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羅兵咸永道

Hon Kenneth Leung
Chairman
Bills Committee on the Inland Revenue (Amendment) (No. 4) Bill 2015
Secretariat, Legislative Council
Hong Kong SAR Government
1 Legislative Council Road
Central
HONG KONG

21 January 2016

Dear Hon Kenneth Leung,

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

We refer to the Inland Revenue (Amendment) (No. 4) Bill 2015 ("the Bill") and set out below our comments on the Bill for the Bills Committee's consideration.

1. Overall comments

As mentioned in our earlier submission during the FSTB consultation, we welcome the proposed measures of introducing a concessionary half-tax rate regime for Corporate Treasury Centre ("CTC") and allowing interest deduction for intra-group borrowing from non-Hong Kong companies in certain circumstances regardless the taxpayer qualifies for CTC or not. We believe the new measures will clarify some uncertainty involved in having multinational enterprises ("MNEs") to set up their corporate treasury functions in Hong Kong, in particular for Chinese MNEs under the "One Belt One Road" national policy.

However we have the following comment on the proposed CTC regime as proposed in the Bill:

- The Bill maintains the requirement of having a standalone entity within the group as the CTC in order to enjoy the half tax rate concession. Practically this may not be feasible for some MNEs which have their treasury functions housed within the headquarters company which also performs other corporate functions. Although there is a safe harbour rule proposed in the Bill, the 75% threshold may not be easy to satisfy since the size of the said other functions or businesses is usually quite significant in terms of the profits derived and/or the asset employed as compared with the treasury functions which only require a team of treasury people.

The new deeming provisions for interest income and the new condition for deduction of interest expenses for intra-group borrowing are applicable to companies regardless whether they qualify as a CTC or not. As such they have wider implications and may result in unintended consequences. We have the following comments on these new rules.

- The deeming provisions on interest income and similar incomes (proposed section 15(ia) and section 15(la)) derived from intercompany lending are highly controversial. They would result in taxing incomes derived from intra-group borrowing and lending activities which are currently not taxable. The issue of the "source" of such incomes, in the context of intra-group borrowing and lending, is highly debatable. The codification of the taxation of such incomes, without sufficient authoritative support from precedent cases in the context of intra-group borrowing and lending, may drive some existing intra-group borrowing and lending activities out of Hong Kong. This is clearly contrary to the good intention of promoting Hong Kong as a group treasury hub by providing half-tax rate incentive to CTC and relaxing the interest deduction rules on intra-group borrowing. Hence, we consider the deeming provisions are unnecessary. Please note that removal of the deeming provisions should not lead to loss of revenue to the Government as a result of the relaxation of intra-group interest deduction rules, on the basis that the existing legislation has already provided safeguard that interest deduction would only be available when such interest was incurred in the production of taxable income.

- Adding a new deduction condition under section 16(2) (section 16(2)(g)) for the interest expenses incurred on borrowing from non-Hong Kong associated corporations will certainly attract MNEs to borrow from overseas associated corporations for their treasury operations in Hong Kong. However modifications are required so as to make sure that such provision can be operative in practice and minimise potential tax disputes between taxpayers and the Inland Revenue Department ("IRD") in respect of the tax deductibility of interest expenses to non-Hong Kong associated corporations, in particular with regard to the requirement of tax "paid" and the reference to the effective tax rate in overseas jurisdictions. It is imperative to ensure that taxpayers would not be barred from using this interest deduction rule because of the impracticality of the conditions attached to such rule.

We also welcome the Bill clarifies the tax treatments on the payments and receipts in relation to Regulated Capital Security ("RCS"). We believe the proposed clarification is important for the banking sector which is a pillar for Hong Kong being an international financial centre. However we have the following comments on the proposed provisions on RCS:

- The introduction of the concepts of "separate entity principle", "profit attribution methodology" and "debt-to-equity threshold" for Hong Kong branches of foreign banks with RCS under section 17G deviates from the principle of simple tax system which Hong Kong has been maintained for years. These rules are unnecessarily complex and may cause unfair competition between Hong Kong branches of foreign banks with RCS issued, and Hong Kong incorporated banks (irrespective of whether RCS has been issued) and Hong Kong branches of foreign banks without RCS. These rules should be reconsidered through thorough public consultation before their introduction.

- The proposed "avoidance of doubt" provision under section 17H is misleading and may be misinterpreted as codification of the application of the new complex principles in section 17G and "arm's length principle" in section 17E to all taxpayers (including non-financial institutions) whether or not RCS is relevant to them. We believe this is not the intent of the proposed legislation and this section should be modified.

- The restrictive definitions of RCS under section 17A should be amended to align with the definition of the regulatory capital instruments in compliance with Basel III global standards.

- The limitation imposed on the indirect issuance of RCS through a group company under Section 17F should be reconsidered to make sure the tax outcome in the indirect issuance of RCS through a group company of a bank should be consistent with the direct issuance of RCS by a bank.

2. Specific comments on the new deeming provisions for interest income and the new condition for deduction of interest expenses for intra-group borrowing

Deeming provisions under Sections 15(1)(ia) and (la)

As stated above, we disagree with the proposal to introduce such deeming provisions in the draft Bill.

We would like to emphasise that the application of the "operations test" in the Privy Council decision of CIR v *Orion Caribbean Limited* case was only based on the specific facts of that case which are not the same for all intra-group borrowing and lending. That decision does not establish a universal rule that taxpayers undertaking intercompany borrowing and lending should have the source of their interest income determined by looking at the location of the business from which that interest is derived. As such, it is inappropriate to try to codify and apply such rule in all situations including the situation where the taxpayer carries on intra-group borrowing and lending activities. These provisions will be recognised by many as being contrary to the tax rate concession under the proposed CTC regime and the relaxation of interest deduction rules on intra-group borrowing.

More importantly, pursuant to the current wording of the deeming provisions and the interest deduction rule under Section 16(2)(g), there can be situations where on one hand, the corporation is subject to profits tax on its interest income or disposal profits as a result of the deeming provisions but on the other hand, it is not able to deduct its interest expenses under Section 16(2)(g) because, for example, it cannot satisfy the condition set out in Section 16(2)(g)(ii) (e.g. the lender is in a tax loss position- see below). As such, introducing this deeming provision may, in fact, exacerbate the current tax issues which discourage the establishment of CTCs in Hong Kong, and even worse, to drive the treasury activities currently undertaken in Hong Kong to move to other jurisdictions.

Deductibility of interest in respect of borrowing and lending of money with associated corporation

(a) Section 16(2)(g)(ii) requires that the lender, in respect of the interest, is subject to tax in a territory outside Hong Kong at a tax rate that is not lower than the reference rate and section 16(2I) clarifies that "subject to tax" means tax "has been paid or will be paid"

Effectively section 16(2I) requires overseas tax to be paid for the condition under section 16(2)(g) is met. The requirement of tax "paid" seems to be unfair if the lender has tax losses and it will also lead to administrative problems in practice, e.g. if the lender has a tax payment date in overseas jurisdiction which is later than the statutory tax filing due date of the corporation in Hong Kong due to some reasons such as different year-end dates of the taxpayer and the lender, the taxpayer in Hong Kong will have to disallow the interest deduction in the first place and then re-open the assessment once the tax is paid by the lender at a later date. We therefore suggest to remove section 16(2I).

In addition, we suggest a partial deduction should be allowed pro-rata if the tax rate of the lender's jurisdiction is lower than the reference rate in Hong Kong, rather than denying the entire tax deduction of the taxpayer as it seems to be unreasonably punitive, in particular where the tax rate is marginally lower than the reference tax rate. Also, given that Hong Kong's headline rate is no longer low by global standards, we believe that the reduction in deductibility should only apply where the rate in the other jurisdiction is lower than, say, 75% of the applicable Hong Kong tax rate.

(b) We note that Section 16(2CC) is proposed to serve as an anti-avoidance provision to disallow interest deduction if the Commissioner is satisfied that the main purpose, or one of the main purposes, of the borrowing of the money is to utilize a loss to avoid or reduce any liability, whether of the corporation or another person, to profits tax in Hong Kong. Such provision is not necessary as the existing general anti-avoidance provision under Section 61A should be able to counteract such tax avoidance scheme. Thus, we suggest deleting this section to simplify the legislation.

3. Specific comments on the proposed tax provisions on RCS

Scope of RCS as defined under Section 17A

Section 17A contains interpretations/definitions that are used for the purpose of tax treatments of interest on RCS. The definition of RCS includes instruments that are classified as Additional Tier 1 Capital and Tier 2 Capital under Basel III requirement. However in the definition of "Security" in section 17A(2)(b) and (c) and section 17A(3), the following instruments are excluded from RCS.

- Debt instruments that are convertible to Common Equity Tier 1
- Debt instruments under which the bank has the discretion to make a distribution or redemption payment depending on the business results of the bank, except under the situation where the business results of the bank are worsen.

To align with the definition of regulatory capital instruments in compliance with Basel III global standards, we suggest that the restrictions under sections 17A(2)(b) and (c) and section 17A(3) be removed to make sure that the eligible Basel III compliance instruments containing key "convertibility" features (in the event of non-viability of the bank) would not be disqualified as RCS for tax purposes.

Rules on deductibility of interest on RCS under Section 17F

Section 17F as currently drafted may result in different treatments between interest on RCS directly issued to non-connected persons and those issued indirectly to non-connected person. Under the proposed section 17F, interest on RCS that is directly issued (i.e. not issued through any interposed entities) by a financial institution is deductible to the extent it is issued to non-connected persons (e.g. the public) whereas interest on the RCS that is indirectly issued (i.e. issued through an interposed entity such as the group holding company) can only be deducted if the interposed entity issues the instruments "entirely" to non-connected persons. In the latter case, there would be "zero" deduction on the RCS interest even if the interposed entity raised most funding from non-connected persons.

We request that section 17F is amended to remove this anomaly and to provide pro-rata deduction of interests on RCS indirectly issued to non-connected persons via an interposed entity.

Treatments of Hong Kong branches of foreign banks under Section 17G

The proposed section 17G contains complex rules which are inconsistent with the Hong Kong simple tax system. In addition, section 17G has far reaching implications which are much more than limiting the amount of interest on RCS that may be allocated by a foreign bank to its Hong Kong branch. While we understand the proposed section 17G is intended to safeguard any possible abuse of the RCS proposed by Hong Kong branches of foreign banks by applying a "separate entity principle" to these branches, the current draft of the proposed section 17G would result in consequences much wider than any possible inappropriate allocation of interest on RCS by foreign banks to their Hong Kong branches. The proposed 17G, as its current form, can be interpreted as it can be applied to determine the chargeable profits of a Hong Kong branch *regardless of whether there is any* interest on RCS being actually allocated by the foreign bank to Hong Kong. In fact, the existing sections 16(a) and 61A should have already provided sufficient power to the IRD to avoid potential abuse of the RCS regime.

In addition, the proposed section 17G will only be applicable to Hong Kong branches of foreign banks with issued RCS while the profits of other banks, for example Hong Kong incorporated banks (irrespective whether RCS has been issued) or Hong Kong branches of foreign banks with no RCS issued, are still subject the general charging section (section 14). As such this will introduce unequal, and probably unfair, tax treatments among for different entities in the banking sector.

We believe it is necessary to safeguard against possible abuse of the Hong Kong tax system, equally we believe the tax legislation should be non-discriminatory. For these reasons, we propose to remove the current section 17G from the Bill and deter the legislation of the new complex taxation principles after thorough consultation with the industry and tax practitioners.

Application of section 17H to banks without RCS and entities other than banks

The current form of section 17H is a safeguard to ensure the existing taxing principles contained within the Inland Revenue Ordinance or established by tax cases can be applied, in addition to sections 17E (to banks with RCS issued) and 17G (to the Hong Kong branches of foreign banks with RCS issued).

However section 17H, in its current form, can be interpreted as it is applicable to all taxpayers, regardless whether they are banks or not and if they are banks regardless whether they have RCS or not. This will result in unnecessary tax disputes. Hence in addition to the removal of section 17G as suggested above, we suggest amendments to the current section 17H to clarify the scope of its application.

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If you would like to discuss any of the specific comments in this response please do not hesitate to contact us.

Yours sincerely
For and on behalf of PricewaterhouseCoopers Ltd.

Reynold Hung
Partner-in-charge
Tax Services
Hong Kong