4 December 2000

The Honourable Eric Li Ka-Cheung, JP
Chairman
Bills Committee on Inland Revenue (Amendment) Bill 2000
Legislative Council
8 Jackson Road
Central
Hong Kong
By mail & fax

Dear Mr Li

Inland Reveune (Amendment) Bill 2000

The Hong Kong Association of Banks (HKAB) is pleased to have this opportunity to make a submission to you in respect of the Inland Revenue (Amendment) Bill 2000.

Our concerns are twofold. The first is that the proposed amendments to section 16(2)(f) of the Inland Revenue Ordinance (IRO) could have a detrimental effect on the debt capital markets in Hong Kong by denying a tax deduction for all interest payments made by a Hong Kong note issuer in circumstances where any of the note holders are "associates" of the issuer. Whilst we understand and sympathise with the government's intention to attack certain tax avoidance arrangements which could be construed as abusive, we believe that the proposed amendments go beyond this and would adversely impact genuine commercial financing transactions. We understand that a detailed submission on this matter will be made to you next week by the Hong Kong Chapter of the Capital Markets Tax Committee of Asia (CMTC), the membership of which includes many HKAB members. We do not therefore intend to go into any further detail on this matter in this letter.

Our second concern is with respect to the proposed amendments to section 16(2)(d) of the IRO. As we understand the proposed amendments, para (i) of sub-section (d) is aimed at attacking sub-participation arrangements which are structured so as to permit interest on a borrowing to flow to an associate of the borrower, whereas para (ii) is aimed at attacking back-to-back loans where the customer's borrowing is secured or guaranteed by a deposit or loan. We have no difficulty with this distinction but it appears to us that the inter-relationship between these two paragraphs needs to be clarified. This is because a sub-participation which is effected on commercial terms, does not involve an associate of the borrower and is therefore acceptable under para (i), may nevertheless constitute a "deposit" or "loan" and may therefore fall foul of para (ii). As a result, interest deductibility will be denied even in a commercial sub-participation arrangement that passes the test for deductibility under para (i).

We can illustrate this with an example. Supposed Bank A lends money to a borrower. Bank A then grants a sub-participation in the loan to Bank B which is based outside Hong Kong. Bank B would therefore be entitled to receive the interest paid by the borrower, and para (i) in this case would seemingly permit a deduction because Bank B is not an associate of the Borrower. From a tax perspective, this is perfectly fair and reasonable. Indeed, the borrower would usually be unaware of the sub-participation. From a commercial perspective, such sub-participations are entered into typically to enable Bank A to pass on some or all of the customer risk to Bank B, or to enable Bank A to manage its balance sheet and capital adequacy requirements by taking the risk off its books. (Tax abuses are prevented under para (i) by denying a deduction only if the person ultimately entitled to the interest is an associate of the borrower, but this is not the case in this example.)

The difficulty, however, is this. Most lawyers would define a sub-participation as a limited recourse loan, i.e., a loan from Bank B to Bank A on which principal and interest is payable to Bank B only to the extent to which Bank A receives principal and interest from the customer. In fact, in some cases, banks actually document their sub-participation arrangements as limited recourse loans. In either case, the intention of para (i) is that the borrower should be permitted to claim a deduction for its interest payments. However, under para (ii), the deduction would be denied because the payment by Bank B to Bank A for the sub-participation would

constitute a "loan". We assume this result was not intended because it would deny para (i) any effect.

We note that the problem arises because, under para (ii), an interest deduction is denied where the borrower's loan is secured or guaranteed by a deposit or loan placed by any person with any person, whether these persons are associates of the borrower or not. This is extremely wide, and we must question the rationale for this. It appears to us that, if the interest is earned by a person unrelated to the borrower, there is no tax abuse. As a result of the proposed amendment, para (ii) will deny an interest deduction even if the interest on the deposit or loan ultimately flows to an unrelated person (such as Bank B in the above example). We do not understand what abuse this seeks to prevent. We suggest that it would be appropriate for para (ii) to apply only if the person entitled to receive the tax-free interest on the deposit or loan is an associate of the borrower. This amendment would be sufficient to curb abuses without impacting on genuine commercial arrangements. (Under the current legislation, the deduction denial provisions apply only if the deposit is placed by an associate of the borrower so that the interest paid by the borrower flows to such associate.)

Another simple illustration demonstrates the problem with the proposed amendment. Suppose that, as security for a borrowing from a bank, a borrower or its associate pledges as security a portfolio of bonds issued by unrelated parties such as US government treasury bills. A bond is a "loan" of money, with the result that there would be a loan that secures the customer's borrowing. Thus, by granting such security, an interest deduction will be denied. This is a common scenario and is hardly a tax-abusive situation, because the holding of the US government notes is an independent investment that is unrelated to the customer's borrowing. This is a legitimate commercial borrowing, not a tax abuse. Under the existing legislation a deduction would be permitted because the deposit is not placed with a financial institution but with the US government. The proposed amendment if enacted will obviously impact on the type of security that borrowers can offer to banks for their facilities and will therefore make it more difficult for borrowers to raise legitimate funds in a manner that would entitle them to tax deductions. We assume that it was never intended that this type of traditional security arrangement would be discouraged by the proposed amendments.

We trust that you find this letter helpful. If you have any questions please do not hesitate to contact us.

Yours sincerely

David May
Secretary