Inland Revenue (Amendment) (No. 4) Bill 2015
Summary of Major Views Received During the Drafting Stage of the Bill and the Government's Responses

	Major Views Received During the Drafting Stage of the Bill	**The Government's Responses**
(A) Profits Tax Concession for Qualifying Corporate Treasury Centres ("CTCs") – Division 1 of Part 2 of the Bill		
1.	While most of them welcome the profits tax concession, some treasurers in the industry have suggested that the requirement for a group company to establish a standalone corporation to conduct CTC activities for the tax concession may be somewhat restrictive. Some companies may not find it most cost-effective or operationally feasible for their CTCs to be set up in Hong Kong in the form of a standalone corporation, or to restructure the present ones and its CTC activities for the sake of obtaining the proposed tax concession.	The support is noted. In providing the profits tax concession, we are mindful of the need to ensure that any tax measures would meet the latest international standards to combat base erosion and profit shifting ("BEPS"), so as to avoid the occurrence of double non-taxation or the shifting of profits to low-tax regimes. The proposed requirement for a qualifying CTC to be a standalone corporate entity is necessary to address tax avoidance concerns. In particular, we need to guard against tax avoidance schemes which generate substantial losses from "financial transactions" being packaged as CTC transactions and utilised for reducing taxable profits accrued to a Hong Kong group company. The standalone CTC corporation requirement in the proposed section 14D(3) (Clause 3) will help prevent a group company from shifting its non-CTC income into the proposed half-rate regime. With this requirement and other safeguards contained in the Bill, we are satisfied that the proposed tax scheme for CTCs would not be labelled as harmful tax practices by the international community under the BEPS regime and action plans as promulgated by the Organisation for Economic Co-operation and Development in November 2015. We envisage that a company will take into account tax efficiency and other relevant considerations in structuring its group's operation.

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2.	A few tax advisers have noted that some "holding companies" (which functions are to hold investments and receive dividend income on behalf of the group) may not be able to enjoy the profits tax concession, because the holding companies are not fully dedicated to perform a CTC function and may not be able to satisfy the safe harbour rule as proposed under section 14E (Clause 3).	Dividend income is not subject to tax in Hong Kong. We do not believe that the current proposal on the tax concession for CTC should have a bearing on the taxation of dividend income of a "holding company". If a holding company is also performing some CTC functions, it may benefit from the profits tax concession if it satisfies the criteria for a "qualifying CTC" in the proposed section 14D or 14E (Clause 3). In particular, by the proposed section 14E and Part 3 of the proposed Schedule 17B (Clause 6), we propose a safe harbour rule to allow corporations having 75% or more of its profits derived from, and 75% or more of its assets used to carry out, corporate treasury activities to be subject to the half-rate profits tax (in respect of the qualifying profits). We believe that this will help strike a reasonable balance to ensure that companies carrying out predominantly corporate treasury activities will meet the proposed qualifying criteria.
(B) Interest in respect of Borrowing and Lending of Money with Associated Corporations – Division 2 of Part 2 of the Bill		
3.	Some tax advisers are uncertain about the policy intent of the proposed section 15(1)(ia) and (la) (Clause 7), which deals with the taxation of interest income and relevant gains or profits (as deemed trading receipts) in respect of an intra-group financing business. Some may be uncertain whether the proposed provision is consistent with the existing case law, or may unintentionally change the current tax position and affect the competitiveness	According to some treasury and tax professionals, there is a perceived asymmetry in the current rules concerning interest income taxation and interest expense deduction under the Inland Revenue Ordinance (Cap. 112) ("Ordinance") in respect of a CTC functioning in Hong Kong, as its interest income arising from a lending transaction to a non-Hong Kong associated corporation in the course of carrying on an intra-group financing business is taxable, yet the interest expense incurred in a borrowing transaction with a non-Hong Kong associated corporation is not deductible. To resolve this, we have amended section 16 (Clause 8) to allow a corporate borrower carrying on in Hong Kong an intra-group financing business deduction of interest payable on money borrowed from a non-Hong Kong associated corporation under specified conditions. To maintain a symmetric tax treatment for interest income, the

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	of CTCs operating in Hong Kong.	proposed section 15(1)(ia) and (la) (Clause 7) seeks to make it clear that the "operation test" applies in the determination of the source of interest income, as well as relevant gains or profits, arising from the carrying on in Hong Kong by a corporation (other than a financial institution) of its intra-group financing business. That is to say, if a corporation (other than a financial institution) lends money to a non-Hong Kong associated corporation in the course of its intra-group financing business carried on in Hong Kong, the relevant interest income is deemed as trading receipts derived from Hong Kong, and hence chargeable to profits tax, even though the loan is made available outside Hong Kong. It was held in *Orion Caribbean Limited v Commissioner of Inland Revenue* [1997] HKLRD 924 that, where the taxpayer earned its profits by borrowing and lending of money, the source of profits should not be solely determined by the place where money was lent. The proper test to determine the source of the profits is the "operation test", i.e. "one looks to see what the taxpayer has done to earn the profit in question and where he has done it". In the case of a money borrowing and lending business carried on in Hong Kong, the profits arise from the business transacted in Hong Kong encompassing a broader range of activities such as fund raising, negotiation and approval of loan arrangements, as well as servicing of loans. The proposed section 15(1)(ia) and (la) does not change the charging provision under section 14. Also, it does not go beyond the principle set out in *Orion Caribbean*, and as noted in the current Departmental Interpretation and Practice Notes ("DIPN") 13 (Profits Tax – Taxation of Interest Received). The "provision of credit test" continues to apply in respect of a lending transaction not constituting the carrying on of an intra-group financing business. It is in line with the current provision (i.e. section 15(1)(i) and (l)) deeming interest income received by or accrued to financial institutions as trading receipts. As Clause 7 seeks to provide greater clarity in the

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		current tax treatment of interest income in an intra-group financing business, we do not see how this may affect the competitiveness of CTCs operating in Hong Kong.
4.	The proposed section 16(2)(g) (clause 8) is welcomed by many treasury professionals as this provides an avenue for interest deductions in respect of a borrowing transaction with an associated corporation outside Hong Kong. However, there are some suggestions that the proposed section 16(2)(g) may be quite restrictive as it requires the interest income in respect of the deductible interest expenses to be subject to tax in a territory outside Hong Kong at a rate not lower than a reference rate. This may confer a limited benefit as the foreign tax rate for the corresponding interest income may not be higher than the Hong Kong's profits tax rate.	We note the support for this additional avenue in the proposed section 16(2)(g) (Clause 8) for a borrowing corporation carrying on in Hong Kong an intra-group financing business to claim profits tax deduction in respect of interest payable by it on money borrowed from a non-Hong Kong associated corporation (i.e. "lender") in the ordinary course of that business. The proposed section 16(2)(g)(ii) requires that the lender is, in respect of the interest income, subject to tax (similar to profits tax in Hong Kong) in a territory outside Hong Kong at a rate not lower than Hong Kong's profits tax rate. This will help prevent tax avoidance opportunities in which a company arranges artificial loan transactions generating a huge interest expense (deductible under the proposed section 16(2)(g)) with a lending associated corporation situated in a tax haven charging ultra-low or even zero rate for the profits derived from the interest income. In the absence of withholding tax and "thin capitalisation rules" in Hong Kong, the proposed requirement is necessary to ensure that the amendments to section 16 would not been seen by other tax jurisdictions as tax base erosion or as encouraging multi-national companies to arrange cross-border transactions subject to "double non-taxation". The proposed amendments strike a reasonable balance in facilitating tax deduction by companies and mitigating risks of tax avoidance.
(C) Tax Treatment of Regulatory Capital Security ("RCS") – Division 3 of Part 2 of the Bill		
5.	The banking industry welcomes the initiative to clarify the tax treatment of	We note the banking industry's support for the proposal of treating a RCS as a "debt security" for profits tax purposes.

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	RCS, as this will allow banks to claim interest expense deduction in respect of RCSs issued in compliance with Basel III capital adequacy requirements. That said, some banks may want to know the intent and the application of the "arm's length principle" contained in the proposed section 17E (clause 14) in respect of RCS transactions between a bank and its associates.	Under the proposed section 17E, the chargeable profits from a RCS transaction between a bank and its associate will be assessed by reference to the amount of profits that would have accrued had the same transaction been carried out on terms that would have been made between parties who are not associates. This is to ensure that any RCSs issued or transferred between a bank and its associates will be carried out on arm's length terms for the purposes of tax assessment. To illustrate, if a subsidiary bank in Place A issues RCSs to its parent bank in Hong Kong at a coupon rate below the market rate, the proposed section 17E can be invoked to adjust the accrued profits in relation to the interest income received by the parent bank in Hong Kong as if the transactions were carried out at the prevailing market rate. After the passage of the Bill, the Inland Revenue Department ("IRD") is prepared to explain the operation of this section through a DIPN.
6.	Some banks and tax professionals are uncertain about the purpose and the application of the "separate enterprise principle" contained in the proposed section 17G (Clause 14). The principle may not be familiar to them and may not relate to RCS transactions. Some are concerned whether section 17G may apply to a Hong Kong branch of an overseas bank which does not issue RCSs, or to the profits of the aforesaid Hong Kong branch arising from business transactions unrelated to	The proposed section 17G (Clause 14) is intended to provide for the application of the "separate enterprise principle" to ensure a reasonable apportionment of profits chargeable to profits tax in relation to a Hong Kong branch of a non-resident bank, when the non-resident bank raises capital through the issuance of RCSs (the proposed section 17G(1)). The section does not apply to a non-resident bank which does not raise capital through the issue of RCSs. Since a payment (other than a payment of the paid-up amount of the security) in respect of a RCS is treated as an interest expense under the proposed section 17B(1)(b), the payment will be allowed for profits tax deductions if it is incurred in the production of chargeable profits of the Hong Kong branch of a non-resident bank. To address tax avoidance concerns, we need to ensure that the size of such deduction is reasonable and proportionate. That is to say, the deduction of the Hong Kong

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	the issuance of RCSs.	branch of the non-resident bank would be that the branch would have made if it were a distinct and separate enterprise that engaged in the same or similar activities under the same or similar conditions and dealt wholly independently of the non-resident bank (the proposed section 17G(2)). In this connection, in determining the amount and mix of equity and loan capital that the Hong Kong branch should have, consideration will be given to the functions performed, assets used and risks assumed by the non-resident bank through the Hong Kong branch and other parts of the bank (the proposed section 17G(3)). It is to be assumed that the Hong Kong branch will have the same credit rating as the non-resident bank, and have such equity and loan capital as it could reasonably be expected to have if it were a distinct and separate enterprise (the proposed section 17G(4)). Any RCS transactions between the Hong Kong branch of a non-resident bank and any other parts of the same bank are treated as taking place at arm's length terms (the proposed section 17G(5)). In applying the aforesaid provisions, if excessive payments under RCSs are allocated to the Hong Kong branch for profits tax deduction, an adjustment of such deduction may be required (the proposed section 17G(6)). Currently, the "separate enterprise principle" is enshrined in Article 7 of the double taxation agreements ("DTAs") concluded by Hong Kong with a number of tax jurisdictions, and they are now part of the Orders made under section 49 of the Ordinance. In practice, when a profits tax assessment is now raised in respect of a Hong Kong branch of a non-resident bank, profits will be attributed to the Hong Kong branch in a way that ensures the compliance with the "separate enterprise principle" set out in the relevant DTA concluded with the tax jurisdiction in which the non-resident bank resides. After the passage of the Bill, IRD is prepared to explain the operation of this section in a DIPN.

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7.	The drafting of the proposed section 17H (clause 14) may have unintended implications as it seems to import the arm's length and separate enterprise principles to other person or circumstances for the Ordinance. Some are concerned whether section 17H may be too onerous as changing the tax position in relation to a situation unrelated to RCSs at all. Some suggest that sections 61 and 61A of the Ordinance should have enough anti-avoidance safeguards, and caution against the use of prescriptive and specific anti-avoidance provisions for the tax treatment of RCSs.	The proposed section 17H should not be read, on proper interpretation, as importing the arm's length and separate enterprise principles to any other areas. Section 17H states in the negative that the proposed sections 17E and 17G do not prevent those principles from applying to persons or in circumstances other than those mentioned in those sections. If, after the Bill is passed, the Commissioner of Inland Revenue seeks to invoke the arm's length or separate enterprise principle in a context to which the principle apply even without the Bill (i.e. other than the RCS transactions mentioned in sections 17E and 17G), a taxpayer may argue that sections 17E and 17G supersede the existing law and prevent the principle from applying in that context. Section 17H makes it clear that the sections do not have any such effect and do not affect the operation of the two principles to other situations outside the RCS context. After the passage of the Bill, IRD is prepared to explain the operation of this section in a DIPN. The existing general provisions under sections 61 and 61A will continue to be invoked under any warranted circumstances. In addition, we consider the proposed anti-avoidance provisions in the Bill necessary and proportionate to guard against any specific tax avoidance schemes associated with interest deduction arising from RCSs.

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