Paper for the Bills Committee

Inland Revenue (Amendment) Bill 2000

Results of the Consultations and
Effects of the Proposed Committee Stage Amendments

Purpose

This paper sets out the results of the two extensive and comprehensive rounds of consultation conducted by the Administration in 2001 and 2002 with the industry, professional bodies, the Securities and Futures Commission and the Hong Kong Monetary Authority, as well as the effects of the proposed Committee Stage Amendments (CSAs).

Background

2. The Inland Revenue (Amendment) Bill 2000 was introduced into the LegCo in October 2000. A Bills Committee to examine the Bill was set up thereafter. The professional and business sectors has expressed concerns, in particular on the anti-avoidance provisions relating to the deduction of interest expenses. A summary of concerns addressed to the Bills Committee in 2000 and the Administration's response is at Appendix A.

3. On due deliberation of the concerns and suggestions made by the professional and business sectors in the first round of consultation as well as the advice from the Securities and Futures Commission and the Hong Kong Monetary Authority, the Administration proposed some draft CSAs to the Bill. The preliminary draft of the proposed CSAs is at Appendix B.

4. In 2002, the Inland Revenue Department held a second round of consultation with some major associations of the accounting, banking and the finance industries on the preliminary draft of the proposed CSAs before they were reported back to the Bills Committee.

5. After taking into account the valuable and useful opinions tendered by the parties consulted in the second round of consultation, the Administration has now

finalized the draft CSAs. The results of the second round of consultation and the Administration's response are summarized at Appendix C.

6. The effects of the proposed CSAs are set out in the ensuing paragraphs.

Clause 2(3) of the Bill

7. The CSAs propose to amend the application clause consequent on the passage of time since the Bill was first introduced. The effect of the CSAs is that clauses 9(b), 10, 11(b)(i) and (iii), 12 and 13 of the Bill will take effect from the year of assessment 2004/05, instead of 2001/02 as proposed in the Bill.

Clause 4 of the Bill

8. In response to the views that "members" in sections 12(6)(b)(ii) and (c)(ii) required clarification, the CSAs propose to delete the words "for its members" from both sections 12(6)(b)(ii) and (c)(ii). The effects of the CSAs are as follows :

(a) Fees in respect of an examination set by a trade, professional or business association, and undertaken by any taxpayer (whether he is an existing member of the association or not) to gain or maintain qualifications for use in any employment can be deducted for salaries tax purposes.

(b) Fees in connection with a training or development course provided by a trade, professional or business association, and undertaken by any taxpayer (whether he is an existing member of the association or not) can be deducted for salaries tax purposes.

Clause 6 of the Bill

9. Clause 6 of the Bill proposed to amend the conditions set out in section 16(2) of the Inland Revenue Ordinance for deduction of interest payable by a person upon money borrowed by him for the purpose of producing assessable profits. The amendments sought to combat tax avoidance schemes that cannot be caught by the existing conditions specified in subsections (d), (e) and (f).

10. For condition in subsection (d), the Bill suggested adding a condition (in addition to the condition that the loan is not secured by a deposit the interest arising

from which is tax free) that the person “entitled” to receiving the interest is not the borrower or an associate of the borrower, and fine-tuning the existing condition in this provision to the effect that the loan in question is not secured by a deposit or loan.

11. For condition in subsection (e), the Bill suggested adding two conditions –

(a) the person “entitled” to receiving the interest is not the borrower or an associate of the borrower; and

(b) the loan is not secured by a deposit or loan made with or to any person that generates tax-free interest.

12. For condition in subsection (f), the Bill suggested adding the condition that none of the holders of the debentures or instrument or the persons “entitled” to receiving interest on the debentures or instruments are the borrower or an associate of the borrower.

13. The views received from various parties during the two rounds of consultation are summarized below :

(a) The definition of “an associate of the borrower” has too wide a scope. It covers the relatives, partners, associated companies etc. of the borrower as well as the directors or principal officers of the borrower (if it is a company) and its associated companies. It will be difficult and costly for the borrower to know whether any of his associates is entitled to the loan interest, or any of them is the holder of his debentures.

(b) The meaning of “the person entitled to” the interest is not clear.

(c) There is no provision allowing partial deduction of interest payments. Once the conditions are not complied with, no matter how trivial the failure may be, the whole amount of interest payment will be disallowed for tax deduction.

(d) The interest deduction will be denied if the interest is entitled by an associate of the borrower, even if the associate pays tax on the interest received by him.

(e) Interest deduction will be denied in certain situations which are considered undesirable –

(i) where part of the interest is paid to a retirement fund or a collective investment fund in which the borrower or any of its associates has interest;

(ii) where interest is payable to an associate of the borrower who acts merely as a bare trustee for a trust which is not related to the borrower;

(iii) interest payable on debentures issued by a Government owned corporation will be denied if part of the debentures issued is held by another Government owned corporation.

(f) The amendments may affect the claim for deduction of interest on loans which were drawn before the commencement of the amendments, including those loans that were cleared by an advance ruling issued by the Commissioner of the Inland Revenue.

14. To address the concerns of the industries and the professional bodies and maintain the effectiveness of the Bill as an anti-avoidance legislation, the CSAs propose to strike a balance by modifying the anti-avoidance provisions on deduction of interest on the following principles :

(a) Deduction of interest on loans borrowed from non-financial institutions (subsection (c) loans), borrowed from financial institutions (subsection (d) loans) or borrowed for specified purposes (subsection (e) loans) will all subject to two additional tests –

(i) the loan is not secured by a deposit or loan made by the borrower or an associate of the borrower with or to the lender, a financial institution, an overseas financial institution or an associate of any of these parties, where the interest generated by such deposit or loan is not taxable (the secured-loan test, see Section 16(2A) in the CSAs); and

(ii) there is no arrangement in place such that the interest payment is ultimately paid back to the borrower or to a person connected with

the borrower (the interest flow-back test, see Section 16(2B) in the CSAs).

(b) Deduction of interest on debentures or debt instruments will be subject to the interest flow-back test referred to in paragraph 14(a)(ii) above (see Section 16(2C) in the CSAs).

(c) Partial deduction of interest payment is permissible –

(i) where the loan is partly secured by "tax-free deposits or loans", interest deduction will be apportioned on a reasonable and appropriate basis (see section 16(2A) in the CSAs);

(ii) where part of the interest payment flows back to the borrower or to a connected person, apportionment is allowed by reference to –

(A) the portion of the loan assigned to or sub-participated by the borrower or the connected person that generates the interest flowed back to the borrower or the connected person; and

(B) the length of time in which such arrangement is in place (see Sections 16(2B) and (2C) in the CSAs).

(d) When determining whether interest is flowed back to a person related to the borrower, a more restricted "connected person" test is used in place of the "associate" test as proposed in the Bill (see Sections 16(2B) and (2C) in the CSAs).

(e) "A person connected with the borrower" is defined to mean –

(i) an associated corporation of the borrower; or

(ii) a person who controls the borrower, who is controlled by the borrower or who is under the control of the same person as the borrower (see Sections 16(3A) and (3B) in the CSAs).

(f) Explicit provisions are added to deal with the loan participation cases to clarify the doubt on "person entitling the interest" (see Sections 16(2E)(a) and (2F)(a) in the CSAs).

(g) Provisions are made to address the situations concerning trusts (see Sections 16(2D), (2E)(b) and (2F)(b) in the CSAs).

(h) The interest flow-back test will not apply if the interest is ultimately paid to an excepted person as defined in the proposed Sections 16(2E)(c) and (2F)(c) in the CSAs. Such provisions are meant to account for the situations referred to in paragraph 13(d) and (e) above and to avoid the application of the test in the case where the interest is payable to a financial institution or an overseas financial institution (the operation of which is expected to be monitored by the local or overseas monetary authorities).

(i) A grand-fathering provision is added to exempt from the application of the new law the interest on a loan that is covered by a favourable advance ruling or advance clearance given by the Commissioner of the Inland Revenue before the enactment of the Bill (see Section 16(5A) in the CSAs).

Clause 17(b) of the Bill

15. The CSAs propose to amend clause 17(b) consequent on the passage of time since the Bill was first introduced. The effect of the CSAs is that the proposed section 82B(1A) shall apply to an appeal relating to any assessment issued on or after the enactment of the Bill, instead of on or after 1 April 2001 as proposed in the Bill.

Clause 23 of the Bill

16. The CSAs propose to amend clause 23 consequent on the proposed amendments to clause 6 as set out in paragraph 14 above.

Inland Revenue Department
September 2003

Appendix A

Summary of Concerns Addressed to the Bills Committee in 2000 and the Administration's Response

Ref	References in the Bill and the IRO	Concerns/suggestions	The Administration's position/ Proposed Amendment to the Bill
1.	**Clause 4 of the Bill** **S.12(6) of the IRO** **Self-education expenses (SEE)**	➢ It may be difficult for taxpayers to prove that the qualifications are *"for use in any employment"* when they incur the expenses – "any employment" may be interpreted to mean "the present employment".	● The phrase "any employment", as it appears in the existing legislation, is wide enough to cover future employment. The Inland Revenue Department (the IRD) has been adopting this interpretation. [In IRD's pamphlet on SEE, it is said (under the heading "Meaning of A Prescribed Course of Education") that any employment could be a current employment or a planned new employment.]
1a.		➢ Under the proposed amendment, a "prescribed course of education" includes a training or development course provided by a trade, professional or business association for its "members". The definition of "members" requires clarification – should include student members and non-voting members.	● The same term is used in the current legislation and has not posed any problems so far. ● **Amendment proposed:** The words "for its members" are deleted both from S.12(6)(b)(ii) and S.12(6)(c)(ii) *[see Clause 4 of the draft CSAs at Appendix B]*.
1b.		➢ The fees for revision courses in respect of professional examinations are not taken care of.	● The Administration's view is that such revision courses are courses taken to gain or maintain qualifications and as such the related fees have been taken care of in the Bill.

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1c.		➢ The provisions should be moved to Part IVA as a concessionary deduction.	● When the SEE deduction was announced in the 1996/97 Budget Speech, the Financial Secretary said he shared LegCo members' view that when it came to tax concessions, priority should be given to salaries tax payers. Part IVA provisions apply not only to Salaries Tax cases, but also to those involving Personal Assessment
2a.	**Clause 5 of the Bill** **Proposed S.15(1)(ba) of the IRO** **Royalty Income**	Violates Source Principle ➢ The proposed S.15(1)(ba) deems a person to have Hong Kong taxable profits even though the profits may not have been derived from Hong Kong. It violates the traditional territorial source principle. ➢ The proposal sends a negative signal that the Government is prepared to deviate from the traditional territorial source concept in its tax regime and create uncertainty to business as to possible further deviation. ➢ The place where an intellectual property is used is a matter of fact which cannot be changed just because it has been used for producing profits chargeable to	● S.15 is itself a deeming provision. Various paragraphs of S.15(1), including paragraph (b), deem sums of income sufficiently connected with Hong Kong to be profits arising in or derived from Hong Kong (i.e. having a Hong Kong source) and from a trade carried on in Hong Kong though such sums may not satisfy all the conditions set out in S.14. ● It should also be noted that the *Emerson* case itself was not concerned with the issue of "source" as such but was concerned with the interpretation of the words "for the use of or right to use in Hong Kong" as they appear in S.15(1)(b). ● Where the payer of royalty carries on a business in Hong Kong and uses the trademark, etc. to produce Hong Kong sourced profits, which is the situation envisaged in the proposed S.15(1)(ba), the trademark is used in Hong Kong in the economic sense. ● The proposed legislation is not intended to break any

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		Hong Kong tax. The logic adopted by the Administration is wrong.	new ground. It is simply intended to give statutory support to this economic concept of "use" which was a widely accepted basis of assessment prior to the *Emerson* decision. Indeed, the *Emerson* case arose from a S.70A claim, i.e. an application for re-opening assessments previously agreed. ● The *Emerson* decision has placed a restrictive meaning on the word "use" in S.15(1)(b). It renders the wordings of the existing S.15(1)(b) inadequate to support a reasonable basis of assessment which was widely accepted previously. The proposed S.15(1)(ba) addresses the situation. ● The proposed S.15(1)(ba) is consistent with the relevant legislation of other jurisdictions, such as Singapore, Malaysia, Australia and New Zealand – royalties are usually taxed in the jurisdiction from which they are paid.

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2b.		Alternative Treatment ➢ It will do less harm to put the legislation under S.17(1) to disallow the deduction for the royalty payments if the income is not subject to Hong Kong tax.	● The proposed amendment is intended to complement S.15(1)(b). It is logical to put it under S.15(1). ● Any attempt to put the proposed amendment under S.17(1), to disallow a deduction in the circumstances described, would almost certainly face strong opposition from businesses to be affected. They would argue that as the expense had been legitimately incurred in deriving chargeable profits, they should be entitled to a deduction and not be discriminated against. It should also be noted that tax is only charged on 30% of the royalty income (except for the situation where payments are made to associates) [10% for sums payable before 1.4.2003.].
2c.		No need for the amendment ➢ The provision in S.15(1)(b) sufficiently deals with the taxation of income earned from the use of intellectual property in Hong Kong.	● The ruling of the *Emerson* case on the interpretation of "use" in S.15(1)(b) deviates from the long-standing assessing practice of CIR that where a Hong Kong business could be said to have incurred royalty expense in producing its Hong Kong sourced profits, the intellectual property concerned must have been used in Hong Kong.

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2d.		Symmetry of Taxability and Deductibility ➢ The principle of "symmetry" between taxability and deductibility, which is introduced explicitly by the Bill, does not currently constitute part of Hong Kong's framework of taxation. This would represent a policy change and would create uncertainly among Hong Kong and non-Hong Kong companies. ➢ The direct linkage between taxability and deductibility is not being applied consistently in this provision. It offends against simplicity and logic to introduce two alternative and inconsistent approaches to taxability. ➢ The pursuit of symmetry is misguided. The test should remain whether the payments are made in the production of assessable income.	● The "deductibility test" provides a means of demonstrating that the payment has a substantial link with Hong Kong. The amendments are not intended to achieve symmetry for symmetry's sake. ● The "deductibility test" is used in other jurisdictions. In Singapore, Malaysia, Australia and New Zealand royalty income is deemed to have a local source if it is borne by a resident or (in the cases of Singapore and New Zealand) if it is deductible against any income accrued or derived locally. ● The proposed S.15(1)(ba) is not an alternative test and is not inconsistent with S.15(1)(b). It simply incorporates the wider meaning of the term "use", i.e. together the two paragraphs are meant to cover what had been understood to be covered by S.15(1)(b) before the Emerson decision.

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2e.		Part Deduction of Royalty ➢ Where the payer of royalties is entitled to offshore income claim, part or whole of the expenses relating to the use of intellectual properties are non-deductible. It is not clear, under such a scenario, whether the expenses attributable to offshore income are regarded as non-deductible or merely excluded from the calculation of assessable profits as a concession (particularly in the case of 50/50 claim for PRC processing arrangement) and, in consequence, whether the expenses are within the scope of S.15(1)(ba).	● Where it is accepted that only part of a taxpayer's profits is chargeable to profits tax, only part of its expenses are deductible under S.16. In such a situation, only part of the royalty payment is considered deductible under S.16 and hence chargeable under the proposed S.15(1)(ba). ● The wording in the Bill already caters for such **a** situation.
2f.		Deter Use of Technology ➢ The proposal will deter the use of technology, is likely to impede Hong Kong's role as a service centre.	● The proposed S.15(1)(ba) does not have the effect of introducing a new tax. It simply gives statutory support to what had been a widely accepted basis of assessment prior to the *Emerson* decision.

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2g.		Revenue Loss ➢ The estimated loss in revenue of $200 million per annum may be overstated.]	● For the years of assessment 1995/96 to 1998/99, the average annual amount of tax assessed for royalty income received by non-residents was $191.2 million. ● With the increased emphasis on technology in the development of Hong Kong's economy, it is reasonable to expect royalty payments, and hence the tax involved, to increase. If no amendments as proposed were to be made and the *Emerson* decision were to be followed, arrangements could easily be structured so that the majority, if not all, royalty payments would not be subject to tax in Hong Kong. ● The potential revenue loss may well exceed $200 million per annum.

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2h.		Double Taxation ➢ The proposal will give rise to double taxation. While the subsidiary receives no relief, the parent or sister company will be assessed upon the income. This will create an impetus for multi-national companies to restructure operations to avoid using Hong Kong as a base.	● The royalty payments by the Hong Kong businesses are deductible in assessing their profits. ● Where double taxation agreement exists, there are normally provisions specifying which jurisdiction is to tax this type of income. ● Even in the absence of double taxation agreement, the country that taxes its residents on a residence basis, not a source basis, will usually give unilateral tax relief.
3.	**Clause 6 of the Bill** **S.16(2) of the IRO** **Interest Deductions**	General Comments on the Amendments ➢ The current S.16 should be left intact. The Revenue should rely on S.61 and S.61A, the general anti-avoidance provision, where there are abuses. It is not wise to tamper with the simple and efficient tax system which is commonly accepted to be a major factor contributing to the success of Hong Kong.	● Invoking the general anti-avoidance provisions and resolving disputes on assessments raised under those provisions are complicated and time-consuming processes. Furthermore, relying on the general anti-avoidance provisions would mean uncertainties for many taxpayers, not just for the Administration. ● Where tax avoidance is only one of the considerations in a transaction, and arguably not the sole or dominant purpose, the application of S.61 and S.61A is restricted. The proposed amendments to S.16 will deal with the general abuses contemplated in the amendments. The proposed amendments to S.16 are intended to address schemes that are currently placing very substantial amounts of revenue at risk. In essence, the schemes are directed at, on the one hand,

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			borrowing funds in order to obtain a tax deduction in Hong Kong for interest paid, while on the other, arranging for the borrower or an associate to receive the interest, or an amount relating to it, in a manner which does not attract tax in Hong Kong.
3a.		➢ Consideration can be given to strengthen the existing anti-avoidance provisions under S.61A to target more effectively the particular form of abuse involved. ➢ Specific terms similar to the current proposed amendments may be incorporated into S.61A. A "motive" or "purpose" test should be included in the relevant provisions.	● However modified, a purpose test has still to be adopted in the S.61A approach suggested by the deputations. This means that the complications and uncertainties mentioned in the two preceding paragraphs cannot be obviated and the suggested approach is unlikely to achieve the purpose of the amendments proposed by the Administration.
3b.		➢ A discretion power can be given to the Commissioner to disregard the operative provisions, such as the one in S.9A, to avoid the denial of interest expenses incurred under genuine commercial loan or financing transactions.	● Such discretionary power may create uncertainty to the taxpayer and may not be welcomed by business operators, especially when debentures or other financial instruments with large sums of money are involved.
3c.			

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		➢ The proposed changes will: - have a detrimental impact on many genuine fund raising business transactions; - impose significant restrictions as to who can participate in debt instruments. There may be commercial reasons why an issuer or an associate may wish to buy some part of a debenture or bond issue; - increase the cost of borrowing for Hong Kong companies and the credit risk of banks, thus make lending to Hong Kong companies less attractive; - make the taxpayer unable to ascertain whether it can or will satisfy the condition required for interest to be deductible; - create undue administrative burden on Hong Kong companies; and	● While the proposed amendments may cause inconvenience to companies in some cases, normal genuine fund raising transactions should not be significantly affected. ● The allowing of apportionment of interest deduction as well as the replacement of the "associates" test by the more restrictive "connected persons" test in some situations as proposed by the draft CSAs have addressed the concern of the parties. ● In a source based taxation regime, particularly where exemptions from tax apply to certain classes of interest receipts, anti-avoidance legislation is essential if the revenue is to be protected from abuse.

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		- run counter to the Government's attempts to promote a debt capital market in Hong Kong.	
3d.		Definition of "associates" is too wide ➢ Taxpayers will find it extremely difficult to keep track and ensure that no associate has had at any point in time been entitled to any sum payable by way of interest from any loan instrument issued. ➢ Sometimes it is beyond an issuer's control to prevent an associate acquiring debentures. ➢ There should be a de minimus exemption – i.e. any interest disallowance under S.16(2)(f) should only apply where more than a certain percentage of the issue is in the hands of associates. ➢ It is difficult for borrowers to comply with the law as the lending banks are not obliged to disclose to them if and to whom the loans have been transferred.	**Amendments proposed:** ● To address the concerns of the parties, the draft CSAs propose to replace the "associate test" with a "connected person test" under the new **S.16(2B)** which deals with the disallowance of interest when the interest payable on the money borrowed flows back to the borrower or a party related to him, and in **S.16(2C)** which deals with the disallowance of interest on debentures and instruments when the interest is payable to a related party of the borrower. The meaning of a "connected person" is more restricted in scope than that of an "associates". ● The "connected person test" involves a "control" element. A connected person is basically a person controlled by the borrower, or one who controls the borrower, or who is under the control of the same person as the borrower. A new definition on "person connected with the borrower" is added under **S.16(3B)** and definition on "control" is defined in the new **S.16(3A)** proposed by the draft CSAs. In broad terms, an interest deduction will be denied if the loans are transferred to or taken up by a connected person ● With the draft CSAs, the parties will only need to

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			know if a connected person is receiving the interest, and this should not generally pose any great difficulty to the borrower. ● The Administration considers that the "associates test" should continue to be used in **S.16(2A)** which disallows interest deduction where the payment of the principal and interest is secured back-to-back by a deposit of the borrower or his associate and the interest income on the deposit is tax-free. This is because in such a situation, the borrower should have no difficulty in knowing whether the person providing the security is an associate or not. ● As apportionment is provided for under the draft CSAs, a de minimus exemption is not necessary.
3e		No apportionment for interest deduction ➢ The absence of a mechanism of apportionment of interest expenses for deduction purpose will be very unfair to taxpayers. ➢ S.16(2)(d)(i) proposed in the Bill should be revised to disallow only the percentage of interest expense that corresponds to the percentage of interest income earned by the	**Amendments Proposed:** ● To address the concern on this issue, the draft CSAs propose to allow the interest deductions be apportioned in the following cases – 1. Where money borrowed is partly secured or guaranteed by a back-to-back deposit or loan held by the borrower or a person associated with him and the interest income on the deposit or loan is not chargeable to tax, the interest incurred on the money borrowed will be apportioned on a basis that is most reasonable and appropriate in the circumstances **[proposed S.16(2A)]**;

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		related party. ➢ The disallowance of the interest deduction under S.16(2)(f) should be limited to the proportion of interest equivalent to the fraction of the total debt held by the taxpayer or a related party. ➢ Allowance should be granted (under S.16(2)(f)) to that part of the interest attributable to the debentures/instruments holdings by third parties. ➢ It seems unfair and against the spirit of S.16(2)(f) to deny a deduction for any interest paid to unrelated parties simply because some portion of the debentures are held by associates. ➢ The disallowance should apply only in respect of that interest actually paid to associates. ➢ The proposed amendments to S.16(2)(f) can have a detrimental effect on the debt capital markets in Hong Kong by denying a tax deduction for	2. Where arrangements are in place whereby the interest on any part of the money borrowed is payable, directly or through any interposed person, to the borrower or a person connected with the borrower other than an excepted person, the interest is apportioned by reference to the time during which such arrangements are in place **[proposed S.16(2B)]**. 3. Where arrangements are in place whereby any of the interest payable on the debenture or instrument concerned is payable, directly or through any interposed person, to the borrower or a person connected with the borrower other than an excepted person, the interest is apportioned by reference to the time during which such arrangements are in place **[proposed S.16(2C)]**. ● The interest apportionments under cases 2 and 3 above are twofold – 1. Quantity basis The apportionments in cases 2 and 3 are applicable to any part of the money borrowed or any part interest in the debenture or instrument that are covered by the arrangement concerned. This means that disallowance of interest will only be applied to interest on the portion of the money borrowed or on the part interest in the debenture or instrument concerned in respect of which the said arrangements are in place. 2. Time Basis

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		all interest payments made by a Hong Kong note issuer in the circumstances where any of the note holders are "associates" of the issuer. ➢ Apportionment should be available where the debenture holders comprise both associates and non-associates. This can be on a pro-rata basis. ➢ There may be genuine commercial reasons why a portion of a note issue may be held by associates of the issuer. ➢ The market practice now is invariably for a fund-raising to be documented by a single "global note" which is lodged with an independent depository. Under this arrangement every investor is effectively a beneficial part-holder of the global note. The result will be that the issuer will be denied a deduction for the whole of the interest that it pays on the global note.	Time apportionment is also allowed where a connected party beneficially holds the loan or debt instrument (or part of them) for only a part of the basis period in respect of which interest deduction is claimed.

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3f.		➢ Suggest allowing the interest deduction if the related party entitled to the interest pays tax on the interest income in Hong Kong.	**Amendments proposed:** ● A person who is chargeable to tax in respect of the interest on the money borrowed which he receives is regarded as an excepted person under S.16(2E)(c)(i) and (2F)(c)(i) as proposed in the CSAs. Thus interest deduction will not be denied by S.16(2B) or (2C) if the interest is payable to a connected person and is chargeable to tax in the hands of that person.
3g.		➢ The meaning of the word "entitled" is unclear.	● In the absence of a definition, the word "entitled" should bear its natural ordinary meaning. One of the dictionary meanings of entitle is: give (person, etc.) a rightful claim (to a thing, to do). It can mean the right to the legal or beneficial interest, or both. ● As amended by the draft CSAs, the relevant sections covered by the Bill make reference to the word "entitled" only in S.16(2E)(c)(ii)(A) and (2F)(c)(ii)(A) where the references to rightful claim or beneficial interest are clear.

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3h.		➢ The proposed S.16(2)(d)(ii) should be revised to disallow the interest expense only if the security is posted by a party related to the borrower or the tax-free interest on the deposit or loan is received by an associate.	**Amendment proposed:** ● The proposed **S.16(2A)(b)** has been drafted to disallow interest deduction only if the "non-taxable deposit or loan" used as security for the borrowing is provided by or on behalf of the borrower, an associate of the borrower or a related trust (as expanded by S.16(2D)). The concern has thus been addressed.
3i.		➢ The inter-relationship between these two paragraphs (amended S.16(2)(d)(i) and (ii) per the Bill) needs to be clarified. This is because a sub-participation which is effected on commercial terms, does not involve an associate and is therefore acceptable under paragraph (i) may nevertheless constitute a "deposit" or "loan" and may therefore fall foul of paragraph (ii). ➢ Suppose Bank A lends money to a borrower. Bank A then grants a sub-participation in the loan to Bank B which is based outside Hong Kong. Bank B would therefore be entitled to receive the interest paid by the	● In the situation mentioned, it is arguable whether it can be said that the repayment of the loan from Bank A to the borrower is secured or guaranteed by the sub-participation loan from Bank B to Bank A. It seems that the reverse (i.e. the repayment of the sub-participation loan is secured by the repayment of the original loan) is more likely to be true. ● In any event, the proposed amendment under **S.16(2A)(b)** to disallow interest deduction only where the deposit or loan used as security is provided by the borrower or an associate will address the concern.

Ref	References in the Bill and the IRO	Concerns/suggestions	The Administration's position/ Proposed Amendment to the Bill
		borrower, and paragraph (i) in this case would seemingly permit a deduction because Bank B is not an associate of the Borrower. However, most lawyers would define a sub-participation as a limited recourse loan, i.e. a loan from Bank B to Bank A on which principal and interest is payable to Bank B only to the extent to which Bank A receives principal and interest from the customer. Under paragraph (ii), the deduction would be denied because the payment by Bank B to Bank A for the sub-participation would constitute a "loan".	
3j.		➢ The proposed amendments will impact on the type of security (e.g. US government treasury bills) that borrowers can offer to banks for their facilities and will therefore make it more difficult for borrowers to raise legitimate funds in a manner that would entitled them to tax deductions.	**Amendment Proposed**: ● S.16(2A) is redrafted in such a way that loan interest will be denied deduction only if the loan is secured by a tax-free deposit or loan made with or to the lender, a financial institution, overseas financial institution or an associate of these parties.
3k.		➢ It is not apparent in what sense	● The loan here is a separate loan given by the borrower

Ref	References in the Bill and the IRO	Concerns/suggestions	The Administration's position/ Proposed Amendment to the Bill
		the money borrowed could be said to be secured by a loan.	or an associate. In other words, it is the borrower's asset. Accordingly, it could be given as security for a borrowing, as is the case with a deposit.
3l.		➢ Banks generally require a credit line (L/C or T/R) be secured by an acceptable form of security, cash deposits being the most acceptable. The proposal under S.16(2)(e)(D) will result in additional business cost to taxpayers and increase the credit risk of banks.	**Amendment proposed:** ● S.16(2A) is drafted to allow apportionment on the *most reasonable and appropriate* basis where the borrowing is only partly secured by tax-free deposit or loan.
3m.		➢ There should be clarification as to the justification for expanding the section [i.e. S.16(2)(e)] after 16 years since its existence.	● The proposed amendments are to help ensure that the provisions cannot be abused.

Ref	References in the Bill and the IRO	Concerns/suggestions	The Administration's position/ Proposed Amendment to the Bill
3n.		➢ Unintended consequences may arise due to the broad definition of "associate" and the extensive application of the deduction restrictions to other types of borrowing. - For example, Corp. A issues listed debentures and 1% of the debenture are purchased by Corp. A's MPF, a trust; the directors of Corp. A are beneficiaries of the trust. Interest on 100% of all the listed debentures will be disallowed. - Corporations controlled by the Government will be caught by the definition of associates. For example, where the debentures of MTRC are acquired by KCRC.	**Amendments proposed**: ● S.16(2E)(c)(ii) and (2F)(c)(ii) are added to provide, in essence, that interest will not be denied deduction where it is payable to a recognized retirement scheme as defined in S.2 of the IRO, a collective investment scheme as per S.26A(1A) of the IRO, or a corporation controlled by the Government. Nor will interest be denied if payable to a connected person who is a trustee if that trustee has no beneficial interest in the income or corpus of the trust and no connected person is a beneficiary under the trust.

Ref	References in the Bill and the IRO	Concerns/suggestions	The Administration's position/ Proposed Amendment to the Bill
3o.		➢ The market practice now is invariably for a fund-raising to be documented by way of a single "global note" which is lodged with an independent depository. Under this arrangement, every investor is effectively a beneficial part-holder of the global note. The result will be that the issuer will be denied a deduction for the whole of the interest that it pays on that global note. ➢ Consideration can be given to extending the definitions of "debentures" and "instrument" to tradable interests in global notes.	**Amendment proposed:** ● The proposed S.16(2C) is drafted in such a way that it takes account of the interest paid on debenture and instrument itself as well as that paid on the partial beneficial interest in a debenture or instrument. Deduction for part of the interest payable on a debenture or an instrument is provided for.

Ref	References in the Bill and the IRO	Concerns/suggestions	The Administration's position/ Proposed Amendment to the Bill
3p.	**Clause 6 of the Bill** **Proposed S.16(7) of the IRO**	➢ There are no transitional provisions. Interest accrued prior to the commencement of the amendments and becoming payable after commencement will be caught thereby giving the section retrospective effect.	**Amendment proposed:** ● Transitional provisions are now proposed in the new S.16(5A) so that the new anti-avoidance provisions will not apply to interest incurred before the enactment of the Bill, or under an arrangement or transaction which is the subject of an advance clearance or advance ruling application on which the Commissioner has ruled that S.61A does not apply.
4.	**Clause 8 of the Bill** **S.26E(8) of the IRO** **Home loan interest**	➢ The retrospective application of the proposed amendment should not be used as a precedent for making retroactive amendments in the future.	● The retrospective application of the amendment will be to the benefit of taxpayers and remove what has proved to be a heavy workload for the Commissioner of Rating and Valuation in dealing with requests for consolidated assessments. Making legislative amendment that has a retrospective effect will be considered on the merits of each occasion.
5.	**Clause 14 of the Bill** **S.68(9) of the IRO** **Cost of the Board of Review**	➢ The potential costs should not be set at such a level as to discourage good faith applications to the Board of Review. The Administration should give an assurance that the proposed changes will not encourage frequent reviews and regular increases in the ceiling figure.	● Any order to revise the costs will be subject to negative vetting by the LegCo. ● The amount of costs should be reviewed and revised periodically to ensure that it carries the desired deterrent effect. It is better to streamline the procedure in the manner proposed. This will not in itself, however, encourage frequent reviews.

Appendix B

附件 B

DRAFT

[Preliminary Draft of Proposed CSAs
Sent to Deputations for Discussion]

INLAND REVENUE (AMENDMENT) BILL [2002]

COMMITTEE STAGE

Amendments to be moved by [ ]

Clause	Amendment Proposed
2(3)	By deleting "2001/02" and substituting "[2002/03]".
4	(a) By deleting the proposed section 12(6)(b)(ii) and substituting - "(ii) fees in respect of an examination set by an education provider or a trade, professional or business association, and undertaken by the taxpayer to gain or maintain qualifications for use in any employment,". (b) In the proposed section 12(6)(c)(ii), by deleting "for its members".
6	By deleting Clause 6 and substituting -

"6. **Ascertainment of chargeable profits**

Section 16 is amended -

(a) in subsection (1)(a), by adding "and subject to subsections (2A) to (2C)" after "satisfied";

(b) in subsection (2), by repealing paragraphs (d), (e) and (f) and substituting -

"(d) the money has been borrowed from a financial institution or an overseas financial institution;

(e) the money has been borrowed wholly and exclusively to finance -

(i) capital expenditure on the provision of machinery or plant incurred by the borrower, where such expenditure qualifies for an allowance under Part VI; or

(ii) the purchase of trading stock by the borrower, where the stock purchased is used by the borrower in the production of profits chargeable to tax under this Part,

and -

(A) the lender is not an associate of the borrower; and

(B) where the lender is a trustee of a trust estate or a corporation controlled by such

a trustee, neither the trustee nor the corporation nor the beneficiary under the trust is the borrower or an associate of the borrower;

(f) the borrower is a corporation and the deduction claimed is in respect of interest payable by it –

(i) on debentures listed on a stock exchange in Hong Kong or on any other stock exchange recognized by the Commissioner for the purposes of this subparagraph;

(ii) on instruments (other than debentures described in subparagraph (i)) –

(A) issued bona fide and in the course of carrying on business and marketed in Hong Kong or in a major financial centre outside Hong Kong approved by the Commissioner for the purposes of this subparagraph; or

(B) issued pursuant to any agreement or arrangements, where the issue of an

advertisement or invitation to the public in respect of the agreement or arrangements, or a document which contains such an advertisement or invitation, has been authorized by the Securities and Futures Commission under section 4(2)(g) of the Protection of Investors Ordinance (Cap. 335); or

(iii) on moneys borrowed from an associated corporation, where the moneys borrowed in the hands of the associated corporation arise entirely from the proceeds of an issue by the associated corporation of debentures described in subparagraph (i) or of instruments described in subparagraph (ii), in an amount not exceeding the interest payable by the associated corporation to the holders of

such debentures or instruments.";

(c) by adding –

"(2A) Where –

(a) the condition set out in subsection (2)(c), (d) or (e) is satisfied;

(b) at any time during the basis period of the borrower for the year of assessment concerned, the payment of any sum payable by way of principal or interest in respect of the money borrowed is secured or guaranteed, whether wholly or in part and whether directly or indirectly, by a deposit or loan made with or to any person by the borrower or an associate of the borrower; and

(c) any sum payable by way of interest on the deposit or loan is not chargeable to tax under this Ordinance,

the amount of the deduction which, but for subsections (2A) to (2C), would have been allowed under subsection (1)(a) for the year of assessment concerned in respect of sums

payable by the borrower by way of interest upon the money borrowed shall be reduced, having regard to the sums payable by way of interest on the deposit or loan, by an amount calculated on such basis as is most reasonable and appropriate in the circumstances of the case.

(2B) Where -

(a) the condition set out in subsection (2)(c), (d) or (e) is satisfied; and

(b) at any time during the basis period of the borrower for the year of assessment concerned, arrangements are in place, whether between the borrower and the lender or otherwise, whereby any sum payable by way of interest on the money borrowed or on any part of the money borrowed is payable, whether directly or through any interposed person, to the borrower or to a person other than the lender who is connected with the borrower, in either case not being an excepted person as defined in

subsection (2E)(c),

the amount of the deduction which, but for subsections (2A) to (2C), would have been allowed under subsection (1)(a) for the year of assessment concerned in respect of sums payable by the borrower by way of interest on the money borrowed or on the relevant part of the money borrowed (as the case may be) shall be reduced by an amount calculated in accordance with the following formula -

$$\frac{A}{B} \times C$$

where A means the total number of days during the basis period of the borrower for the year of assessment concerned, at the end of each of which the arrangements are in place;

B means the total number of days during the basis period of the borrower for the year of assessment concerned, at the end of each of which any sum payable by way of principal in respect of the money borrowed or in respect of the relevant part of the money borrowed (as the case may be) remains outstanding; and

C means the total amount of sums payable by the borrower by way of interest on

the money borrowed or on the relevant part of the money borrowed (as the case may be) which, but for subsections (2A) to (2C), would have been deductible under subsection (1)(a) for the year of assessment concerned.

(2C) Where -

(a) the condition set out in subsection (2)(f) is satisfied; and

(b) at any time during the basis period of the borrower for the year of assessment concerned, arrangements are in place, whether between the borrower and the holder of the debenture or instrument concerned or otherwise, whereby any sum payable by way of interest on the debenture or instrument concerned or on any interest in the debenture or instrument concerned is payable, whether directly or through any interposed person, to the borrower or a person who is connected with the borrower, in either case not being an

excepted person as defined in subsection (2F)(c),

the amount of the deduction which, but for subsections (2A) to (2C), would have been allowed under subsection (1)(a) for the year of assessment concerned in respect of -

(i) (where the condition set out in subsection (2)(f)(i) or (ii) is satisfied) sums payable by the borrower by way of interest on the debenture or instrument concerned or on the relevant interest in the debenture or instrument concerned (as the case may be); or

(ii) (where the condition set out in subsection (2)(f)(iii) is satisfied) sums payable by the borrower by way of interest on moneys borrowed from the associated corporation, being moneys arising entirely from the proceeds of the issue of the debenture or instrument concerned or of the relevant interest in the debenture or instrument concerned (as the case may be),

shall be reduced by an amount calculated in accordance with the following formula –

$$\frac{X}{Y} \times Z$$

where: X means the total number of days during the basis period of the borrower for the year of assessment concerned, at the end of each of which the arrangements are in place;

Y means the total number of days during the basis period of the borrower for the year of assessment concerned, at the end of each of which any sum payable by way of principal in respect of the debenture or instrument concerned or in respect of the relevant interest in the debenture or instrument concerned (as the case may be) remains outstanding; and

Z means the total amount of sums referred to in paragraph (i) or (ii) (as the case may be) which, but for subsections (2A) to (2C), would have been deductible under subsection (1)(a) for the year of assessment concerned.

(2D) For the purposes of subsection (2A),

if a deposit or loan is made by a trustee of a trust estate or a corporation controlled by such a trustee, the deposit or loan shall be deemed to have been made by each of the trustee, the corporation and the beneficiary under the trust.

(2E) For the purposes of subsection (2B)(b) -

(a) the reference in that subsection to any sum payable by way of interest on the money borrowed or on any part of the money borrowed shall be construed as including a reference to any sum payable by way of principal or interest in respect of any other loan, where the payment of such sum is -

(i) secured or guaranteed, whether wholly or in part and whether directly or indirectly, by any sum payable by way of principal or interest in respect of the money borrowed or in respect of any part of the money

borrowed; or

(ii) conditional, whether wholly or in part and whether directly or indirectly, upon the payment of any sum payable by way of principal or interest in respect of the money borrowed or in respect of any part of the money borrowed;

(b) if any sum payable by way of interest on the money borrowed or on any part of the money borrowed, as construed in accordance with paragraph (a), is payable, whether directly or through any interposed person, to a trustee of a trust estate or a corporation controlled by such a trustee, such sum shall be deemed to be so payable to each of the trustee, the corporation and the beneficiary under the trust; and

(c) the term "excepted person" in that subsection means -

(i) a person who is chargeable

to tax under this Ordinance in respect of any sum payable by way of interest on the money borrowed or on any part of the money borrowed, as construed in accordance with paragraph (a);

(ii) in the case of a person other than the lender who is connected with the borrower -

(A) a person who is entitled to any such sum in the capacity of -

(I) a person acting as a trustee of a trust estate or holding property belonging to others pursuant to the terms of a contract, where the person is not beneficially

entitled to the sum in question;

(II) a beneficiary of a unit trust of the kind referred to in subparagraph (ii) or (iv) of section 26A(1A)(a), where the sum in question is payable to a trustee of the unit trust in respect of a specified investment scheme referred to in section 26A(1A)(b); or

(III) a member of a retirement scheme which is either a recognized retirement scheme or a

substantially similar scheme established outside Hong Kong where the Commissioner is satisfied that the scheme complies with the requirements of a supervisory authority within an acceptable regulatory regime;

(B) a public body;

(C) a body corporate, where the Government owns beneficially more than half in nominal value of the issued share capital of that body corporate for the time being; or

(D) a financial institution or an overseas financial

institution.

(2F) For the purposes of subsection (2C)(b) -

(a) the reference in that subsection to any sum payable by way of interest on the debenture or instrument concerned or on any interest in the debenture or instrument concerned shall be construed as including a reference to any sum payable by way of principal or interest in respect of any other loan, where the payment of such sum is -

(i) secured or guaranteed, whether wholly or in part and whether directly or indirectly, by any sum payable by way of principal or interest in respect of the debenture or instrument concerned or in respect of any interest in the debenture or instrument concerned; or

(ii) conditional, whether wholly or in part and

whether directly or indirectly, upon the payment of any sum payable by way of principal or interest in respect of the debenture or instrument concerned or in respect of any interest in the debenture or instrument concerned;

(b) if any sum payable by way of interest on the debenture or instrument concerned or on any interest in the debenture or instrument concerned, as construed in accordance with paragraph (a), is payable, whether directly or through any interposed person, to a trustee of a trust estate or a corporation controlled by such a trustee, such sum shall be deemed to be so payable to each of the trustee, the corporation and the beneficiary under the trust; and

(c) the term "excepted person" in that subsection means -

(i) a person who is chargeable to tax under this Ordinance in respect of any sum payable by way of interest on the debenture or instrument concerned or on any interest in the debenture or instrument concerned, as construed in accordance with paragraph (a);

(ii) in the case of a person who is connected with the borrower –

(A) a person who is entitled to any such sum in the capacity of –

(I) a person acting as a trustee of a trust estate or holding property belonging to others pursuant to the terms of a contract, where the person

is not beneficially entitled to the sum in question;

(II) a beneficiary of a unit trust of the kind referred to in subparagraph (ii) or (iv) of section 26A(1A)(a), where the sum in question is payable to a trustee of the unit trust in respect of a specified investment scheme referred to in section 26A(1A)(b); or

(III) a member of a retirement scheme which is either a recognized retirement scheme or a

substantially similar scheme established outside Hong Kong where the Commissioner is satisfied that the scheme complies with the requirements of a supervisory authority within an acceptable regulatory regime;

(B) a public body;

(C) a body corporate, where the Government owns beneficially more than half in nominal value of the issued share capital of that body corporate for the time being; or

(D) a financial institution or an overseas financial institution.";

(d) in subsection (3) -

(i) by repealing "subsection (2) and this subsection" and substituting "the

foregoing subsections and in this subsection";

(ii) by repealing the definitions of "control" and "debentures";

(iii) in the definition of "overseas financial institution", by repealing "subsection (2)" and substituting "this section";

(e) in subsection (4), by repealing "subsection (2)" and substituting "this section";

(f) by adding -

"(3A) In this section -

(a) a corporation shall be regarded as being controlled by a person if the person has the power to secure -

(i) by means of the holding of shares or the possession of voting power in or in relation to that or any other corporation; or

(ii) by virtue of any power conferred by the articles of association or any other document regulating that or

any other corporation,

that the affairs of the first-mentioned corporation are conducted in accordance with his wishes; and

(b) a person other than a corporation shall be regarded as being controlled by another person if the first-mentioned person is accustomed or under an obligation, whether express or implied, and whether or not enforceable or intended to be enforceable by legal proceedings, to act, in relation to his investment or business affairs, in accordance with the directions, instructions or wishes of that other person.

(3B) In this section, a person shall be regarded as being connected with a borrower if the person is -

(a) an associated corporation;

(b) a person other than a corporation -

(i) who controls the borrower;

(ii) who is controlled by the borrower; or

(iii) who is under the control of the same person as is the borrower;

(c) a director or shadow director or the chief executive of an associated corporation;

(d) where the borrower is a corporation, a person who is a director or shadow director or the chief executive of the borrower,

and, for the purposes of this subsection, "director", "shadow director" and "chief executive" have the meanings assigned to them by section 2 of the Securities (Disclosure of Interests) Ordinance (Cap. 396).";

(g) by adding -

"(7) The amendments made to this section by paragraphs (a) to (f) of section 6 of the Inland Revenue (Amendment) Ordinance [2002] (of [2002]) do not apply to sums described in subsection (1)(a) which were incurred before the commencement of that Ordinance.".

17 In the proposed section 82B(1A), by deleting "1 April

2001" and substituting "[1 April 2002]".

23 By deleting Clause 23 and substituting -

"23. Exemption from profits tax

Section 2(2) of the Exemption from Profits Tax (Interest Income) Order (Cap. 112 sub. leg.) is amended by repealing "where the condition specified in section 16(2)(d) of the Ordinance is satisfied" and substituting "where the condition specified in section 16(2)(c), (d) or (e) of the Ordinance is satisfied and section 16(2A) of the Ordinance does not apply".".

Appendix C

Summary of Follow-on Concerns Raised in the Second Round of Consultation and the Administration's Response

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
1.	**Clause 4 of the draft CSAs** **Proposed S.12(6)(b)(ii) of the IRO**	➢ Welcomed the deletion of "for the members" in the proposed S.12(6)(b)(ii), however ➢ Further pursued the deletion of "for use in any employment". The rationale was that for taxpayers who had foresight and were proactive to invest their time and effort in upgrading themselves or acquiring new skills in order to prepare for future challenges that were foreseeable but not certain, it might be difficult for them to satisfy or prove that the course of education or examination undertaken would be for use in any employment.	● The phrase "any employment" in the existing legislation is wide enough to cover future employments. ● Should the course taken not be shown to be related to any likely employment that the taxpayer might seek to take up, there is no reason that the expense incurred for such course should be allowed as deduction. The requirement of a nexus between the expenses and employments (present or future) is essential to prevent abuses.

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
2.	**Clause 5 of the Bill** **Proposed amended S.15(1)(b) and Proposed S.15(1)(ba) of the IRO**	➢ Considered that the amendments are justified - as goods manufactured in China and shipped direct would not be affected and the Commissioner will extend the 50:50 rule presently used in assessing companies with operations in both Hong Kong and China to deemed royalties. ➢ Accepted the position in principle, but ➢ Suggested that the wordings of the draft legislation be further considered to remove the impression to unwary readers that Hong Kong attempts to extend its tax net by taxing income derived from "use" of intellectual properties outside Hong Kong.	● Noted. ● Noted. ● Proposed change is not desirable because – – The provisions under the Bill are clear and we have made it clear that the amendment is only made to give statutory support to the economic concept of "use" which was a widely accepted basis of assessment prior to the *Emerson* decision. – Amending the provisions for the only purpose of avoiding possible misconception of some non-wary readers is not desirable as it may cause confusion as to the real purpose of making the amendment.

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
3.		➢ Considered that the royalties are unfortunately brought into Hong Kong tax net because deduction is allowed to payer.	● Since deductions of royalties paid will only be allowed to the extent to which they are incurred in the production of the chargeable profits of the payer, it will be fair to charge the royalties income to tax in the hands of the recipient.
4.		➢ Reiterated the concerns previously raised that the amendment would undermine the "source principle". To seek symmetry between deductibility and taxability of an expense by taxing an entity which conducts no business and has no place of business in Hong Kong is inappropriate and contrary to the basic tenets of Hong Kong Tax System.	● See Item 2a of Appendix A (in page A 2). ● The tax symmetry to be achieved accords with international taxation practice (see United Nations Model Double Taxation Convention 2001, Article 12). Countries in the Asia - Pacific region like Singapore and Malaysia also adopt this principle. [see Mr. Andrew Halkyard's article on "To Use or Not to Use Trade Marks? The Taxation of Royalty Income", notes 21 and 22, published in Asia-Pacific Journal of Taxation, Vol. 5 No. 2 – Summer 2001.]
5.	**Clause 6 of the draft CSAs** **S.16 of the IRO** **General comments on the amendments**	➢ Though there was a clear dichotomy of views between the professional and business/ taxpaying communities, some considered the enactment of a specific anti-avoidance provision preferable to tackle the perceived mischief, as distinct from relying upon (or even amending) S.61A.	● The view is noted and welcomed.

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
6.		➢ Concerned that the proposed legislation will affect genuine business transactions due to the wide definitions of "control" and "connected person" which extend to directors etc. The legislation looks very complex and confusing, particularly when it comes to the definitions of "associate", "associate corporation", "control", "director", "connected person" etc. These definitions should be simplified and standardized under S.2 of the IRO.	● "Control" with respect to a corporation has the same meaning as it does in the existing law. The concept of "control over a person other than a corporation" is defined along similar lines as in other legislations. [For example, S.58B(8) of the Bankruptcy Ordinance (Cap. 6), S.9 of Insurance Companies Ordinance (Cap.41), S.2 of Travel Agents Ordinance (Cap. 218), S.2 of Banking Ordinance (Cap. 155) etc.]. ● The definition of "connected person" under S.16(3B) as contained in the draft CSAs sent to the deputations for comment is proposed to be amended to restrict its scope by deleting items (c) and (d) of the definition in view of the concerns addressed. [See Item 44 below.] ● Tidying up the legislation by generalising the terms requires an in-depth study on the implications. It is not appropriate to do so in the current exercise.
7.		➢ Suggested that there should be a provision in S.16 that no penalty would be levied on the borrower if it has wrongly claimed certain interest deduction based on the written confirmations collected from its and its associated corporations' directors, chief executives, associated corporations, etc. regarding	● The proposed provision is not necessary. This is because the provisions that impose penalty on taxpayer for submitting incorrect returns and information, or making an improper claim for a deduction or an allowance are written in such manner that the taxpayer can be excused if there is good reason for his mistakes. For example, S.80 and 82A will penalise a taxpayer who has made an incorrect tax return or made an incorrect statement in connection with a claim for deduction only if the taxpayer has done so without

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
		whether he/she is one of the recipients of interest paid by the corporation in respect of any money borrowed, and those information subsequently proved to be incorrect.	reasonable excuse. S.82 can only be invoked where the taxpayer has made incorrect return and statement wilfully with intent to evade tax.
8.		➢ Considered that a simple tax system has contributed a lot to Hong Kong's success and the proposed Amendment Bill will destroy this competitive factor. The Bill is now revised to an even more complicated version and the revised S.16 will become the most complicated part of the IRO.	● The Administration reckons the value of having a simple tax system. However we also need to ensure the fairness and integrity of our tax system and to avoid, as far as possible, exploitations and abuses of our taxing scheme. Anti-avoidance provisions are therefore unavoidable. At the same time we have to minimise the inconvenience that the anti-avoidance provisions may cause to genuine commercial activities. The provisions now proposed are lengthy but we have strived to reduce them to the necessary minimum.
9.		➢ Suggested the IRD to produce a checklist for determining the deductibility of interest to provide guidance to taxpayers.	● The IRD will publish a practice note following the enactment of the Bill to assist the taxpayers in understanding the new scheme.

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
10.		➢ Reiterated the view that S.61A should still be an effective tool to handle tax avoidance cases. Introducing so many complications to the law regarding interest deductions would only undermine the flexibility of genuine fund-raising activities.	● Invoking the general anti-avoidance provisions and resolving disputes on assessments raised under the general anti-avoidance provisions are complicated and time-consuming. There is an opposing view that it would be better, both to the taxpayer and to the Administration, to provide more explicit rules to ensure greater certainty in making the interest deduction claims (see Item 6 above). The Administration agrees to this view.
11.		➢ Welcomed the positive response of the Commissioner to the concerns raised which were principally directed at the potential injustice which would arise from the lack of apportionment provisions and transitional arrangements.	● Noted.
12.		➢ Considered that the scope of application of the anti-avoidance provisions were too wide on the following regards – – Shareholders, directors and each corporation are separate entities. – It is unfair that a corporation	● While the independent identities of shareholders, directors and associated companies are recognised, the reality is that the existing system of tax treatment of interest income and deduction has been blatantly abused by tax avoidance schemes which involve connected parties. In essence, the schemes seek to create allowable interest deduction whereas the corresponding interest income, which in most cases is arranged to be payable to a connected party of the payer, is not taxable. The anti-avoidance provisions

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
		is deprived of the right to interest deduction solely because of the personal investment decisions of its or its associated corporation's directors and chief executives as well as the investment decision of its associated companies and major shareholders.	proposed in the revised bill are essential to upkeep the integrity and fair administration of our tax system. ● Under the existing law [i.e. S.16(2)(d)], reference to an "associate" has already been extended to such persons for anti-avoidance purposes. The proposed new S.16(2A) is drafted along similar lines. The scopes covered by the new S.16(2B) and (2C) are even more restrictive in recognition of the anticipated difficulties of identifying the participation of connected parties. ● The impacts of the new provisions on genuine commercial investments of the connected parties in the company have been taken into consideration. In the proposed provisions, a connected party who is chargeable to tax in respect of his interest income derived from the taxpayer company is classified an "excepted person". Where interest is received by an excepted person, the new provisions will not operate to deny the deduction. Likewise, where the company's loan is secured by a deposit or loan held by itself or its associates and the interest on such deposit or loan is chargeable to tax, the anti-avoidance provision under S.16(2A) will not apply. As such, we are confident that the proposed provisions have struck the right balance of having anti-avoidance provisions to maintain fairness in our taxation scheme and at the same time limiting the impacts that may be caused to genuine commercial practices.

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
13.	**Proposed amended S.16(2)(d) and (e) of the IRO**	➢ Welcomed the use of a fair and reasonable basis to calculate the portion of disallowable interest. ➢ Suggested that S.16(2)(e) should cover the loan raised to finance the purchase of "prescribed fixed assets" and "expenditure on building refurbishment" that are allowable for deduction under S.16G and 16F of the IRO.	● Noted. ● The proposal of extending the scope does not fall within the purpose of the current amendment, which is the introduction of anti-avoidance provisions. They can however be considered separately for future legislative amendments.
14.		➢ Recommended an addition to S.16(2)(e) so that both "finance" and "refinance" are included.	● It is not necessary to specifically provide for the case of refinancing. In practice, where a new loan is raised wholly and exclusively to repay a loan previously borrowed wholly and exclusively to finance capital expenditure on machinery or plant or the purchase of trading stock, the new loan is treated as being raised for the same purpose as that of the previous loan. The deductibility of the interest incurred on the new loan is then determined in the same way as that incurred on the previous loan, i.e. by reference to the other conditions in S.16(2)(e) and those in the proposed S.16(2A) and (2B).

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
15.	**Proposed amended S.16(2)(f) of the IRO**	➢ Welcomed to replace the "associates" test by a "control" test and where the debenture/instrument is partly held by a person controlled by the issuer, only a portion of the interest paid will be disallowed. ➢ Considered that interest should be deductible if the notes are held by an associate of the issuer who holds its notes in the ordinary course of its business of selling notes, and the notes constitute trading stock in its hands.	● Noted. ● This treatment will favour the "notes" dealers and will be perceived as unfair to other non-dealer holders of notes who are associates of the notes issuer.

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
16.		➢ Considered that interest should be deductible if the notes are beneficially owned by persons who are not associated with the issuer (so that, in a trust situation, the fact that the trustee is an associate of the issuer would be an irrelevant factor). Where an associate is a beneficiary of a fixed trust, there would be disallowance of a deduction attributable to the portion of debentures held by the trustee which is beneficially owned by the associate under the trust. Where an associate is a beneficiary of a discretionary trust, the interest deduction will be disallowed with respect to all notes held by the trustee.	● Under paragraph (c)(ii)(A) in each of S.16(2E) and (2F) proposed by the CSAs, a person acting as a bare trustee or holding properties belonging beneficially to others, a beneficiary of a unit trust of the kind referred to in subparagraphs (i) and (ii) of S.26A(1A)(a) and a member of a recognized retirement scheme or similar scheme established outside Hong Kong and accepted by the Commissioner are treated as "excepted persons" for the purposes of S.16(2B)(b) and S.16(2C)(b). This means that deduction will not be denied in respect of interest payable to them. ● Interest payable to a trust is deemed to be payable to (among other persons) the beneficiaries (paragraph (b) of S.16(2E) and (2F)). The deductibility of the interest will depend on whether the beneficiaries are persons connected with the borrower. Apportionment is allowed in the deduction.

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
17.		➢ Suggested that there should be a "de minimus" or "safe harbour" rule to the effect that, if the proportion of notes not qualifying for deduction constitutes 5% or less of the total notes on issue, a deduction should be allowed with respect to the whole of the notes issue.	● With the allowance of interest deduction *in part* and the use of "connected person" test in place of "associates" test in S.16(2C), the "de minimus" rule is no more necessary.
18.		➢ Suggested in all other cases that the interest disallowance be reduced by the proportion of non-qualifying notes.	● "Apportionment" of interest deduction is allowed in S.16(2C).
19.		➢ Suggested permit tax deduction in the case of a pension trust where the issuer or an associate is a potential beneficiary with respect to any over-funded portion (or an associate who is an individual is a beneficiary with respect to the retirement benefits).	● This proposal has been provided for under paragraphs (c)(ii)(A)(III) of S.16(2E) and (2F).

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
20.		➢ Noted that the word "marketed" is used in the current draft in place of "marketable" in the existing law.	● The change was proposed in the Bill. ● The term "marketed" is favoured as it would avoid the possibility of a taxpayer arguing that interest paid in respect of a theoretically marketable instrument should qualify for deduction despite that the instrument is never actually marketed.
21.		➢ Suggested that a new sub-section be added to cater for instruments issued or sold directly to the following types of investors (through private placement) – 1. financial institutions; 2. licensed corporations within the meaning of Securities and Futures Ordinance; 3. insurance companies or any associated companies of these insurance companies; and 4. funds or schemes registered within the MPF Scheme Authority.	● As explained in Item 23 below, S.16(2)(f) is only meant to cover marketable debentures and instruments. Instruments issued by private placement, particularly those issued to a few investors and do not have a secondary market, are not within the intended scope of this section. The issuers of such instruments have to resort to other subsections for claiming interest deduction. [For example, instruments issued to financial institutions can be deductible by virtue of S.16(2)(d). Instruments issued to other types of investors have to be considered within the ambit of S.16(2)(c) or (e).]
22.	**Proposed S.16(2)(f)(i) of the IRO**	➢ Suggested extending the benefit	● It seems that the Medium Term Note Programme is a

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
		of listing (coverage of S.16(2)(f)(i)) to Medium Term Note Programme	note issuing programme under which a corporate borrower appoints a dealer or some dealers, in most cases the commercial banks, to place the issuer's medium term notes to the end investors. The issues from the programme (the medium term notes issued by the corporate borrower) may or may not be listed. ● Where the notes are listed on an approved Exchange, the interest deductions are allowable under S.16(2)(f)(i). If the notes are not listed but are issued to the public under the approval of the Securities and Future Commission, the interest thereon can be deducted under S.16(2)(f)(ii)(B). In other cases, the deductibility of the interest of the notes is subject to the "marketability" test under S.16(2)(f)(ii)(A). ● Since the medium term notes are simply one of the debt instruments the issue of which are covered by S.16(2)(f), a special provision for this type of notes issuance is not warranted. ● It is mentioned that the programmes are usually listed. It is not clear how the "programme" can be listed. One possibility is that under the programme, the corporate borrower will issue the medium term notes to a vehicle company. The vehicle company will in term issue a separate tranche of debt instruments to the investors and such instruments are listed. In such a situation the interest on notes issued by the corporate borrower can be deductible under S.16(2)(f)(iii) if the vehicle company is an associate of the corporate borrower. ● If, however, the vehicle company is not an associate of

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
			the corporate borrower, the interest on the notes issued to the vehicle company may not satisfy S.16(2)(f) and thus not allowable for deduction under that section. As the purpose of this Bill is to enact anti-avoidance provisions, expansion of the scope of deduction is beyond the scope of the Bill. Any proposal for expansion has to be considered separately and, if accepted, effected by another legislative amendment.
23.	**Proposed amended S.16(2)(f)(ii)(A) of the IRO**	➢ Uncertain whether a private placement of bonds or an issue of floating rate notes can receive the same treatment. ➢ Considered that the introduction of the "marketed" condition should not preclude the existing "marketable condition". ➢ Suggested that S.16(2)(f)(ii)(A) be amended as – *"bona fide and in the course of carrying on business and which is **marketed or marketable** in Hong Kong or in a major financial center outside Hong Kong approved by the Commissioner…"*	● Distinguished from the borrowings under the conditions of S.16(2)(a) to (e), the existing S.16(2)(f) extends the interest deductions to the interest payable on *marketable debentures or instruments* which are either – 1. listed in a stock exchange (S.16(2)(f)(i)), 2. issued to the public as authorised by the Securities and Futures Commission (S.16(2)(f)(ii)(B)), or 3. issued bona fide in the course of carrying on business and which is marketable (as per existing law) in Hong Kong or in a major financial centre approved by the Commissioner (S.16(2)(f)(ii)(A)). [S.16(2)(f)(iii) caters for the indirect issue of the marketable securities through an associate.] ● "Marketable" commonly means that the instrument is negotiable and transferable, and that there exists a secondary market in Hong Kong or elsewhere in which they can be sold readily. ● The change of the term "marketable" to "marketed"

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
			does not intend to remove the requirement that the instrument has to be marketable in the sense used in the existing law. The change signifies that in addition to being marketable, the instrument has to be actually marketed in the secondary market. This requires the launching of a marketing programme involving advertising, credit rating assessment, and the offering of quotes for buying and selling the instruments. Thus a private issue of debt instruments that are not readily saleable in a secondary market is not intended to be covered by this section. ● The guidelines suggested as regards "marketable" or "marketed" requirements are helpful. The guidelines can be included in the DIPN to be issued following the passing of the Bill.
		➢ Suggested that more specific guidelines are to be issued in the form of Departmental Interpretation and Practice Notes (DIPN). Some guidelines are recommended by reference to market practices.	

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
24.	**Proposed S.16(2A) of the IRO**	➢ Suggested that a clear basis should be specified in S.16(2A) as that in S.16(2B) and (2C). ➢ Considered that the legislative provision which confers a discretionary power on the IRD, or introduce a test the application of which is to be determined primarily by the IRD, is not desirable because of the uncertainty that this would introduce.	● In contrast to S.16(2B) which captures cases where the loan or part of the loan raised by a taxpayer is "assigned" to or "sub-participated" by a connected party of the taxpayer and the interest payable on the "assigned" or "sub-participated" loan or part can thus be objectively identified, S.16(2A) deals with the case where the loan raised by a taxpayer is secured by another deposit or loan held by the taxpayer or an associated person. Because of the wide range of borrowing facilities and securities arrangements that are used in the market, it is not practicable in the case of S.16(2A) to set out a simple, universal and objective formula in the legislation. The proposed approach follows that used in Rule 2A of the Inland Revenue Rules that provides for the apportionment of expenses on a basis that is "reasonable and appropriate in the circumstances of the case". ● The test is an objective one that is determinable on the circumstances of each case and is not discretion vested in the Commissioner.

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
25.		➢ Wondered why the word "associate" is still maintained in S.16(2A). ➢ Suggested that the "control test" should also replace the "associate test" in this section (where non-taxable deposit or loan used as security is provided by the borrower or its associates).	● The Administration considers that it is justifiable to have two different tests to cater for different situations. In tracing whether the interest payment are ultimately paid to connected parties in S.16(2B) and (2C), we reckon that adopting the "associate" test may have the difficulties of identification. This is because "associates" include persons who are having certain relationship with the borrower as defined in the definition, such as a relative of the borrower. In some circumstances, it may be difficult for the borrower to know whether such persons have invested in the loan he raised or the debt instruments he issued. ● The same difficulties do not arise in the case of S.16(2A). Where the loan is secured or guaranteed, the borrower should have no difficulty in identifying the person who provides the security or guarantee and thus should be able to ascertain whether such person falls within the definition of an "associate". ● Furthermore, the provisions contained in S.16(2A) are largely reflective of the existing anti-avoidance provisions under S.16(2)(d). The use of "associate" test in the proposed new section follows that adopted in the existing provisions that have been operated smoothly for a number of years.

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
26.		➢ Under S.16(2A), the amount of interest to be disallowed is expressed in a very unclear term of "on such basis as is most reasonable and appropriate in the circumstances of the case". Wondered whether or not penalty will be imposed if a taxpayer's basis is not considered reasonable and appropriate by the Administration.	● In making his claim for interest deduction in a reduced amount pursuant to S.16(2A), taxpayer should show his basis of calculation of interest to be disallowed in his tax computation and disclose all relevant facts in support of the basis he adopted. With full disclosure of the facts, there will be no question of penalty in case the Administration cannot agree to the basis adopted by the taxpayer.
27.		➢ Acknowledged that the practicalities of incorporating all relevant matters into the legislation would be very difficult. ➢ Suggested that the Commissioner should issue a practice note with representative examples showing IRD's concerns and providing a flavour of how and in what circumstances the discretion would be exercised.	● The Commissioner will publish a practice note, with representative examples, showing the basis that the IRD will consider reasonable and appropriate in general circumstances.

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
28.		➢ Considered that the legislation should not affect stock loans.	The Administration considers that – ● In case of a loan of stocks (e.g. listed shares) with cash collateral given, the claim for deduction of interest arising from the collateral (which satisfies a condition under S.16(2)(c), (d) or (e)) should not be caught by subsection (2A) since the security for the loan (if the cash collateral is treated as a loan of money) is the stock which is neither a deposit or loan of money that will generate interest. ● However, the position will be different in the case where the objects of the "stock loan" are not listed shares but deposit certificates or other debt instruments (which may be a specified security within the meaning of S.15E(8)). In such case the test under subsection (2A) applies.
29.		➢ Noted that some scheme relied upon non-interest payments (such as payment of profits) rather than principal and interest. The new provisions may not catch these schemes.	● In theory, such scheme is possible, but in practice not common at present. Nevertheless, the IRD shall monitor the developments after the new legislations are implemented.

Ref	**References in the Bill, draft CSAs and the IRO**	**Concerns/suggestions**	**Administration's Response/ Proposed Amendment to the Bill**
30.		➢ The reworded draft S.16(2A) dispensed with the necessity for an instrument. ➢ Enquired the rationale for the change. ➢ Enquired whether the legislation is intended to cover a bank's common law right of set off.	● This change was proposed in the Bill itself. ● The rationale for dispensing with the necessity for an instrument is to tighten the control so that the provision would not be bypassed simply because of the absence of an instrument which has the effect of providing the security. ● A bank's common law right of set off is not intended to be covered by the provisions. Since bank's common law setoff right is a right provided by the law and is exercisable only at the time of default of payment in respect of the loan, we therefore take the view that the mere setoff right in itself is not an arrangement under which the deposit account balance is used as the security for the loan. However if the right is coupled with a requirement for the borrower to maintain a certain balance in a specific deposit account during the time when the loan is outstanding, the arrangement as a whole may constitute the provision of the deposit as security for the loan even if the term is not expressly spelt out in any loan document.

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
31.		➢ Considered the scope too wide - The new provisions under S.16(2A) now proposes to disallow deduction of interest payment in respect of a loan where the repayment of the loan is secured or guaranteed by a deposit held with or a loan to *any* person that may generate tax-free interest.	● It is recognized that there may be good commercial reason for a person or company to borrow money or to maintain a credit line (e.g. loans relating to L/C and T/R) which has to be secured by an acceptable form of securities, such as US Government Treasury Bills. Widening the scope of the back-to-back deposit test to cover deposits or loans held by the borrower or his associate with any person may limit the borrowers' choice of securities and increase the cost of borrowing. ● **Proposed Amendment** - **To address this problem the Administration proposes to limit the application of the provisions under subsection (2A) to cases where deposits or loan made with or to the following persons –** **1. the lender;** **2. a financial institution;** **3. an overseas financial institution; or** **4. an associate of the lender, a financial institution or an overseas financial institution.**

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
32.	**Proposed S.16(2B) of the IRO**	➢ Recommended to redraft subsection (2B)(b) as follows: "… any sum payable by way of interest on (i) the money borrowed or (ii) any part of the money borrowed, whether directly …" ➢ Suggested that the term "arrangements" be given some definition. Same applies to the term in S.16(2C).	• Recommend revising subsection (2)(b) as "…….. by way of interest on the money borrowed or on any part of the money borrowed ……". It is not necessary to add the suggested "(i)" and "ii"". • There is already a definition for "arrangement" in S.2 of the IRO.
33.		➢ Believed that the proportional disallowance of interest expenses could in practice be complicated and time-consuming to operate in situations where, for example, the sub-participated amount fluctuates at different times of the year.	• Though it is possible to have some cases where the sub-participation of loan would be fluctuating, we believe that the majority of the cases are simple and straightforward. Given that the formula for proportional disallowance is clearly and expressly stated in the legislation, the calculation of the interest disallowed would not be cumbersome.
34.	**Proposed S.16(2A) and (2B) of the IRO**	➢ Cannot see the mischief in S.16(2)(c) which may call for the application of the anti-avoidance provisions to this section.	• It is necessary for the anti-avoidance provisions under the proposed S.16(2A) and (2B) to apply also to the loans that satisfy the condition under S.16(2)(c) in order to achieve the anti-avoidance purpose. Should the provisions have no application to such loans,

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
		• Considered that a possible double taxation problem may exist - a deduction could be denied to the borrower yet, at the same time, the lender would also become subject to tax. • Suggested that all references to paragraph (c) should be deleted from sub-sections (2A) and (2B).	taxpayers intending to make any borrowing under subsections (2)(d) or (e) but would be denied a deduction claim on the interest payable because of the new subsections (2A) or (2B) may easily by-pass those new provisions by inserting an unrelated company as an intermediate financing vehicle. For example, the taxpayer will borrow from the intermediary who will in turn borrow from the intended lender. The intermediary will be taxed on interest it received from the taxpayer (the borrower) but can obtain deduction in respect of the interest payable to the lender and is thus in a tax neutral position. The taxpayer, however, may obtain deduction by way of S.16(2)(c) of the interest he pays which would otherwise be denied by the new anti-avoidance provisions of subsections (2A) or (2B) if the intermediary were not so added. The intermediary may be provided by a tax planner who would earn a fee for providing such service to the borrower. • The new subsection (2A) will only operate when the loan raised by a taxpayer is secured back to back by a deposit or loan held by him or by an associated party of him and the interest on the deposit or the second-mentioned loan is not taxable. This resembles the provision under S.16(2)(d) of the existing law. As the taxpayer is only denied a deduction of the interest payable on a loan that is secured by a deposit or loan from him or his associated party that generates tax-free interest, there seems to be nothing unfair. • The new sub-section (2B) will only operate when the interest paid by the taxpayer finds some ways to flow

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
			back to the taxpayer or a connected party of his. The provision will not apply where the connected party of the borrower who ultimately receives the interest pays tax on the interest he receives [in which case the connected party will be an excepted person – S.16(2E)(c)(i)]. The insertion of S.16(2)(c) loans to this subsection is intended to catch the borrowing from connected parties who do not pay tax on the interest that routes through an unrelated intermediary as mentioned in the first paragraph above. In such a case the taxability of the interest received by the intermediary (if it is an unrelated party) is offset by the deductibility of the interest it pays back to the taxpayer or his related party. Thus there is no question of double taxation.
35.		➢ Questioned the rationale for the imposition of the additional conditions to S.16(2)(e).	● Loans satisfying the condition under S.16(2)(e) can be assigned to or sub-participated by a party related to the borrower, or secured back to back by a deposit or loan held by the borrower or his associate. Thus tax avoidance techniques that can be effectively applied to loans satisfying the condition under S.16(2)(d) can be equally effective when applied to loans satisfying the condition under S.16(2)(e). The effort of fighting against the abuses will be futile if the anti-avoidance provisions are not made applicable to loans that satisfy the condition in S.16(2)(e).
36.	**Proposed S.16(2C) of the IRO**	➢ Concerned that the issuer may not be able to identify who the	● Given the restricted definition of "connected person" under S.16(3B) as proposed in the CSAs, the issuer

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
		ultimate recipient of interest on Notes in bearer form or derivatives products and the onus of proof that the ultimate recipient is chargeable to tax cannot lie with the issuer.	should have knowledge whether a "connected person" has invested in the loan or debentures issued.
37.	**Proposed S.16(2B) and (2C) of the IRO**	➢ Considered that the reference to "arrangements … whether between the borrower and the lender or otherwise" in subsections (2B) and (2C) is capable of being interpreted in a very wide manner. ➢ The subsections imposed a strict objective test and therefore do not cater for situations where the arrangements may be in place for strictly commercial reasons and there is no intention on the part of the taxpayer to avoid or minimise the amount of tax.	● The "arrangements" that are intended to be circumscribed by the sections are clearly spelt out in the provisions. They must be arrangements under which the interest payable on the loan in question is payable directly or indirectly back to the borrower or a person connected with him. We do not see how the reference can be interpreted to cover unintended targets. ● The purpose of these anti-avoidance provisions is to set up some objective rules to restrict the deduction of interest in situations where the existing law is widely exploited by tax planners. To adopt a test of intention would not serve the purpose of introducing these provisions.

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
38.		➢ Considered that it will be difficult for the borrowing corporation to ascertain whether, or the extent to which, the securities are held by associates, given the broad definition of "associated corporation" in the case of a borrower in a multinational group. To comply with these provisions, a corporation would need to establish complex and possibly costly audit procedures. This is particularly so when non-Hong Kong listed companies are involved where directors are not required to disclose connected party transactions. ➢ Recommended that exemption from the provision be given for transactions undertaken as part of a bona fide market-making operation, and a general de minimis exemption to cater for the situations where associates of a borrower hold no more than 30% of the issue of securities.	● As regards the scope covered by "connected person", see Item 44 below. ● As regards market-making activities and the de minimis rule exemption see Item 45 below.
39.	**Proposed S.16(2E) of the IRO**	➢ Definition of "excepted persons"	● See Item 34 above. There is a salient need for

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
		under subsection (2E)(c)(i) seems to confirm the point that the anti-avoidance provisions under subsections (2A) and (2B) should not be extended to S.16(2)(c) when there is no mischief in that section which is a symmetry provision.	extending the anti-avoidance provisions of subsections (2A) and (2B) to loans satisfying the condition under S.16(2)(c).
40.	**Proposed S.16(2E) and (2F) of the IRO**	➢ Sought to clarify the meaning of S.16(2E)(a) and (2F)(a) and the situations they intended to be covered.	● The two subsections are intended to capture loan sub-participation cases in which the loan raised by the borrower is funded by another non-recourse loan raised by the lender from another person, and the repayment of the non-recourse loan is secured by or made conditional on the repayment by the borrower on the first loan. In such a case, the anti-avoidance provisions will operate if the non-recourse loan is made by a person connected with the borrower. For example, Bank A lends a loan to the borrower and another person (X) makes another loan to Bank A. The repayment of the second loan to X is secured by the repayment of the first loan by the borrower to Bank A. In other words, Bank A needs not repay the second loan to X if the borrower fails to repay the first loan to Bank A. Effectively, Bank A passes the risk to X. If X is a connected person of the borrower, the anti-avoidance provisions will operate to deny the interest deduction of the borrower.
41.		➢ Sought to clarify the meaning of the references "as construed in	● In the example given above, if X pays tax on the interest income from the second loan, X is an

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
		accordance with paragraph (a)" in S.16(2E)(c)(i) and (2F)(c)(i).	"excepted person".
42.		➢ Sought to clarify the following– Paragraph (a) in S.16(2E) and (2F) seem to be extending "any sum payable *by way of interest* or on any part of the money borrowed" to "any sum payable *by way of principal* ***and*** *interest* in respect of any other loan". Under normal circumstances payment of principal is not chargeable to tax. Therefore, in most situations if not all, a person is not an "excepted person" [for the purpose of S.16(2E)(c)(i) and (2F)(c)(i)].	● The wordings used in S.16(2E)(a) and (2F)(a) are actually "any sum payable by way of principal ***or [not and]*** interest in respect of any other loan". Thus a person would be an "excepted person" if he is chargeable to profits tax in respect of the interest he received notwithstanding that the principal he received is not chargeable.
43.	**Proposed S.16(2F) of the IRO**	➢ Believed that the formula could in practice be cumbersome and time consuming. ➢ Questioned on how parts of days during which the arrangements are in place are to be calculated.	● The calculation should not be too complicated as the formula is clear and straightforward. ● The situation existing at the end of a day is taken into account. Thus, there is no problem with treatment of parts of days.
44.	**Proposed S.16(3B) of the IRO**	➢ Not certain as to how the borrower could identify whether or not the persons entitled to any	● **Amendment Proposed –** The proposed S.16(3B) in the draft CSAs sent to the deputations for comment was wider in scope. **The**

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
		sum payable by way of interest on the money borrowed are "connected" with it under the proposed S.16(3B). ➢ Considered this definition to be very wide. Particularly concerned on how a corporate borrower would know what action might be taken by individuals such as directors and shadow directors of associated companies. To comply with these provisions, the corporate would need to establish complex and costly audit procedures.	**definition of "connected person" under the proposed S.16(3B) is now redrafted in such a manner as to restrict its scope by excluding the directors, shadow directors and chief executive officers of the borrower and its associated corporation from the definition.** This effectively confines the meaning of the term to associated corporations of the borrower and the person who controls, or is controlled by, or is under the same control as, the borrower. ● Following this proposed amendment, a director etc. of the borrower or its associated corporation will be a connected person only if there is an element of "control" between the director and the borrower.
45.	**Proposed S.16(3A) and (3B) of the IRO**	Proposed, in relation to the definition of "connected party" and "associated corporation" in the context of S.16(2)(f), – ➢ To exclude the activities of market makers from the scope of the legislation, provided they acted in the ordinary course of business and that the holding is short-term. ➢ To allow, in the case of other persons, a de minimis rule, but subject to disallowance by the	● The Administration does not support the introduction of a de minimis rule in allowing interest deduction payable to market makers who are connected with the borrower for the following reasons – 1. Since the provisions for apportionment of interest deduction are now proposed, there is no need for a de minimis exemption. 2. There may be difficulties in defining and identifying market makers since apparently they are not clearly defined in the legislations. 3. With the modification of the definition of connected parties (see Item 44 above), the issuer of debt securities should have no difficulty in

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		Commissioner where she considers that the holding was not for a genuine commercial purpose. ➢ To consider comparing the de minimis rules adopted in Singapore.	knowing what portion of the interest payment, if any, would ultimately be received by a person connected with him. 4. The anti-avoidance provision under subsection (2C) will have no application if interest is paid to a market maker who is not connected with the borrower. 5. If the market maker is connected with the borrower, there should be no difficulty for the borrower to identify the part of interest payable to the market maker and to be excluded from the deduction claim. ● In Singapore, an issue of debt securities will not be treated as qualified debt securities (QDS) if the securities are issued to less than 4 persons and 50% or more of the issue are beneficially held or funded by related parties of the issuer. The implications of being treated as QDS are that the interests payable to non-residents are exempt from income tax in the hands of the recipients and the payer is not required to pay withholding tax on the interest paid. The application of the so-called de minimis rule in Singapore, which provides only a qualifying condition for the grant of exemption on the *part* of interest payments earned by non-residents, is different from our current application where the de minimis rule is to be adopted as a test in deciding whether the *whole* of the payment will be deductible.

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46.		➢ Enquired whether the concept of "control" referred to legal or de facto control.	● The concept of "control" is defined under S.16(3A). It refers to both legal and de facto control.
47.	**Proposed S.16(7) of the IRO**	➢ Some transactions that had already been completed, were not abusive, and had received advance clearance from the IRD. Such cases generally involved leasing and asset finance transactions, which would be very difficult to restructure if affected adversely by the legislation. Suggested that these transactions be grand fathered as not being subject to the legislation, subject of course to the operation of S.61 and 61A. This could be done by following the precedent established when S.39E was enacted.	● **Amendment Proposed** Recommend introducing grand-fathering provisions (under proposed new S.16(5A)) to cover both advance ruling cases approved by the Commissioner under S.88A and the advance clearance cases under the non-statutory clearance system before the enactment of S.88A on the following grounds – ● According to S.16(a) of Part I of Schedule 10 to the IRO, where any provision that is the subject of an advance ruling given under S.88A is amended or repealed, the ruling shall cease to apply to the extent of the amendment or repeal. The rulings previously given can only survive by adding specific grandfathering provisions. ● Some of the schemes on leverage leasing on which an advanced ruling was given may cover a long period of time. The legislative change may cause the taxpayers, who have acted upon the ruling given under the existing law, to suffer for the transactions that had already taken place.

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			● Affected taxpayers have submitted their requests for grandfathering provisions to preserve the validity of the rulings previously granted. ● There are precedents of allowing grandfathering when anti-avoidance provisions were introduced under S.39E and 61A.
48.		➢ Suggested that the proposed legislation should not seek to disrupt the existing arrangements, but would only apply to borrowings put in place after the proposed legislation becomes effective.	● If the arrangements concerned are of the kinds that the proposed amendments are trying to counteract, there is no reason to continue to allow interest incurred under the arrangements after the proposed amendments come into effect. However there are certain situations where the Administration considers justified not to apply the new provisions as proposed. Grandfathering provisions are therefore added under S.16(5A)(b) and (c) to deal with these cases.

Ref	References in the Bill, draft CSAs and the IRO	Concerns/suggestions	Administration's Response/ Proposed Amendment to the Bill
49.		➢ Suggested that S.16(7) should also refer to interest "payable" or "accrued", given that S.16(1)(a) refers to "payable".	● The amount of interest (indeed all outgoings and expenses) claiming deduction under S.16(1) proper is the amount that is "*incurred* during the basis period…". In CIR v National Mutual Centre (HK) Ltd. [1998, 3 HKC 397] it was held that interest was "incurred" if it was a sum where there is an obligation to pay and it was "payable" for the purposes of S.16(1)(a) even though not paid during the relevant basis period. The use of the word "incurred" is thus more appropriate and is in accordance with S.16(1) proper. ● The use of the word "payable" may also give rise to tax planning opportunity e.g. by arranging advance payment of interest.
50.	**Clause 23 of the draft CSAs**	➢ Suggested deleting the reference to S.16(2)(c) on reasons stated in Item 34 above.	● Not necessary. See Item 34 above.
51.	**General Point**	➢ Considered that the IRO is in need of an overall revision to make it more simple and easy to understand.	● This has to be considered in a separate exercise.