The Administration's Reponses to the Concerns Raised by the Bills Committee at the 6th and 20th November 2000 Meetings

Introduction

The Bills Committee met on 6th and 20th November 2000 to discuss the Inland Revenue (Amendment) Bill 2000. At the meeting, the Assistant Legal Advisor of the Legislative Council (LegCo) and Bills Committee Members have raised concerns about retrospective application of the amendment to the provision on **home loan interest deduction**; whether the new provision relating to the charge of **royalty income** to Profits Tax deviates from the long-standing source-based taxation principle in Hong Kong; and the rationale behind disallowing **deduction of interest expenses** if payment of the interest or principal is secured or guaranteed in part by a deposit or loan only.

2. The Administration's responses to the above concerns are set out in the following paragraphs.

Home loan interest deduction

3. The Assistant Legal Advisor indicated at the 6th meeting that she has some doubts as to whether the retrospective application of the proposed amendment (Clause 8 refers) would be sufficient to allow the amendment of assessments where interest in respect of a car parking space had not been claimed, or had been disallowed on the basis of the present terms of the law.

4. According to our legal advice, section 70A of the Inland Revenue Ordinance will empower the Commissioner of Inland Revenue to amend tax assessments in respect of cases where claims were not previously made, on the basis that they have been rendered incorrect by the retrospective amendment, because there would be "an omission" in each relevant return.

5. Similarly, if in respect of a prior year of assessment, a taxpayer made and was actually denied a claim for home loan interest deduction in

relation to a car parking space, the retrospective application of the amendment to section 26E(8) would result in there being "an error" in the assessment concerned. As a result, the Commissioner will be able to rely on section 70A to correct the assessment.

6. As regards the concern over publicity, the Administration considers that it should suffice if the Inland Revenue Department places advertisements in two Chinese newspapers (Apple Daily and Oriental Daily) and one English newspaper (South China Morning Post) and a notice on the Department's webpage, upon the enactment of the Bill. After all, we believe that few cases are likely to be involved. This is because Departmental Interpretation and Practice Note No. 35 makes it clear that the Department is not enforcing the requirement for the dwelling and car parking space to be valued as a single tenement where they are situated in the same residential development. As a matter of fact, many claims have already been allowed in accordance with this concession.

Royalty income

7. The Bills Committee enquired whether whether the proposed section 15(1)(ba) would represent a departure from the source-based principle of Hong Kong's tax system (Clause 5 refers).

8. We do not consider that this proposal deviates from the source-based principle of Hong Kong's tax system, on the following grounds:

a) The existing section 15(1)(b) of the Ordinance charges to Profits Tax sums which are received for the **"use of"** or **"right to use"** a patent, trademark, copyright etc. in Hong Kong, and which are otherwise not chargeable to tax under the Ordinance. This is done by deeming them to be receipts arising in, or derived from Hong Kong from a trade, profession or business carried on in Hong Kong. This deeming provision, which was enacted in 1971 has been recognised as being in accordance with the territorial-based taxation principle applied in Hong Kong.

In practice, the Commissioner has all along been applying the test in circumstances where a payer (a business entity in Hong Kong) has incurred royalty expenses for a patent, trademark, copyright etc. in producing assessable profits arising in or derived from Hong Kong, and been allowed a deduction for such expenses, the intellectual property concerned would be considered to have been used in Hong Kong. In other words, the royalty income for the intellectual property even though it has been received by an entity outside Hong Kong. will be considered to be sourced from Hong Kong, because it is sourced from a Hong Kong business entity which has been carrying on a trade, profession or business in Hong Kong, and has been making use of the intellectual property for producing assessable profits in Hong Kong. The proposed amendment seeks simply to codify under the Ordinance this longstanding practice of the Commissioner, which is consistent with the source-based taxation principle in Hong Kong. This has been made necessary as a result of the ruling of the Court of Final Appeal which has reduced the intended scope of this deeming provision, by stipulating that, in the circumstances of the case, only the part of the royalty income attributable to the sale of goods manufactured in Hong Kong (instead of the entire amount paid and claimed as a deduction by the Hong Kong business entity) should be chargeable to Hong Kong's profits tax under the existing section 15(1)(b) of the Ordinance.

b) The nature of the proposed amendment to the existing deeming provision is similar to that of other existing provisions which deem certain sums, that are otherwise not chargeable to profits tax, to be Hong Kong source receipts of a business carried on in Hong Kong. Such sums which may be received by a non-resident person include, under section 15(1)(c), any grant or subsidy in connection with the carrying of a business in Hong Kong. This amendment is no different from these other existing deeming provisions in seeking to uphold the territorial-based taxation principle in that these profits are deemed to be derived from, or arising from Hong Kong.

9. That said, we would like to stress that, in line with the Commissioner's established practice, where only a proportion of a royalty payment is deducted under section 16, for instance where a

manufacturer's profits are assessed on a 50:50 basis because it is accepted that they are partly derived from a source outside Hong Kong, only that proportion will come within the new section 15(1)(ba).

Deduction of interest expenses

10. Regarding section 16(2)(d), the Bills Committee Members would like to know the rationale for disallowing a company all interest expense deductions in respect of money it borrows from a financial institution if the repayment of the principal or interest is secured or guaranteed in part by a deposit or loan made with or to any person where any sum payable by way of interest on the deposit or loan is not chargeable to tax.

11. The Administration has researched into the subject. However, records relating to the position adopted in the legislation were limited. This very same point was raised by a professional body when the Inland Revenue (Amendment) Bill 1984 was introduced. A LegCo Ad hoc Group was set up to study the 1984 Amendment Bill. According to our available records, the then Commissioner of Inland Revenue was of the view that there would be difficulties in drafting to spell out clearly back to back apportionments in section 16(2)(d) of the Ordinance (clause 4 of the bill). The proposal would give rise to administrative problems and could be subject to abuse.

12. The Inland Revenue Department maintains the view that if interest were to be allowed on an apportionment basis for cases involving borrowings only partly secured by "non-tax" deposits, the Department would encounter great administrative difficulties in relation to various matters associated with ascertaining the deductions. These difficulties include the following:

(a) It would be necessary to ascertain the relative value of a deposit in relation to any other securities involved. Should the interest be disallowed on the basis of the percentage of the borrowing represented by the deposit, or the percentage of the deposit as compared to the total value of securities?

(b) The respective values of securities can fluctuate from day to day, e.g.

shares, landed properties, deposits in foreign currencies. Disputes would almost certainly arise in relation to valuations at a particular point in time.

(c) Disputes could arise as to the appropriate time to value securities i.e. should it be as at the date of the loan, at the end of each year or at various times to obtain average figures? If it were to be at a particular date, it would be subject to abuse. If it were to be a weighted average, calculations would be too tedious.

(d) The security could be provided by way of a floating charge in which case changes in the components of the security would further complicate calculations.

(e) Additional complications would arise in relation to borrowings (particularly overdraft facilities which might vary on a daily basis) used partly to derive profits chargeable to Profits Tax in Hong Kong and partly for other purposes (would a taxpayer be entitled to argue that no part of the deposit should be regarded as security for the finance in respect of the Hong Kong operations, if the deposit was less than the portion of the borrowings applied to finance the ex-Hong Kong operators?)