File Ref: G6/123/8C

LEGISLATIVE COUNCIL BRIEF

Inland Revenue Ordinance
(Chapter 112)

INLAND REVENUE (AMENDMENT) BILL 2011

INTRODUCTION

A

At the meeting of the Executive Council on 25 January 2011, the Council **ADVISED** and the Chief Executive **ORDERED** that the Inland Revenue (Amendment) Bill 2011 (the "Bill"), at Annex A, should be introduced into the Legislative Council ("LegCo") to provide for the implementation of the proposed enhancements to the qualifying debt instrument ("QDI") scheme.

JUSTIFICATIONS

QDI Scheme

2. An active and diverse debt market is important to the further development of Hong Kong as an international financial centre. The QDI scheme was formulated with the policy intention of developing and enhancing the competitiveness of the local debt market. For the QDI scheme to achieve its policy intention, enhancements need to be introduced from time to time in response to the changing market landscape and measures adopted by other financial centres in the region for developing their respective debt markets.

3. Interest income and trading profits of debt instruments issued and traded in Hong Kong are chargeable to profits tax under the Inland Revenue Ordinance ("IRO"). Currently, a 100% exemption from profits tax for interest income and trading profits arising from certain categories of debt instruments is granted pursuant to section 26A of IRO. These debt instruments include government bonds, Exchange Fund debt instruments, Hong Kong dollar denominated multilateral agency debt instruments, and long-term debt instruments with an original maturity of seven years or longer. In addition, under section 14A of IRO, a tax concession at 50% of the normal profits tax rate is applied to interest income and trading profits derived from a debt instrument that satisfies the relevant criteria, including those instruments which -

(a) are lodged with and cleared by the Central Moneymarket Unit operated by the Hong Kong Monetary Authority ("HKMA");

(b) have an original maturity of not less than three years but less than seven years;

(c) have a minimum denomination of HK$50,000 or its equivalent in a foreign currency;

(d) are issued to the public in Hong Kong; and

(e) are issued by a person and have at all relevant times a credit rating acceptable to HKMA from a credit rating agency recognized by HKMA (which is currently set at minimum BBB- from Standard and Poor's).

4. Notwithstanding the refinements introduced to the QDI scheme in 1999 and 2003 respectively, the percentage of QDI issuance in Hong Kong's total debt issuance remained small. Only 4% of Hong Kong's total debt issuance have been QDI issuance since the last refinement in 2003. We believe that there is still room for improving the scheme to enable it to better serve its policy objectives.

5. We have conducted a review of the QDI scheme and identified several areas for improvement. First, the structure of the tax incentives offered under the scheme does not match the landscape of Hong Kong's corporate bond market. While Hong Kong's corporate bond market is dominated by privately-placed short-term debt instruments with an original maturity of less than three years (46% of total issuance), the scheme only offers tax incentives to debt instruments with an original maturity of three years or more and which are "issued to the public". Second, since the "issued to the public" criterion is not clearly defined in IRO, there are some uncertainties in the market about how such criterion should be interpreted in practice. In addition, the eligibility criteria of the scheme appear to be more stringent than those of similar schemes in other financial centres in the region(1).

Enhancement Measures

6. To address the issues mentioned in paragraph 5 above, we propose to make some enhancements to the QDI scheme. These enhancement measures, which aim to strike a balance between meeting the market development needs and minimising the risk of tax avoidance, are expected to help further develop the local debt market and put Hong Kong on a more equal footing with other financial centres in the region in attracting debt market activities.

(a) Extending Tax Concession to Short-term Debt Instruments

7. First, we propose that the 50% tax concession currently granted under section 14A of IRO be extended to interest income and trading profits derived from debt instruments with an original maturity of less than three years.

8. This proposed amendment aims to place short-term debt instruments on a level-playing field with longer-term debt instruments in respect of profits tax treatment. As an international financial centre, Hong Kong should aim at developing a debt market that is deep, active and

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Note (1) For example, under a similar scheme in Singapore, debt instruments only need to meet certain requirements on the issuer and the arranger and fulfil a clearly defined criterion on "issued to the public" to be eligible for tax concessions under the scheme. No maturity requirement is applied under Singapore's scheme.

diverse, and with a wide spectrum of participants (including issuers, investors and services providers) as well as issues. This proposed amendment is expected to help stimulate new demand for bond issues in Hong Kong.

(b) Replacing the "Issued to the Public" Criterion by a New Requirement

9. Second, to remove the uncertainties concerning what constitutes "issued to the public" as stipulated in paragraph (e) of the definition of "debt instrument" in section 14A(4) of IRO, we propose to replace the "issued to the public" criterion by a new requirement that, at issuance, the instrument is issued in Hong Kong to -

(a) ten or more persons; or

(b) if less than ten persons, none of whom is an associate of the issuer of the instrument.

10. The "issued to the public" criterion has been introduced to address potential tax avoidance through arranging as QDIs intra-group or inter-group debt issues that are otherwise not necessary so as to enjoy tax benefits. However, since IRO does not specify what constitutes "issued to the public", the legal uncertainties involved have put many debt market participants off using the QDI scheme. The proposed amendment has been formulated taking into account the landscape of Hong Kong's debt market and the criterion's original intent of preventing tax avoidance. In drawing up the proposal, we have made reference to similar schemes overseas which are considered successful in facilitating the development of the relevant local debt market(2).

Note (2) Under Singapore's scheme, debt securities would be deemed "issued to the public" if they are issued to four persons or more; or have less than 50% of the issue of debt securities being beneficially held or funded by related parties of the issuer of those debt securities at the time of primary launch. If, at any time during the life of an eligible debt issue, 50% or more of the issue is beneficially held or funded, directly or indirectly, by a related party of the issuer, the portion of the issue held by related parties will not be eligible for tax concessions under the scheme. On the other hand, under Australia's scheme, issuers are only required to offer the issue to a specified minimum number of potential investors. No requirement is set on the number of investors to whom the debt securities are ultimately issued.

11. We propose that the minimum number of persons a debt instrument has to be issued to so that it would be eligible for the QDI scheme be set at ten. To cater for the large amount of private-placement debt issues in Hong Kong that may be offered to a large number of potential investors but are usually only issued to less than ten investors at the end, an alternative requirement is provided for debt instruments that are issued to less than ten persons at issuance. To fulfil this alternative requirement, none of the investors should be an associate of the issuer at the time of issuance.

(c) Addition of Further Anti-avoidance Provision

12. To provide further safeguard against potential intra-group tax avoidance arrangements, we propose adding a new provision that the relevant profits tax concession will not apply in respect of any interest income and trading profits received by or accrued to a person in relation to QDI if, at the time during which such interest income and trading profits is/are so received or accrued, the person is an associate of the issuer of QDI.

(d) Addition of Definition of "Associate" and Carve-out Provision

13. In connection with the proposed amendments in paragraphs 9(b) and 12 above, there is a need to include a definition of "associate" in section 14A of IRO. In considering the definition, we have drawn reference to similar definitions in the existing provisions in IRO, e.g. section 16(3) concerning the ascertainment of chargeable profits. If such definition is to be fully adopted, an "associate" would in essence mean an entity which controls the issuer, or is subject to control of the issuer, or is subject to the control of the same person as is the issuer, either directly or indirectly. We are mindful that such a definition might unduly undermine the participation of some practically non-associated companies in the debt market, particularly companies which are associated merely because of common ownership by the central government of a country or its sovereign wealth funds or similar state-owned enterprises, but in practice operate independently as separate commercial entities. We see the need to carve out such companies from the definition of "associate" for the purpose of the QDI scheme. This is important because we would like to encourage

and attract more such companies, including those from the Mainland, to make use of the debt market platform in Hong Kong to meet their financial intermediation needs, either as an issuer or investor. It is consistent with our efforts to promote Hong Kong as an international financial centre.

OTHER OPTIONS

14. An active and diverse debt market is important to the further development of Hong Kong as an international financial centre. One of the most commonly used and effective ways to promote the development of a debt market is to provide tax incentives to participants of the market. Some financial centres in the region are indeed providing such tax incentives to participants of their debt markets. An effective tax incentive scheme is essential for enhancing the competitiveness and promoting the further development of the debt market in Hong Kong. Amending IRO is the only means of implementing the proposed enhancements to the QDI scheme.

THE BILL

15. The main provisions of the Bill are as follows -

(a) **Clause 3** amends section 14A of IRO by -

(i) specifying that any interest or gain or profit derived from a debt instrument with an original maturity of less than three years is also subject to a concessionary profits tax rate at 50% of the normal rate specified in IRO;

(ii) specifying that a debt instrument has to be issued in Hong Kong, at issuance, to ten or more persons, or less than ten persons none of whom is an associate of the issuer of the debt instrument, so that it may be qualified for the tax concession under section 14A or 26A of IRO;

(iii) stipulating that the tax concession available under section 14A of IRO does not apply if the person who obtains the interest or gain or profit in respect of a medium term debt instrument issued on or after the commencement date of this Bill or a short term debt instrument so issued is an associate of the issuer of the debt instrument; and

(iv) adding a definition of "associate", and a provision stipulating that a corporation is not regarded as being under the control of the same person as is the issuer of a debt instrument by reason only that (1) both the corporation and the issuer are wholly owned by the Government of Hong Kong or the central government of the same country; (2) more than 50% of the voting power in the corporation and the issuer respectively is held or controlled by corporation(s) which is/are established and wholly owned by the Government of Hong Kong or the central government of the same country for the purpose of carrying on the business of investment ("government investment vehicle(s)"), or the wholly-owned subsidiary(ies) of the government investment vehicle(s); or (3) more than 50% of the voting power in the corporation is held or controlled by a corporation wholly owned by the Government of Hong Kong or the central government of the same country ("government enterprise") and more than 50% of the voting power in the issuer is held or controlled by another government enterprise;

(b) **Clause 4** amends section 26A of IRO to stipulate that the 100% tax concession available to long term debt instruments under the QDI scheme does not apply if the person who obtains the interest or gain or profit in respect of a long term debt instrument issued on or after the commencement date of this Bill is an associate of the issuer of the debt instrument;

(c) **Clauses 5 and 9** are transitional arrangements; and

(d) **Clauses 6, 7 and 8** deal with some minor technical amendments.

LEGISLATIVE TIMETABLE

16. The relevant legislative timetable is as follows -

Publication in the Gazette	2 February 2011
First Reading and commencement of Second Reading debate	16 February 2011
Resumption of Second Reading debate, committee stage and Third Reading	to be notified

IMPLICATIONS OF THE PROPOSAL

17. The proposal is in conformity with the Basic Law, including the provisions concerning human rights. It has no productivity, environmental, sustainability or civil service implications. The amendments proposed in the Bill will not affect the current binding effect of IRO.

B 18. The economic and financial implications are set out at Annex B.

PUBLIC CONSULTATION

19. We briefed the LegCo Panel on Financial Affairs on the major elements of our proposal at its meeting on 5 July 2010. While some technical questions were raised, members supported our proposal in general.

20. In addition, HKMA has tapped the views of treasury market participants through the Treasury Markets Association ("TMA")[3] on the principles and outline of the proposed legislative amendments. They are generally supportive.

PUBLICITY

21. We will issue a press release upon the gazettal of the Bill (i.e. 2 February 2011). A spokesman will be available to answer media and public enquiries.

BACKGROUND

22. Hong Kong's QDI scheme was introduced in the mid-1990s. The scheme provides concessionary tax treatment in respect of interest income and trading profits derived from QDIs with the policy objectives of attracting overseas issuers to Hong Kong, enlarging the local debt market, and enhancing the competitiveness of Hong Kong vis-à-vis other financial centres in the region. The QDI scheme was refined subsequently in 1999 and 2003. In 1999, the minimum denomination for debt instruments eligible for the 50% concessionary rate of profits tax was reduced from $500,000 to $50,000. In 2003, the 50% profits tax concession was extended for interest income and trading profits derived from QDIs with original maturity period of not less than five years to three years, and the profits tax concession was enhanced from 50% to 100% for interest income and trading profits arising from QDIs with an original maturity of at least seven years.

Note [3] TMA was set up in November 2005 to promote co-operation among market participants with a view to raising the professionalism of practitioners and the overall competitiveness of the treasury markets in Hong Kong. Specifically, TMA develops and promotes appropriate codes and standards for treasury markets; promotes market and product development; provides training and accreditation of relevant qualifications; and raises the profile of Hong Kong as the preferred hub for treasury market businesses in the region. TMA consists of both individual and institutional members from the foreign exchange and money markets, debt, derivatives and other treasury markets.

23. In his Budget for 2010-11, the Financial Secretary announced the Government’s plan to extend the 50% profits tax concession to cover QDIs with a maturity period of less than three years and to amend the provisions concerning the “issued to the public” criterion so as to better meet market requirements.

ENQUIRIES

24. For any enquiries relating to the brief, please contact Miss Natalie Li, Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) at 2529 0121, or Mr Daryl Ho, Head (Market Development), HKMA at 2878 8265.

Financial Services Branch
Financial Services and the Treasury Bureau
2 February 2011

Inland Revenue (Amendment) Bill 2011

Contents

A BILL

To

Amend the Inland Revenue Ordinance to give effect to the proposals in the Budget introduced by the Government for the 2010-2011 financial year concerning tax concessions for qualifying debt instruments; to make further provisions relating to debt instruments; and to provide for related matters.

Enacted by the Legislative Council.

1. Short title

This Ordinance may be cited as the Inland Revenue (Amendment) Ordinance 2011.

2. Inland Revenue Ordinance amended

The Inland Revenue Ordinance (Cap. 112) is amended as set out in sections 3 to 9.

3. Section 14A amended (Qualifying debt instruments)

(1) Section 14A(1)(a)—

Repeal

"; and"

Substitute

"or short term debt instrument; or".

(2) Section 14A(1)(b), before the comma—

Add

"or short term debt instrument".

(3) After section 14A(1)—

Add

"(1A) In relation to—

(a) a medium term debt instrument issued on or after the date of commencement of the Inland Revenue (Amendment) Ordinance 2011 (of 2011); or

(b) a short term debt instrument,

subsection (1) does not apply in respect of any sums received by or accrued to a person as referred to in that subsection if, at the time the sums are so received or accrued, the person is an associate of the issuer of the debt instrument.".

(4) Section 14A(4), definition of ***debt instrument***—

Repeal paragraph (e)

Substitute

"(e) is, at issuance, issued in Hong Kong to—

(i) 10 or more persons; or

(ii) less than 10 persons none of whom is an associate of the issuer of the instrument;".

(5) Section 14A(4), definition of ***debt instrument***, paragraph (g)—

Repeal

"the commencement of this section"

Substitute

"14 November 2003".

(6) Section 14A(4), English text, definition of ***medium term debt instrument***, paragraph (b)(iii)—

Repeal the full stop

Substitute a semicolon.

(7) Section 14A(4)—

Add in alphabetical order

"***associate*** (相聯者), in relation to the issuer of a debt instrument, means—

(a) if the issuer is a natural person—

(i) any relative of the issuer;

(ii) any partner of the issuer;

(iii) if a partner of the issuer is a natural person, any relative of that partner;

(iv) any partnership of which the issuer is a partner;

(v) any corporation controlled by—

(A) the issuer;

(B) a partner of the issuer;

(C) if a partner of the issuer is a natural person, any relative of that partner; or

(D) a partnership of which the issuer is a partner; or

(vi) any director or principal officer of a corporation referred to in subparagraph (v);

(b) if the issuer is a corporation—

(i) any associated corporation;

(ii) any person who controls the issuer;

(iii) any partner of a person who controls the issuer;

(iv) if a person who controls the issuer is a natural person, any relative of that person;

(v) if a partner referred to in subparagraph (iii) is a natural person, any relative of that partner;

(vi) any director or principal officer of the issuer or of any associated corporation;

(vii) any relative of a director or principal officer referred to in subparagraph (vi);

(viii) any partner of the issuer; or

(ix) if a partner of the issuer is a natural person, any relative of that partner; or

(c) if the issuer is a partnership—

(i) any partner of the issuer;

(ii) if a partner of the issuer is a partnership, any partner (***Partner A***) of that partnership or any partner (***Partner B***) with that partnership in any other partnership;

(iii) if Partner A is a partnership, any partner of Partner A;

(iv) if Partner B is a partnership, any partner of Partner B;

(v) if a partner of, or with, or in any of the partnerships referred to in subparagraph (ii), (iii) or (iv) is a natural person, any relative of that partner;

(vi) any corporation controlled by—

(A) the issuer;

(B) a partner of the issuer;

(C) if a partner of the issuer is a natural person, any relative of that partner; or

(D) a partnership of which the issuer is a partner;

(vii) any director or principal officer of a corporation referred to in subparagraph (vi); or

(viii) any corporation of which any partner of the issuer is a director or principal officer;

associated corporation (相聯法團), in relation to the issuer of a debt instrument which is a corporation, means—

(a) a corporation over which the issuer has control;

(b) a corporation which has control over the issuer; or

(c) a corporation which is under the control of the same person as is the issuer;

control (控制), in relation to a corporation, means the power of a person to secure—

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

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

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

principal officer (主要職員), in relation to a corporation, means—

(a) a person employed by the corporation who, either alone or jointly with one or more other persons, is responsible under the immediate authority of the directors of the corporation for the conduct of the business of the corporation; or

(b) a person employed by the corporation who, under the immediate authority of a director of the corporation or a person to whom paragraph (a) applies, exercises managerial functions in respect of the corporation;

relative (親屬), in relation to a person, means the spouse, parent, child, brother or sister of that person, and, in deducing such a relationship—

(a) an adopted child is regarded as a child of both the natural parents and the adopting parents; and

(b) a step child is regarded as a child of both the natural parents and the step parents;

short term debt instrument (短期債務票據) means a debt instrument that—

(a) is issued on or after the date of commencement of the Inland Revenue (Amendment) Ordinance 2011 (of 2011);

(b) has an original maturity of less than 3 years or is undated; and

(c) can be redeemed within 3 years from the date of its issue;

wholly owned subsidiary (全資附屬公司) has the same meaning as it is given for the purposes of section 124 of the Companies Ordinance (Cap. 32) by subsection (4) of that section.".

(8) After section 14A(4)—

Add

"(4A) For the purposes of paragraph (c) of the definition of ***associated corporation*** in subsection (4), a corporation is not regarded as being under the control of the same person as is the issuer of a debt instrument issued on or after the date of commencement of the Inland Revenue (Amendment) Ordinance 2011 (of 2011) by reason only that—

(a) both the corporation and the issuer are wholly owned by—

(i) the Government of Hong Kong; or

(ii) the central government of the same country;

(b) more than 50% of the voting power in the corporation and more than 50% of the voting power in the issuer are held or controlled by—

(i) one or more than one corporation which is established and wholly owned by the Government of Hong Kong or the central government of the same country for the purpose of carrying on the business of investment (***government investment vehicle***); or

(ii) a wholly owned subsidiary of a government investment vehicle; or

(c) more than 50% of the voting power in the corporation is held or controlled by a corporation wholly owned by the Government of Hong Kong or the central government of the same country (***government enterprise***) and more than 50% of the voting power in the issuer is held or controlled by another government enterprise.".

4. Section 26A amended (Exclusion of certain profits from tax)

After section 26A(1A)—

Add

"(1B) In relation to a long term debt instrument issued on or after the date of commencement of the Inland Revenue (Amendment) Ordinance 2011 (of 2011), subsection (1) does not apply in respect of—

(a) any interest referred to in paragraph (h) of that subsection; or

(b) any gain or profit referred to in paragraph (i) of that subsection,

if, at the time the interest or gain or profit is received by or accrued to any corporation or other person, that corporation or person is an associate (as defined in section 14A(4)) of the issuer of the debt instrument.".

5. Section 89 amended (Transitional provisions)

After section 89(5)—

Add

"(6) Schedule 21 has effect in relation to the amendments made by the Inland Revenue (Amendment) Ordinance 2011 (of 2011).".

6. Schedule 1 amended (Standard rate)

Schedule 1—

Repeal

"[ss. 2 & 5]"

Substitute

"[ss. 2(1), 14A(1) & 19CA(4) & (5)]".

7. Schedule 6 amended

Schedule 6—

Repeal

"[s. 26A(2) & (3)]"

Substitute

"[ss. 14A(4) & 26A(2) & (3)]".

8. Schedule 8 amended (Rate of profits tax in respect of a corporation)

Schedule 8—

Repeal

"[ss. 14(2) & 63H(1A)]"

Substitute

"[ss. 14(2), 14A(1), 14B(1), 19CA(4) & (5) & 63H(1A)]".

9. Schedule 21 added

After Schedule 20—

Add

"Schedule 21 [s. 89(6)]

Transitional Provisions Relating to Inland Revenue (Amendment) Ordinance 2011

1. In this Schedule—

amending Ordinance (《修訂條例》) means the Inland Revenue (Amendment) Ordinance 2011 (of 2011).

2. Paragraph (e) of the definition of ***debt instrument*** in section 14A(4) of this Ordinance that was in force immediately before the date of commencement of the amending Ordinance continues to have effect in relation to an instrument issued before that date as if the amending Ordinance had not been enacted.".

Explanatory Memorandum

The main object of this Bill is to amend the Inland Revenue Ordinance (Cap. 112) (***the Ordinance***) to give effect to the following proposals in the Budget introduced by the Government for the 2010-2011 financial year—

(a) to extend the tax concession for qualifying debt instruments (which is available under section 14A of the Ordinance) to those debt instruments with an original maturity of less than 3 years; and

(b) to amend the provision under the Ordinance which provides that debt instruments issued to the public in Hong Kong may be qualified for the tax concession.

2. Clause 1 provides for the short title of the Bill.

3. Clause 3 amends section 14A of the Ordinance—

(a) by adding a new definition of ***short term debt instrument*** so that any interest or gain or profit derived from a debt instrument with an original maturity of less than 3 years is subject to a concessionary profits tax rate at one-half of the normal rate specified in the Ordinance;

(b) to specify that a debt instrument has to be issued in Hong Kong, at issuance, to—

(i) 10 or more persons; or

(ii) less than 10 persons none of whom is an associate of the issuer of the debt instrument,

so that it may be qualified for the tax concession under section 14A or 26A of the Ordinance; and

(c) to stipulate that the tax concession available under section 14A of the Ordinance does not apply if the person who obtains the interest or gain or profit in respect of a medium term debt instrument issued on or after the commencement date of this Bill if enacted (***the***

commencement date) or a short term debt instrument so issued is an associate of the issuer of the debt instrument.

4. Clause 4 amends section 26A of the Ordinance to stipulate that the tax concession available under that section does not apply if the corporation or person who obtains the interest or gain or profit in respect of a long term debt instrument issued on or after the commencement date is an associate of the issuer of the debt instrument.

5. Clauses 5 and 9 provide for transitional arrangements.

6. Clauses 6, 7 and 8 deal with minor technical amendments.

Annex B

Economic Implications

We expect that the extension of the profits tax concession will help to stimulate new demand for bond issuance activities, thereby conducive to Hong Kong's development as an international financial centre.

Financial Implications

2. Taking into account the data collated for 2009, the relaxation of the maturity requirement and the replacement of the "issued to the public" criterion would expand the eligible QDI pool from 3.7% of total gross issuance to about 21%. On that basis and assuming a 3% interest/profit margin, the estimated profits tax forgone is about HK$158 million per annum.