Bills Committee on Inland Revenue (Amendment) Bill 2000

Tax Treatment of Interest Income and Payments: A Comparison with Overseas Jurisdictions

Purpose

This paper compares the tax treatment of interest income and expenses in Hong Kong with those in overseas jurisdictions.

Background

2. At the Bills Committee meeting on 24 February 2004, Members asked the Administration to find out how four overseas jurisdictions (namely Singapore, the United Kingdom, Australia and Japan), treat interest income and expenses and in particular, whether the "tax symmetry" principle is also applied in these tax regimes in considering interest deduction as in the case of Hong Kong. The comparison is summarised at the table at ***Annex***.

Tax on Interest Income and Withholding System

3. In the four overseas jurisdictions studied, all interest income that is derived locally (in addition to income not derived locally in some of the jurisdictions) is subject to tax in the hands of the recipients. And in all four jurisdictions, interest paid by local residents/companies to non-residents are treated as taxable income.

4. All these jurisdictions impose a withholding tax system on interest paid to non-residents (the United Kingdom imposes a withholding tax on all interest paid by companies and Japan imposes a withholding tax on all interest paid to residents, in addition to this).

5. Normally, the interest expense that is paid to non-residents may be deducted from income tax assessment of the payers according to

specific rules/only if certain conditions are met. In the United Kingdom, interest expense paid to non-residents is deductible only if the interest is charged at commercial rate. In Australia, interest expense paid to non-residents must meet the "thin capitalization rules" before it may be deducted from the payer's income tax assessment. The "thin capitalization rules", which require that the debt-to-equity ratio of the borrower must not exceed the prescribed ratio (generally 3 to 1), are designed to limit the amount of interest deduction if the debt borrowed is excessive.

6. The consequences are that in all four jurisdictions, it is ensured that all interest derived locally and paid to non-residents is taxed by the local Tax Authority under a withholding tax system. The situation that interest is not taxed as income in the hands of the non-resident recipients while at the same time is tax deductible as expense by the local payers will not arise. In short, "tax symmetry" is maintained in all four jurisdictions. In fact, it may be said that in the UK, Australia and Japan, there is actually "tax asymmetry", but it is in favour of the local tax authorities rather than the taxpayers/interest recipients.

Comparison with Tax Treatment in Hong Kong

7. In Hong Kong, locally derived interest income which is not exempted is subject to Profits Tax, if it is received by a person carrying on business in Hong Kong. However, interest earned by individuals and bank deposit interest earned by an individual/a company carrying on business in Hong Kong other than a financial institution, as well as interest derived from loans arranged outside Hong Kong by non-financial institutions all enjoy exemption. We do not impose any withholding tax.

8. Hong Kong's regime (the existing section 16(2)(c) of the Inland Revenue Ordinance (IRO)(Cap. 112)) allows deduction of interest so long as it is taxed in the hands of the recipients ("tax symmetry"). Deduction is also allowed in the following cases even when "tax symmetry" is not present: borrowing from financial institutions (s.16(2)(d), where the loan is not secured or guaranteed by the borrower or his associates), borrowing for specified purposes (s.16(2)(e), where the lender is not an associate of

the borrower) and from issuing debentures and marketable instruments to the public.

9. It can be seen from the above comparison that the tax treatment of interest income and payments and the related tax deductibility rules adopted under Hong Kong's regime is much favourable to taxpayers compared with overseas jurisdictions.

Purpose of Current Amendment Exercise

10. Operational experience reveals that our existing provisions may not be capable of achieving the "tax symmetry" intended. In particular, the rule under section 16(2)(c) can easily be bypassed through the use of sophisticated arrangements, giving rise to the following situation: interest derived locally and paid to recipients, whether local or overseas, may on the one hand, not subject to Hong Kong tax as income, while, on the other, the interest may be deducted as an expense in the hands of the payer from profits tax liability, creating "tax asymmetry".

11. Such situations have led to substantial losses in profits tax revenue, particularly in cases where money is borrowed between related parties with a view to reaping the tax benefits from the asymmetric tax treatment. There is therefore a need to plug the loophole by introducing specific anti-avoidance provisions on interest deduction.

Financial Services and the Treasury Bureau
Inland Revenue Department
1 March 2004

Tax Treatment of Interest Income and Payments in Hong Kong and Overseas Jurisdictions

	Singapore	**UK**	**Australia**	**Japan**	**Hong Kong**
Taxation on Interest Income	All locally-sourced interest is taxed. In addition, interest paid by a Singapore resident or permanent establishment (whether to Singapore resident or not) and interest deductible against any income derived from Singapore, are deemed to be sourced in Singapore.	All locally-sourced interests are taxed. Besides, interest payable out of the UK, whether locally-sourced or not, is taxable.	All locally-sourced interests are taxed. In addition, interest paid to a non-resident by a resident, or by a non-resident to the extent that the interest is incurred in carrying on business in Australia, is also taxed by way of a final withholding tax.	All locally-sourced interests are taxed. Besides, interest on loan used for domestic business by the debtor who carries on business in Japan is taxable.	Except for financial institutions, only locally sourced interest income is chargeable to tax. Besides, there is a wide scope of exemption for locally-sourced interests, e.g. interests on bank deposits are generally exempted.
Withholding Tax on interest payment	Withholding tax charged on interest paid to non-residents.	Withholding tax charged on all interest paid by companies, whether to residents or not, and on interest paid to non-residents (unless the loan is related to foreign activities or in foreign currency).	Withholding tax charged on interest paid to non-residents.	All interest income is subject to withholding tax.	No withholding tax on interest payments.
Condition for allowing deduction for interest expenses	Interest paid outside Singapore not deductible unless withholding tax has been charged.	Interest paid to non-residents is deductible only – - if the interest is charged at commercial rate - if the interest is paid after deducting tax at source (or the loan is related to foreign activities or in foreign currency)	Payment to non-residents is subject to thin capitalization rules and withholding tax has been charged.	Deduction for interest payment to foreign controlling shareholders is subject to thin capitalization rules and withholding tax has been charged.	- Interest on loans, except from financial institutions or through debt instruments, is not deductible if not taxed in the hands of recipients. - Interest on a loan from a financial institution that is secured by a deposit or loan of an associate of the borrower which will produce tax-free interest is not allowable for deduction.

	Singapore	UK	Australia	Japan	Hong Kong
Tax Symmetry	**Yes** – All interests paid by residents and local businesses are taxed. This will ensure that revenue will not be lost due to asymmetry. Nevertheless, tax deduction on interest expense is subject to other condition to provide further protection to revenue.	**Yes** – All interests paid by residents and local businesses are taxed. This will ensure that revenue will not be lost due to asymmetry. Nevertheless, tax deduction on interest expense is subject to other condition to provide further protection to revenue.	**Yes** – All interests paid by residents and local businesses are taxed. This will ensure that revenue will not be lost due to asymmetry. Nevertheless, tax deduction on interest expense is subject to other condition to provide further protection to revenue.	**Yes** – All interest paid by residents and local businesses are taxed. This will ensure that revenue will not be lost due to asymmetry. Nevertheless, tax deduction on interest expense is subject to other condition to provide further protection to revenue.	**Yes (with specific exemptions)–** Tax symmetry is intended, except for certain exemptions (for bona fide borrowings from financial institutions, borrowings for specified purposes under section 16(2)(e), and from interest on debentures and marketable instruments issued to the public). However, the existing provisions could be bypassed by sophisticated arrangements and thus the symmetry intended could not be achieved. Hence the need for legislative amendments to plug the loophole.

Financial Services and the Treasury Bureau
Inland Revenue Department
1 March 2004