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FINANCIAL SERVICES AND
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(The Treasury Branch)

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14 June 2012

Mr Derek LO
Clerk to Bills Committee
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road, Central
Hong Kong
(Fax: 2978 7569)

Dear Mr LO,

Inland Revenue (Amendment) Bill 2012 (“the Bill”)

Thank you for your letter of 7 June 2012. Our responses to the follow-up actions arising from the first meeting of the Bills Committee are set out in the following paragraphs.

(A) To enhance the clarity of the proposed section 26E(4)(d) of the Inland Revenue Ordinance, as the current drafting could be misinterpreted by readers who do not know the background or purpose of this provision to the effect that those home owners who have been allowed deduction of home loan interest (“HLI”) for ten assessment years (whether continuous or not) prior to the

assessment year commencing on 1 April 2012 will not enjoy the additional five years of HLI deduction

2. The Administration has carefully considered the concern of the Bills Committee, but remains of the view that the current drafting of the new section 26E(4)(d) as proposed in clause 3(3) of the Bill has clearly reflected the policy intent of the Administration without any ambiguity. The wording “that year of assessment” in the new section 26E(4)(d) proposed by the Bill clearly refers to a year of assessment which is earlier than the year of assessment commencing on 1 April 2012. Hence, the condition proposed in the new section 26E(4)(d) will not affect the relevant taxpayer’s entitlement to HLI deduction for the five additional years proposed by the Bill prospectively.

3. The Administration has studied the amendments to section 26E(4)(d) proposed by the Assistant Legal Advisor (“ALA”) of the Legislative Council Secretariat (see revised wording at Appendix). We consider that as the wording proposed by the Bill refers directly to the relevant year of assessment under consideration, it is clearer and more specific than the suggested revisions of the ALA. To further explain the Administration’s policy intent of this provision in order to avoid any misinterpretations by taxpayers, the Administration undertakes that the purpose and effect of this provision would be mentioned in the speech of the public officer in charge during the resumption of the Second Reading debate on the Bill. Moreover, after the Bill has been passed by the Legislative Council, the Inland Revenue Department (“IRD”) would issue guidelines to explain the relevant requirements.

(B) The implications including the estimated loss in tax revenue if the proposed extension in the total entitlement years for HLI deduction could be given retrospective effect

4. From the perspective of public finance, if we were to give retrospective effect to the proposal of extending the entitlement years for HLI deduction, the government revenue would be reduced. According to IRD’s records, some 91 100 salaries tax payers had used up their 10-year entitlement for HLI deduction between the years of assessment 2007/08 and 2010/11. If we were to give retrospective effect to the proposed five-year extension for HLI deduction, the above 91 100 salaries tax payers would be allowed to claim HLI deduction for previous years (starting from the year of assessment 2008/09 the earliest, depending on circumstances) during which the relevant deduction was denied due to exhaustion of the 10-year

entitlement. Assuming that all these taxpayers would claim HLI deduction for all the previous years in one go, this would lead to reduction of government revenue in 2012-13 by about \$980 million.

5. Apart from causing reduction in government revenue, the proposal of giving retrospective effect will also carry significant implications on manpower, resources and implementation time. IRD estimates that some 250 000 tax assessment cases would have to be revised under the proposal. This would entail additional operating expenditure of some \$40 million. Moreover, IRD foresees that taxpayers would submit reassessment claims in the latter half of this year, which coincides with the peak season of IRD's assessing work in processing some 2.9 million tax returns for the year of assessment 2011/12 filed by salaries tax payers. As such, this would impose considerable pressure on IRD's resources.

6. As a principle in implementing tax measures, it has been the established practice of the Administration to adjust allowances and deductions for salaries tax on past occasions by specifying that the relevant adjustments would only be applicable to prospective years of assessment. If we were to give retrospective effect to individual deductible items selectively, this would inevitably arouse controversy. Some taxpayers would also question as to why no retrospective effect is given likewise to other tax measures from which they could benefit.

7. All along, the Administration's policy intent of the current proposal of extending the entitlement years for HLI deduction is that the extended period is applicable only to prospective years of assessment. That is, the relevant measure does not have retrospective effect. IRD already made clear indication on this point on its website on 1 February 2012, the same day when the Financial Secretary announced the above proposed extension in the 2012-13 Budget. This shows that the Administration has already clearly set out the relevant policy. On fairness grounds, we have no intention to make any changes in this respect.

8. From the legal perspective, tax legislation should be clear, fair and certain such that taxpayers are able to ascertain their tax liabilities reasonably and clearly when making economic or investment decisions. As such, we do not agree to make retrospective amendments to the Inland Revenue Ordinance.

9. Given the above various considerations in relation to public finance, policy consistency and fairness treatment, the Administration could not accept the proposal of giving retrospective effect to the additional entitlement years for HLI deduction.

Yours sincerely,

(Miss Fiona CHAU)
for Secretary for Financial Services and the Treasury

c.c. Commissioner of Inland Revenue (Attn: Mr KK CHIU)
Department of Justice (Attn: Ms Leonora IP)

Inland Revenue (Amendment) Bill 2012

The proposed amendments to section 26E(4)(d) made by the Assistant Legal Advisor are underlined below –

Section 26E(4)

A deduction shall not be allowable under this section to a person in respect of any home loan interest paid during any year of assessment for the purposes of a home loan obtained in respect of a dwelling where –

- (a) the sum representing the home loan interest is allowable as a deduction under any other section of this Ordinance;
- (b) any other home loan interest paid in respect of any other dwelling has been allowed to the person as a deduction for that year of assessment under this section other than by virtue of subsection (3)(b);
- (c) a deduction has been allowed to the person under this section, whether in respect of the same dwelling or in respect of any other dwelling, for 15 years of assessment (whether continuous or not); or
- (d) that year of assessment is earlier than the year of assessment commencing on 1 April 2012 and the following occur—the person paid the home loan interest concerned in the year of assessment which is earlier than the year of assessment commencing on 1 April 2012 and the following occur –
 - (i) a deduction has been allowed to the person under this section, whether in respect of the same dwelling or in respect of any other dwelling, for 10 year of assessment (whether continuous or not); and
 - (ii) those 10 years of assessment are all earlier than the year of assessment commencing on 1 April 2012.