Bills Committee on Inland Revenue (Amendment) Bill 2000

Summary of views and the Administration's response on the impacts of proposed section 16(2C) and the proposed exemption of "market-makers" under proposed sections 16(2G) and 16(2H)

(as at 26 April 2004)

Name of organization	Major views on the Bill and Committee Stage amendments (CSAs)	Administration's response
Hong Kong General Chamber of Commerce The Real Estate Developers Association of Hong Kong (REDA)	<u>Anti-avoidance - situation under current regime</u> Based on public statistics, the amount of bond issues by Hong Kong based groups (including issues made by their foreign affiliates and guaranteed by the Hong Kong parents) during the years 1997 to 2003 amounted to no less than $553.4 billion. On the other hand, the Administration has indicated that the tax revenue collected by the Inland Revenue Department (IRD) on related abuse and avoidance cases exceeds $1 billion. Against the size of the total bond issues, REDA questions whether the level of bond related tax abuse is as severe as the Administration might suspect. Isolated abuse cases should be adequately covered by existing anti-avoidance provisions. Indeed, the Inland Revenue Department has been applying **section 61A** of the Inland Revenue Ordinance (IRO) to counteract isolated tax avoidance cases with notable success.	IRD has been relying on the general anti-avoidance provision under section 61A to counteract schemes that abuse the interest deduction rules under the existing law. Since IRD started vigorous investigation in 1997 on the tax avoidance plans that exploit the interest deduction scheme, tax of over **$6 billion** (representing the disallowing of interest of $37.5 billion) has been assessed through disallowing interest deduction claims (though a major part of the tax assessed are still under objection or appeal), of which **over $1 billion** (representing disallowing interest of $6.25 billion) is attributable to schemes on debenture interest in 7 cases. These cases all involved interest deduction claims made by group companies where there were in fact no external financing. Some more cases are still under investigation. The existing anti-avoidance provisions are far from effective in tackling section 16(2) cases because of the highly restricted scope of application. In particular, the provisions only apply where the transaction or arrangement in question is carried out with the sole or dominant purpose of obtaining

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		a tax benefit. **Anti-avoidance cases in relation to section 16(2) are far from isolated. The situation is worrying.** If the loophole is not plugged, much revenue will be at stake. And there may be avoidance plans that are more sophisticated, such as the partially commercial cases, against which IRD is not adequately empowered to tackle. Very often offshore set-ups are involved making it even more difficult, or impossible to trace and investigate. The detection of tax avoidance schemes and collection of evidences to tackle them by general anti-avoidance provisions are often very difficult and resources consuming. It is <u>not</u> appropriate to compare the revenue loss to the total value of bond issues during the period from 1997 to 2003. This is because it is the tax revenue, not the principal of the bonds, that is at risk. It should also be noted that some of the issues might be revolving during the period and that some of the bonds were issued by government authorities (such as the Exchange Fund), by government-owned corporations (such as the MTRC) which are not the targets of our amendment exercise. According to information provided by HKMA, bonds issued in Hong Kong by corporations other than financial institutions and government owned corporations which were outstanding as at end 2003 had a value of US$4.3 billion (equ. HK$33.5 billion), and bonds issued offshore by Hong Kong companies (other than government owned companies and financial institutions) amounted to US$25 billion (equ. HK$195 billion). As explained above, **over $1 billion** has been assessed through disallowing interest deduction claims attributable to debenture schemes. This represents interest of $6.25 billion, which is significant when compared with the value of bonds

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		issued by corporations other than financial institutions and government owned corporations (i.e. $228.5 billion),. The revenue loss is also considerable in terms of the annual corporation profits tax collection of Hong Kong, which was HK$33.7 billion in the year 2002/03.
Hong Kong General Chamber of Commerce The Real Estate Developers Association of Hong Kong (REDA) *(Cont'd)*	<u>Effect of **proposed section 16(2C)** on legitimate business practices</u> **Proposed section 16(2C)** would disallow a deduction for interest incurred on debentures issued by a Hong Kong taxpayer to the extent to which the debentures are held by a connected person not subject to Hong Kong profits tax on the interest received. There are commercial reasons why shareholders should be able to participate in local debt issues without being penalized by the tax regime. For example- (a) controlling shareholders may be required to underwrite the issue; (b) show confidence to the market to have shareholders participate and increases chance of a successful launch; and (c) convertible bond acquisitions in order to avoid dilution of their percentage shareholding. According to survey conducted by REDA, 70% of the respondents envisage commercial circumstances in which corporate groups wish their controlling shareholders to acquire their own debentures. 80% envisage commercial circumstances in which controlling shareholders would want to acquire debts issued by groups they control.	The Administration’s view is that 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. It was also the intended policy at the time when the conditions under section 16(2) were introduced in 1984. Section 16(2)(f) was introduced in 1986 with a view to allow deduction of interest on debentures issued bona fide to the public. It should not be taken as a means for the debenture-issuing company to take advantage of deduction of interest on loans advanced by its controlling shareholders or associated companies, so as to bypass the symmetry requirements of section 16(2)(c). The fact that there may be commercial reasons for shareholders to participate in debt issue activities of companies they have control over should therefore be irrelevant. The proposed section 16(2C) is not meant to penalise any arms-length debt raisings, but to clarify and uphold the policy intention of the existing section 16(2)(f). It is also the only and the most effective way to stop abuses in this area. Other tax

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		jurisdictions' requirements are all stricter than Hong Kong's in this respect with most demanding 'tax symmetry' in full scale. For instance, in Australia, on top of the withholding tax requirement, specific provisions were introduced in 2001 to treat convertible bonds as "equity interest" such that interests payable on convertible bonds are treated the same way as dividends (which are not deductible for tax purposes). The shareholders' aim of preventing dilution of their equity interest by holding sufficient convertible bonds is clearly an objective of maintaining their equity interest. A more equitable treatment therefore is to disallow deduction of such interest expense, as in the case for small and medium sized companies in Hong Kong's context. If deduction is allowed, the major shareholder will be allowed to seek protection of his interest as a shareholder on one hand and on the other allowed to take advantage of the tax benefits, which are otherwise not available to shareholders. At a meeting with the Administration on 20 April 2004, REDA indicated 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 has not been received as at Monday, 26 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,

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		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.
Hong Kong General Chamber of Commerce The Real Estate Developers Association of Hong Kong (REDA) *(Cont'd)*	<u>Tax symmetry - current Hong Kong law</u> The proposed amendments are intended to bring tax symmetry to the treatment of interest income and payments on debentures and marketable instruments. IRO currently has many instances where tax symmetry is not maintained, such as deductible service fees paid to offshore entities which are not subject to tax in Hong Kong. In respect of interest income and expenses, the Hong Kong regime has effectively been non symmetrical since the abolition of interest tax in 1989. Foreign corporations that do not carry on business in Hong Kong are not normally taxed on interest from Hong Kong debentures, while the Hong Kong issuer can still deduct the interest expense. This differential (17.5%) will continue to apply to debt issues under **proposed section 16(2C)** provided payments are not made to connected persons.	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 and the issues are bona fide and in the course of carrying on business. For (i) and (ii), although strict or pure 'tax symmetry' is not insisted upon, precautionary measures have been added in order to ensure that the source of funding does not come from internal avenues Conditions were also added in case (i) to mitigate the possibility for the business proprietors, who have surplus funds, to take advantage of the interest deduction scheme by raising loan to claim interest deduction on the one hand and to make deposit to gain tax-free interest on the other. Borrowings from connected parties are disallowed from claiming interest expense deduction in the case of a section 16(2)(e) loan (case (ii)) which is borrowed for a specified business purpose. These are important for preventing abuse of the interest expense deduction in the absence of strict 'tax symmetry'.

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		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) (case (iii)). 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 equitable: deduction in respect of interest on a loan advanced to a business concern by a controlling shareholder of a small and medium size corporation is not allowed, unless the symmetry condition is complied with (section 16(2)(c) refers); dividend payments to shareholders which are the paid offs for equity injection are not deducted from Profits Tax liability. As explained above, it might not be appropriate to apply strict or pure ‘tax symmetry’ in certain situations. The cases quoted by HKGCC and REDA, which relate to Hong Kong’s territorial-sourced taxation principle, are such situations. However, these cases do not involve borrowings between connected parties, which are vulnerable to abuse and are the subject of the amendment exercise.
Hong Kong General Chamber of Commerce The Real Estate Developers Association of Hong Kong (REDA) *(Cont'd)*	<u>Tax symmetry - overseas jurisdictions</u> Full tax symmetry in relation to interest is not prevalent in most overseas tax regimes, including the United Kingdom (UK), Australia, Singapore and Japan. In these four jurisdictions, the interest withholding tax rate is significantly lower than the domestic income tax rate. The rate differentials range from 5% (in Singapore) to 22.5% (in Japan), and they are all in the taxpayers favour. In Singapore, withholding tax is waived in respect of interest	**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

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	payments on debt issues that satisfy the requirements under the "Qualifying Debt Securities" (QDS) scheme. In UK, specific provisions have been introduced to waive the withholding tax requirements for all instruments that qualify as "quoted Eurobonds". None of the jurisdictions has sought to disallow an interest deduction simply on the basis that the recipient is a foreign affiliate. To forestall the potential abuses of the tax asymmetry, UK, Japan and Australia have adopted the "thin capitalization rules". In general terms, so long as domestic corporations observe the prescribed debt-to-equity ratios, they will not be disallowed deduction for interest payments merely because the payments are made to foreign affiliates.	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**. In all four tax jurisdictions (UK, Australia, Japan and Singapore) examined, 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. 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 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

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		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. 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 non-resident is deductible only if the interest is charged at commercial rate. REDA has misinterpreted the relationship between 'thin capitalization rules' and 'tax symmetry'. 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 the 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 is 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. They are <u>not</u>

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		criteria to award tax deductibility but to limit tax deduction, when ‘tax symmetry’ has already been achieved through withholding tax, to only genuine internal borrowings rather than capital injection. In Singapore, only Singapore Government securities and bonds etc. issued in Singapore and arranged by financial institutions, approved bond intermediaries and financial sector incentive (bond market) companies qualify for the exemption of withholding tax on interest paid to foreigners. In addition, the scheme excludes debt securities that are substantially held (over 50% of the issue) by related parties of the issuer. The exemption to withholding tax only applies to interests paid to foreigners, which are normally subject to tax in the home country of the recipient. In the case of interest payable to local resident or businesses, tax symmetry is in place. In Hong Kong’s case, interest expenses incurred from borrowings from public issues of debt securities may be deducted even when there is no ‘tax symmetry’. Our arrangements in this respect is no less favourable than Singapore’s. In the UK, the requirement to deduct tax at source in respect of payments of interest on Eurobond has been waived completely from 1 April 2001 onwards. It should be noted that the waiving of the withholding tax in the UK does not necessary mean full exemption of tax chargeable on the interest payment on Eurobonds by a UK company. If the recipient is a UK resident or a company carrying on business in the UK, his interest income is still chargeable to income tax (under Schedule D case I or III). Thus in the majority of cases, tax symmetry is maintained as regards the payments of Eurobonds interest by UK companies. In addition, the Controlled Foreign Company

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		(CFC) legislation in the UK taxation regime has provided safeguards for the UK authorities to counteract the possible abusive arrangements of using foreign associates to hold the Eurobonds issued by a UK company with a view to taking advantage of the exemption. Under this legislation, the UK tax authorities can make a charge on the UK resident shareholders of the CFC resident in a low-tax jurisdiction (or a tax haven) on their proportionate interest in the CFC's profits. The CFC legislation applies if the UK shareholder has an interest of at least 25% in the foreign company. In Hong Kong, we allow deduction of interest on debentures held by unrelated parties, despite that 'tax symmetry' does not exist. Hong Kong's treatment is no less favourable than the UK's in this respect. On the point about different tax rates, the withholding rates in the four places are 20% in the UK (vis-à-vis corporation tax rates of 10-30%), 20% in Japan (vis-à-vis corporation tax rates of 22% – 37.5%), 15% in Singapore (vis-à-vis corporation tax rate of 22%), and 10% in Australia (vis-à-vis income tax rate of 30%). While the rates under the withholding system may be lower than the income tax rates in these jurisdictions (probably because interest is treated as a form of investment, hence attracting different tax rate from other income), **there is no doubt that an important purpose of it is to maintain symmetry in derivation of tax benefits and payment of tax in order to prevent abuse.**
Hong Kong General Chamber of Commerce (HKGCC) The Real Estate	<u>Impact on debt market development</u> **Proposed section 16(2C)** has the effect of discriminating against the controlling shareholder of a Hong Kong company, who would be discouraged from reinvesting its	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

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Developers Association of Hong Kong (REDA) *(Cont'd)*	overseas funds into Hong Kong. If the section is put through, the after-tax cost for raising capital in Hong Kong by way of debenture issues would increase. Hong Kong corporation groups may be discouraged from issuing debentures. The situation is likely to become more acute when compared to the environment in Singapore. Since 1998/99, the government of Singapore has introduced a package of tax incentives to encourage the growth of its local debt market, including the QDS scheme.	arrangement will continue under the Administration's proposals, which should have a neutral impact on our public debt market. 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. 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 Units, they would not have any positive impact on our infrastructure development. These products are not particularly 'innovative' either. The proposed provision only disallows interest on debentures

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		issued to connected persons, but has no impact on debentures issued bona fide to the public. This provision will apply equally to debentures issued in Hong Kong and overseas, and is thus will not discriminate corporate groups to raise funds in Hong Kong by way of debt issue. In Hong Kong, interests on debentures issued to the public (not held by associates) are allowable for deduction irrespective of the fact that such interest is not taxable in the hands of the recipient. As far as genuine public issue of debentures is concerned, the interest deduction policy of Hong Kong is absolutely attractive. Thus the QDS scheme of Singapore should have little threat to our debt market. **Hong Kong's tax treatments concerning loan interest income and expense are more favourable than all the jurisdictions examined.** Coupled with our other low-tax characteristics, such as low Profits Tax rate, no tax on dividends, no tax on capital etc., **it is widely acknowledged by the financial sector that Hong Kong compares more favourably than other major financial centres in the world in terms of tax burden.** There is no sound basis for REDA's argument. **The Administration's assessment is that the development of the local bond market will not be adversely affected by the current Bill.**
The Real Estate Developers Association of Hong Kong	<u>Survey results of REDA</u> According to REDA's survey among its key members - • 90% of respondents "strongly agree" that the enactment	Section 16(2C) only disallows deduction of interest paid to persons connected with the issuer who are its associated companies and the person who is controlled by or has control over the issuer or who is controlled by the same person as the

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	of **proposed section 16(2C)** may impose an undue administration burden on corporate groups to ascertain whether any connected persons may have acquired their debentures, and will increase the cost of debt issue; and • 70% of respondents "strongly agree" that the section may discourage corporate groups to raise funds in Hong Kong by way of debt issues, and would inhibit the development of the debt market in Hong Kong. Overall, the survey shows that companies have genuine concerns that the introduction of **proposed section 16(2C)** will adversely impact on their business.	issuer. In view of the close relationship between the issuer and the ‘connected person’, there should not be difficulty for the issuer to ascertain the portion of the debentures acquired by the connected persons. The Administration only envisages that difficulties may exist where the connected persons are securities dealers who are heavily involved in dealings in a wide range of securities. An exemption has been provided insofar as the transactions are within the normal course of business of the securities-dealing market makers. The Administration does not agree that the proposed section 16(2C) will have significant adverse impact on the development of a debt market in Hong Kong on the reason discussed above. The Administration recognizes that some businesses have taken advantage of the existing provision of section 16(2)(f) to claim deduction of interest payable to their associated companies or controlling shareholders. The introduction of the new provision may restrict their interest claims in future. It should however be noted that the new provision is crucial to the protection of revenue against abuses to the existing legislation and to the reinforcement of the policy intent of the regime for interest deduction. As small and medium sized companies are unlikely to be in the position to issue public bonds (and thus cannot take the benefit currently enjoyed by big companies), the new provision has the effect of enhancing fairness and the integrity of our taxation system, and is therefore in the interest of the general taxpaying public.
Capital Markets Tax Committee of Asia	<u>Exemption of "market-makers" from the operation of</u>	The Administration welcomes the views of the Capital

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(Hong Kong Chapter)	**<u>proposed section 16(2C)</u>** Market making activities are typically carried out by dealers or brokers. It is extremely unlikely that other persons such as controlling shareholders or directors of a company would engage in market making. A market maker would at all normal times hold himself out as willing to buy or sell on a continuous basis the securities for which they act as a market maker. Otherwise, it would defeat the purpose of providing liquidity in the securities. This must be distinguished from purchases or sales of securities by any persons for various commercial reasons at only selective items. The scope of the exemption for market making activities as it currently stands in the draft CSAs is sufficient to cover genuine market making activities and would also address IRD's concern of the risk of an abuse.	Market Tax Committee in this regard.
The Taxation Institute of Hong Kong (TIHK)	<u>Exemption of "market-makers" from the operation of</u> **<u>proposed section 16(2C)</u>** From a technical perspective, TIHK believes that the **proposed section 16(2H)** is clear and unequivocal to allow interest deductions on bonds and debentures held by "market makers". On some Bills Committee members' concern that the proposal only seeks to exempt "market makers" rather than "market making activities", TIHK does not see any reason why the exemption could not be extended to genuine "market making activities" provided that the term "market making activities" is clearly defined in IRO, for example, by means of percentage threshold and the length of holding etc.	The Administration does not support extending the market maker exemption to the non-securities dealers on the following reasons – a. This can rectify the fault of the existing section 16(2)(f) that allows deduction of debenture interests paid to connected persons, an amendment which is consistent with other similar tax treatment in the IRO, and hence more equitable. b. Disallowing deduction of interest payable to connected persons is a crucial measure to protect revenue.

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	Such an extension, together with the initiatives of issuing government bonds, would enhance Hong Kong's position as an international debt/bond centre.	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.
Joint Liaison Committee on Taxation (JLCT)	Exemption of "market-makers" from the operation of **proposed section 16(2C)** JLCT supports the proposed exemption of "market-makers" from the operation of **proposed section 16(2C)** but cautions 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. However, JLCT points out that two of its constituent members do not necessarily agree with this conclusion.	The Administration agrees to the caution of the JLCT that extending the scope of the exemption will open the avenue to tax avoidance, and will thus undermine the anti-avoidance effect of the proposed amendments, in addition to the point about the Administration's proposed amendments are consistent with other taxation rules and hence more equitable.
The Taxation Institute of Hong Kong (TIHK)	Departmental Interpretation & Practice Note on exemption of "market-markers" It will be more appropriate for the percentage threshold and the length of holding (if these were the main criteria in determining market making activities) to be set out unequivocally in IRO and not just in IRD's practice notes.	Deputations from the market, such as the CMTC, do not consider it practicable to specify a threshold percentage and the length of holding in the legislation. There may be cases where the thresholds may be exceeded, particularly at the earlier stage of an issue where the take up rate of the debentures is slow. Specifying the thresholds in a practice

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		notes as a refutable presumption can provide flexibility to the genuine cases.
Joint Liaison Committee on Taxation (JLCT)	<u>Departmental Interpretation & Practice Note on exemption of "market-markers"</u> JLCT welcomes IRD to specifically state the percentage threshold (not more than 5%) and the length of holding (not more than 3 months) in its practice notes. Where these conditions are breached, IRD would require a reasonable explanation. As it is quite possible that a market-maker would hold more than 5% of the amount of issue pending initial distribution to the market, JLCT considers that IRD should specify in the practice notes that this is a type of situation where there is likely to be a reasonable explanation in order to avoid disputes in the future. JLCT points out that there would be no obligation on the part of an issuer of debentures and notes to disclose to IRD whether these thresholds have been exceeded, as it is not possible to impose a disclosure requirement in a practice note of IRD	The IRD shall specify in the practice notes the common situations where a departure from the thresholds would be acceptable. While agreeing that there would be no strict obligation on the part of an issuer of debentures and notes to disclose to the IRD whenever the thresholds have been exceeded, the assessor has the authority to require the issuer to provide such information under section 51(4) of the Inland Revenue Ordinance, as it may affect the liability of the issuer who claims a deduction on the debenture interest. Thus it would be a good practice for the issuer to disclose such information in the tax return.

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Joint Liaison Committee on Taxation (JLCT)	<u>Definition of "market-makers" in **proposed section 16(2H)**</u> JLCT strongly urges that the words in **proposed section 16(2H)(iv)** "for the purposes of providing liquidity in respect of such debentures or instruments" be deleted, as this will impose an excessive and unnecessary threshold for the concession to apply. 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.	The definition on "market-makers" was drawn up with reference to CMTC's proposal and overseas practices. The Administration has major reservations about deleting the criteria specified in section 16(2H)(iv) in defining a market maker. Providing market liquidity or making a market of the securities concerned is a major objective of a market maker in respect of securities. This subsection only reflects this major function of the market maker. Without this criteria, a securities dealer who satisfies the other three criteria of the definition, i.e. he is registered dealer; he holds himself out as market maker; and provides market making function for a wide range of securities, may hold the debentures issued by its associate companies for long-term investment or for tax-benefit purposes. In such case, the IRD may not be able to turn down his claim for the market maker exemption.

Council Business Division 1
<u>Legislative Council Secretariat</u>
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