23 December 2003

Clerk to Bills Committee on Inland Revenue (Amendment) Bill 2000
Legislative Council Secretariat
3/F, Citibank Tower
3 Garden Road
Central
Hong Kong
(Attn.: Mr. Matthew Loo)

Dear Mr. Loo

Inland Revenue (Amendment) Bill 2000

We thank you for your letter of 13 December and as requested would like to offer our views on the Administration's response to our previous submission.

1. *Administration's response related to existing section 61A and financial support from controlling shareholders and directors*

   It is common in a typical so-called "tax avoidance" arrangement (which may be justified by commercial and non-tax reasons depending on the facts of individual cases), that the provision of funding is, in substance, from within a group of companies and no funds are raised from outside the group. However, cases where funds are genuinely raised from controlling shareholders and/or directors should not be considered as tax avoidance arrangement. The existing section 61A allows the flexibility to examine the commercial reasons for such arrangement to determine whether it is tax avoidance case; but this flexibility will be disallowed under the proposed amendments.

2. *"Under the existing sections 16(2)(c), interest on a loan from a controlling shareholder and/or director is not allowable for deduction if the interest is not chargeable to tax in the hands of the controlling shareholder and/or director."*

   Under the existing law, section 16(2)(c) is not the only provision under which interest is deductible. For example, the existing section 16(2)(f) allows deduction of interest incurred on listed debentures even if the interest is not chargeable to tax in the hands of the recipients, no matter whether the recipients are the controlling shareholders and/or directors or not. We do

not understand why the controlling shareholders and directors, who are separate legal entities from the borrower and the group to which the borrower belongs, should be distinguished from other non-related lenders.

3. *"The aim of adding the proposed anti-avoidance provisions by the Bill and the CSAs is to tackle the avoidance schemes which would enable deduction of the interest payments that should be denied if the scheme were not in place."*

   The above explanation reflects the Administration's presumption that such genuine fund raising activities from controlling shareholders or directors are avoidance schemes. Under the proposed amendments, interest is deductible on funding raised by debentures from overseas non-related lenders even if it is not taxable in the hands of the recipients. However, should funding be raised from overseas controlling shareholders or directors through the same arrangement, interest deduction is disallowed. Consequently, a group of companies will be discouraged from obtaining financial support from its controlling shareholders or directors because the after tax interest cost of borrowing from controlling shareholders or directors will be higher. We do not understand why genuine business activities should be interfered in this manner.

4. *"Thus the denying of deduction of interest payable to controlling shareholders and/or directors who are not taxed on the interest income is in line with the existing policy, intention and provision of the legislation."*

   The existing law, including section 16(2)(c) referred to by the Administration, does not distinguish the tax treatment of interest on money borrowed from controlling shareholders and/or directors from the tax treatment of interest on money borrowed from the others. This <u>new</u> distinction is not caused by section 16(2)(c) which is not changed by the proposed amendments; but the result of sections 16(2B), 16(2C) and 16(3B) which are all new provisions not found in the existing law. Deductions on interest paid to controlling shareholders and/or directors, which are allowable under the existing law such as section 16(2)(f), are now proposed to be denied. This can hardly be in line with the existing policy, intention and provision of the legislation.

   In addition, we wish to point out that such unfair tax treatment in the proposed amendments will affect not only the controlling shareholders and directors, but also the group of company and minority shareholders as a result of the increased borrowing cost of the group. If the Bill is passed in its existing form, the controlling shareholders and/or directors will keep their

funds overseas and the borrowers will be forced to borrow at less cost-efficient pricing to maintain the interest deduction. In the end, no additional revenue is collectable. We would advocate for a level playing field and that the discriminatory provisions to the controlling shareholders and directors should be dropped from the Bill.

5. *"When a debenture or note is sold, the seller's entitlement to the accrued interest on the debenture or note will normally be reflected in the selling price of the debt instrument. Thus the apportionment formula of section 16(2C) (which bases on the time of holding the debenture by the debenture holder) is a fair basis that reflects the commercial practice."*

   In the year of acquisition or disposal of debenture, if the amount of interest ultimately received by the taxpayer or its associated companies is made known to the taxpayer, it would be appropriate to disallow the same amount, instead of arriving at the disallowable amount by means of the apportionment formula stated in the proposed section 16(2C).

6. *The test of a person's control over a corporation is spelt out under the definition of "control" under existing section 16(3). The Bill only proposes to recast the existing provision by grouping them under the new section 16(3A)(a).*

   Clear guidance on the definition of "control" in the form of a Departmental Interpretation and Practice Note would be helpful.

Yours sincerely

Louis Loong
Secretary General