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Clerk to the Bills Committee
Inland Revenue (Amendment) (No.4) Bill 2015
Legislative Council Secretariat
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Dear Hon Kenneth Leung,

Submission on the Inland Revenue (Amendment) (No. 4) Bill 2015

We refer to the Bills Committee's invitation for submission on the captioned bill and our comments on the bill are as follows.

Legislative proposal for corporate treasury centers (CTCs)

The Institute supports the legislative proposal for rectifying the current asymmetrical tax treatment in respect of the interest income and expense of CTCs by way of relaxing the interest deduction rule.

We however consider that, in order to enhance the attractiveness of the bill to CTCs, certain legislative proposals contained in the bill could be refined and changed.

The "Subject to tax" requirement should suffice, without requiring overseas tax being necessarily paid

Under the proposed section 16(2)(g)(ii), interest paid by a CTC to its overseas associated corporation can be allowed for tax deductions in Hong Kong if the overseas associated corporation is "subject to tax" overseas in respect of the interest income at a rate not lower than the reference rate (i.e. 16.5% or 8.25% as the case may be).

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For this purpose, under the proposed section 16(2I), the "subject to tax" condition will only be met if the Commissioner of Inland Revenue is satisfied that overseas tax has been or will be paid at the applicable reference rate in respect of the interest income.

We however consider that "subject to tax" requirement should simply refer to the gross interest income being chargeable to tax overseas at not less than the applicable reference rate. For example, the fact that the overseas associated corporation may have tax losses so that the effective tax rate paid overseas in respect of the interest income is less than the applicable reference rate should not generally affect the tax deduction by the CTC in Hong Kong.

In addition, the proposed section 16(g)(iii) also requires that the overseas associated corporation's right to use and enjoy that interest is not constrained by a contractual or legal obligation to pass that interest to any other person (i.e. the "beneficial ownership" test).

However, the legal interpretation of what constitutes "beneficial ownership" of an income is unclear and controversial in many circumstances.

Furthermore, requiring the CTC to demonstrate that actual overseas tax has been or will be paid and that the overseas associated corporation is the beneficial owner of the interest income would also impose onerous due diligence requirements on the CTC before the CTC can claim the tax deduction in Hong Kong.

These onerous due diligence requirements would undermine the effectiveness of the proposed legislation in attracting CTCs to locate in Hong Kong.

We consider that the abusive arrangements envisaged by the proposed section 16(2)(g)(ii) and (iii) would likely be addressed by the application of the existing general anti-avoidance provisions contained in section 61A and the proposed interest pass-through test under section 16(2CA) of the bill.

On the basis of the above, we propose that section 16(2)(g) should only impose the requirement that the relevant gross interest income is chargeable to tax overseas at not less than the applicable reference rate.

"Activities-based" approach should be adopted for granting the concessionary tax rate

The proposed legislation has adopted the "entity-based" approach to granting the 50% concessionary tax rate to CTCs.

Under the "entity-based" approach, subject to certain safe-harbor rules, a CTC would only qualify for the concessionary tax rate if its business is devoted solely to certain qualifying corporate treasury services or transactions or intra-group financing activities.

The "entity-based" approach, we understand, is adopted out of concerns that taxpayers may exploit the proposed legislation through misclassification of the relevant income or misallocation of expenses.

We however consider that so long as the qualifying conditions are clearly set out in the proposed legislation, the ascertainment of the amount of profits within the company concerned that qualifies for the concessionary tax rate could not be abused by CTCs.

In any case, if the qualifying conditions are not clearly defined, under the proposed 75% safe-harbor rule, the risks of taxpayers misclassifying the relevant income or misallocating the expense would still exist.

Under the "entity-based" approach, many large corporations that now conduct CTC activities as part of their wider operations would not be able to enjoy the concessionary tax rate, without spinning off the CTC operations into a separate legal entity.

However, for various reasons e.g. the substance requirement for tax treaty benefits, such a spin-off may not always be feasible. This may be the case since such a spin-off may give rise to the concern of whether there is enough "substance" of the spin-off entity or the original large corporation. This may be a concern given that the "substance" e.g. in terms of headcount and business operations would now need to be spread over the two entities concerned.

In this regard, we understand that similar CTC tax incentives in Singapore are granted flexibly, often being made under the "activities-based" approach.

We therefore submit that the government should adopt a whole or at least more "activities-based" approach to granting the concessionary tax rate to CTC, possibly including lowering the 75% safe-harbor threshold.

Deeming provisions for interest and certain related income derived from an intra-group financing business

We consider that the two deeming provisions contained in the proposed sections 15(1)(ia) and (la) cannot be justified by the proposed relaxation of the interest deduction rule. This is because if based on the current case-law principles, the relevant interest income of a corporation is not taxable, the corresponding interest expense would be disallowed, regardless of the proposed relaxation of the interest deduction rule under section 16(2)(g).

The taxability of interest income derived from a business of intra-group financing by a corporation has been well established by case-law principles. As such, we see no justifiable reasons for the government to purportedly "codify" but in fact extend the charging scope for interest (and certain related) income.

These two deeming provisions to extend the charging scope for the relevant interest and related income may also render the bill, which is meant to grant tax incentive and relief, to be negatively perceived by multinational corporations, thus lessening the attractiveness of the bill.

Specifically, the introduction of these two deeming provisions could send the wrong message that taxpayers would no longer be able to rely on the "provision of credit" test to claim their interest income as being non-taxable offshore income, even where the intra-group financing activities involved do not amount to a business or the lending involved still essentially a simple loan of money. As such, these two deeming provisions have the potential of driving away such financing activities from Hong Kong, which would not be good for the general economy of Hong Kong.

Furthermore, these two deeming provisions may also be said to be discriminatory in the sense that they only apply to an intra-group financing business of a corporation, but not to other on-lending business of a corporation, which is not a financial institution.

On the basis of the above, we urge the government exclude these two deeming provisions from the bill.

Legislative proposal for regulatory capital securities (RCS)

The Institute supports the legislative proposal for allowing distributions paid on RCS as being tax deductible interest.

We however consider that sections 17E, 17F, 17G and 17H of the Bill are at least not immediately necessary and can be excluded from the legislative proposal. Such an approach would allow the stakeholders concerned to have further and wider discussion on the relevant provisions which may have wide implications.

Section 17G, proposing to treat the Hong Kong branch of a non-resident financial institution (FI) as an enterprise separate and distinct from other parts of the FI, could potentially fundamentally change the basis of taxation and the source rules for profits derived by such Hong Kong branch.

Specifically, sections 17G(1) and (3) taken together, apparently provide that the chargeable profits of such Hong Kong branch of a non-resident FI have to be ascertained taking into account "the functions performed, assets used and risks assumed by the non-resident financial institution (a) through the Hong Kong branch; and (b) through other parts of the non-resident financial institution". However, this apparent proposed statutory source rules of "the functions performed, assets used and risks assumed" may not necessarily align with the source principles and rules developed by the courts over the years.

As such, this may lead to the undesirable result that there is one set of statutory source rules for Hong Kong branches of non-resident FIs under section 17G and a different set of case-law based source rules for resident FIs. Such potential fundamental change to the basis of taxation for Hong Kong branches of non-resident FIs requires further and wider discussion.

Furthermore, section 17G only applies to Hong Kong branches of non-resident FIs which have issued RCS. As such, section 17G would also create an uneven playing field between Hong Kong branches of non-resident FIs which have issued RCS and those which have not.

Section 17H relates to the possible extension of the arm's-length transfer pricing rules applicable to RCS transactions specified in section 17E to non-RCS transactions, and also to the possible extension of the "separate and distinct enterprise" approach under section 17G to other types of non-resident enterprises that are not FIs. As such, sections

17E and 17H would have broad ramifications and also require further and wider discussion.

Section 17F contains some complicated specific anti-avoidance provisions that may render this legislative proposal difficult to comply in certain circumstances involving RCS instruments down-streamed by a group from outside Hong Kong.

It would be much more preferable to rely on the existing general anti-avoidance provisions of the IRO than on section 17F to deal with any abusive tax arrangements involving RCS. Both Singapore and the UK rely on their existing relevant general anti-avoidance legislation to deal with any abusive tax arrangements involving RCS. If Singapore and the UK can adopt this approach, so should Hong Kong.

On the basis of the above, we urge the government exclude sections 17E, 17F, 17G and 17H from the Bill.

If after a public consultation, the relevant provisions contained in sections 17E, 17F, 17G and 17H are found to be desirable in the wider context, then the relevant legislation may later be enacted in a form and manner that is most appropriate and acceptable to the stakeholders concerned under a separate legislative exercise.

We trust the above is of use to the Bills Committee when it scrutinizes and deliberates on the bill. Should you have any questions on the above, please feel free to contact us.

Yours sincerely,

For and on behalf of
The Taxation Institute of Hong Kong

Karmen Yeung
President