MEMORANDUM
on
Inland Revenue (Amendment) Bill 2000

(A) Introduction

We understand that the Bill is to address aggressive tax avoidance schemes. Under the Bill, amendments are proposed to close the loopholes where *"created"* interest expense is deductible where related interest income is not taxable. The amendments by design therefore restrict more stringently the deductibility of interest expense.

We understand and support Government's initiative to prevent abuses. We submit that this should be achieved through the anti-avoidance provisions under Sections 61 and/or 61A which are designed for this purpose and which can be strengthened or amended to deal specifically with interest, if thought appropriate.

We hope that Government will reconsider the current Bill for the benefit of Hong Kong corporations and financial institutions and the status of Hong Kong as a major fund raising centre in Asia.

(B) Overview

The Government is overreacting. The Bill, in its present form, will result in-

1. genuine interest expense incurred by a business being disallowed,

2. a taxpayer being unable to ascertain whether it can or will satisfy the conditions required for interest to be deductible,

3. increase in the cost of borrowing by Hong Kong corporations, and

4. lending to Hong Kong corporations becoming less attractive to financial institutions as compared with lending to corporations in other countries.

(C) Views and concerns

1. Revenue should rely on section 61 and 61A, the general anti-avoidance provision, where there are abuses.

2. The amendments assume that the ultimate recipient of the interest is known by the issuer which is not practicable in the following situations:

- bearer instruments/securities that are traded daily and therefore change hands many times during a fiscal year
- derivative products that “strip” interest
- financial institutions that on-sell or sub-participate with no change in title holder loans

A borrower is therefore unable to ascertain whether it can or will satisfy the conditions required for interest to be deductible.

3. In many jurisdictions privacy ordinances restrict the trustees and paying agents from disclosing the identity of the recipients of interest.

4. The after tax interest cost of Hong Kong companies can inadvertently increase due to events which are outside their control.

This is because:-

- loans and debt instruments may be sold to their “associates” which has a very wide meaning in the amendments

- a beneficiary under a MPF (a trust) which has acquired loan and debt instruments of a corporation may be caught by the definition of “associate of the relevant corporation” due to, for instance, a family relationship with a director of the corporation.

This is also the case for the term “control” and some other terms used but not defined in the Ordinance, for instance, “partner”, “affairs”… conducted in accordance with the wishes…”.

5. Financial institutions will have difficulty in syndicating loans. Under the definitions of associate and beneficiary of trust in the amendments,

corporations will put limitations on the eligible debt holders. This will translate into a higher risk for the financial institutions in not being able to syndicate the loans or arrange debt security issues as freely as they can currently and this will ultimately mean higher interest rates and syndication fees for Hong Kong corporations.

6. The marketability of Hong Kong corporations listed debt securities will decline as the complexity of who can be an eligible purchaser increases. This will put Hong Kong corporations at a competitive disadvantage compared to corporations of other countries.

7. The Hong Kong Government has been trying to promote a debt capital market for Hong Kong and these measures will make Hong Kong debts less attractive than those of other jurisdictions.

(D) Specific comments on some aspects of amendments on S16(2)

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

(i) where a person other than the financial institution or overseas financial institution is entitled to any sum payable by way of interest upon the money borrowed–"

Comment:

"person entitled" is not clearly defined and contemplates a pass through of interest and the ultimate person entitled cannot be determined by the borrower due to

- privacy ordinances
- derivative products to pass on entitlement without change in named lender

- hedging transaction such as interest rate swaps or currency swaps affect entitlement
- securitised loans sold into mutual funds and unit trusts
- any clauses in agreements by the borrower to demand identity of recipients will increase fiscal agents administration costs and risk of error resulting in increased fees to Hong Kong corporations

(A) *"the person entitled is not the borrower or an associate of the borrower; and"*

Comment

- definition of associate is so broad that legitimate joint venture partners in various business ventures in the ordinary course of business may be caught. For example, a corporation A has its principal banker as a partner in its business, any interest on loans by the banker will not be an allowable expense

- this seriously and adversely affects the ability of businesses to raise funds

(B) *"If the person entitled is a trustee …."* (see comments below)

(e) re capital expenditure and trading stock

see comments above and below

(f) re listed instruments

(A) *"none of the holders of the debentures or instruments is the relevant corporation or an associate of the relevant corporation;"*

Comment

Listed instruments are almost always bearer to facilitate trading and increase marketability of the bonds and therefore

1. a corporation is unable to determine who the holder is.

2. If an "associate" holds one note instrument of a multi holder facility for one week and sells thereafter;

   - is one week's interest not allowed on the entire "global note"?
   - if not, which portion? and
   - how to track this time period for every instrument?

   This will create uncertainty and imposes heavy administrative burden on the issuer.

3. Lenders will increase interest rate to compensate reduced marketability. This will adversely affect Hong Kong issuers.

4. The terms of these instruments typically allow an issuer to purchase and resell the instruments to help to

   - increase the marketability
   - maintain an orderly market; and
   - demonstrate a corporation's support for its instruments.

   Under the amendment proposals, such steps taken by an issuer will render all interest under the issue not deductible.

5. Restricting Hong Kong issuers to "registered" instruments will increase costs of administration and reduce marketability to potential lenders / investors in listed instruments and will leave Hong Kong corporations at a serious disadvantage.

6. "Associate" definition can include financial institutions that are partners of a corporation and thus a financial institution cannot act as arranger nor hold temporarily or for the long term the listed instruments of such corporation without giving rise to a significant and inadvertent cost to this issuer.

7. If listed corporation A has "control" of another listed corporation B, and B issues a listed instrument exchangeable into its common shares, A may wish to take up its pro rata share to maintain its equity position on exchange, but B's minority shareholders would bear a portion of the increased costs of the interest disallowed. This severely alters the economics and may deter B from such course of action and funding alternative.

(B) *"where any of the debentures or instruments is held by 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 relevant corporation or an associate of the relevant corporation; and"*

<u>Comment</u>

The words "where any of the debentures", combined with "any beneficiary is an associate of the relevant corporation" and further combined with the definition of associate, give rise to circumstances that will inadvertently disallow interest where the circumstances are not in control of the issuer corporation with heavy consequences, such as:

1. corporation A issues listed debentures and 1% of the debentures are purchased by corporation A's MPF, a trust; the Directors of corporation A are beneficiaries of the trust; interest on 100% of all the listed debentures will be disallowed.

2. the Director's spouse works in corporation B and is a beneficiary of corporation B's MPF, a trust, which purchases corporation A's listed debenture – as this falls within the definition of associate, corporation A is denied the interest deduction of 100% of all listed debentures.

3. Are the MPF's of Hong Kong corporations employees to be defined by all Hong Kong issuer companies to be ineligible to purchase listed instruments to avoid inadvertent errors?

   - where will the market be for these instruments if not Hong Kong pension and retirement plans?
   - how will Hong Kong pension plans meet their Hong Kong investment content requirements?

4. A Director of corporation A invests for his retirement in a public unit trust that invests and trades in listed debt instrument, and so the trust manager buys some of corporation A's listed debt instrument

   - how is the Director to monitor this activity?
   - the Director is only one of thousands or millions of beneficiaries, but under the amendment bill, 100% of the interest on all listed debentures is

disallowed

(C) *"where a person other than the holder of the debenture or instrument concerned is entitled to any sum payable by way of interest upon that debenture or instrument –*

(I) *the person entitled is not the relevant corporation or an associate of the relevant corporation; and*

(II) *if the person entitled 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 relevant corporation or an associate of the relevant corporation."*

<u>Comment</u>

- see above re: "*entitled*", but acutely more significant with publicly traded bearer instruments which trades are not within the control of the Hong Kong issuer, inadvertently increase the cost of the borrowing if purchased by an associates, as defined

- see above (f)(B)