From: **Maurice Lee** <[redacted]>
Date: Wed, May 23, 2018 at 4:34 PM
Subject: Comments on CSAs on Inland Revenue (Amendment)(No.6) Bill 2017 from the Real Estate Industry
To: info@kennethleung.hk

Dear Kenneth,

We are from members of The Real Estate Developers Association of Hong Kong ("REDA") and refer to the Committee Stage Amendments ("CSAs") to the Inland Revenue (Amendment)(No. 6) Bill 2017 ("the Bill"). We notice some problems with the CSAs and hope to raise some comments to the Bills Committee. However, due to the tight schedule of Bills Committee Meeting, we are not able to go through the approval procedures of REDA in time. As a result, we would like to let you have our comments on the CSAs by this personal email. We hope that you are open to listen to our concerns. As the matters involved are very technical and complicated, we are prepared to meet you for a face-to-face discussion if it is necessary.

In REDA's submission, we pointed out that the arm's length principle should not be applied to domestic transactions. We were happy to know that the Government understood our concern and agreed to move CSA to address it. However, when the CSAs came out on 11th May 2018, we found them difficult to understand and some of the problematic situations referred to in REDA's submission still exist.

Enclosed please find a paper which contains our comments on the CSAs in detail.

In a more global sense, we hope to point out that the Government originally agreed to exempt the application of the arm's length principle to domestic transactions only if the actual provision confers no potential advantage in relation to Hong Kong tax ("No Tax Advantage Condition"). This is understandable and we have no objection against it. However, in defining the No Tax Advantage Condition, the CSAs bring in a new concept known as "No Actual Tax Difference Condition". We are uncertain of the meaning of the "No Actual Tax Difference Condition" because the definition in section 50AAJ(5) is ambiguous.

It seems that Actual Tax Difference is a much wider concept than Tax Advantage because it should cover both tax advantage and tax disadvantage. Accordingly, the "No Actual Tax Difference Condition" in the CSAs narrows the exemption of arm's length principle to domestic transactions because we are worried that the arm's length principle will be applied in situations where taxpayers receive tax disadvantage. More examples will be given in the enclosed paper to explain this.

Please let us know if a meeting is necessary to discuss the above.

Best regards,

Maurice Lee
Cecilia So
Ernest Tam

Comments on Committee Stage Amendment ("CSA") to the Inland Revenue (Amendment)(No.6) Bill 2017 ("Bill")

No Actual Tax Difference Condition (Section 50AAJ(5))

According to section 50AAJ(5), *the "no actual tax difference condition" is met if*

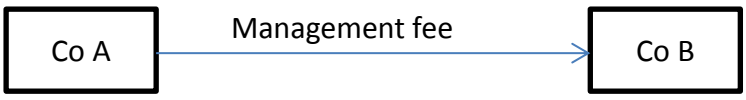
(a) each affected person's income arising from the relevant activities is chargeable to Hong Kong tax or each affected person's loss so arising is allowable for the purposes of Hong Kong tax; and

(b) no concession or exemption for Hong Kong tax applies to any affected person's income or loss arising from the relevant activities.

The definition of "no actual tax difference condition" in section 50AAJ(5)(a) is ambiguous. We hope to clarify the followings:

1. Is "loss allowable" equal to "expense deductible"? Is it necessary for the taxpayer to have tax loss brought forward to meet the condition of having loss allowable?

   Example:

   Management fee is deductible in Co A but does not cause Co A to result in a tax loss position

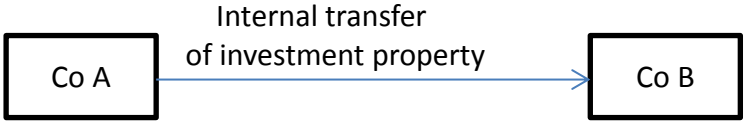
   Management fee is taxable in Co B

   Question :

   Is the "no actual tax difference condition" met?

2. If an income is non-taxable capital gain, is the income chargeable to tax for the purpose of section 50AAJ(5)(a)? If an expense is non-deductible (e.g. capital expenditures), is the loss allowable for the purpose of section 50AAJ(5)(a)?

   Example :

   Capital gain of Co A is non-taxable

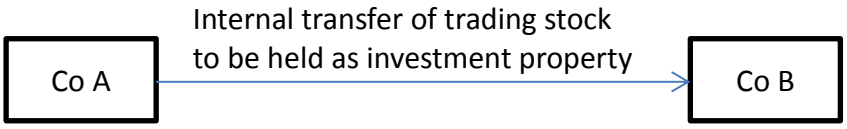
   Acquisition cost in Co B is non-deductible capital expenditure

Question :

This should be a tax neutral situation but is the "no actual tax difference condition" met? If the "no actual tax difference condition" is not met, who will be the advantaged person whose profits are to be adjusted for tax purposes, bearing in mind that the capital gain, even if adjusted upwards, is non-taxable?

3. If an affected person's income arising from the relevant activities is chargeable to Hong Kong tax and the other affected person's loss so arising is not allowable, the taxpayers' group as a whole is suffering from tax disadvantage.

Example :



Trading gain of Co A is taxable

Acquisition cost in Co B is non-deductible capital expenditure

Question :

This should be a tax disadvantageous situation to taxpayers' group but is the "no actual tax difference condition" met? If the "no actual tax difference condition" is not met and the transfer price is considered to be below the arm's length price, will the taxable income of Co A be adjusted upwards, bearing in mind that there will not be any corresponding increase of deduction in Co B?

Why should the arm's length principle be applied on taxpayer with no tax advantage but tax disadvantage instead? Is this intended?

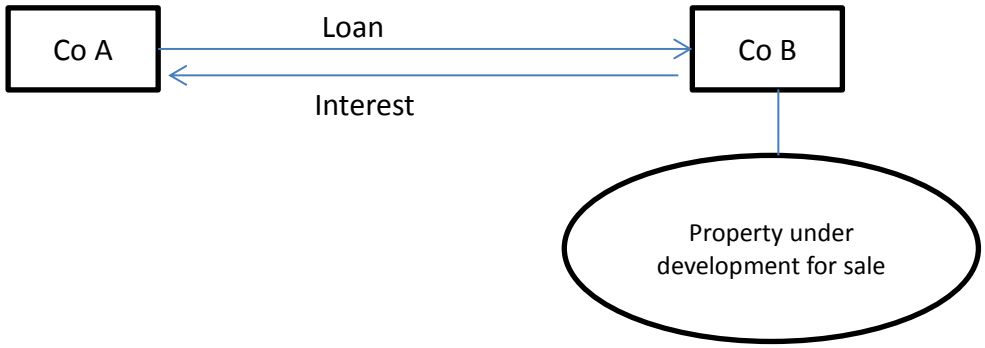
4. Same as the situation in (2) above. Co A claims for capital gain but the IRD considers it as trading gain.

Question:

Will the Inland Revenue Department ("IRD"), in addition to assessing the gain, apply the arm's length principle to increase the trading gain for tax purposes?

5. For some domestic transactions, the timing of "income chargeable to Hong Kong tax" and "loss allowable for purpose of Hong Kong tax" may not match.

Example :



Question :

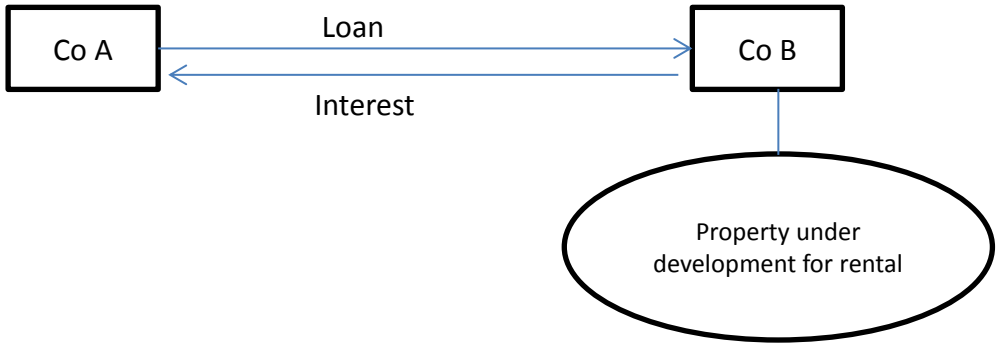
The interest income is immediately chargeable to tax in Co A but the interest expense is only deductible in Co B upon completion of the development and sale of completed property units. The interest income will be subject to tax in Co A in a year of assessment earlier than Co B's enjoyment of the interest deduction. Is the "no actual tax difference condition" met?

If the "no actual tax difference condition" is not met and the interest rate is considered to be below the arm's length interest rate, will the IRD adjust the taxable income of Co A upwards, bearing in mind that the corresponding increase of interest deduction in Co B will be delayed?

Why should the arm's length principle be applied on taxpayer with no tax advantage but tax disadvantage (timing disadvantage) instead? Is this intended?

6. Is capital expenditure qualified for depreciation allowance "loss allowable for purpose of Hong Kong tax"?

Example :



Question :

The interest income is chargeable to tax in Co A but the interest expense attributable to construction cost is not deductible and is only qualified for depreciation allowance upon completion of the development. Is the "no actual tax difference condition" met?

If the "no actual tax difference condition" is not met and the interest rate is considered to be below the arm's length interest rate, will the taxable income of Co A be adjusted upwards, bearing in mind that the corresponding increase of interest deduction in Co B by way of depreciation allowance will be delayed?

The interest expense attributable to land cost is not deductible and is NOT qualified for depreciation allowance. Is the "no actual tax difference condition" met?

If the "no actual tax difference condition" is not met and the interest rate is considered to be below the arm's length interest rate, will the taxable income of Co A be adjusted upwards, bearing in mind that there will not be any corresponding increase of interest deduction in Co B?

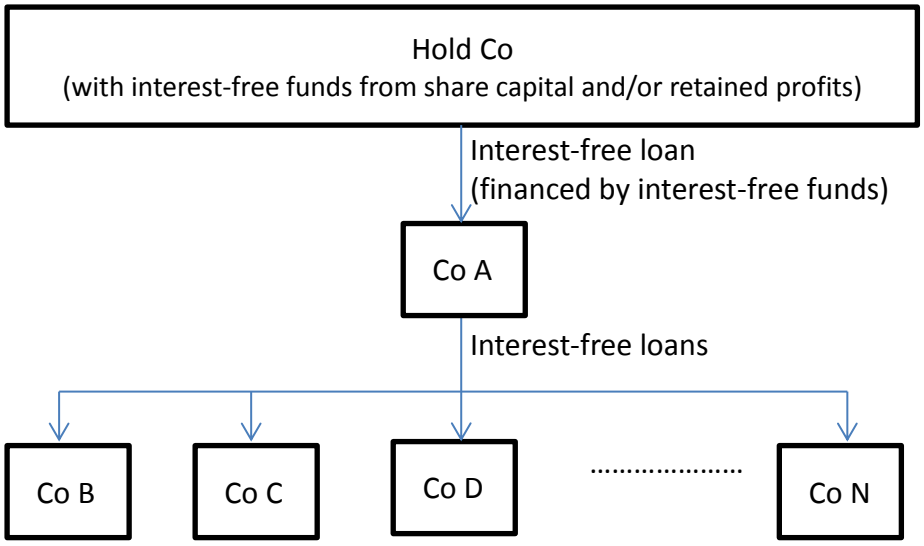
Why should the arm's length principle be applied on taxpayer with no tax advantage but tax disadvantage instead? Is this intended?

Non-business Loan Condition (Section 50AAJ(6)

According to section 50AAJ(6), *the "non-business loan condition" is met if the actual provision relates to lending money otherwise than in the ordinary course of a business of lending money or an intra-group financing business (as defined by section 16(3)).*

We believe this is intended to address our concern on interest-free loans in the REDA submission. However, it does not solve the problem.

Example A: Interest-free loans financed by interest-free funds of a group



(a) Most groups (whether real estate group or not) should have some interest-free funds of their own (e.g. funds from share capital and retained profits).

(b) These funds are centralized in Co A which then on-lends them to other group companies (Co B to Co N). These inter-company loans are interest-free to reflect the fact that there is no interest cost to the group for these funds.

(c) If the group has a large number of subsidiaries, Co A is likely to fall within the definition of "intra-group financing business" and the exemption from arm's length principle does not apply.

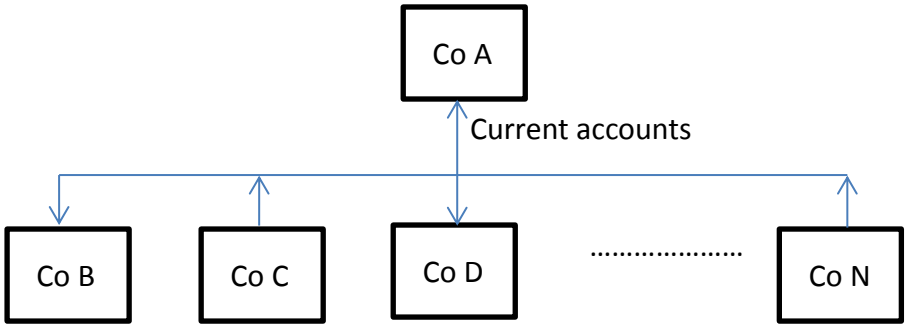
(d) It should be noted that even if the inter-company loans are set interest-free in the above-mentioned situation, there is no tax advantage to the taxpayers' group as a whole.

Question:

Will Co A be deemed to receive arm's length interest for tax purposes? If the answer is affirmative, why should the arm's length principle be applied on such a situation where the taxpayers' group has no tax advantage?

If the “non-business loan condition” is not met, should the “no actual tax difference condition” be considered? If the answer is affirmative, does Co A need to apply the “no actual tax difference condition” test to each of the loans to Co B to Co N to identify which of them must be charged interest on arm’s length basis? This creates extra work load on the group which receive no tax advantage even if all the loans are interest-free.

Example B: Interest-free current account within a group



(a) Co A is a management service company within a group which receives and makes payments on behalf of other group companies (Co B to Co N). This practice is common to control the number of bank accounts within a group.

(b) The current accounts are not genuine loans but represent working capital of the group companies. No interest is charged on such current accounts.

(c) Co A should fall into the definition of “intra-group financing business” or even “business of lending money”.

Question:

Will Co A be deemed to receive and pay arm’s length interest for tax purposes? If the answer is affirmative, why should the arm’s length principle be applied on such a situation where the arrangement has genuine commercial purpose?

If the “non-business loan condition” is not met, should the “no actual tax difference condition” be considered? If the answer is affirmative, does Co A need to apply the “no actual tax difference condition” test to each of the current accounts with Co B to Co N to identify which of them must be charged interest on arm’s length basis? This creates extra work load on the group which receive no tax advantage even if all the loans are interest-free.

No tax avoidance purpose condition (Section 50AAJ(7))

According to section 50AAJ(7), *an actual provision has a tax avoidance purpose if the Commissioner is satisfied that the main purpose, or one of the main purposes, of the provision is to utilize a loss sustained by an affected person to avoid, postpone or reduce any liability, whether of the other affected person or any other person, to Hong Kong tax.*

We believe this is a tax avoidance provision to avoid situations where income of more than arm's length amount is received by the affected person(s) who have tax losses brought forward for setting-off. We have no objection to adding this anti-avoidance provision but the "main purpose, or one of the main purposes" test adopted is much wider than the "sole or dominant purpose" test adopted by the general anti-avoidance provision (section 61A).

Question:

1. Why is a test more stringent than that adopted by the general anti-avoidance provision required in this situation?

2. Under the Hong Kong tax law, tax losses can be carried forward to set-off against the future profits of the same taxpayer. The injection of profits to a tax loss company with no commercial reasons may be subject to the general anti-avoidance provision (section 61A) which adopts the "sole or dominant purpose test". If a company passes the "sole or dominant purpose test" in section 61A but fails the "main purpose or one of the main purposes test" in section 50AAJ(7), what will be the tax position? Is it that the utilization of tax losses by injected profits up to the arm's length amount should be allowed (no tax avoidance under section 61A) but only the profits in excess of the arm's length amount should be adjusted in and taxed under section 50AAF? This creates a strange situation where two different anti-avoidance tests are applied on one transaction.

3. If there is no valid reason for a more stringent test here, should the "sole or dominant purpose test" be restored to avoid complications?

Recommendations:

1. Our original concern is that extra burden will be put on taxpayers if the arm's length principle applies to domestic transactions. Efforts will be spent on setting the arm's length price and preparation of local files while the revenue to be collected remains unchanged.

2. We are glad to learn that the Government understands our concern and agrees to move CSAs to reduce taxpayers' burden.

3. Unfortunately, the CSAs do not completely remove the application of arm's length principle on domestic transactions but introduce very complicated and not clearly explained "no actual tax difference condition" and "non-business loan condition" to exempt only part of the domestic transactions. As a result, taxpayers need to spend extra efforts to

   (a) understand these "conditions" under section 50AAJ (which is not an easy job); and

   (b) apply these tests to separate their domestic transactions into two categories, only one of which can be exempt from the arm's length principle.

   Effectively, taxpayers are required to do more rather than less as a result of these CSAs!

4. We have no objection on exempting only domestic transactions with no tax advantage. The only problem is that the Bill (before CSAs) refers to tax advantage at the company level which means that a tax advantage will be found in any domestic transaction.

5. In view of (4) above, we should find a solution based on the crux of the problem. We recommend that there is no need to have the "no actual tax difference condition" and the "non-business loan condition". Instead, CSAs should be moved to ensure that "potential advantage in relation to Hong Kong tax" in section 50AAF(1)(d) refers to all the affected persons together as a whole.

6. Further, "potential advantage in relation to Hong Kong tax" should be defined as "income arising from the relevant activities is not chargeable to Hong Kong tax AND the corresponding expense arising from such activities is deductible for the purpose of Hong Kong tax". Other than this situation, no potential advantage in relation to Hong Kong tax is conferred for the purpose of section 50AAF(1)(d).

7. In any event, if the IRD considers any domestic transaction of a taxpayer is priced with a tax motive, the general anti-avoidance provision (section 61A) is always ready for its use. This is much better than complicating the tax law of Hong Kong by the "no actual tax difference condition" and "non-business loan condition" which are difficult to understand.