –

"a commercial building or structure –

(i) subject to subparagraph (ii), means the amount of the capital expenditure incurred on the construction

of the building or structure reduced by –

(A) the amount of any initial allowance made under section 34(1);

(B) the amount of any annual allowance made under section 33A or 34(2);

(C) the amount of any balancing allowance made under section 35, or under section 33B or 35 that was in force immediately before the commencement of the Inland Revenue (Amendment) Ordinance 2004 (of 2004),

and increased by the amount of any balancing charge made under section 35, or under section 33B or 35 that was in force immediately before the commencement of the Inland Revenue (Amendment) Ordinance 2004 (of 2004);

or

(ii) where the building or structure is a building or structure to which section 33A(4) applies, means the amount of the capital expenditure incurred on the construction of the building or structure as determined under section 33A(4)(a) reduced by –

(A) the amount of any initial allowance made under section 34(1) in respect of any year of assessment commencing on or after 1 April 1998;

(B) the amount of any annual allowance made under section 33A or 34(2) in respect of any year of assessment commencing on or after 1 April 1998;

(C) the amount of any

balancing allowance made under section 35, or under section 33B or 35 that was in force immediately before the commencement of the Inland Revenue (Amendment) Ordinance 2004 (of 2004), in respect of any year of assessment commencing on or after 1 April 1998,

and increased by the amount of any balancing charge made under section 35, or under section 33B or 35 that was in force immediately before the commencement of the Inland Revenue (Amendment) Ordinance 2004 (of 2004), in respect of any year of assessment commencing on or after 1 April 1998:";".

(b) In paragraph (b)(i), by deleting everything after "substituting -" and substituting –

""(i) the amount of any initial allowance made under

section 34(1);

(ii) the amount of any annual allowance made under section 33A or 34(2);

(iii) the amount of any balancing allowance made under section 35, or under section 33B or 35 that was in force immediately before the commencement of the Inland Revenue (Amendment) Ordinance 2004 (of 2004),

and increased by the amount of any balancing charge made under section 35, or under section 33B or 35 that was in force immediately before the commencement of the Inland Revenue (Amendment) Ordinance 2004 (of 2004):";".

14(b) In the proposed section 68(9A), by deleting "The Secretary for the Treasury" and substituting "The Secretary for Financial Services and the Treasury".

15(b) In the proposed section 69(1A), by deleting "The Secretary for the Treasury" and substituting "The Secretary for Financial Services and the Treasury".

New By adding –

"**16A**. **Section added**

The following is added –

"**70AA. Revision of assessment due to commencement of section 4 or 8 of Inland Revenue (Amendment) Ordinance 2004**

(1) Notwithstanding any other provisions of this Ordinance, if, upon application in respect of a year of assessment ("the relevant year") that expires before the date of commencement of section 4 or 8 of the Inland Revenue (Amendment) Ordinance 2004 (of 2004) made within 12 months after that date, or within 6 years after the end of the relevant year, whichever is the later, it is established to the satisfaction of an assessor that the tax charged for the relevant year is excessive solely by reason of the commencement of that section, the assessor shall revise the assessment for the relevant year.

(2) Where an assessor refuses to revise an assessment in accordance with an application under this section, he shall give notice thereof in writing to the person who made such application and such person shall thereupon have the same rights of objection and appeal under this Part as if such notice of refusal were a notice of assessment.".".

17(b) In the proposed section 82B(1A), by deleting "1 April 2001" and substituting

"the commencement of the Inland Revenue (Amendment) Ordinance 2004 (of 2004)**".**

New By adding immediately before the heading "**Consequential Amendments**" –

"**20A. Schedule 13 added**

The following is added –

"SCHEDULE 13 [s. 12]

INSTITUTIONS THAT MAY ACCREDIT OR RECOGNIZE TRAINING OR DEVELOPMENT COURSES FOR THE PURPOSE OF SECTION 12(6)(c)(iii)

Item	Institution
1.	The Architects Registration Board established by section 4 of the Architects Registration Ordinance (Cap. 408)
2.	The Chinese Medicine Council of Hong Kong established by section 3 of the Chinese Medicine Ordinance (Cap. 549)
3.	The Chiropractors Council established by section 3 of the Chiropractors Registration Ordinance (Cap. 428)
4.	The Construction Industry Training Authority established by section 4 of the Industrial Training (Construction Industry) Ordinance (Cap. 317)
5.	The Dental Council of Hong Kong established by section 4 of the Dentists Registration Ordinance (Cap. 156)
6.	The Engineers Registration Board established by section 3 of the Engineers Registration Ordinance (Cap. 409)
7.	The Estate Agents Authority established by section 4 of the Estate Agents Ordinance (Cap. 511)
8.	The Hong Kong Academy of Medicine established by section 3 of the Hong Kong Academy of Medicine Ordinance (Cap. 419)
9.	The Hong Kong Bar Association referred to in section 2(1) of the Legal Practitioners Ordinance (Cap. 159)

10. The Hong Kong Institute of Architects incorporated by section 3 of The Hong Kong Institute of Architects Incorporation Ordinance (Cap. 1147)

11. The Hong Kong Institution of Engineers incorporated by section 3 of The Hong Kong Institution of Engineers Ordinance (Cap. 1105)

12. The Hong Kong Institute of Housing incorporated by section 3 of The Hong Kong Institute of Housing Ordinance (Cap. 507)

13. The Hong Kong Institute of Landscape Architects incorporated by section 3 of The Hong Kong Institute of Landscape Architects Incorporation Ordinance (Cap. 1162)

14. The Hong Kong Institute of Planners incorporated by section 3 of The Hong Kong Institute of Planners Incorporation Ordinance (Cap. 1153)

15. The Hong Kong Institute of Surveyors incorporated by section 3 of The Hong Kong Institute of Surveyors Ordinance (Cap. 1148)

16. The Hong Kong Society of Accountants incorporated by section 3 of the Professional Accountants Ordinance (Cap. 50)

17. The Hong Kong Society of Notaries referred to in section 2(1) of the Legal Practitioners Ordinance (Cap. 159) as amended by section 5(1)(e) of the Legal Practitioners (Amendment) Ordinance 1998 (27 of 1998)

18. The Housing Managers Registration Board established by section 3 of the Housing Managers Registration Ordinance (Cap. 550)

19. The Land Surveyors Registration Committee appointed under section 6 of the Land Survey Ordinance (Cap. 473)

20. The Landscape Architects Registration Board established by section 3 of the Landscape Architects Registration Ordinance (Cap. 516)

21. The Law Society of Hong Kong referred to in section 2(1) of the Legal Practitioners Ordinance (Cap. 159)

22. The Medical Council of Hong Kong established by section 3 of the Medical Registration Ordinance (Cap. 161)

23. The Medical Laboratory Technologists Board established by section 5 of the Supplementary Medical Professions Ordinance (Cap. 359)

24. The Midwives Council of Hong Kong established by section 3 of the Midwives Registration Ordinance (Cap. 162)

25. The Nursing Council of Hong Kong established by section 3 of the Nurses Registration Ordinance (Cap. 164)

26. The Occupational Therapists Board established by section 5 of the Supplementary Medical Professions Ordinance (Cap. 359)

27. The Optometrists Board established by section 5 of the Supplementary Medical Professions Ordinance (Cap. 359)

28. The Pharmacy and Poisons Board established by section 3 of the Pharmacy and Poisons Ordinance (Cap. 138)

29. The Physiotherapists Board established by section 5 of the Supplementary Medical Professions Ordinance (Cap. 359)

30. The Planners Registration Board established by section 3 of the Planners Registration Ordinance (Cap. 418)

31. The Radiographers Board established by section 5 of the Supplementary Medical Professions Ordinance (Cap. 359)

32. The Security and Guarding Services Industry Authority established by section 4 of the Security and Guarding Services Ordinance (Cap. 460)

33. The Social Workers Registration Board established by section 4 of the Social Workers Registration Ordinance (Cap. 505)

34. The Surveyors Registration Board established by section 3 of the Surveyors Registration Ordinance (Cap. 417)

35. The Travel Industry Council of Hong Kong referred to in section 32A(1) of the Travel Agents Ordinance (Cap. 218)

36. The Veterinary Surgeons Board established by section 3 of the Veterinary Surgeons Registration Ordinance (Cap. 529)

37. The Vocational Training Council established by section 4 of the Vocational Training Council Ordinance (Cap. 1130)”.”.

23 By deleting everything after “substituting” and substituting ““where the condition for the application of section 16(1)(a) of the Ordinance is satisfied under section 16(2)(c), (d) or (e) of the Ordinance and section 16(2A) of the Ordinance does not apply”.”.