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Bills Committee on Inland Revenue (Amendment) (No. 7) Bill 2018

Background brief

Purpose

This paper provides background information on the Inland Revenue (Amendment) (No. 7) Bill 2018 ("the Bill"). It also summarizes the major views and concerns expressed by Members on the proposed legislative amendments.

Background

Aligning tax and accounting treatment of financial instruments

2. According to the Administration, since 1 January 2005, enterprises in Hong Kong have been required to account for financial instruments on a fair value basis (i.e. both realized and unrealized profits of the financial instruments have to be accounted for in the financial statements) in accordance with applicable accounting standards. The Inland Revenue Department ("IRD") uses profits computed in accordance with applicable accounting standards as the basis for computing the profits chargeable to profits tax under the Inland Revenue Ordinance (Cap. 112), unless provided otherwise in Cap. 112.

3. However, in *Nice Cheer Investment Limited v Commissioner of Inland Revenue* (2013) 16 HKCFAR 813 ("Nice Cheer case"), the Court of Final Appeal ("CFA") held that since "profits" connoted actual or realized (not potential or anticipated) profits, revaluation gains (i.e. increases in the value of a company's trading stock of marketable securities which represented unrealized profits) were not assessable to tax under the existing provisions of Cap. 112. As a result of the judgment, profits on financial instruments

computed on a fair value basis (i.e. accounting for both realized and unrealized profits) in accordance with Hong Kong and international financial reporting standards cannot be used for tax reporting, and must be re-computed on a realization basis for that purpose. According to the Administration, this would cause financial institutions and securities dealers hitherto using the fair value basis to incur substantial costs for re-computation of their profits. In view of the industry's request and the practical difficulties faced by taxpayers, IRD has been accepting tax returns from enterprises with assessable profits computed on a fair value basis as an interim administrative measure.

4. According to the Administration, accounting on a realization basis is not an established commercial practice and indeed departs from the Hong Kong Financial Reporting Standard 9 ("HKFRS 9"), and there are suggestions from stakeholders to codify the abovementioned interim administrative measure. As such, the Administration proposes amending Cap. 112 to allow, on the taxpayer's election, the alignment of tax treatment of financial instruments with their accounting treatment for assessing profits.

Interest expenses payable to overseas export credit agencies

5. Under section 16(1)(a) and (2)(d) of Cap. 112, interest expense payable to, among others, an overseas financial institution ("OFI") shall be deducted in ascertaining the profits chargeable to tax. Currently, an overseas export credit agency ("OECA") that is run as a public institution is not recognized as an OFI since it is not carrying on banking or deposit-taking business 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 OECA. In this connection, the Administration proposes amending the definition of OFI in section 16 of Cap. 112 to include OECAs so that interest expenses payable to them would be deductible for profits tax purposes, with an aim to foster trading activities between Hong Kong and overseas jurisdictions.

Refinements to the legislative framework of the automatic exchange of financial account information in tax matters

6. According to the Administration, the Organization for Economic Co-operation and Development ("OECD") has earlier examined the legislative framework of the automatic exchange of financial account information in tax matters ("AEOI") of Hong Kong which was put in place in June 2016, and made a number of recommendations for better aligning the relevant provisions of Cap. 112 with the requirements of the Common Reporting Standard ("CRS") promulgated by OCED in March 2017. While most of the

necessary refinements have been incorporated in the Inland Revenue (Amendment) Ordinance 2018 approved by the Legislative Council ("LegCo") on 24 January 2018,[1] some further legislative amendments are required for Hong Kong to align the AEOI provisions of Cap. 112 with the requirements of CRS.

7. In addition, the Administration proposes to take the opportunity of this legislative amendment exercise to add 51 reportable jurisdictions to Schedule 17E to Cap. 112. Among the 51 proposed jurisdictions, 48 are signatories to the Convention on Mutual Administrative Assistance in Tax Matters ("the Convention") that is extended to Hong Kong by the Central People's Government, and three (namely Dominica, Maldives and Trinidad and Tobago) are non-signatories to the Convention but have committed to implementing AEOI.

Income of visiting teachers and researchers

8. According to the Administration, to foster exchanges in teaching or research between Hong Kong and other places, Hong Kong may include a Teachers and Researchers Article ("TRA") providing for tax exemption for visiting teachers and researchers in the jurisdiction visited for a prescribed period of time in the Comprehensive Avoidance of Double Taxation Agreements (or Arrangements) ("CDTAs") concluded with appropriate partners. So far, a TRA has been included in the CDTA signed with Saudi Arabia and a TRA is planned to be added to the proposed CDTA with the Mainland.

9. As Hong Kong adopts a territorial basis of taxation, salaries tax, under section 8(1A)(b) of Cap. 112, is not chargeable to income derived from employment where the person renders all the services in connection with the employment outside Hong Kong. On the other hand, visiting teachers or researchers could enjoy tax exemption during the prescribed period in the visited jurisdiction. To avoid double non-taxation under TRA, the Administration proposes amending section 8 of Cap. 112 so that a Hong Kong resident person's income derived as a visiting teacher or researcher in the visited jurisdiction to which a TRA applies would be exempted from salaries tax in Hong Kong only if the tax is paid or payable in the visited jurisdiction.

[1] The Inland Revenue (Amendment) Ordinance 2018 ("Amendment Ordinance") was gazetted on 2 February 2018. The technical amendments on AEOI (i.e. clauses 5 to 11) under the Amendment Ordinance will come into operation on 1 January 2019, while other provisions take effect on the day of gazettal of the Amendment Ordinance.

Sibling relationship

10. In the course of scrutinizing the Inland Revenue (Amendment) (No. 4) Bill 2018 ("No. 4 Bill") which sought to introduce a new concessionary deduction for premiums paid in respect of insurance plans certified under the Government's Voluntary Health Insurance Scheme, the Legal Service Division ("LSD") of LegCo noted that the definition of "sibling" under the proposed section 26J of Cap. 112 only covered an adopted brother or sister of the taxpayer or the taxpayer's spouse, i.e. the adopted children of the parents of the taxpayer or the taxpayer's spouse (該人的或其配偶的父母的領養子女), but not the natural children of the adoptive parents of the taxpayer (or the taxpayer's spouse) where the taxpayer (or the spouse) is himself or herself adopted.[2]

11. The Administration advised the Bills Committee scrutinizing the No. 4 Bill that the proposed definition of "sibling" was modelled on the definition of "brother or sister or brother or sister of the spouse" under the existing section 30B(3)(b) of Cap. 112, but agreed to move an amendment to the No. 4 Bill (which was passed by LegCo on 31 October 2018) to rectify the omission. The Administration also considered it prudent to correspondingly amend the definition of "brother or sister" in section 30B(3)(b) of Cap. 112 so as to align with the meaning of "sibling" under the new section 26J added by the No. 4 Bill.

Inland Revenue (Amendment) (No. 7) Bill 2018

12. The Bill was gazetted on 2 November 2018 and received its First Reading at the Council meeting of 14 November 2018. The Bill seeks to:

(a) align the tax treatment of financial instruments with their accounting treatment;

(b) allow the deduction of interest expenses payable to OECAs;

(c) refine the provisions that implement the AEOI arrangement;

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[2] A Bills Committee was formed to scrutinize the Bill, which was passed by LegCo on 31 October 2018. The above observation of LSD regarding the definition of "sibling" is detailed in paragraphs 20 and 21 of the Bills Committee's report tabled at the Council.

(d) avoid potential double non-taxation of income of visiting teachers and researchers; and

(e) revise the meaning of the sibling relationship.

13. Details of the major provisions of the Bill are set out in paragraph 23 of the LegCo Brief (File Ref.: TsyB R 00/800/24/0 (C)) and paragraphs 3 to 18 of the LSD Report on the Bill (LC Paper No. LS14/18-19). If the Bill is passed, the proposed amendments relating to AEOI under the Bill would come into operation on 1 January 2020, while the remaining provisions would come into operation on the date of gazettal of the enacted amendment ordinance.

Major views and concerns expressed by Members

14. The Administration consulted the Panel on Financial Affairs at its meeting on 3 July 2018 on the proposed alignment of tax treatment of financial instruments with their accounting treatment, deduction of interest expenses payable to OECAs and refinements to the AEOI regime. Members did not object to the legislative proposals. Their major views and concerns are summarized in the ensuing paragraphs.

<u>Proposed alignment of tax treatment of financial instruments with their accounting treatment</u>

15. Members enquired whether the amount of assessable profits arising from financial instruments computed on a fair value basis or a realization basis would have significant difference, and whether the Administration had assessed if the legislative proposal on fair value accounting would be subject to judicial review. Members also asked whether a company could elect realization accounting for its tax computation after passage of the Bill. There was a concern that if a listed company was allowed to account for its financial instruments on a realization basis, it might be able to manipulate its financial results.

16. The Administration advised that from the tax perspective, as long as both the amount of revenue and expenditure were computed on the same basis, it would not generate taxation problems. In the long run, the overall assessable profits arising from financial instruments computed on a fair value basis or on a realization basis would be the same. Moreover, with effect from 1 January 2018, it had been compulsory for companies other than small and medium enterprises to adopt HKFRS 9 to account for their financial instruments. In accordance with the CFA's ruling in the Nice Cheer case,

unrealized profits were not chargeable to tax. Therefore, profits computed on a fair value basis in accordance with HKFRS 9 would have to be re-computed on a realization basis for tax reporting. In order to facilitate companies and save their costs for re-computing their profits on a realization basis, the legislative proposal put forward by the Administration allowed companies to elect fair value accounting as a basis for tax computation in respect of their financial instruments.

17. According to the Administration, the above election by companies was optional but once made, it would be irrevocable and would have effect for the year of assessment in respect of which the election was made and all subsequent years of assessment. In the case of a company undergoing corporate restructuring, the Administration advised that as corporate restructuring usually involved transfer of assets, in general, if the transferee company had elected fair value accounting basis for tax computation, the same basis should be applied to the financial instruments being transferred.

18. The Administration further advised that it would be difficult for a listed company to manipulate its financial results because HKFRS 9 should be applicable to all financial instruments held by the company. According to the existing accounting standards, a company had to restate its balance sheets and profit and loss accounts in the previous financial years if there was a change of the adopted accounting standards.

<u>Proposed deduction of interest expenses payable to overseas export credit agencies</u>

19. Members noted that under the legislative proposal to amend the definition of OFI to include OECAs, an OECA would be accepted as an OFI for the purpose of deduction of interest expenses under Cap. 112 if the OECA concerned was 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, so that interest expenses payable by the borrowers from such OECA could be eligible for interest deduction under Cap. 112. Members sought details of the term "overseas investment activities", including whether it covered investment in overseas real estates. Members also enquired about the amount of money borrowed by Hong Kong companies from OECAs in recent years, the estimated amount of tax revenue forgone under the relevant legislative proposal, and whether other jurisdictions would offer similar tax deduction treatment to Hong Kong.

20. The Administration explained that there were foreign companies operating in Hong Kong and chargeable to Hong Kong profits tax. Such foreign companies might borrow money from OECAs. The Administration estimated that the existing amount of loans granted by OECAs was relatively small due to the absence of relevant tax deduction measures in Hong Kong. Nevertheless, a number of subsidiaries of foreign companies were planning to participate in infrastructure projects relating to the Belt and Road Initiative and some of them requested the Administration to provide tax deduction for their interest payments made on loans from OECAs. In fact, many jurisdictions provided tax deduction for similar interest expenses.

Latest development

21. At the House Committee meeting held on 16 November 2018, Members agreed to form a Bills Committee to study the Bill.

Relevant papers

22. A list of relevant papers with their hyperlinks is in **the Appendix**.

Council Business Division 1
Legislative Council Secretariat
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Appendix

List of relevant papers

Date	Event	Paper
22 June 2016	The Legislative Council passed the Inland Revenue (Amendment) Bill 2016	Hansard The Bill passed Report of the Bills Committee [LC Paper No. CB(1)984/15-16)]
16 March 2017	Meeting of the Panel on Financial Affairs	Administration's paper on "Update on Implementation of Automatic Exchange of Financial Account Information in Tax Matters" [LC Paper No. CB(1)660/16-17(09)] Minutes of the meeting [LC Paper No. 1178/16-17]
7 June 2017	The Legislative Council passed the Inland Revenue (Amendment) (No. 3) Bill 2017	Hansard The Bill passed Report of the Bills Committee [LC Paper No. CB(1)1022/16-17]
24 January 2018	The Legislative Council passed the Inland Revenue (Amendment) (No. 5) Bill 2017	Hansard The Bill passed Report of the Bills Committee [LC Paper No. CB(1)497/17-18]

Date	Event	Paper
3 July 2018	Meeting of the Panel on Financial Affairs	Administration's paper on "Proposed Amendments to the Inland Revenue Ordinance" [LC Paper No. CB(1)1166/17-18(02)] Minutes of the meeting [LC Paper No. 1372/17-18]
14 November 2018	The Inland Revenue (Amendment) (No 7) Bill 2018 was introduced into the Legislative Council	The Bill Legislative Council Brief [File Ref.: TsyB R 00/800/24/0 (C)] Legal Service Division Report [LC Paper No. LS14/18-19]