1 December 2003

Mrs. Anita Sit
Clerk to Bills Committee on Inland Revenue (Amendment) Bill 2000
Legislative Council Secretariat
3/F, Citibank Tower
3 Garden Road
Central
Hong Kong

Dear Mrs. Sit

Inland Revenue (Amendment) Bill 2000

We thank you for your letter of 14 November and as requested would like to offer our views on the Bill and the proposed Committee Stage Amendments (CSAs) as follows. We wish to start with two fundamental principles, as we trust they will help to put our comments on the specific provisions in context.

1. Importance of a simple tax system to Hong Kong

   The Administration admits in its response to deputations' comments that the proposed amendments are lengthy but claims that anti-avoidance provisions are unavoidable. On the contrary, we consider that the lengthy proposed provisions are unnecessary and the existing Section 61A of the Inland Revenue Ordinance is already an effective tool in handling tax avoidance cases. The proposed provisions would only damage the simplicity of Hong Kong's existing tax system.

   Our current tax system has been functioning well on collection of tax and more importantly, it has been very successful in attracting foreign investors due to its simplicity and low tax rate. It will be far too costly for Hong Kong to collect some more taxes at the expense of damaging one of its most competitive factors: a simple tax system. Given the complexity of the provisions in the Bill, we wish to point out to the Bills Committee that there is a very genuine risk of the Bill discouraging investment activities in Hong Kong.

2. Importance of financial support from controlling shareholders and directors

   Financial support from shareholders and directors may be crucial in some cases for companies to survive, particularly during a period like the Asian Financial Crisis. Such support would most likely take the form of controlling shareholders and/or

directors underwriting and/or subscribing for shares or debt securities of these companies. If a group of companies successfully obtains an agreement from its overseas controlling shareholders to provide financial support at an attractive interest rate, the cost effectiveness of such arrangement, which is unlikely to be achieved with unrelated parties especially in the case of financial crisis, may be completely destroyed by the Bill which disallows interest deduction to the group for tax purpose. We would like to highlight that there are a number of provisions in the listing rules of the Stock Exchange which encourage such support by controlling shareholders and/or directors. For example, Rule 14.24 (8) gives special treatment to transactions between a connected person and the company, the main purpose of which is the granting of financial assistance by the connected person to the company.

The Bill will discourage such financial support by effectively imposing a heavier tax burden on the borrower. It should be noted that financial support from controlling shareholders and/or directors is a genuine commercial transaction and there is no reason for the borrower to be penalized simply because it chooses to borrow from a connected person. The Bill will only inhibit such commercial transactions which are considered to be highly desirable from a wider economic perspective.

Regarding the specific provisions in the Bill, we have the following comments:

1. The proposed amendments to Section 16(2) are very complicated and difficult to understand. We believe the existing general anti-avoidance provision, Section 61A of the Inland Revenue Ordinance, is an effective tool and a better approach to handle tax avoidance cases because it provides the opportunity of looking into the situation of each particular case to ensure that no genuine commercial transaction is blindly penalized. Introducing so many complications to the interest deduction legislation will only hinder genuine fund-raising activities.

2. Under the proposed Section 16(2C), the disallowable portion of interest expense on debentures is arrived at on time apportionment basis. Since debentures may be acquired ex-interest or cum-interest for a particular interest payment, there may be situations where in the year of acquisition or disposal, certain interest is disallowed in the hands of the taxpayer in accordance with the apportionment formula set out in Section 16(2C) while none of the associated interest is received by the taxpayer or any of its associated companies.

3. Under the proposed Section 16(3A), a corporation shall be regarded as being controlled by a shareholder if the shareholder has the power to secure by means of (a) the holding of shares or the possession of voting power; or (b) any power

conferred by the articles of association or any other document regulating the corporation, the affairs of the corporation are conducted in accordance with his wishes. It is not clear as to what extent this proposed Section is to be applied. Noting that a shareholder holding less than 40% shares in a corporation which has dispersed shares may still be regarded as having control over the corporation under this proposed section, annual confirmations from subsidiaries and even associated companies are required to ensure a corporation is entitled to deduction on interest paid. Eventually, additional administrative burden will be created onto taxpayers.

4. Under the proposed Sections 16(3A) and (3B), controlling shareholders will be regarded as connected person to the company and interest deduction will be disallowed. Such provisions will discourage business from seeking financial support from controlling shareholders.

Finally, we would like to reiterate that Section 61A is very effective in addressing tax avoidance cases. Introducing so many complications to the law regarding interest deductions will only undermine the flexibility of genuine fund-raising activities and the competitiveness of our simple tax system.

Yours sincerely

Louis Loong
Secretary General