JOINT LIAISON COMMITTEE ON TAXATION

CONSTITUENT MEMBERS: **THE AMERICAN CHAMBER OF COMMERCE**
THE GENERAL CHAMBER OF COMMERCE
THE HONG KONG SOCIETY OF ACCOUNTANTS
THE INTERNATIONAL FISCAL ASSOCIATION - HONG KONG BRANCH
THE LAW SOCIETY OF HONG KONG
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8 April 2004

Mr Matthew Loo
Clerk to Bills Committee
Legislative Council
Legislative Council Building
8 Jackson Road
Central
Hong Kong

Dear Mr Loo,

Inland Revenue (Amendment) Bill 2000

We refer to your letter dated 3 March 2004 inviting us to comment on the proposal to exempt from the application of the proposed interest-denial provisions interest paid on marketed debentures and notes to holders who are engaged in market-making activities (as compared to the initial proposal of exempting such interest only where the debentures and notes are held by market makers). We refer to this proposal as the "concession".

1. At the outset, we are pleased that the proposal for an exemption for market makers was accepted by government in the first place. The issue now under consideration is whether the scope of the proposed exemption should be widened to cover market making activities generally, whether performed by recognized market makers or not.

2. We do not see the need for such widening. We caution that extending the exemption to cover persons who are not market makers in the strict sense, but who merely perform sporadic market making activities, could open the avenue to tax avoidance. This is because issuers could arrange trading of their debentures and notes through their subsidiaries for this purpose. Conversely, the requirement that the holding be by a "market maker" would impose a higher threshold for the concession to apply, because it would then be necessary for the entity concerned to carry on a business of dealing in a broad range of securities, and not just in debentures and notes of one issuer. That being said, out of fairness, I do point out that two of the JLCT's constituent members do not necessarily agree with this conclusion.

3. It appears to us that confining the concession to market makers would address the concerns that have previously been raised.

4. On a related point, the letter dated from the Financial Services and the Treasury Bureau to the Bills Committee, dated 1 March, indicated that the IRD had agreed, in a

Departmental Interpretation & Practice Note ("DIPN"), to state that it would generally accept that a market maker is engaged in appropriate activities if it holds the subject debentures and notes for no more than three months, and if its holding in those debentures and notes does not exceed 5% of the issuance. Where these conditions are breached, the IRD would require a reasonable explanation why such thresholds were exceeded.

We note that, upon an original issue of debentures and notes, it is quite possible that a market maker would hold more than 5% of the amount of issue pending initial distribution to the market. We would welcome the IRD specifically stating in its DIPN that this is a type of situation where there is likely to be a reasonable explanation. Otherwise, we fear that the issue of the 5% of threshold may give rise to disputes in the future.

5. Further, we note that there would be no obligation on the part of an issuer of debentures and notes to disclose to the IRD whether these thresholds have been exceeded. Hence, if the guidelines are breached but an issuer takes the view that the debentures and notes have nevertheless been held by a market maker who was acting genuinely as a market maker, the IRD is unlikely to become aware of the situation. The DIPN will have no force in law, and therefore it is not possible to impose a disclosure requirement in the DIPN. There is no ready answer to this, short of amending the Bill further. That being said, we do not regard this point as crucial.

6. On a final point, we have one comment about the proposed definition of "market maker". We would strongly urge that the words in part (iv) "for the purposes of providing liquidity in respect of such debentures or instruments" be deleted. This in our view imposes an excessive and unnecessary threshold for the concession to apply. Those words make it essential for the issuer to prove that the market maker was holding those notes with that purpose in mind. However, the reality is that market makers trade for the purpose of making a profit, and not for the purpose of providing liquidity. The provision of liquidity is merely an *effect* of the role of the market maker, but not the *purpose* or intention of the market maker. It appears to us that the four conditions set out in the proposed amendments are already sufficient to ensure that only bona fide market makers would fall within these provisions, and so the words we have cited are unnecessary.

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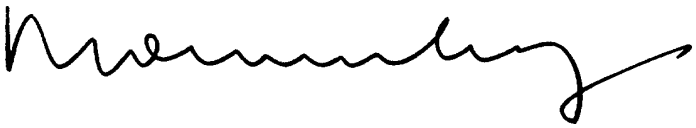
If you have any questions, please feel free to contact me at 2846 1716.

Yours faithfully,



Michael Olesnicky,
Chairman,
for and on behalf of
The Joint Liaison Committee on Taxation
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