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25 February 2016

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Dear Miss Wong,

Inland Revenue (Amendment) (No. 4) Bill 2015

Thank you for your letter of 25 January 2016. The Government's responses to your questions are set out in the ensuing paragraphs.

Long title

2. Part 3 of the Bill provides for the consequential amendments to the Inland Revenue Rules (Cap. 112, sub. leg. A) (Division 1) and related amendments to the Stamp Duty Ordinance (Cap. 117) (Division 2), in connection with the proposed tax treatment of regulatory capital securities. As the amendments contained in Division 2 of Part 3 of the Bill are covered in the long title by the expression "to amend the Stamp Duty Ordinance to give stamp duty relief in relation to regulatory capital securities", we do not consider it necessary to add "related and" before "consequential amendments" in the long title.

Clause 3: Proposed section 14C (qualifying corporate treasury centre: interpretation)

3. Under the proposed section 14C(1), ***corporate treasury activity*** is defined to mean (a) carrying on an intra-group financing business; (b)

providing a corporate treasury service; or (c) entering into a corporate treasury transaction. Since the concept of the expression "in relation to a corporation" is already encompassed through the terms "intra-group financing business", "corporate treasury service" and "corporate treasury transaction", we do not consider it necessary to add the aforesaid expression in the definition.

4. As regards the proposed section 14C(2) which supplements the definition of ***associated corporation*** in section 14C(1), given that the concept of "control over a corporation" elaborated in section 14C(2) is relevant to all of the three paragraphs of the definition of ***associated corporation***, the existing reference to "subsection (1)" in section 14C(2) should not be revised as suggested to narrow its application to paragraph (b) of the definition only.

Clause 3: Proposed section 14D (qualifying corporate treasury centre: profits tax concession)

5. The proposed section 14D(1) provides that the assessable profits of a corporation that is a qualifying corporate treasury centre ("CTC") for a year of assessment are, subject to subsections (5) and (8), chargeable to tax at one-half of the rate specified in Schedule 8 to the extent to which those profits are qualifying profits. The proposed section 14D(5)(b) provides that subsection (1) applies to a corporation for a year of assessment only if the corporation has elected in writing that subsection (1) applies to it. The proposed section 14D(6) provides that the election, once made, is irrevocable for so long as the corporation remains as a qualifying CTC.

6. In this connection, the word "irrevocable" in subsection (6) means that the election, once made by a corporation, cannot be revoked by the corporation. That is to say, the election under subsection (5)(b) is effective across all relevant years of assessment after the election, and is effective so long as the corporation remains as a qualifying CTC. It is not necessary for the corporation to make an election to the Commissioner of Inland Revenue ("the Commissioner") every year. The Government's intent is to avoid the half-rate regime being abused by a corporation, which chooses to opt in or out of the regime in different years of assessment, depending on whether it makes a profit or incurs a loss. Without subsection (6), a qualifying CTC may elect for the half-rate regime when it makes chargeable profits in a year of assessment (so that the profits would be taxed at half rate), but may seek to opt out from the half-rate regime when it incurs tax losses in another year of

assessment (so that the full amount of tax losses can be carried forward and set off against profits in subsequent years).

7. The status as a qualifying CTC is considered separately from an election under subsection (5)(b). As provided in subsection (2), a corporation is a qualifying CTC for a year of assessment ***if***, for that year of assessment, (a) it satisfies the conditions specified in subsection (3); (b) it satisfies the safe harbour rule under section 14E; or (c) it has obtained the Commissioner's determination under section 14F(1). Therefore, regardless of whether an election under subsection (5)(b) is still effective, if a corporation no longer meets the requirement set out in subsection (2) for a year of assessment, the corporation is not a qualifying CTC, and thus is not entitled to the half-rate for its chargeable profits, for that year of assessment. The Inland Revenue Department ("IRD") will consider whether the aforesaid requirement in subsection (2) is fulfilled through examining the annual return filed by a corporation. Part 9 of the Inland Revenue Ordinance (Cap. 112) ("IRO") contains existing provisions regarding the powers necessary for IRD to, among others, require taxpayers to furnish tax returns, and seek information and examine business records, for the purposes of an assessment.

Clause 3: Proposed section 14F (qualifying corporate treasury centre: Commissioner's determination)

8. The proposed section 14F(3) provides that the Commissioner may determine that the corporation is a qualifying CTC for a year of assessment if the Commissioner is of the opinion that the conditions specified in section 14D(3), or the safe harbour rule under section 14E, would, in the ordinary course of business of the corporation, have been satisfied for the year of assessment.

9. This is intended to enable the Commissioner to, in case a corporation fulfils neither section 14D(3) nor 14E, exercise a discretionary power to allow the corporation's qualifying profits to be subject to the half-rate, provided that the Commissioner is satisfied that the corporation would (but for, say, extraordinary circumstances) have fulfilled in the ordinary course of its business either section 14D(3) or 14E. In making this determination under section 14F, the Commissioner may take into account the activities carried out by the corporation (such as its operational history, assets and liabilities, functions and risks undertaken, and the capacity, role and responsibility of the corporation within the group, etc.) and all other relevant information. As we envisage that this may involve an assessment of the factual circumstances

of a particular case, we do not consider it necessary to make express provisions on such circumstances in the Bill. After the passage of the Bill, IRD is prepared to explain the operation of this section through issuing Departmental Interpretation and Practice Notes ("DIPN").

Clause 7: Proposed amendments to section 15 (certain amounts deemed to be trading receipts)

10. To maintain a symmetric tax treatment for interest income received by a corporation, the proposed section 15(1)(ia) and (la) seeks to stipulate clearly that the "operation test" applies to the determination of the source of interest income, as well as relevant gains or profits, arising through or from the carrying on in Hong Kong by a corporation (other than a financial institution) of its intra-group financing business. As defined in the proposed section 16(3), ***intra-group financing business***, in relation to a corporation, means the business of the borrowing of money from and lending of money to its associated corporations. The Government's intent is that the proposed section 15(1)(ia) and (la) would apply to a corporation carrying on an intra-group financing business in Hong Kong with a view to profit, in line with the current provision (i.e. section 15(1)(i) and (l)) deeming interest income received by or accrued to financial institutions as trading receipts.

11. It was held by the Privy Council in *Commissioner of Inland Revenue v Orion Caribbean Limited* ("OCL") [1997] HKLRD 924 that, while the ascertaining of the actual source of profits was a "practical hard matter of fact" according to the whole range of authority, the so-called "provision of credit" test (per Lord Bridge in *CIR v Hang Seng Bank Ltd* [1991] 1 HKLR 323) "did not extend to ***situations*** such as OCL's operations ***which involved not only loans but also the borrowing of money for on-lending***" (emphasis added). If the business in question is "borrowing and on-lending money with a view to profit" (essentially an "intra-group financing business" as defined in the proposed section 16(3)), the proper test to ascertain the source of income is "***what [one] did to earn the profits in question, and where [one] did it***" (per Lord Nolan at page 931) (i.e. the "operation test"), as distinguished from the "provision of credit" test applying to the simple type of loan transactions contemplated in the *Hang Seng* case.

12. Since the *Orion Caribbean* case, DIPN No. 13 (Profits Tax – Taxation of Interest Received) has been revised to stipulate the "operation test" for general application in the determination of the source of income (including interest income and relevant profits) derived from a money

borrowing and lending business carried on in Hong Kong. The "provision of credit" test (i.e. profits arising in or derived from the place where the money was lent) continues to apply in respect of a lending transaction not constituting the carrying on of an intra-group financing business, i.e. simple loans of money. In this connection, section 15(1)(ia) and (la) merely seeks to reflect the decision in *Orion Caribbean* and the existing guidance in DIPN No. 13 concerning the source of profits arising through or from the carrying on in Hong Kong by a corporation of its intra-group financing business. The proposed provision seeks to apply to any corporation (other than a financial institution) carrying on in Hong Kong an intra-group financing business, including but not limited to a qualifying CTC within the meaning of the proposed section 14D(2) which carries on in Hong Kong an intra-group financing business. The proposed provision will not affect the operation of the "provision of credit" test in respect of simple loans of money.

Clause 8: Proposed amendments to section 16 (ascertainment of chargeable profits)

13. The proposed section 16(2)(g) seeks to allow a corporate borrower carrying on in Hong Kong an intra-group financing business deduction of interest payable on money borrowed from a non-Hong Kong associated corporation under specified conditions. It is the Government's intent that this provision applies to any corporation, including but not limited to qualifying CTCs, provided that the conditions set out in the section are satisfied.

14. The proposed section 16(2CC) provides that, in respect of a deduction claimed under subsection (1)(a) by virtue of subsection (2)(g), no deduction is to be allowed in respect of the interest 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, postpone or reduce any liability to profits tax under the IRO. The "main purpose test" is increasingly found in overseas tax legislation and avoidance of double taxation agreements (including those signed by Hong Kong and our tax treaty partners and incorporated in the subsidiary legislation of the IRO – see, for example, Articles 10(6), 11(8) and 12(7) in the Schedule to the Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (Republic of South Africa) Order (Cap. 112, sub. leg. CM)). To align with the latest international practices, the Government intends to adopt the "main purpose test" for section 16(2CC), though the "main purpose test" (considered in some cases in the United Kingdom, say, *Snell v HMRC*

[2006] All ER (D) 336) may be regarded as more stringent (from some taxpayers' perspectives) than the "sole or dominant purpose test" under the existing section 61A (considered in, say, *Yick Fung Estates Limited v CIR* [2000] 1 HKLRD).

Clause 14: Proposed section 17H (arm's length and separate enterprise principles not prevented from application in other circumstances)

15. As we mentioned in LC Paper No. CB(4)534/15-16(01), the proposed section 17H should not be read, on proper interpretation, as importing the arm's length and separate enterprise principles to other areas outside the context of regulatory capital securities. Having regard to the views of the Bills Committee and some deputations, the Government would consider proposing committee stage amendments to remove the proposed section 17H, and all references to the section, from the Bill. After the passage of the Bill, the IRD will explain in DIPN that sections 17E and 17G are additional to, and do not derogate from, any other laws on the arm's length and separate enterprise principles (such as relevant case law and Articles 7 and 9 of avoidance of double taxation agreements between Hong Kong and various tax jurisdictions implemented by orders made under section 49 of the IRO).

Yours sincerely,

(Jackie Liu)
for Secretary for Financial Services and the Treasury

c.c.
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