BY FAX AND BY POST
(2869 6794)

Our Ref.: C/TXG, M8020 1 December 2000

The Hon. Eric Li,
Chairman, Bills Committee on
Inland Revenue (Amendment) Bill 2000,
3rd Floor, Citibank Tower,
3 Garden Road,
Central, Hong Kong.

Dear Mr. Li,

Inland Revenue (Amendment) Bill 2000

The Taxation Committee of the Hong Kong Society of Accountants has a number of concerns regarding the above Bill.

In general the Committee believes that in the effort to rectify various specific problems of interpretation of the Inland Revenue Ordinance ("IRO") and potential and actual abuses, the Bill casts a net that is far too wide, which could have significant adverse implications for the commercial life of Hong Kong. The Committee's specific concerns are explained in more detail below.

Clause 5 (section 15, IRO)

The proposed new section 15(1)(ba) appears to be inconsistent with the fundamental principle of "source" in the Hong Kong tax regime because it may make the recipient of royalty taxable in situations in which that person is charging the royalty for activities conducted (almost) exclusively outside of Hong Kong. In the case of Commissioner of Inland Revenue ("CIR") v Emerson Radio Corp [(1999) 2 HKCFAR 501] itself, for example, which was the trigger for this proposal, goods to which a particular trade mark related were being manufactured primarily outside of Hong Kong for export to the United States of America.

The judgment in the Emerson case appears to have been a reasonable decision in the circumstances. The Inland Revenue Department ("IRD"), however, seems to take the view that the decision deviates from their long-standing practice regarding the taxation of royalties on certain forms of intellectual property rights. We would suggest, on the other hand, that where the existing section 15(1)(b) states that "sums not otherwise chargeable to tax, received by or accrued to a person for the use of or right to use in Hong Kong any patent.….", this could not reasonably be interpreted to mean "sums not otherwise chargeable to tax received by or accrued to a person for the use of or right to use outside Hong Kong any patent.…." [underlining added]. The latter clearly has a different and contrary meaning. Nevertheless, the Bill now proposes to add such a provision into the IRO as s15(1)(ba).

The additional qualification contained in s15(1)(ba), namely that the sums concerned should be deductible in the hands of a Hong Kong taxpayer, ought not to be relevant. The ability of a Hong Kong taxpayer to deduct outgoings depends, under s16(2), IRO, upon the extent to which they are incurred during the basis period in the production of profits chargeable to tax. 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. There are many situations in which such symmetry does not apply in practice and if it is to be invoked as the justification for the proposed amendment to section 15, then this would represent a policy change that should be brought out into the open and fully debated. If it were to be entrenched as a basic principle of the regime now, it would create considerable uncertainty amongst both Hong Kong and non-Hong Kong companies.

Secondly, the direct linkage between taxability and deductibility, even if accepted, is not being applied consistently in this provision. Under s15(1)(b) no reference is made to deductibility. Thus, where a royalty is paid for the use or right to use intellectual property in Hong Kong, the taxability of the recipient of the royalty is not predicated upon the ability of the payer of royalty to claim a deduction. We believe that it offends against simplicity and logic to introduce two alternative and inconsistent approaches to taxability particularly, in a single provision.

Clause 6 (section 16, IRO)

Section 16(2)(f)

The proposed paragraph 16(2)(f)(iii)(A) of the IRO provides that interest payable on debentures or other marketable instruments will be precluded from deduction where any of the holders of the debentures or instruments is the issuer of those instruments or an associate of the issuer. This seems particularly draconian. The amendments are aimed at closing a loophole whereby some taxpayers seek to circumvent the general intention of s16(2) by issuing debentures which are then subscribed for by an offshore associate. However, even in such circumstances it seems unfair and against the spirit of s16(2)(f) to deny a deduction for any interest paid to unrelated parties simply because some portion of the debentures are held by associates. Moreover, it sometimes will be beyond an issuer's control to prevent an associate acquiring debentures. (The breadth of the definition of "associate" would mean, for example, that in the case of a corporation controlled by the Government, any other corporation controlled by the Government would be caught by it. Accordingly, if any bonds issued by the MTRC were acquired by e.g. the KCRC, the entire interest paid on the whole of the bond issue would strictly become non-deductible). Also, there may be valid commercial reasons why an issuer or an associate thereof may wish to buy some part of a debenture or bond issue. For example, the issuer may wish to support the price or ensure liquidity in the market; however, such commercial actions would result in all interest payable on the issue becoming non-deductible.

The Committee would prefer to see the loophole referred to above dealt with through the use of the existing anti-avoidance provisions under s61A of the IRO. If need be, consideration could be given to strengthening those provisions to target more effectively the particular form of abuse involved. It is not clear why such an approach cannot be adopted rather than relying on the scatter-gun effect of the proposed provision. Members of the Committee are firmly of the belief that, if implemented in this form, the proposal will have an adverse impact on Hong Kong's image as a commercial centre and will undermine the efforts to develop the debt market here. Furthermore, we do not believe that any assurances as to how the provisions might be applied in practice could adequately address these concerns.

As a bare minimum, we believe that the Bill needs to be amended in two ways. Firstly, there should be a de minimis exemption for this provision. That is, any interest disallowance should only apply where more than, say, 5% of the issue is in the hands of associates.

Secondly, the disallowance should apply only in respect of that interest actually paid to associates, leaving the interest paid to non-associates deductible (provided other conditions for deductibility are met).

The proposed s16(7) also needs amendment. This is essentially the transitional provision which is designed to ensure that the new restrictions in s16(2) do not have retrospective effect and provides that they will not apply to amounts of interest payable before the new Bill becomes law. The word “payable” should be changed to “accrued” to ensure that the new provisions will not apply to amounts of interest payable in arrears, but which accrued prior to the new Bill becoming law.

We would also suggest that, whilst the drafting of s16(2)(f) is under review, consideration be given to revising the definitions of “debentures” and “instrument”. Although the problem here does not arise directly from the Bill, the concern is that s16(2) was drafted at a time when bonds and debentures took the form of paper certificates (notwithstanding that these tended to be held by clearing houses rather than the actual subscribers). Nowadays, however, it is more common for no paper certificates to be issued, but rather a single “global note” to be issued and what subscribers/investors acquire is a legal interest in that note. Accordingly, there are in reality no longer any holders of debentures or bonds in the manner contemplated by s16(2)(f). Accordingly, it is appropriate for the definitions of “debentures” and “instrument” to be extended to tradable interests in global notes. Such an amendment to the definitions will give more certainty to taxpayers and would also strengthen the anti-abuse provisions being introduced.

Section 16(2)(d)

We are not clear as to the full implications of this provision. We understand that the mischief the CIR is trying to prevent is the assignment of the loan on which the interest expenses are being claimed as a deduction by the borrower, to an overseas associate of the borrower, so that the loan interest is not taxable in the hands of the assignee. If so, then this should be provided for more specifically in the Bill if it cannot be dealt with adequately under s61A (and the Committee is not convinced that it cannot be). The current drafting appears to be too broad-brush and unclear in its meaning. Under the proposed s16(2)(d)(ii), the Bill seeks to extend the conditions that attach to borrowings secured or guaranteed by deposits to arrangements involving loans. It is not apparent, however, in what sense the money borrowed in the situations described above could be said to be secured by a loan.

Section 16(2)(e)

The restrictions under the existing s16(2)(e) are expanded considerably by the Bill. Currently, where money has been borrowed to finance capital expenditure on certain types of plant and machinery or trading stock, there is no provision to deny the deduction of interest where the loan is secured by a deposit. We would like to obtain clarification as to the justification for expanding the section in a way which has seemingly not been deemed to be necessary for the previous 16 years of its existence. In addition, the doubts raised above in relation to the proposed extension of s16(2)(d) to loans as well as deposits, apply equally to this provision.

Clause 14 (section 68, IRO)

Section 68(9)

It is appreciated that moving the specification of the ceiling on potential costs that the Board of Review may award under s68(9) from the main body of the IRO to a Schedule does not in itself represent a change in the policy in respect of awarding such costs. Nevertheless, the Committee would like to make the point that the potential costs should not be set at such a level as to discourage good faith applications to the Board. Members hope that by making it administratively simpler to propose increases in the ceiling, this will not encourage frequent reviews and regular increases in the ceiling figure. We would welcome an assurance from the Administration on this point.

We hope that the Bills Committee will take the above points into consideration in its examination of the Bill

Yours sincerely,

PETER TISMAN
DEPUTY DIRECTOR
(PROFESSIONAL PRACTICES)
HONG KONG SOCIETY OF ACCOUNTANTS

PMT/ay