中華人民共和國香港特別行政區
Hong Kong Special Administrative Region of the People's Republic of China

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LEGAL SERVICE DIVISION
LEGISLATIVE COUNCIL SECRETARIAT

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12 November 2018

Ms YONG Pui Wan, Pecvin
Principal Assistant Secretary for
Financial Services and the Treasury (Treasury) (R1)
Financial Services and the Treasury Bureau
The Treasury Branch
24/F, West Wing
Central Government Offices
2 Tim Mei Avenue, Tamar
Hong Kong

Dear Ms YONG,

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

We are scrutinizing the legal and drafting aspects of the captioned Bill and should be grateful if you would please clarify the following matters:

Aligning tax and accounting treatment of financial instruments (clause 3)

(a) In *Nice Cheer Investment Ltd v. Commissioner of Inland Revenue* ("CIR") (2013) 16 HKCFAR 813, 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 the Inland Revenue Ordinance (Cap. 112). According to paragraph 4 of the Legislative Council ("LegCo") Brief (File Ref.: TsyB R 00/800/24/0 (C)) issued on 31 October 2018, the Inland Revenue Department has been accepting tax returns from enterprises with assessable profits computed on a fair

value basis as an interim administrative measure. Please confirm whether this interim measure has resulted in any unrealized profits including revaluation gains being taxed contrary to CFA's judgment. If so, is it necessary for the Bill to include a saving provision to cover any such charging of profits tax on a fair value basis, which would appear to be *ultra vires* the existing provisions of Cap. 112?

(b) Clause 3 of the Bill seeks to add a "note without legislative effect" after section 18F of Cap. 112 ("Note") to explain, *inter alia*, the "fair value" accounting basis, that is, both realized and unrealized profits of financial instruments must be accounted for in the financial statements (see paragraph 1 of the Note). The same explanation is also given in paragraph 2 of the LegCo Brief. However, since neither the Note nor the LegCo Brief has legislative effect, please consider whether it is necessary for the substantive provisions of the Bill to define or explain the concept of "fair value" which appears multiple times in, for example, the proposed sections 18J(4) and (5) and 18L(2) and (3)(a) of Cap. 112.

(c) Paragraph 27 of the LegCo Brief refers. Please elaborate on the suggestions on various technical matters proposed by stakeholders/ organizations in July to August 2018, and how they have been appropriately addressed or incorporated in the Bill.

(d) As regards the election procedures under the proposed section 18H:

(i) CIR would be able to revoke a person's election if satisfied that there are "good commercial reasons" for the revocation. It is noted that the expressions "commercial reasons" and "legitimate and sound commercial reasons" have previously been used in paragraph 7 of Schedule 2 to the Estate Duty Ordinance (Cap. 111) and paragraph (g)(ii)(B) of Schedule 9 to the Banking (Capital) Rules (Cap. 155L). Neither of those expressions appears to be defined. Please provide examples of what "good commercial reasons" CIR would take into account in approving the revocation of an election under the proposed section 18H(5)(a) of Cap. 112. Is it necessary for the Bill to define the term, or to provide non-exhaustive examples of such "good commercial reasons"?

(ii) Under the proposed section 18H(5)(b), one of the conditions for the approval of revocation of the person's election is that the avoidance of tax is not the main purpose, or one of the main purposes, of the revocation. If the revocation of election would *result* in the deduction of chargeable profits of the person concerned, would tax avoidance be regarded as the or a main *purpose* of the revocation under the proposed section 18H(5)(b)?

(iii) The proposed section 18H(7) suggests that upon an election ceasing to have effect as a result of CIR's approval of its revocation, the proposed sections 18I to 18L would not apply to *all subsequent years* of assessment. Please clarify whether a person whose application for revocation of an election is approved by CIR under the proposed section 18H(5) may subsequently make a fresh election under the proposed section 18H(2) if, for example, the "good commercial reasons" for the previous revocation no longer apply.

(e) Under the proposed section 18I(2), the proposed sections 18J, 18K and 18L would not affect the operation of sections 17C and 17D, both of which provide that profits are to be determined as if fair value accounting were not generally accepted accounting practice in relation to the security or part of the security. Please explain the reason for excluding fair value accounting under sections 17C and 17D, and provide examples to illustrate how, if at all, the exclusion would affect the operation of the proposed sections 18G to 18L.

(f) Under the proposed section 18G(2)(b), an expression not defined in the proposed sections 18G to 18L would have the same meaning as the expression has in the specified financial reporting standard if the expression is defined in the standard. It is noted that the proposed section 18J(5) refers to the expression "effective interest rate" which is undefined in the Bill or Cap. 112. Please confirm whether that term is to be understood with reference to Appendix A to the Hong Kong Financial Reporting Standard 9 (Financial Instruments) ("HKFRS 9") which defines the term as "[t]he rate that

exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortized cost of a financial liability". If "effective interest rate" is meant to be a defined term under HKFRS 9, should paragraph 3(b) of the Note also refer to "effective interest rate" (as defined in Appendix A to HKFRS 9) in lieu of "effective rate"?

(g) Under the proposed section 18L(8) and (9), the amount of profit, gain, loss, income or expense chargeable to tax, or allowable as a deduction, for a loan or debt security made or issued otherwise than at arm's length would be computed in accordance with the *contractual* terms of the loan or debt security without, however, affecting the operation of section 50AAF or 50AAK vis-à-vis transactions between associated persons or those between a non-Hong Kong resident person and its permanent establishment in Hong Kong. Please provide examples to illustrate the application of the *arm's length amount* (as defined in section 50AAF or 50AAK) to a loan or debt security to displace the contractual amount which would otherwise apply under the proposed section 18L(9).

Interest expense payable to overseas export credit agencies (clause 4)

(h) In the proposed definition of "governmental entity" under clause 4(2), why does "political subdivision" appear twice in paragraphs (b) and (d)?

(i) The proposed definition of "overseas export credit agency" requires that the agency either is owned by, or was established *and* is operated by, a governmental entity of a jurisdiction outside Hong Kong. Please explain why: (A) an agency established and/or owned by a private entity, but operated by a governmental entity; and (B) an agency established by a governmental entity but owned and/or operated by a private entity, are excluded from the definition.

(j) Is an "overseas export credit agency" intended to cover one owned, established and/or operated by a governmental entity of Mainland China? If so, would the term "overseas" be appropriate for such an agency?

Automatic exchange of financial account information ("AEOI") (clauses 5 to 9)

(k) The proposed definition of "entity" under clause 5(2) seeks to add a "note without legislative effect" to refer to the Common Reporting Standard, CRS publications and FATF Recommendations as defined in the proposed sections 50A(1) and 50L(4) ("Relevant Materials"). Please confirm whether the proposed AEOI amendments under Part 4 of the Bill comply in all material respects with the latest requirements set out in the Relevant Materials, and highlight all material deviations or modifications, if any. Please also identify (by section and paragraph numbers etc.) all relevant provisions in the Relevant Materials on which the proposed amendments are modelled, and provide copies thereof (or hyperlinks thereto).

(l) Paragraph (b)(ii)(C)(I) of the proposed definition of "pre-existing account" under clause 5(3) refers to the requirement in section 2 of Part 7 of Schedule 17D to Cap. 112 which provides that a reporting financial institution may not rely on self-certification or documentary evidence if it knows or has reason to know that the self-certification or documentary evidence is incorrect or unreliable. Please explain the relevance between the correctness or reliability of self-certification or documentary evidence under section 2 of Part 7 of Schedule 17D, and treating an account holder's subsequent and/or old account(s) as a single financial account under paragraph (b)(ii)(B) of the proposed definition.

(m) In view of the proposed definition of "controlling person" in relation to a trust under clause 5(1) which would include the settlor, trustee, protector, *enforcer* and beneficiaries of the trust, please consider whether clause 5(8), insofar as it seeks to amend section 50A(6)(c) as regards individuals who exercise control over a trust, should also include "the enforcer of the entity".

(n) Clause 5(15) seeks to add to Cap. 112 a new section 50A(15)(d), which refers in subparagraph (ii) to a financial institution's "place of management (including effective management)", whereas the existing provisions of section 50A(15) refer to the place where a financial institution "is normally managed or controlled". Please explain any difference in meaning between the two expressions.

(o) The proposed sections 50A(16A) and 50L(5) seek to empower the Secretary for Financial Services and the Treasury ("SFST") to publish notices in the Gazette to amend the definitions of FATF

Recommendations, Common Reporting Standard and CRS publications, and the "specified percentage" in section 50A(7) (currently 25%) for the purpose of defining "controlling person". Please confirm that SFST's notices under these proposed sections would be subsidiary legislation subject to scrutiny by LegCo.

(p) It is noted that guidelines published by CIR under the proposed new section 50L are not subsidiary legislation. Would CIR consult any persons before publishing the guidelines, and how would they be made known to the public (besides being published in the Gazette)?

Income of visiting teacher or researcher (clause 10)

(q) The proposed section 8(1D) defines "visiting teacher or researcher" as one who visits a territory outside Hong Kong "for the sole or primary purpose of teaching or conducting research". Please advise what factors CIR would take into account in determining a person's sole or primary purpose for visiting a territory.

Sibling relationship (clause 11)

(r) Paragraph 21 of the LegCo Brief does not explain why the proposed definition under section 30B(3)(b) seeks to replace "natural brother (or sister)" with "brother (or sister) of full or half blood". Please explain the change in terminology, and confirm whether "natural" brother or sister has hitherto covered siblings of half blood, and whether the scope of relatives eligible for a dependent brother or sister allowance under section 30B of Cap. 112 would be altered by the change in terminology.

Transitional provisions (clauses 12 and 13)

(s) Under section 2 of the proposed Schedule 48 to Cap. 112, the tax treatment of financial instruments under the proposed sections 18G to 18L would apply in relation to a year of assessment for which the basis period begins on or after 1 January 2018. Please explain why the proposed sections 18G to 18L would apply retrospectively, and how CIR would treat or handle tax returns involving financial instruments for a basis period beginning on or after 1 January 2018 which are filed before the enactment of this Bill as an Ordinance and its publication in the Gazette.

Chinese text

(t) Under clause 3, the proposed section 18G(2)(b) seeks to abbreviate "本條或第18H、18I、18J、18K或18L條" as "有關條文". Please explain why the abbreviation is not used under paragraph (ii).

(u) The proposed section 50A(15)(d)(ii) under clause 5(15) proposes rendering "place of ... effective management" as "實際管理機構", while "institution" (as in "financial institution") is also rendered as 機構 under that proposed subparagraph. Please consider whether the use of the same Chinese rendition to refer to two different English terms in the same subparagraph would confuse readers, bearing in mind that "place of effective management" is rendered as "實際管理工作地點" in Article 4(3) of Part 1 of the Schedule to the Inland Revenue (Double Taxation Relief and Prevention of Tax Evasion with respect to Taxes on Income) (Kingdom of Saudi Arabia) Order (Cap. 112DB).

Please reply to the above in both languages **as soon as practicable**.

Yours sincerely,

(Bonny LOO)
Assistant Legal Adviser

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Ms Carmen CHAN (SGC)) (By Fax: 3918 4613)
Legal Adviser
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