For discussion
on 3 July 2018

Legislative Council Panel on Financial Affairs

Proposed Amendments to the Inland Revenue Ordinance

Purpose

This paper briefs Members on our plan to amend the Inland Revenue Ordinance (Cap. 112) ("IRO") so as to –

(a) allow the computation of assessable profits arising from financial instruments on a fair value basis;

(b) expand the definition of "overseas financial institutions" to cover "export credit agency" for interest deduction in relation to the borrowers; and

(c) align the relevant provisions of the IRO with the common reporting standard ("CRS") for automatic exchange of financial account information in tax matters ("AEOI").

Justifications

Adoption of Fair Value Accounting for Financial Instruments for Tax Reporting

2. Since 2004, enterprises in Hong Kong have been required under the applicable accounting standards to account for financial instruments on a fair value basis (i.e. both realised and unrealised profits of the financial instruments have to be accounted for in the financial statements). Subject to other provisions in the IRO, the Inland Revenue Department ("IRD") has been using the profits computed in accordance with the applicable accounting standards as the basis to compute the profits chargeable to profits tax under the IRO.

3. In *Nice Cheer Investment Limited v CIR* (2013) 16 HKCFAR 813 ("Nice Cheer case"), however, the Court of Final Appeal ("CFA") ruled that unrealised profits are not chargeable to profits tax under the existing provisions of the IRO. The contentious issue in the Nice Cheer case is the taxability of the gains resulting from revaluation of trading securities held at the end of the accounting period as required by fair value accounting. As the prevailing IRO does not expressly allow the use of fair value accounting in tax computation in respect of financial instruments, CFA held that the unrealised revaluation gains in respect of listed securities held by enterprises for trading purposes were not chargeable to tax in Hong Kong. In accordance with this judgment, profits computed on a fair value basis would have to be recomputed on a realisation basis for tax reporting.

4. After the CFA judgment, financial institutions and securities dealers, which mark their financial instruments to market and account for financial instruments on a fair value basis, have requested the IRD to continue accepting financial statements prepared on a fair value basis for tax reporting. Otherwise, substantial costs would have to be incurred to re-compute their profits on a realisation basis. In view of the industry's request and the practical difficulties faced by the taxpayers, the IRD has been accepting tax returns by enterprises with assessable profits computed on a fair value basis as an interim administrative measure.

5. Accounting financial instruments on a realisation basis is not an established commercial practice, and also departs from the Hong Kong Financial Reporting Standard 9 ("HKFRS 9") which has been implemented since 1 January 2018. Under HKFRS 9, financial instruments should be accounted for on a fair value basis. While the IRD has been accepting fair value accounting as an interim administrative measure for tax reporting, legal backing should be provided. The Hong Kong Association of Banks has also urged the Government to codify the interim administrative measure into the IRO for the sake of clarity and certainty.

6. We hence propose amending the IRO to allow the recognition of financial instruments on a fair value basis for tax reporting. An election for fair value accounting for tax reporting, once made, should be irrevocable and shall have effect for the year in which the election is

made and all subsequent years of assessment. The Government is now consulting relevant stakeholders on the details of the legislative proposal.

Overseas Financial Institution – Definition Expanded to Cover Export Credit Agency

7. Pursuant to section 16(1)(a) of the IRO, interest expense incurred in the production of chargeable profits is deductible from the assessable profits of the person, provided that at least one of the prescribed conditions under section 16(2) of the IRO is satisfied. Interest expenses payable by a person on money borrowed from an "overseas financial institution" as defined under section 16(3) of the IRO[1] is one of the prescribed conditions under section 16(2) of the IRO.

8. Currently, an overseas export credit corporation run as a public institution is not recognised as an "overseas financial institution" since it is not carrying on the business of banking or deposit-taking outside Hong Kong, and is not regulated by an overseas authority as a banking or deposit-taking institution. It follows that Hong Kong borrowers cannot claim tax deduction in respect of interest payments made on loans from an overseas export credit corporation.

9. We therefore propose amending the IRO so that an export credit agency, which is owned or established and operated by a foreign state or government (or any sub-division or local authority of a foreign state or government) for the purposes of supporting and developing international trade by providing financing support to its local exporters or investors for international export or overseas investment activities, can be accepted as "an overseas financial institution" for the purpose of deduction of interest under the IRO. This would help foster trading activities between Hong Kong and the respective overseas jurisdiction.

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[1] Under section 16(3) of the IRO, overseas financial institution is defined as "*a person carrying on the business of banking or deposit-taking outside Hong Kong other than a person whom the Commissioner has, in accordance with the powers vested in him by subsection (4), determined shall not be recognised for the purposes of this section as an overseas financial institution*". Section 16(4) of the IRO further stipulates that "*[t]he Commissioner may for the purposes of this section determine that a person shall not be recognised as an overseas financial institution if he is of the opinion that that person's banking or deposit-taking business is not adequately supervised by a supervisory authority.*"

Refinements to the AEOI Legislative Framework

10. The Organisation for Economic Co-operation and Development ("OECD") has earlier examined the AEOI legislative framework of Hong Kong which has been in place since July 2016 and made a number of recommendations with a view to better aligning the provisions with the requirements of the CRS. While most of the necessary refinements have been incorporated in the Inland Revenue (Amendment) Ordinance 2018[2] approved by the Legislative Council on 24 January 2018, some further legislative amendments are required for Hong Kong to comply with the CRS promulgated by the OECD. These technical amendments include the following –

(a) amend the definition of "entity" to include "legal persons";

(b) where the entity is a trust, clarify that the term "controlling person" covers trustees and beneficiaries as far as identification of controlling person is concerned;

(c) provide that the term "investment entity" is to be interpreted in a manner consistent with the recommendations of the Financial Action Task Force; and

(d) incorporate the residency rules in relation to financial institutions (other than trusts) that do not have a residence for tax purposes.

11. Given the territorial extension to Hong Kong of the Convention on Mutual Administrative Assistance in Tax Matters ("Convention") by the Central People's Government, we have taken the opportunity to revise the list of reportable jurisdictions under Schedule 17E to the IRO[3] by including all Hong Kong's prospective AEOI partners so that reporting financial institutions can collect relevant data for future exchange with these prospective AEOI partners under the AEOI regime. This would involve adding around 50 new jurisdictions, which are signatories to the Convention and/or AEOI committed jurisdictions, to the list of reportable jurisdictions. A list of these new jurisdictions as at 1 June 2018 is at

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[2] The Inland Revenue (Amendment) Ordinance 2018 was gazetted on 2 February 2018. It contains technical amendments to certain provisions on AEOI so as to align them with the Common Reporting Standard promulgated by the OECD.

[3] Currently, reporting financial institutions in Hong Kong are required to collect information in respect of 75 listed reportable jurisdictions.

Annex.

12. While the refinements in paragraph 10 above serve to align with the CRS without making substantial changes to the systems and operations of reporting financial institutions, sufficient and reasonable lead time will be provided. We would also be liaising with stakeholders on the implementation schedule for the proposed expanded list of reportable jurisdictions.

Implementation Timetable

13. Our plan is to introduce an amendment bill into the Legislative Council in the last quarter of 2018.

Advice Sought

14. Members are invited to note and provide views on the proposed amendments to the IRO.

The Treasury Branch
Financial Services and the Treasury Bureau
June 2018

Annex

Proposed Jurisdictions to be Included in the List of Reportable Jurisdictions under Schedule 17E of the Inland Revenue Ordinance (as at 1 June 2018)

1	Albania	25	Maldives
2	Andorra	26	Marshall Islands
3	Anguilla	27	Moldova
4	Armenia	28	Monaco
5	Aruba	29	Morocco
6	Azerbaijan	30	Nauru
7	Bahrain	31	Nigeria
8	Barbados	32	Niue
9	Belize	33	Pakistan
10	Bermuda	34	Panama
11	British Virgin Islands	35	Paraguay
12	Burkina Faso	36	Peru
13	Cameroon	37	Philippines
14	Cook Islands	38	Saint Kitts and Nevis
15	Dominican Republic	39	Saint Lucia
16	EL Salvador	40	Samoa
17	Gabon	41	San Marino
18	Georgia	42	Senegal
19	Ghana	43	Sint Maarten
20	Guatemala	44	Trinidad and Tobago
21	Jamaica	45	Tunisia
22	Kazakhstan	46	Turks & Caicos Islands
23	Kenya	47	Uganda
24	Macau	48	Ukraine