Bills Committee on Inland Revenue (Amendment) Bill 2000

Administration's Response to Comments relating to Exemption from 'tax symmetry' Rule for Internal Borrowings by Associated Corporations

Introduction

At the Bills Committee meeting on 2 March 2004, in response to comments made by the Real Estate Developers Association of Hong Kong (REDA), the Administration was requested to consider expanding the definition of 'market markers' in the proposed section 16(2G) of the Administration's Committee Stage Amendments (CSAs) to achieve the effect that interest expense incurred on internal borrowings involving non-financial institutions and non-security dealers may be deducted from Profits Tax liability, even if the interest income is not taxed in the hands of the recipient (i.e. even if the 'tax symmetry' condition is not met).

2. This paper explains the following aspects-

(a) principles governing Profits Tax deductibility of interest expense under the Inland Revenue Ordinance (IRO), Cap 112 and in particular, the rationale behind the 'tax symmetry' principle relating to the allowance of Profits Tax deduction for debt security interest involving internal borrowing;

(b) the loophole that exists with the current section 16(2)(f), how typical tax avoidance schemes involving debt securities operate, the magnitude of tax revenue at stake and the need to plug the loophole by the proposed amendments to the existing section 16(2)(f) and the addition of the proposed 16(2C);

(c) how other tax jurisdictions maintain 'tax symmetry' on interest income/payment and how their treatments compare with ours; and

(d) the relationship between the proposed sections [16(2)(f) and 16(2C)] and the development of our bond market.

3. The Administration's view is that 'tax symmetry' and/or restrictions to external borrowings should be maintained on Profits Tax deductibility of debt security interest expense (i.e. expense on borrowings may be deducted from the borrower's liability, only if the same amount is taxed as income in the hands of the lender). This general principle is both appropriate and equitable. It was the intended policy at the time when the conditions under section 16(2) were introduced in 1984. The development of the local bond market will not be adversely affected by the amendments.

4. In this relation, at a meeting with the Administration on 20 April 2004, REDA indicated that they suggested that debentures subscribed by majority shareholders of the issuing corporations for 'genuine commercial reasons' should be exempted from the 'tax symmetry' rule and that they intended to submit concrete proposals on the definition of 'genuine commercial reasons'. The Association's proposal had not been received as at noon on Wednesday, 28 April. We will examine the Association's proposal when it is received. However, we would maintain that rules on tax deductibility on the interest expense on borrowings on debt securities should be consistent with other tax related taxation arrangements in the IRO (para 12 below refers). Also, deductibility should be restricted by sufficient conditions which can effectively ringfence the exemption, as otherwise, much revenue would be at stake and the objective of the present Bill to plug the existing loophole will be defeated.

Tax Principles and Policy Intent on Profits Tax Deductibility of Loan Interest Expense

5. IRO allows loan interest expense to be deducted from the taxpayer's Profits Tax liability. At the same time, in order to prevent abuse, various rules and conditions providing for 'tax symmetry' are imposed. Detailed requirements and the policy intent leading to their enactment are set out in the ensuing paragraphs.

6. Sections 16(1)(a) and 16(2)(c) of IRO provide that loan interest

that is incurred for the purpose of producing assessable profits may be deducted from Profits Tax assessment so long as the sums payable by way of interest are chargeable to Hong Kong Profits Tax (i.e. when there is 'tax symmetry')-

> *"the money has been borrowed from a person other than a financial institution or an overseas financial institution and the sums payable by way of interest are chargeable to Hong Kong Profits Tax." [section 16(2)(c)]*

7. This 'tax symmetry' rule is extremely important for this area of deduction, as it is about the only and most effective tool in preventing abuse in this area, because the sophistication of the loan/debenture arrangements and the involvement of overseas set-ups in the transactions often make investigations by the tax authority extremely difficult. By applying 'tax symmetry', the incentives to deploy tax avoidance schemes to take advantage of the deduction would be removed, as recipients need to pay tax on the interest to offset any savings gained by the issuer company. This rule is widely adopted in other tax jurisdictions.

8. While the 'tax symmetry' rule is in general appropriate, it was considered that strict or pure 'tax symmetry' should not be applied in certain circumstances of **genuine external borrowings.** The specific circumstances include (i) borrowings from financial institutions; (ii) borrowings to finance capital expenditure incurred on the provision of machinery or plant which qualifies for depreciation allowance or the purchase of trading stock; and (iii) interest payable by a corporation on publicly listed (in Hong Kong or a reputable overseas financial centre) debentures or other debt securities where the issues are bona fide and in the course of carrying on business.

9. For the specific circumstances described in para 8(i) and (ii), although strict or pure 'tax symmetry' is not insisted upon it is provided that the borrowings concerned must not be secured or guaranteed by tax-free deposits of the associates, or lent from 'associates' respectively in order to ensure that the source of funding does not come from internal avenues-

(i) for borrowings from financial institutions, it is provided that the repayment of the principal or interest is not secured or guaranteed by any instrument/undertaking executed/given by or on behalf of the borrower/an associate of the borrower against the borrowing [section 16(2)(d)];

(ii) for borrowings to finance capital expenditure, it is provided that the lender is not an associate of the borrower [section 16(2)(e)];

For these two sections, 'associate' is defined to mean, where the person is a corporation, a) any associated corporation; b) any person who controls the corporation and any partner of such person, and, where either such person is a natural person, any relative of such person; c) any director or principal officer of that corporation or of any associated corporation and any relative of any such director or officer; d) any partner of the corporation and, where such partner is a natural person, any relative of such partner.

10. Conditions were added in these two subsections to mitigate the possibility for the business proprietors, who have surplus funds, to take advantage of the interest deduction scheme by raising loans to claim interest deduction on the one hand and to make deposits to gain tax-free interest on the other. Borrowings from associates (which include shareholders, directors and associated companies) are disallowed from claiming interest expense deduction in the case of a section 16(2)(e) loan which is borrowed for a specified business purpose. These are important tools to prevent abuse of the interest expense deduction in the absence of strict 'tax symmetry'.

11. **The only circumstance where neither the 'tax symmetry' rule nor the 'no deduction for borrowings between associates rule' was imposed is in section 16(2)(f).**

12. The 'no deduction for borrowings between associates/for internal borrowings' rule, which has been omitted from the existing section 16(2)(f), is consistent with other related taxation arrangements in the IRO and therefore more equitable: deduction in respect of interest on a loan advanced to a business concern by a controlling shareholder of a small

and medium sized corporation is not allowed, unless the symmetry condition is complied with (section 16(2)(c) refers); dividend payments to shareholders which are the pay-offs for equity injection are not deducted from Profits Tax liability. Some illustrations showing that the rule is equitable are set out at ***Annex A***.

Annex A

Background Leading to the Enactment of section 16(2)(f)

13. Subsections 16(2)(c), (d) and (e) were added in 1984, as it was considered by the then Financial Secretary essential to restrict the deduction of loan interest expense, subsequent to the removal of interest tax, to avoid abuse through tax planning. The policy intent was clearly spelt out in the extracts from the 1984-85 Budget Speech at ***Annex B***.

Annex B

14. As explained above, the 'tax symmetry' and the 'no deduction for borrowings between associates' rules are important themes of the 1984 amendment exercise, as they help to minimise the scope for abuse and are very important for revenue protection purposes, especially considering the substantial amounts of loan interest expense deductions claimed by taxpayers.

15. Subsection 16(2)(f) was not part of the 1984 Amendment Bill pursued by the Administration. It was proposed during a later Amendment exercise in 1986 and was initiated in response to a call by the industry to relax the interest expense deductibility to cover funds flowing from public issues of debentures and marketable commercial papers even when the 'tax symmetry' rule is not met. The justification put forward by the industry at that time was that the rules added in 1984 had restricted a company from raising funds by issuing debentures overseas as in such case the interest payable by the debenture issuer will not be allowed for tax deduction owing to the fact that the interest received is offshore income and not taxable in the hands of the debenture-holder. While no explicit restriction was set out in the provision in respect of borrowings between companies in the same group, it was clear from the provisions of that section that the **policy intention was to extend the interest deductibility only to public issues** (i.e. to non-associates of the issuer) of debt securities as opposed to private ones

(i.e. associates) and only to interests on **external borrowings** instead of internal ones. Unfortunately, the drafting of the **existing 16(2)(f) fails to reflect the full policy intent.** A few years after the enactment of section 16(2)(f), relying upon the fact that an interest payment could be deductible to the borrower but not taxable under the IRO to the lender by virtue of having an offshore source, **aggressive tax avoidance schemes exploiting this loophole began to emerge** (details are explained in paras 17 and 18 below).

Problem with the drafting of the existing section 16(2)(f) and the loophole

16. The dual purposes of the Administration's present proposed amendments to section 16(2)(f) and the new 16(2C) are to reinstate the rule and plug the tax avoidance loophole by disallowing deduction in respect of interest incurred from borrowings between connected parties, unless there is 'tax symmetry'. Connected parties are proposed to be defined as parties having a control relationship between them, and include associated companies and controlling shareholders of the debenture issuer.

17. As mentioned, several years after the enactment of section 16(2)(f), The Inland Revenue Department (IRD) has seen the increasing use of aggressive tax avoidance schemes that were designed to take advantage of the loophole in this section. A typical tax avoidance scheme would involve the issue of debentures by a borrower in an overseas stock exchange (and very often a place where supervision over listing control is very limited), and the subscription of the debentures so issued by an overseas entity (the lender) which is in the same company group as the borrower. In more sophisticated plans, some commercial activities would invariably be added to the loan-raising package. For example: a lender issues debentures with value well exceeding the commercial need of the company (assuming the company needs to raise $100 million in loans, debentures with a value of $200 million are issued) and then another entity situated overseas within the same group will subscribe for the debentures. In most cases, the transactions are made through multiple layers of companies in order to increase the difficulty

for IRD to trace the relationship between the borrower and the ultimate lender and the purpose of the loans etc. Very often, there is no increase in external loans resulting from the series of transactions but an interest payment stream will be created. The lender who receives the interest payment is not subject to Hong Kong Profits Tax (because it is located offshore and the interest is sourced offshore) while at the same time, the borrower may claim deduction from Profits Tax liability for its interest expense by virtue of section 16(2)(f). The operation of some typical avoidance schemes is set out in the form of flow charts at ***Annex C*** for Members' easy reference.

Annex C

18. **These schemes have grown both in number and size in the last several years.** According to IRD's statistics, the **Profits Tax liability involved in these questionable transactions** which is being investigated by the department (by challenging the interest deduction claims lodged by taxpayers with the use of the general anti-avoidance provision) **amounted to $6 billion** in the past 6 years. Out of these, **$1 billion is attributable to schemes involving debenture interest in 7 cases.** The bulk of the companies involved are in the same trade/business. There are other cases still under investigation with the quantity of tax involved yet to be assessed. These figures however only reflect partly the real situation, because there are avoidance plans that are more sophisticated (such as the partially commercial cases as described above) which IRD is not adequately empowered to tackle[1]. **Anti-avoidance cases in relation to section 16(2) are far from isolated. The situation is worrying. If the loophole in the existing section 16(2)(f) and other sections of the interest deduction scheme (such as section 16(2)(c), (d) and (e)) are not plugged, it is estimated that over $1 billion of Profits Tax revenue a year will be at stake. Our tax base will be seriously eroded.**

How Other Major Tax Jurisdictions Treat Interest Expense

[1] The existing general anti-avoidance provision of section 61A is very restrictive and may not be capable of dealing with sophisticated avoidance cases of interest deduction claims, in particular those packaged with some commercial activities of the taxpayer. On this last point about inadequate power to combat avoidance schemes, the Administration's proposal is to set out the circumstances where deduction in respect of interest expenses is allowed and not allowed very precisely in the legislation such that IRD may raise taxes with the internal borrowing cases without much dispute.

19. We have examined the interest expense treatment in four overseas jurisdictions as specified by the Bills Committee, namely the UK, Australia, Japan and Singapore. In all these four tax jurisdictions interest paid by local residents/companies both to residents and non-residents is generally treated as taxable income without regard to the place in which the loan that generates interest was drawn. This wide scope of taxing interest income in these jurisdictions ensures symmetry – the interest payment is taxable in the hands of the recipient while it is deductible in the hands of the payer.

20. While in Hong Kong, subsequent to the repeal of the Interest Tax, only locally derived interest income which is received by a person carrying on business in Hong Kong (but except 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) is subject to Hong Kong Profits Tax. Interest derived from loans the moneys of which were made available outside Hong Kong is considered to have a non-Hong Kong source and is generally not taxable. Our narrow scope of taxing interest income has caused an imbalance in our system, which can only be restored by restricting deduction of interest from Profits Tax liability only to cases where it is taxed in the hands of the recipients.

21. All four jurisdictions studied **maintain a withholding tax system on interest payable to non-resident persons to ensure collection of tax on interest income**. Some of them make it a condition for deduction of interest that tax on the interest payment must be withheld by the interest payer. In addition to the application of withholding tax system, most of the places studied impose other specific conditions that have to be met before the corresponding loan interest expense incurred by the borrower may be deducted. For instance, in the UK, interest expense paid to a non-resident is deductible only if the interest is charged at a commercial rate. In Australia, Japan and the UK, interest expense paid to non-residents must meet the 'thin capitalization rules' before it may be fully deducted from the borrower'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 as a tool, **additional to tax symmetry**, to

limit the amount of interest deduction to the specified ratio if the loan borrowed is excessive. In other words, if the 'thin capitalization rule' is breached, the excessive part of the interest expenses would not be deductible notwithstanding that withholding tax on the interest has been paid (i.e. a double tax situation). The 'thin capitalization rules' are designed to remedy the imbalanced tax deduction rules for dividend and interest expense – the former is not deductible while the latter is.

22. **Hong Kong's treatment of debt security interest expense after the enactment of the Administration's proposed sections 16(2)(f) and 16(2C) which has the following characteristics, will be generally more favourable compared to the four overseas places studied**:

(a) interest expense incurred from **public issues** of debt securities (i.e. external borrowings) is allowed to be deducted from the borrower's tax liability even when the lender does not pay Hong Kong tax on the payment received and there is no 'thin capitalization rule' to restrict such deduction;

(b) interest expense incurred from **private issues of debt securities subscribed by connected parties** (associated companies and shareholders having control over the company), i.e. internal borrowings, may be deducted from the borrower's tax liability without having to meet other specified conditions such as those applicable elsewhere in relation to the equity to debt ratio ('thin capitalisation rules') or the interest rate, **so long as the lender pays Hong Kong tax on the corresponding interest income.**

A summary table comparing the tax treatments of interest expense in the four overseas jurisdictions and Hong Kong is at ***Annex D***.

Annex D

Relationship between the proposed 16(2)(f) and 16(2C) and the development of the bond market in Hong Kong

23. An active public debt market is the most important element of a prosperous bond market. Currently, **interest expense on external borrowings through public issues of debt securities is allowed without**

any condition (i.e. without insisting on 'tax symmetry' and no thin capitalization rule). **This arrangement will continue** under the Administration's proposals, which should have a neutral impact on our public debt market.

24. What the Bill seeks to do is to uphold the 'tax symmetry' principle as well as to plug an existing tax loophole by disallowing Profits Tax deduction in respect of interest expense flowing from internal borrowing through **issues** of debt securities in cases of no 'tax symmetry'. As analysed, this 'no-deduction for internal borrowings' rule is consistent with the treatment for smaller corporations and for alternative sources of funding for companies, sole-proprietorships and partnerships.

25. From the market development perspective, according to the Hong Kong Monetary Authority (HKMA), if the **private issues of debt securities** are primarily for tax avoidance purposes and if a large portion is held in the hands of connected parties, the **market development benefits, especially in terms of liquidity, of these securities would be small.** We also understand that these types of debt securities would not involve active trading or create any secondary markets, thus having no positive impact on market liquidity. They are not available to the investing public, hence do not have any positive implications on product mix available in the local bond market. Since these products are generally not offered for trading in the stock exchange and do not need to be cleared through the Central Moneymarkets Unit, they would not have any positive impact on our infrastructure development. These products are not particularly 'innovative' either.

26. **The Administration's assessment is that the development of the local bond market will not be adversely affected by the current Bill.**

Proposal of Expanding the Definition of 'market making' to Cover Corporates

27. The Administration was asked at the last Bills Committee meeting to consider expanding the definition of 'market making' to cover

non- financial institutions or non- securities dealers such that internal borrowings by corporates might be exempt from the 'tax symmetry' rule.

28. To recap, the securities dealing industry was of the view that the operation of the proposed section 16(2C) may cause difficulties in practice for multinational giant securities-dealing and investment groups to keep track of dealings in securities issued by members of their group. The issuers, therefore, would face a **compliance problem** when they are required to complete the annual tax returns. After consultation with the industry, the Administration has agreed, even though there is no need for an exemption for the moment, that in principle, exempting market-making activities of securities dealers from the operation of the restriction on interest deduction as provided in the proposed section 16(2C) is reasonable, provided that they are genuine and that there are ways to suitably ring-fence the exemption. The exemptions have been incorporated in the revised draft CSAs submitted on 1 March 2004. The exemption is limited to the activities of market makers who are registered securities dealers actively involved in the securities dealing business. **The same compliance issue is not relevant in the case not involving securities-dealing market makers.**

29. Although the term 'market makers' is not defined under the HKMA's Exchange Fund Notes Programme, only authorised institutions (which have to be financial institutions according to the relevant legislation) may qualify as 'market makers'. According to HKMA, in the UK, US and Singapore, 'market makers' or 'primary dealers' in relation to government securities are generally characterised by their on-going obligations to quote two-way prices to the market, hence promoting the liquidity in the underlying securities. In addition, the market makers are usually securities dealers dealing in wide range of securities. The dictionary meaning of the term 'market maker' is a 'member of the Stock Exchange granted certain privileges and trading to prescribed regulations'. In practice, the term refers to the securities dealers who are recognized by a stock exchange to trade in accordance with laid down regulations.

30. It therefore follows that **the definition of 'market making' deployed in the Administration's CSAs is appropriate and in line with international practices.** The HKMA also notes that it is currently

not usual for a non-securities dealer/associated company of an issuer to assume the role of arranger or market marker for debt securities issued by the issuer. Normally, the corporate issuer would appoint a securities dealer to act as arranger and market maker if deemed necessary. The trading activities referred to by REDA, i.e. companies which are not involved in the normal business of securities dealing buying and selling debt securities issued by their fellow group companies or underwriting the securities are not common 'market making activities'.

31. The JLCT also pointed out in its letter of 8 April the following: "extending the exemption to cover persons who are not market makers in the strict sense, but who merely perform sporadic market marking 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." JLCT stated that they did not see the need for such widening of the scope of exemption. The Capital Markets Tax Committee has written in to support the Administration's proposal to ring-fence the exemption to market makers in the ordinary sense who need the exemption on compliance grounds.

32. **To conclude, widening the market marker definition to accommodate exemption for trading/underwriting transactions by non-market-maker corporates would retain and possibly enlarge the loophole for tax avoidance. It is also inconsistent with the general 'tax symmetry' principle on internal borrowings. We do not consider this suggestion appropriate.**

Inland Revenue Department and
Financial Services and the Treasury Bureau
April 2004

Illustrations to show equity of "no deduction for internal borrowings" rule

Sole proprietor

Mr A has $500,000 savings in banks. He starts a retail business, using his savings of $500,000 as capital.

- He loses the interest income from the banks.
- He has genuine commercial reasons (to start his business).
- But he cannot get a deduction for interest expenses under existing law, even if such expenses are charged in his profits & loss accounts.
- Reasons: The sum ($500,000) is clearly his capital to run the business. It does not matter whether he puts it into the business by way of "capital" or by way of "loan".

Partnership

Mr B and Mr C are partners. Each lends $100,000 to the partnership business for buying trading stock.

- They have genuine commercial reasons to lend money to the business.
- The partnership business cannot get a deduction for the interest expenses under existing law.

Private Company

Mr D and Mr E form a private limited company to run a restaurant. The share capital is $2.

- The dividends received by Mr D and Mr E are not taxable.

- The company cannot get a deduction for the dividends paid.

Since the share capital is $2, Mr D and Mr E each have to lend $1m. to the company to run the restaurant: -

- Mr D and Mr E have genuine commercial reasons. [How can the company run the restaurant with $2 capital?]

- They receive interest income from the company, free of tax.

- The company cannot deduct the interest expenses under existing law.

Public Company

K family is the controlling shareholders of a listed company. The company is short of cash to expand.

K family lends $100m. to the company to finance its expansion.

- K family has genuine commercial reasons.

- K family does not pay tax on the interest income.

- The listed company cannot deduct the interest expenses under existing law (s.16(2)(c) not satisfied).

If K family lends $100m. to the listed company by way of debentures listed in Luxemburg for the same reason: -

- K family has genuine commercial reasons.

- K family does not pay tax on the interest income.

- Then why should the listed company get a deduction for the interest expenses

[as REDA suggest]?

[Note: The only difference is the method of lending.]

Genuine Commercial Reasons

In all cases, there are genuine commercial reasons.

If this is the basis for the deduction (as suggested by REDA), why not give deduction in all cases? The Government certainly cannot afford to do so, as tax asymmetry will result in a colossal loss of revenue!

Debenture issue - s. 16(2)(f)

When debentures are issued to the public, the company's objective is to get external funds.

- If the subscribers are unrelated parties (i.e. not shareholders, associated companies etc.), the interest expenses are deductible, even if tax symmetry does not exist. Government is prepared to give up tax symmetry in this situation in order to facilitate corporations getting external funds.

- If a small shareholder subscribes for the debenture, in theory, part of the interest expenses should be disallowed. But this is not practical because the company would not know whether small shareholders take up the debentures and if so, how much and for how long (i.e. the identification problem).

- If a controlling shareholder takes up the debenture, the situation is different. The identification problem does not exist. Therefore, part of the interest expenses should be disallowed (to maintain the tax symmetry principle).

- Whether or not the public, the small shareholders or the controlling shareholder have genuine commercial reasons is irrelevant.

Development of Bonds Market

- Last year, the rules for qualifying debt instruments (QDI) are relaxed. (Income from 3-7 years QDI is taxed at half rate and income from 7 years QDI is not taxed). This is already a tax measure to promote the market.

- It has never been the government's policy to promote the bonds market by allowing interest deduction for "internal" borrowing by way of debentures.

- Neither has been the government's policy to disallow interest deduction if the debentures are in fact used to raise “external” funds.

- The government is even prepared to relax the tax symmetry rule for small shareholders (to address the identification problem).

Annex B

Extracts from 1984-85 Budget Speech

"I have referred frequently to the possible effects which the removal of the interest tax might have on the Profits Tax and thus the further serious consequences for Government revenue..... I do not need to spell out in precise terms the details of the tax avoidance devices which are now available to business enterprises by virtue of the repeal of interest tax on deposits. In essence they involve a reduction of the liability to Profits Tax through the use of high debt to equity capitalisation arrangements, whilst at the same time the business proprietors can enjoy tax-free interest income outside the business through the placing of deposits with financial institutions. There is already evidence that bankers and tax avoidance specialists have set about advising customers and clients of the opportunities for tax diminution under the present law. The longer term prospects are that huge Profits Tax revenue could be lost. In all prudence immediate steps must be taken to minimise these losses, while remaining themselves neutral in effect..."

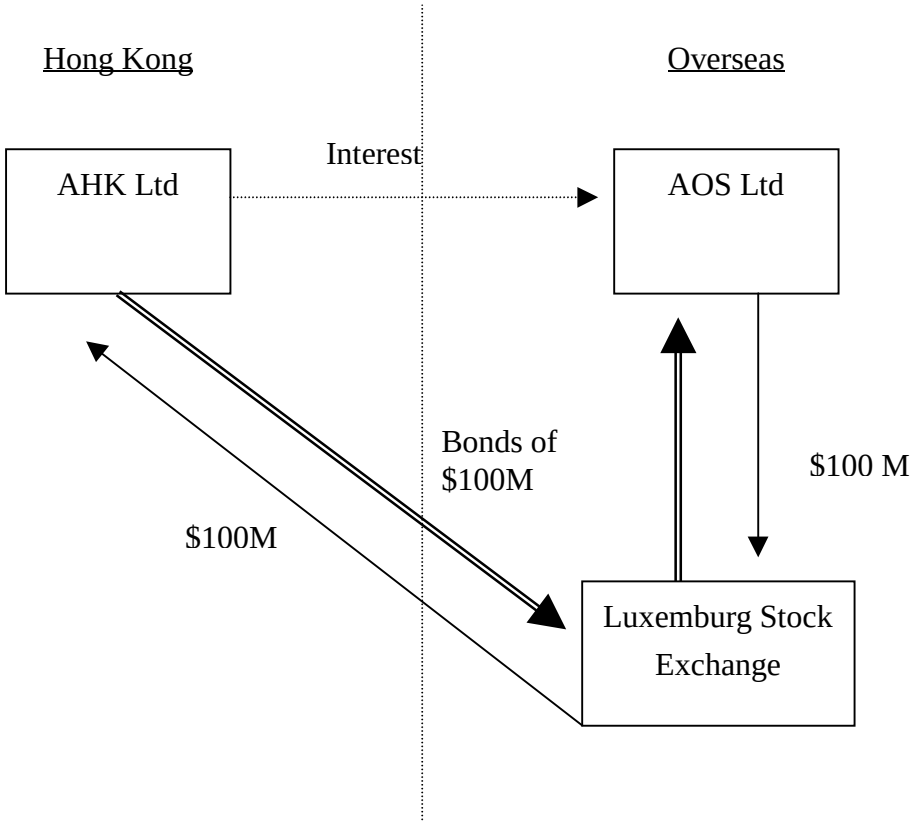
Examples for interest deduction on debenture issues

Example 1 – Debentures Substantially Subscribed Internally

1. AHK Ltd, a company carrying on business in Hong Kong, acquires an income-producing asset for $100m. The funds for the acquisition come from a debenture issue, which is listed in the stock exchange of Luxembourg.

2. AOS Ltd, an overseas subsidiary of AHK Ltd, has surplus funds of $100m.

3. AOS Ltd acquires all the debentures issued by AHK Ltd.



Taxation consequences under existing law

(a) The interest paid by AHK Ltd to the holder of the debentures, its associate AOS Ltd qualifies for tax deduction under section 16(2)(f)(i) as it is paid in respect of debentures listed in a stock exchange recognised by the Commissioner of Inland Revenue for the purpose of that section.

(b) The interest received by AOS Ltd from AHK Ltd is offshore income (derived from Luxembourg) which is not chargeable to tax in Hong Kong.

(c) The group as a whole enjoys a tax benefit from the loan, which is raised internally, due to asymmetry in taxation.

Taxation consequence under the proposed legislation

(a) The interest paid by AHK Ltd on the debentures would be disallowed for tax deduction by the proposed section 16(2C).

(b) The interest received by AOS Ltd from AHK Ltd is offshore income (derived from Luxembourg) which is not chargeable to tax in Hong Kong.

(c) Tax symmetry is restored and the tax benefit to the group is neutralized.

Observation

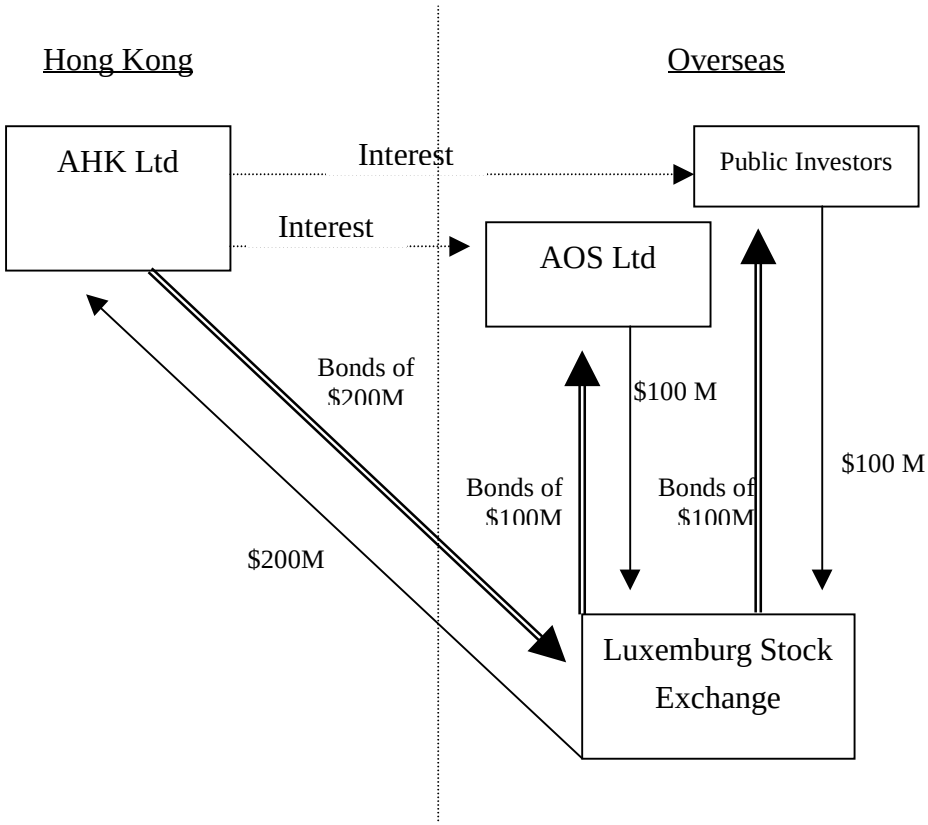
The group as a whole has fund to buy the asset. If AOS Ltd were to lend the funds to AHK Ltd outside Hong Kong by way of a simple loan arrangement, the interest expenses of AHK Ltd would not be deductible because the interest income of AOS Ltd would not be taxable (section 16(2)(c)). However, AHK Ltd can take advantage of issuing debentures to obtain the interest deduction, which would otherwise be not allowable. If evidences are sufficient to show that the fund-raising arrangement was conducted for the sole and dominant purpose of obtaining a tax benefit, the CIR may invoke section 61A to disallow the interest deduction.

Example 2 – Partly Held Internally

1. AHK Ltd, a company carrying on business in Hong Kong, acquires an income-producing asset for $100m. It raises the required funds by issuing debentures of $200m, which are listed in the stock exchange of Luxembourg.

2. AOS Ltd, an overseas subsidiary of AHK Ltd, subscribes $100m of the debentures issued by AHK Ltd.

3. The remaining debentures of value $100m are taken up by public investors.



Taxation consequences under existing law

(a) The interest paid by AHK Ltd in respect of the whole issue, including the portion paid to its associate AOS Ltd in respect of the $100m debentures held by the latter, qualifies for tax deduction under section 16(2)(f)(i) as it is paid in respect of debentures listed in a stock exchange recognised by the CIR for the purpose of that section.

(b) The interest received by AOS Ltd from AHK Ltd is offshore income (derived from Luxembourg) which is not chargeable to tax in Hong Kong.

(c) Asymmetry in taxation exists as regards the interest paid to AOS Ltd. The group as a whole enjoys a tax benefit from the internal loan of $100m.

Taxation consequence under the proposed legislation

(a) The portion of interest paid by AHK Ltd on the debentures held by AOS Ltd would be disallowed for tax deduction by the proposed section 16(2C).

(b) The interest received by AOS Ltd from AHK Ltd is offshore income (derived from Luxembourg) which is not chargeable to tax in Hong Kong.

(c) Tax symmetry is restored. As far as the interest payment on the internal loan is concerned, the group is in a tax neutral position.

Observation

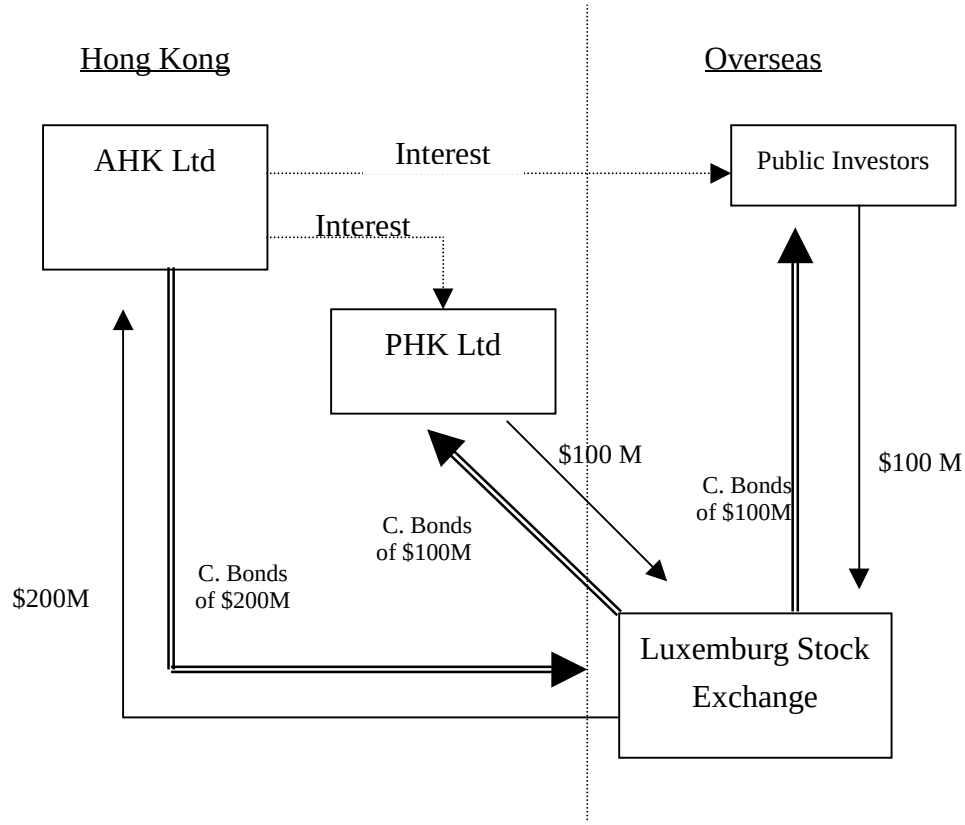
The group as a whole needs only $100m to buy the asset. The debentures are excessively issued with a view to taking advantage of the tax benefit of the existing provisions of section 16(2)(f) which does not explicitly disallow interest on internal loans. The CIR may face difficulties in invoking the general anti-avoidance provision of section 61A, as the taxpayer may claim that the arrangement is not made for the sole or dominant purpose of obtaining tax benefits. Indeed the taxpayers will try to cover their tax avoidance objective with genuine commercial activities, which may increase the difficulties for CIR to counteract it with section 61A.

Example 3 – Internal Holding of Convertible Bonds

1. AHK Ltd, a company carrying on business in Hong Kong, acquires an income-producing asset for $100m. It raises the required funds by issuing convertible bonds of $200m, which are listed in the stock exchange of Luxembourg.

2. PHK Ltd, Hong Kong based parent company of AHK Ltd, subscribes $100m of the convertible bonds issued by AHK Ltd to avoid potential dilution of its shareholding in AHK Ltd.

3. The remaining bonds of value $100m are taken up by public investors.



Taxation consequences under existing law

(a) The interest paid by AHK Ltd in respect of the whole issue, including the portion paid to its parent company PHK Ltd in respect of the $100m convertible bonds held by the latter, qualifies for tax deduction under section 16(2)(f)(i) as it is paid in respect of debentures listed in a stock exchange recognised by the CIR for the purpose of that section.

(b) The interest received by PHK Ltd from AHK Ltd is offshore income (as the loan

is drawn in Luxembourg) which is not chargeable to tax in Hong Kong.

(c) Asymmetry in taxation exists as regards the interest paid to PHK Ltd. The group as a whole enjoys a tax benefit from the internal loan of $100m.

Taxation consequence under the proposed legislation

(a) The portion of interest paid by AHK Ltd on the convertible bonds held by PHK Ltd would be disallowed for tax deduction by the proposed section 16(2C).

(b) The interest received by PHK Ltd from AHK Ltd is offshore income (derived from Luxembourg) which is not chargeable to tax in Hong Kong.

(c) As far as the interest payment on the internal loan is concerned, tax symmetry is restored and the group is in a tax neutral position.

Observation

The group as a whole needs only $100m to buy the asset. The convertible bonds issued are in excess of the money needed. The issuer may claim that there is a genuine need to do so as the parent company has to hold a portion of the convertible bonds to avoid the possible dilution of its controlling shareholding in AHK Ltd. They may deny that the arrangement is conducted with a view to taking the tax benefit of the existing provisions of section 16(2)(f).

The CIR may face difficulties in invoking the general anti-avoidance provision of section 61A, as the taxpayer may claim that the arrangement is not made for the sole or dominant purpose of obtaining tax benefits. The tax effect of this example resembles very much the case in Example 2. This indicates that it would often be difficult to identify the genuine commercial purpose of a transaction, particularly when it is intermingled with tax avoidance motives. If “commercial motive” were to be taken as an excuse for the proposed section 16(2C) not to apply, the position would become uncertain and the possibility of the provision being abused would increase.

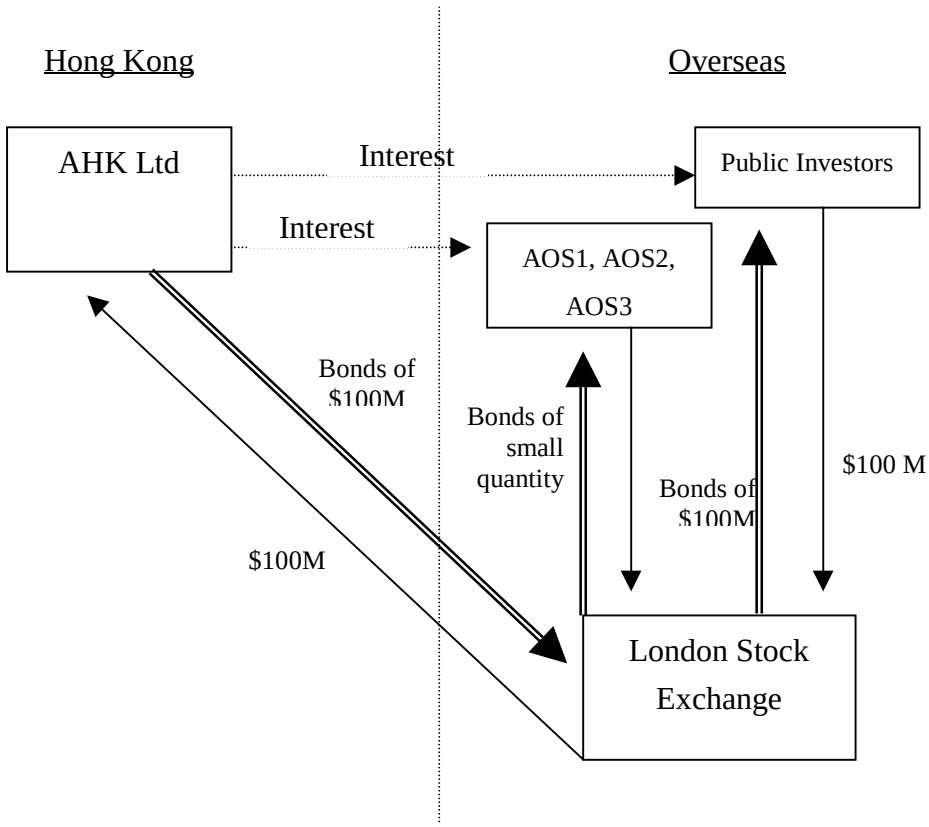
Having regard to the background of introducing section 16(2) in the 1984 exercise, we believe that disallowing deduction of interest payments to connected parties of the issuer in the absence of tax symmetry was the intended policy which is a crucial measure to protect revenue. As the mechanism for apportionment of interest is now available in the proposed provision, there is no reason why this policy should not be pursued.

Example 4 – Registered Securities Dealing Market Maker

1. AHK Ltd is a company in an international financial services and investment group carrying on business in Hong Kong. It acquires an income-producing asset for $100m. It raises the required funds by issuing bonds of $100m, which are listed in the London Stock Exchange.

2. AOS1, AOS2, AOS3… are overseas associate companies of AHK Ltd and are registered securities dealers and market makers in the London Stock Exchange and other stock exchanges over the world. AOS1 underwrites the issue of bonds by AHK Ltd. Thereafter the AOS's act as market makers for the bonds, among other securities they trade.

3. The bonds issued are substantially subscribed by public investors, though from time to time the AOS's will buy, sell and hold a small quantity of the bonds for market making purposes.



Taxation consequences under existing law

(a) The interest paid by AHK Ltd in respect of the whole issue, including the portion paid to the AOS's in respect of their holdings for market making purposes, qualifies for tax deduction under section 16(2)(f)(i) as it is paid in respect of

debentures listed in a stock exchange recognised by the CIR for the purpose of that section.

(b) The interest received by the AOS's from AHK Ltd is offshore income (as the loan is drawn offshore) which are not chargeable to tax in Hong Kong.

(c) Asymmetry in taxation exists as regards the interests paid to the AOS's. The group as a whole enjoys a tax benefit as far as the interest paid to the AOS's is concerned, though the amount is small.

Taxation consequence under the proposed legislation

(a) The portion of interest paid by AHK Ltd on the debentures held by the AOS's would be disallowed for tax deduction by the proposed section 16(2C) as it is interest payable to connected person and is not chargeable to tax. However, exemption from application of this section is available under section 16(2G) if the interest payable to the AOS's arises from their holding of the debentures in the ordinary course of their market making business.

(b) The interest received by the AOS's from AHK Ltd is offshore income (derived from London) which is not chargeable to tax in Hong Kong.

Observation

Submissions of deputations in the securities dealing industry claim that the operation of the proposed section 16(2C) may cause difficulties in practice for multinational giant securities-dealing and investment groups to keep track of their dealings in securities issued by members of their group. The issuer, therefore, face a compliance problem when they are required to complete the annual tax returns.

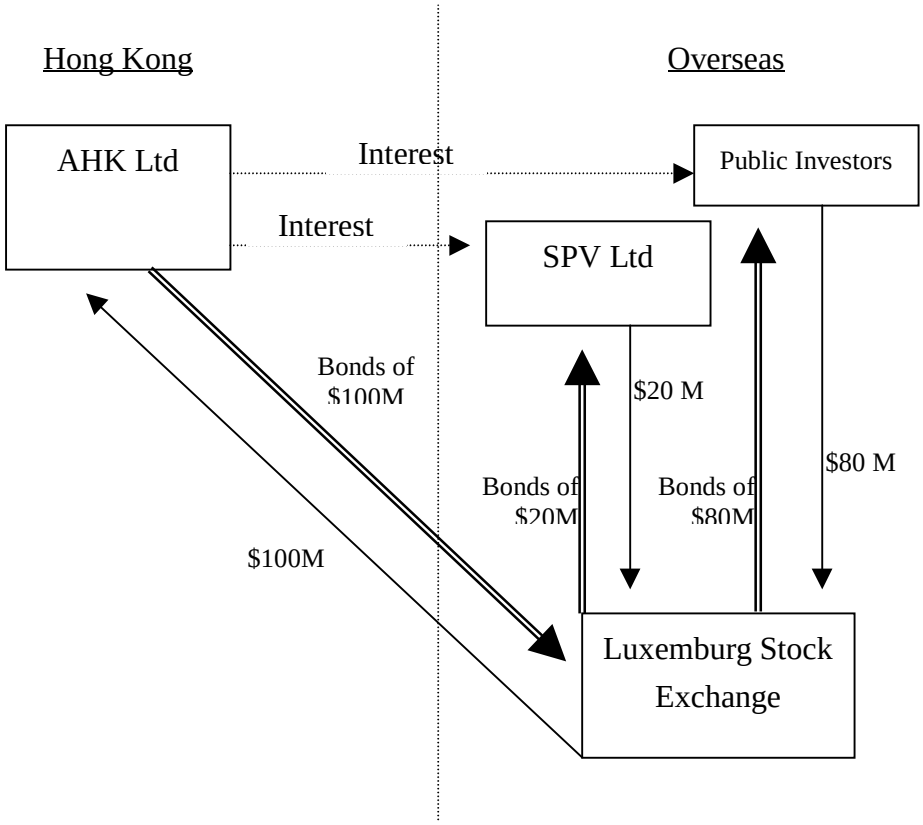
The Administration recognizes that requiring securities dealing market makers to keep track of their transactions on securities issued by their fellow group companies would be extremely laborious and costly. In view of the practical difficulties faced and that the interest payable within the group arising from the market making activities of the market makers would generally be small, the Administration agreed to exempt the interest arising from the market making activities of the market makers from the restriction of section 16(2C), despite that tax deduction of interest payable to a connected party when tax symmetry is not in place should not be allowed as a matter of principle.

Example 5 – SPV Market Maker

1. AHK Ltd is a company carrying on business in Hong Kong. It acquires an income-producing asset for $100m. It raises the required funds by issuing bonds of $100m, which are listed in Luxemburg.

2. SPV Ltd is an overseas associate company of AHK Ltd formed for the purposes arranging the issue of bonds. It underwrites the issue of bonds by AHK Ltd. Thereafter it buys and sells the bonds to enhance the attractiveness of the bond issue.

3. The bonds issued are substantially subscribed by public investors. SPV Ltd, however, from time to time keeps a stock of some 20% of the issue.



Taxation consequences under existing law

(a) The interest paid by AHK Ltd in respect of the whole issue, including the portion paid to the SPV Ltd in respect of it holdings, qualifies for tax deduction under section 16(2)(f)(i) as it is paid in respect of debentures listed in a stock exchange

recognised by the CIR for the purpose of that section.

(b) The interest received by SPV Ltd from AHK Ltd is offshore income (as the loan is drawn offshore) which is not chargeable to tax in Hong Kong.

(c) Asymmetry in taxation exists as regard the interests paid to SPV Ltd. The group as a whole enjoys a tax benefit as far as the interest paid to SPV Ltd is concerned.

Taxation consequence under the proposed legislation

(a) The portion of interest paid by AHK Ltd on the debentures held by SPV Ltd would be disallowed for tax deduction by the proposed section 16(2C) as it is interest payable to connected person and is not chargeable to tax.

(b) The exemption for market makers does not apply to the holdings of the SPV Ltd, which is not a registered securities dealer who is regularly engaged in the securities dealing business involving a wide range of securities.

(c) The interest received by SPA Ltd from AHK Ltd is offshore income (the bonds are issued overseas) which is not chargeable to tax in Hong Kong.

Observation

Some deputations submitted that there might be justification to apply the relaxation to genuine market making activities undertaken by corporate groups used to enhance attractiveness of a bond issue. Others contended that the operation of section 16(2C) has the effect of discriminating against the controlling shareholder of a Hong Kong company, who would be discouraged from reinvesting its/his overseas funds into Hong Kong.

The Administration does not support extending the market maker exemption to the non-securities dealers on the following reasons –

a. Disallowing deduction of interest payable to connected persons is a crucial measure to protect revenue.

b. This can rectify the fault of the existing section 16(2)(f) that allows deduction of debenture interests paid to connected persons, which is inequitable vis-à-vis discriminatory to small and medium sized companies who cannot afford to raise

fund by issuing debentures.

c. The justification for an exemption of the market making activities – the compliance difficulties - does not exist.

d. The SPV is not a market maker as commonly understood. It is questionable that its buying and selling of its associate's bonds are genuine "market making activities". There is indeed no objective way (unlike the normal business of a regulated market maker) of distinguishing the "market making" activities of the SPV from transactions for other purposes.

e. The extension of scope of the exemption will make the provisions vulnerable to abuses and undermine the intended effect of the whole legislative exercise.

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