Capital Markets Tax Committee of Asia
Hong Kong Chapter

December 18, 2000

Ms Leung Siu-Kum
Clerk to Bills Committee
Legislative Council
Legislative Council Building
8 Jackson Road
Central
Hong Kong

Dear Ms Leung,

Inland Revenue (Amendment) Bill 2000
Section 6 – deductibility of interest on notes

We refer to the Bill in respect of which you have requested submissions from interested organizations.

1. Description of CMTC

The Hong Kong Chapter of the Capital Markets Tax Committee of Asia ("CMTC") was established in 1995 and has as its objects (i) the study and advancement of fiscal law and the financial and economic aspects of taxation, particularly as fiscal law and taxation affect capital and securities markets and the activities of investment banks, securities firms, as well as others involved in similar activities, and (ii) the participation, through representation, in other groups or societies concerned with fiscal matters.

The Committee's membership consists of a number of commercial and investment banks based in Hong Kong including Barclays Capital, Citibank, Credit Suisse First Boston, Deutsche Bank, Goldman Sachs, Hang Seng Bank, HSBC, ING Barings, Jardine Fleming, JP Morgan, Lehman Brothers, Merrill Lynch, Nomura, Salomon Smith Barney, Standard Chartered Bank and UBS Warburg, all of whom are represented on the CMTC through their regional tax directors. The CMTC holds monthly meetings in order to discuss tax matters of mutual concern relating to their banking and investment operations.

2. Our general approach to the Bill

Within its terms of reference, the chief interest of the CMTC in the Bill is its potential effect on the capital debt market in Hong Kong.

We sympathize with the government's motives for introducing the Bill, namely, to attack certain types of tax-motivated arrangements which are being utilized by certain taxpayers to claim interest deductions through arrangements that could be regarded as abusive. We do not object to this policy. Our particular concern is to enable the government to meet its objective but at the same time to ensure that the Bill does not go so far as to impact adversely on genuine commercial (i.e., non tax-abusive) note issues. This is a particularly sensitive area because Hong Kong's debt market is not very well established (compared to, say, her equity market), and obviously care must be taken to ensure that the future development of Hong Kong's debt market is not inadvertently jeopardized by the measures that are being proposed. Indeed, both the government and the Legislative Council have taken steps in the past to make Hong Kong more attractive as a debt market centre (e.g., through the introduction of a preferential tax rate for interest earned on marketable debt instruments), and it would be retrograde at this stage to introduce new measures that would be regarded as disincentives in this regard.

That being said, we admit from the outset that this balancing act is not an easy task. As we have discovered through our own deliberations, it is easy enough to identify the sorts of problems that the Bill would create with respect to genuine note issues, but it is more difficult to make precise recommendations as to how the Bill should be amended to avoid these undesirable effects while at the same time giving effect to the government's objectives. In other words, we do not at this stage have a magic solution as to where the “fine line” can be drawn, and we would like to have more time to think about this aspect further. However, because of the imminent meeting of the Bills Committee, we wish to take this opportunity now to state our concerns, and to follow up with another letter before a later meeting of the Bills Committee.

3. Impact on genuine commercial financing arrangements

We now turn to address the specific provisions of the Bill.

Our principal concern lies with respect to section 6 of the Bill which proposes amendments to section 16(2)(f) of the Inland Revenue Ordinance because this is the provision that applies to debt market instruments. For convenience, we refer to "debentures" and "instruments" generically as "notes".

As the Bills Committee is no doubt aware, the proposed amendments provide that if *any* of the holders of the notes is an “associate” of the issuer (including a related trust), then *all* of the interest paid on the note issue will not be deductible.

This is extreme. This is the feature of the Bill what gives us our greatest concern because there may be genuine commercial reasons why a portion of a note issue may be held by associates of the issuer.

This problem would not have arisen many years ago when the market practice was to issue separate debenture certificates and instruments with respect to particular portions of the total note issue, so that each note-holder would hold individual instruments. Under such an old-fashioned type of arrangement, it would have been possible to deny an interest deduction with respect to the interest paid on the particular instruments held by the issuer's associates. However, the market practice now is invariably for a fund-raising to be documented by way of a single "global note" which is lodged with an independent depositary (such as the CMU, CEDEL or Euroclear). Under this arrangement, every investor is effectively a beneficial part-holder of the global note. Under the Bill, the result would be that the issuer will be denied a deduction for the whole of the interest that it pays on that global note. We find it difficult to believe that this could have been the draftsman's intention and we can only suspect that the draftsman was not aware of the mechanics and procedures by which such note issues are nowadays made. Instead, he appears to have assumed that each note-holder is the holder of a separate instrument.

Why, commercially, would a member of the issuer's group hold notes? A few examples will suffice.

a. *Investment trusts and fund managers.* The first example concerns trust companies. As you are no doubt aware, Hong Kong is a major centre for fund managers. These funds are often administered by trust companies. The beneficiaries of the trust would include the public investors and certainly not associates of the trustee. The trustee has a fiduciary duty to invest the assets of the trust in the most beneficial manner taking into account the interests of the beneficiaries of the trust, subject to requirements of prudence and the need to hold a diversified portfolio. Trustees may choose to hold notes issued by their associates as part of the trust's general investment portfolio.

Under the Bill, the issuer would be denied a deduction for all of the interest that it pays with respect to the note issue, even though the interest accrues to the beneficiaries of the trust who are unrelated parties. The result of the Bill would be to discourage trustees of public funds and other fund managers who act for such trusts to invest in notes issued by associates of the trustee, and this would be to the detriment of the competitiveness of the trustees and fund managers concerned whose main concern should be to seek the best returns available from the market.

Worse, a trustee cannot legitimately avoid this result by choosing not investing in its associates' notes because this failure would be a breach of its fiduciary obligation to make the best investments possible and not to subjugate the interests of the beneficiaries to its own group's interests.

If the note issuer is a bank, this would admittedly not be a problem because a bank could claim a deduction under section 16(2)(a) which remains unaffected by the Bill. However, the problem will arise where the note issuer is an associate of the bank, or where the trustee is not part of a banking group but holds notes issued by an associated non-banking entity.

The reality is that such trusts are major sources of investment funds. It would be detrimental to make such funds unavailable for appropriate investments in debt instruments.

In such circumstances, it is difficult to understand any policy for denying the issuer a deduction for *all* of the interest that it pays on its notes. It is even difficult to see why it should lose deductibility for the *part* of the interest that it pays to a related trustee where the trustee is obliged to account for the interest to the beneficiaries of the trust, except perhaps where the beneficiaries are somehow related to the issuer.

b. *Private trusts.* The situation described above in the context of investment trusts applies also to private family trusts. As you are no doubt aware, many families for various reasons hold their assets through family trust arrangements. These trusts are administered by trust companies which are typically, but not always, members of a group of companies that is headed by a bank. This type of “private banking” business can be a very significant part of a banking group’s operations. The beneficiaries of the trust would include the family's members and certainly not associates of the trustee.

   Again, the result of the Bill would be to discourage trustees of such trusts to invest in notes issued by associates of the trustee. Such private trusts are major sources of investment funds from the private sector.

c. *MPF regime.* The position of trustees is exacerbated as a result of the recent introduction of the MPF regime. Such schemes are required to be administered by trustees who are required to invest in a wide array of investments. There will inevitably be pressure on trustees who administer MPF schemes and who receive escalating funds to identify suitable investments, and these will inevitably result in MPF trustees holding notes issued by their associates as part of a general balanced investment portfolio. It would be absurd, e.g., for a major MPF provider to stipulate to its customers that it will not offer facilities to invest in notes issued by the trustee's affiliates. This will deny a level playing field for MPF providers.

d. *Group treasury operations.* A similar situation arises where an affiliate of an issuer, which is responsible for general treasury management operations within a group, holds a portfolio of investments and decides, as part of that portfolio, to hold some notes issued by an associate. We can see the potential for tax abuse if this holding amounts to a significant portion of the total portfolio, but less so if the holding is nominal and constitutes a genuine commercial investment. It is extreme to deny the issuer a deduction for *all* of the note interest in this type of case. A partial disallowance of the interest deduction is perhaps appropriate in proportion to the portion of the note issue held by the treasury company, but for simplicity's sake it would be easier and create less market distortion if a "safe harbour" could be established to disregard nominal holdings by affiliates (say, 5% or less of the total issue). However, as we note further below, this will give rise to compliance difficulties that would make such a "safe harbour" meaningless.

In all of the above cases, it is important to bear in mind that, given the current state of the corporate bond market in Hong Kong, there are very few HK$ denominated notes in the market. Hence, any investor who wants to hold HK$ denominated notes as part of its investment portfolio may inevitably need to hold some notes issued by an associated company. The Bill if enacted would make Hong Kong less attractive as a debt market centre, and would act as a deterrent to the issue of HK$ denominated notes by Hong Kong groups.

e. *Market-making activities*. There might also be good reasons for an associate to hold an issuer's notes where the notes are held as part of a market-making exercise in order to stimulate the demand for the notes in the market-place. This type of commerciality is usually apparent. Such market-making is typically handled by a third party (e.g., the underwriter of the note issue), but many groups – particularly in the financial services sector – perform their own market-making activities. A criterion for an exemption in the Bill could stipulate a maximum period during which such notes are held by the market-making associate.

We hope that these examples demonstrate that there are often valid commercial reasons for notes to be held by the associates of the note issuer without there being an overriding tax avoidance motive.

4. What is the solution?

As mentioned in part 2. above, the solution is not obvious and we need more time to think about a way to amend the Bill in a way that meets the government's legitimate concerns without adversely creating disincentives for commercial note issues.

We would however offer a few preliminary observations at this stage.

a. In the five cases mentioned in part 3. above, we suggest that there be no disallowance of interest deductions.

b. In other cases, the more equitable approach would at first appear to be to deny a deduction only with respect to the interest that accrues to the associated note-holder, but to permit a deduction for the other interest that is paid to non-associated note-holders. Such a "proportionality" approach appears attractive. Regretfully, we have identified a problem with this proposal which in our view makes this solution unviable.

   The difficulty is that, in most cases involving a wide issue of notes, the issuer will not know who are the note-holders.

   In the case of a trust holding, for example, this information would not be generally available. We do however assume that an issuers' group would be able to put in place appropriate reporting systems, but two difficulties would nevertheless remain which appear to us to be problematic (and explain our inability to come up with a solution at this stage). These are related.

The first is that an auditor, in checking the issuer's taxation liability as stated in its accounts, will not be able to opine conclusively that none of the notes are held by associates of the issuer, because the auditor will not know who holds all of the notes that have been issued.

The second is that, if the IRD were to deny an interest deduction, the burden would be upon the issuer to prove that none of the notes are held by its associates. The burden of proof would not be on the IRD to prove that some or all of the notes are held by the issuer's associates.

This distinction is subtle but problematic. An issuer may be able to determine which of its notes are held by its associates. However, because it has the burden of proof, the issuer will need to prove conclusively that none of its notes are held by its associates. Practically, the only way in which the issuer can do this is to identify all of the holders of its notes and prove that they are all unrelated to it. If any notes remain unaccounted for, the issuer will not have discharged its burden of proving that the notes that are unaccounted for are held by unrelated parties. The reality, however, is that an issuer of widely-held notes will never be able to identify all of the holders of its notes. This is because, in the issuer's note register, the global note will be registered in the name of a depositary such as the CMU, CEDEL or Euroclear; in turn, the depositary will in its own registers identify financial institutions as being entitled to portions of that global note; and those financial institutions in turn will identify in their own registers the customers for whom it holds such interests. In fact, beneficial entitlements may be held at even further levels down the chain. The issuer will not have access to this information, and there is simply no way in which such information could be obtained in the case of a widely-distributed issue. Even if the issuer were to make enquiries of the financial institutions concerned (assuming it is able to identify them), those institutions would be obliged to refuse to disclose their customers' identities.

It therefore follows that an issuer will never be able to prove that its notes are not held by its associates as that term is widely defined in section 16(2).

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We will revert to you in due course with more concrete suggestions. We hope that you find this letter helpful in the meantime. If you have any questions, please call me at 2978-1688 or Michael Olesnicky at 2846-1888.

Yours truly,

Archie Parnell
Chairman

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