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By email (bloo@legco.gov.hk)

29 November 2018

Mr Bonny LOO
Assistant Legal Adviser
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Dear Mr Loo,

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

Thank you for your letter of 12 November 2018. Our response to your letter is set out below –

Aligning the tax treatment of financial instruments with their accounting treatment

(a) It was at the request from the financial sector and the practical difficulties faced by taxpayers that the Inland Revenue Department ("IRD") has been accepting tax returns from enterprises with assessable profits computed on a fair value basis in years of assessment ("YA") from 2013/14 to 2017/18 as an interim administrative measure. With the election from respective taxpayers, tax assessments on a fair value basis involving unrealized profits of financial instruments had been made. Under section 64 of the Inland Revenue Ordinance ("IRO"), any person aggrieved by an assessment made under the IRO may object to the assessment within one month after the date of the notice of assessment made by the Commissioner of Inland Revenue ("Commissioner"). No objections were received that cite IRD's relevant interim measures for taxing on a fair value basis as the ground of objections. Such assessments should have now become final and conclusive under section 70 of the IRO. Indeed, the profits assessed in such assessments were based on taxpayers' profits tax return and should not be challenged by those elected. Practically, even if the unrealized gains were not taxed during the interim arrangement period, any cumulative revaluation gains, during such period will be brought into account for the election year as provided in the proposed section 18H(3).

Further, assessments would not be made invalid simply because the assessable profits included unrealized gain/loss. At most, one may argue that the assessable profits were incorrect. In this regard, the IRO has provided under sections 64 and 70A proper channels for taxpayers to challenge incorrect assessments. Therefore, we consider it not necessary to include a saving provision to cover the charging of profits tax on a fair value basis under the interim administrative measure.

(b) The term "fair value" refers to the same concept in the relevant accounting standards and financial reporting standards. The note without legislative effect after section 18F of the IRO ("Note") serves to explain the effect of alignment of the tax treatment of financial instruments and their accounting treatment under "fair value" accounting, that is, both realized and unrealized profits of the instruments have been accounted for.

According to the Hong Kong Financial Reporting Standard 9 (Financial Instruments) ("HKFRS 9"), financial instruments are required to be classified as subsequently measured at "amortized cost", "fair value through profit or loss" or "fair value through other comprehensive income". The respective meaning of "fair value through profit or loss" and "fair value through other comprehensive income", which appear in the proposed section 18J(4) and (5) and 18L(2) and (3)(a) of the IRO, refer to that provided in HKFRS 9.

Appendix A to HKFRS 9 provides that the term "fair value" is defined in paragraph 11 of the Hong Kong Accounting Standard 32 ("HKAS 32") and Appendix A to HKFRS 13, and is used in HKFRS 9 with the meaning specified in HKAS 32 and HKFRS 13. "Fair value" is defined in HKAS 32 and HKFRS 13 as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

We consider it not necessary to define the concept of "fair value", "fair value through profit or loss" and "fair value through other comprehensive income" in the Bill. The proposed section 18G(2)(b) has explained that if a person prepares financial statements for the basis period for a YA in accordance with a specified financial reporting standard, an expression used in proposed section 18G, 18H, 18I, 18J, 18K or 18L has the same meaning in relation to the person and the year as the expression has in the standard, if the expression is defined in the standard and not defined in proposed section 18G, 18H, 18I, 18J, 18K or 18L.

(c) A brief summary of views received in our stakeholder consultation conducted in mid-2018 and how they have been addressed or incorporated into the Bill are set out at **<u>Annex A</u>**.

(d) (i) An election under the proposed section 18H(2) is, in general, irrevocable. During the stakeholder consultation, there were suggestions that flexibility should be provided in certain circumstances (e.g. business merger / acquisition / disposal / restructuring where the taxpayer is taken over by a group of companies that adopt a different tax reporting basis), so that the taxpayer should be allowed to revoke an earlier election. It was suggested that an "escape clause" be provided to authorize the Commissioner to allow revocation of the election if the Commissioner is satisfied that the revocation is not driven by a tax avoidance motive and that there are good commercial reasons for doing so. For example, the taxpayer may have been a member of group A where financial instruments of members of group A are reported and taxed on a fair-value-accounting basis. On the merger or acquisition, the taxpayer may have become a member of group B where financial instruments of members of group B are reported and taxed on another basis. As each case should be considered on its own facts and merits, we consider it not necessary for the Bill to define the term or to provide examples of "good commercial reasons", which is to be understood as its ordinary meaning in the context of the election.

(ii) Mere reduction in amount of tax is not equivalent to tax avoidance. Tax avoidance generally refers to the use of provisions in tax legislation, in ways that were unintended by governments, to reduce a person's tax liability. The Commissioner would consider the taxpayer's purpose of revocation when handling the application of revocation.

(iii) A person whose application for revocation of an election is approved by the Commissioner under the proposed section 18H(5) may subsequently make a fresh election under the proposed section 18H(2). The proposed section 18H does not prohibit the person from doing so.

(e) The legislative intent regarding the tax treatment of regulatory capital security ("RCS")[1] has always been as follows: profits of the issuer and the specified connected person of the issuer of a RCS are to be determined as if fair value accounting were not applicable in relation to the RCS. This is reflected in section 17C(2) and 17D(2) of the IRO. The purpose of the provisions is to disregard the fluctuation in value of the RCS.

The following example illustrates the operation of proposed section 18G to 18L and the effect of exclusion under proposed section 18I(2) –

[1] RCS means a security that, for the purposes of the Banking (Capital) Rules (Cap. 155 sub. Leg. L) or of the equivalent laws or regulatory requirements of another member jurisdiction of the Basel Committee, qualifies as an Additional Tier 1 capital instrument or a Tier 2 capital instrument for compliance with the capital adequacy requirement.

On 1 January 2018, Company A issues a RCS to Company B at $50,000. Company B is a specified connected person of Company A. Company B classifies the RCS as subsequently measured at fair value through profit or loss. Both Company A and Company B close their annual accounts on 31 December 2018. On 31 December 2018, the fair value of the RCS is $60,000. According to HKFRS 9, Company B should measure the RCS at $60,000 and recognizes a gain of $10,000 in the profit or loss on 31 December 2018.

Suppose Company B makes an election under the proposed section 18H(2) for YA 2018/19. According to the proposed section 18J(1), the tax-relevant amount in respect of a financial instrument is the accounting-relevant amount in respect of the instrument. In the absence of the proposed section 18I(2), the accounting gain of $10,000 recognized by Company B will be brought into account for computing Company B's assessable profits for YA 2018/19.

However, by virtue of the proposed section 18I(2), the accounting gain due to changes in fair value of the RCS will not be brought into account for computing Company B's assessable profits for YA 2018/19. Similarly, any accounting loss recognized by Company A in respect of the RCS in accordance with HKFRS 9 will not be brought into account for computing Company A's assessable profits for YA 2018/19.

(f) The expression "effective interest rate" appears in the proposed section 18J(5) is to be understood with reference to Appendix A to 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 amortised cost of a financial liability". The meaning of "interest is computed in some cases at the effective rate instead of the contractual rate" in paragraph 3(b) of the Note is clear. As the Note is intended to explain the effect of the provisions in simple terms and use of the defined terms seems not essential, no amendments are needed.

(g) An illustrative example is as follows –

Company A makes a loan of $100,000 to Company B at an interest rate of 10% (i.e. the contractual interest rate) for 4 years. The market interest rate for a similar loan that would be made between unrelated parties at arm's length is 15% (also the effective interest rate in this example). Company A's accounting records show the following details –

Year	Income recognized (in profit or loss) (at 15%)	Cash received (at 10%)	Carrying value (in the balance sheet)
	$	$	$
0			85,730[2]
1	12,859	(10,000)	88,589
2	13,288	(10,000)	91,877
3	13,782	(10,000)	95,659
4	14,341	(110,000)	0

At the end of Year 1, Company A will recognize interest income of $12,859 (at an effective interest rate of 15%) though the interest received from Company B is $10,000 only (at the contractual interest rate of 10%).

As the loan is not made at arm's length, by virtue of the proposed section 18L(9), the amount of taxable interest income for Year 1 would be $10,000 (i.e. at the contractual interest rate). Similarly, the amount of taxable interest income for Year 2 to Year 4 would be $10,000 each year.

The proposed section 18L(8) clarifies that the proposed section 18L(9) does not affect the operation of the transfer pricing provisions in section 50AAF and 50AAK of the IRO to the loan. It should be noted that section 50AAF of the IRO applies if the participation

[2] According to HKFRS 9, the fair value of the loan at initial recognition will be measured as the present value of all future cash receipts discounted using the prevailing market rate of interest of a similar loan. $85,730 is the present value of the annual interest of $10,000 for 4 years and the repayment of the principal amount of $100,000 at the end of Year 4, being discounted at 15%.

condition is met under section 50AAG[3] of the IRO and the loan gives rise to a potential advantage in relation to Hong Kong tax under section 50AAJ of the IRO. The mere fact that the loan is not made at market interest rate might not trigger the application of the provisions.

If section 50AAF of the IRO does apply, Company A's taxable interest income will be computed as if the loan was made at the arm's length interest rate (15% in this example). In other words, the amount of taxable interest income from the loan for Year 1 would be adjusted to $15,000 (i.e. $100,000 x 15%). Similarly, the amount of taxable interest income for Year 2 to Year 4 would be adjusted to $15,000 each year.

Allowing the deduction of interest expenses payable to overseas export credit agencies

(h) We will consider proposing Committee Stage Amendments ("CSAs") to remove "political subdivision of the jurisdiction" in paragraph (d) of the definition of ***governmental entity*** under the proposed section 16(3) to avoid duplication with paragraph (b) in that definition. The definition of ***governmental entity*** under the proposed section 16(3) is modelled on the definition of ***governmental entity*** in existing section 50A(1) of the IRO. A similar amendment may be made to the definition in section 50A(1) of the IRO for consistency.

(i) In order to promote international trade and development, many jurisdictions have established export or development financing programmes or export credit agencies to provide financing support to their exporters and investors. Usually, an export credit agency is owned by the government or is established and operated by the

[3] Section 50AAG of the IRO is reproduced for ease of reference—
"**50AAG. Interpretation: *participation condition***
As between affected persons, the participation condition is met if, at the time of the making or imposition of the actual provision—
(a) one of the affected persons was participating in the management, control or capital of the other affected person within the meaning of section 50AAH; or
(b) the same person or persons was or were participating in the management, control or capital of each of the affected persons within the meaning of section 50AAH."

government. A private institution performing similar function is often a financial institution, which carries on the business of taking deposits and advancing loans (including export credit finance), and is already covered by the existing definition of "overseas financial institution". Therefore, the proposed definition of "overseas export credit agency" is only meant to cover situations where the export credit agency is owned by the government or is established and operated by the government. Such agencies do not normally take deposits for its business.

(j) Our intent is that overseas export credit agency covers a Mainland export credit agency, if any. This is reflected by the definition of overseas export credit agency in the Bill. The proposed term "overseas export credit agency" is in line with the existing term "overseas financial institution" under section 16(3) of the IRO[4]. The latter term, which also covers a qualified financial institution from the Mainland, has been used since the section was enacted in 1984.

Refining the provisions that implement the arrangement for automatic exchange of financial account information in tax matters ("AEOI")

(k) The proposed AEOI amendments under Part 4 of the Bill comply in all material respects with the latest requirements set out in the Common Reporting Standard ("CRS"), CRS publications and FATF Recommendations ("Relevant Materials") where applicable. A summary of the relevant proposed amendments and the corresponding provisions in the Relevant Materials is set out at **Annex B**.

(l) Although Clause 5(3) of the Bill proposes to replace the existing definition of "pre-existing account", the proposed definition is substantially the same as the existing definition. In particular, both the existing definition and the proposed definition refer to section 2 of Part 7 of Schedule 17D to the IRO in the same way. The changes

[4] As per section 16(3) of the IRO, ***overseas financial institution*** (海外財務機構) means 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 recognized for the purposes of this section as an overseas financial institution.

incorporated in the proposed definition seek to cater for 2020-covered institutions (i.e. those financial institutions which will be removed from the list of non-reporting financial institutions under Schedule 17C to the IRO and become reporting financial institutions with effect from 1 January 2020 pursuant to Clauses 5(5) and 7(2) of the Bill).

Paragraph (b) of the definition of "pre-existing account" allows a reporting financial institution to treat certain new accounts held by pre-existing customers as pre-existing accounts for due diligence purposes. A customer is treated as pre-existing if it holds a financial account with the reporting financial institution or a related entity of the institution. Thus, if a pre-existing customer opens a new account, the financial institution may rely on the due diligence procedures it (or its related entity) applied to the customer's pre-existing account to determine whether the new account is a reportable account. One of the requirements for applying this rule is that the reporting financial institution (or its related entity) must treat the subsequent new account and the old account as a single financial account for the purposes of satisfying the standard of knowledge requirements applicable to a self-certification or documentary evidence.

The standard of knowledge requirements contained in Section 2 of Part 7 of Schedule 17D to the IRO provides that a reporting financial institution may not rely on a self-certification or documentary evidence if the reporting financial institution knows or has reason to know that the self-certification or documentary evidence is incorrect or unreliable. If multiple accounts maintained by a single person are treated by a reporting financial institution as a single account for the purposes of satisfying the standard of knowledge requirements, the self-certification and other documentary evidence collected will be shared amongst the accounts. As such, if a reporting financial institution has reason to know that the status assigned to the account holder of one of the financial accounts is inaccurate, then it has reason to know that the status assigned for all other financial accounts of the same account holder is inaccurate.

(m) The Inland Revenue (Amendment) Ordinance 2018 (Ord. No. 5 of 2018) contains an amendment to section 50A(6)(c)(iii) to include the enforcer of the entity (see section 5(14) of the Amendment Ordinance). This amendment will come into operation on 1 January 2019 pursuant to section 1(3) of the Amendment Ordinance.

(n) The expression "normally managed or controlled" is commonly used in the Comprehensive Avoidance of Double Taxation Agreements signed by Hong Kong as one of the criteria in determining whether an entity is a resident of Hong Kong. In general, an entity is considered to be a resident of Hong Kong if either (i) it is incorporated in Hong Kong or constituted under the laws of Hong Kong; or (ii) it is normally managed or controlled in Hong Kong. The provisions of section 50A(15) of the IRO have borrowed this concept in determining whether a financial institution is a resident of Hong Kong.

On the other hand, the proposed section 50A(15)(d) is intended to cover a special type of financial institution (other than a trust) that is not subject to taxation as a resident in any territory. The expression "place of management (including effective management)" therein is provided in the CRS publications as one of the criteria in determining whether the institution is subject to the jurisdiction of a participating jurisdiction (i.e. subject to CRS reporting in that jurisdiction) (see item 4 of **Annex B**). While "normally managed or controlled in Hong Kong" and "place of management (including effective management) in Hong Kong" are similar in effect, we consider it more appropriate to use the latter phrase under the proposed section 50A(15)(d) for the sake of consistency with the CRS requirements.

(o) The notices to be published by the Secretary for Financial Services and the Treasury in the Gazette under the proposed section 50A(16A) and 50L(5) would be subsidiary legislation subject to scrutiny by the Legislative Council.

(p) The Commissioner may consult the relevant stakeholders where appropriate before publishing the guidelines for the interpretation of the Part 8A-related provisions. The guidelines would be made known to the public at the website of IRD apart from being published in the Gazette.

Avoiding potential double non-taxation of income of visiting teachers and researchers

(q) A person's purpose of visiting a territory is a question of fact, depending on the particular circumstances of each case. There is no exhaustive list of the factors to be considered. To determine whether a person visits a territory and is present in that territory for the sole or primary purpose of teaching or conducting research as specified in the proposed section 8(1D), the factors that would be taken into consideration by the Commissioner include but are not limited to –

(i) the period and length of stay in the visited territory. For example, whether such stay is in accordance with the school calendar or teaching schedule;

(ii) any conditions imposed for the person's entry and stay in the visited territory. For example, whether the person obtained employment visa or permit required for teaching or conducting research;

(iii) whether the usual employment terms and conditions for a teacher or researcher applies to the person;

(iv) the type and extent of all the activities carried out by the person in the visited territory.

Revising the meaning of the sibling relationship

(r) The change of the terminology from "natural brother (or sister)" to "brother (or sister) of full or half blood" is to align with the definition of "sibling" in section 26J(4) of the IRO. We propose using "brother (or sister) of full or half blood" to describe the relationship with the taxpayer instead of the general description "natural brother (or sister)". We consider that "natural" brother or sister has hitherto covered siblings of half blood, and the scope of relatives eligible for a dependent brother or sister allowance under section 30B of the IRO would not be altered by the aforementioned change in the terminology.

(s) Given that enterprises in Hong Kong are required to apply HKFRS 9 for annual periods beginning on or after 1 January 2018, our intention is that the tax treatment of financial instruments under the proposed sections 18G to 18L can come into operation at the same time for better alignment and avoid additional accounts preparation burden. Basis period begins on 1 January 2018 will end on 31 December 2018 and fall into the YA 2018/19. Profits tax returns for the YA 2018/19 will be issued in early April 2019. With the block extension for filing of the tax return, taxpayers with basis period ending on 31 December 2018 will only be required to file their tax returns by 15 August 2019. Computation of profits in accordance with the proposed sections 18G to 18L will only apply on the taxpayer's election and should have no retrospective effect in the objectionable sense.

Chinese text

(t) While the tag-definition "(*有關條文*)" under the proposed section 18G(2)(b) can shorten the provision, there may be ambiguities as to whether it refers to "本條或第 18H、 18I、18J、18K 或 18L 條" or only "第 18H、 18I、18J、18K 或 18L 條" in the proposed section 18G(2)(b). We will consider proposing CSAs to remove the tag-definition.

(u) The Chinese equivalent of "effective management" is "實際管理機構" in the definition of ***resident for tax purposes*** in section 50A(1) of the IRO. We consider the same is applicable to the proposed section 50A(15)(d)(ii) in the context of AEOI.

Yours sincerely,

(Ms Pecvin Yong)
for Secretary for Financial Services and the Treasury

c.c.

Commissioner of Inland Revenue	(Attn: Mr KK CHIU)
Department of Justice	(Attn: Miss Betty CHEUNG Ms Carmen CHAN)

Annex A

Summary of Views Received on Aligning the Tax Treatment of Financial Instruments with their Accounting Treatment

	Views	Government's Response	Section in the Bill
1.	Clarification that the proposed amendments are not intended to change the fundamental taxation principles (i.e. offshore sourced or capital profits / loss not taxable / deductible).	The proposed amendments serve to provide an election for financial instruments to be taxed on fair value basis without affecting the general taxability and deductibility under the Inland Revenue Ordinance ("IRO"). We have explained this position in the Inland Revenue (Amendment) (No. 7) Bill 2018 ("Bill").	Note without legislative intent after section 18F; section 18I
2.	Clarification that the proposed amendments only apply in circumstances where a taxpayer has adopted Hong Kong Financial Reporting Standard 9 (Financial Instruments) ("HKFRS 9") in preparing its financial statements.	This has been clarified in the relevant section.	Section 18H(1)(a)

	Views	Government's Response	Section in the Bill
3.	A level of flexibility be introduced in certain circumstances (e.g. business merger / acquisition / disposal / restructuring where the taxpayer is taken over by a group of companies that adopt a different tax reporting basis), so that the taxpayer should be allowed to revoke an earlier election if the Commissioner of Inland Revenue ("Commissioner") is satisfied that the revocation is not driven by a tax avoidance motive.	We understand that there might be situations where revocation of an earlier election is genuine, and therefore an "escape clause" has been included in the Bill. In general, the revocation should have no retrospective effect and only take effect from the year of assessment ("YA") specified by the Commissioner.	Section 18H(4) to (7)
4.	Taxpayer with huge unrealized loss in the election year may not have sufficient profits in future years that can utilize the loss. Some flexibility should be provided to allow the taxpayer to amend historical tax returns that would effectively allow the taxpayer the choice to early adopt such reporting basis in earlier YAs.	Under Hong Kong profits tax, tax losses are not allowed to be carried backward. Allowing taxpayers the choice to amend back year tax returns for early adoption of fair value accounting for tax reporting would effectively allow taxpayers to carry backward the tax losses. We consider that taxpayers should not be allowed to make such amendments for back year returns.	-

	Views	Government's Response	Section in the Bill
5.	Section 50AAF and 50AAK should already address non-arm's length transactions. The reasons for new provisions to make adjustment on non-arm's length loan should be clarified.	For non-arm's length loans, by virtue of the proposed section 18L(9), any imputed profits, gain, loss, income or expenses computed in accordance with HKFRS 9 will not be taxable or deductible. Instead, any actual profits, gain, loss, income or expenses computed in accordance with the contractual terms will be taxable or deductible. Whether section 50AAF and 50AAK should be invoked would be governed by the respective transfer pricing rules.	Section 18L(8) and (9)
6.	Tax position of hedging arrangements where the underlying asset or liability is of a revenue / trading nature, in which case any profit, gain or loss in respect of the hedging arrangements will be taxable / deductible, should be clarified. Also, the purpose of entering into the hedging arrangement should not be too narrowly interpreted.	The tax treatment of hedging arrangements where the underlying asset or liability is of a revenue / trading nature will follow the proposed section 18J(1). Section 18L(10) applies only if the underlying asset or liability is of a capital nature. The facts and circumstances of each individual case have to be examined to determine whether the hedging instrument is really a hedge against the hedged item. In general, if the hedging relationship qualifies for hedge accounting under HKFRS 9 and is accounted for as such, the Inland Revenue Department ("IRD") will accept that there is prima facie evidence that the arrangement is for the purpose of hedging against any risk associated with the asset or liability.	Section 18J(1) and 18L(10)

	Views	Government's Response	Section in the Bill
7.	Deduction for all stages of impairment losses under the HKFRS 9 impairment framework should be allowed. The tax deductibility of impairment losses for trading financial instruments where the loss has already been marked-to-market in the profit or loss accounts should be clarified.	This legislative exercise aims to provide a legal basis for election of tax assessment on fair value basis in accordance with the prevailing accounting standards. After considering the impact on taxpayers under the HKFRS 9, we consider it prudent to maintain the status quo (i.e. no tax deduction for non-credit-impaired debts). The recognition of expected credit loss under the impairment model under HKFRS 9 is applicable to financial assets measured at amortised cost or fair value through other comprehensive income and has no application to trading securities which are measured at fair value through profit or loss ("FVTPL"). Therefore, section 18K will not affect the tax treatment for trading securities. For trading securities measured at FVTPL, any impairment losses will be reflected in the change in fair values and recognized in profit or loss.	Section 18K

	Views	Government's Response	Section in the Bill
8.	Clarifications as to whether the special treatment of equity instrument aims to bring into account for tax reporting purposes income / loss that has previously been recognized in other comprehensive income but is not "recycled" into the profit or loss upon maturity, redemption or disposal of the financial instrument to the extent such instrument is held or issued on revenue account.	For equity instrument that is measured at fair value through other comprehensive income, any fair value changes will be recognized in other comprehensive income and will not be "recycled" into the profit or loss upon disposal of the equity instrument. If the equity instrument is on revenue account of the taxpayer, all the gain / loss on disposal, including the amount that has previously been recognized in other comprehensive income but is not "recycled" into the profit or loss, is chargeable / allowable for the year of disposal.	Section 18L(2)
9.	Clarifications as to whether the special treatment of financial liability aims to bring into account for tax reporting purposes income / loss that has previously been recognized in other comprehensive income but is not "recycled" into the profit or loss upon maturity, redemption or disposal of the financial instrument to the extent such instrument is held or issued on revenue account.	For financial liability that is measured at fair value through profit or loss, any gain / loss attributable to change in the issuer's own credit risk will be recognized in other comprehensive income and will not be "recycled" into the profit or loss upon maturity, redemption or disposal (collectively "disposal") of the financial instrument. If the financial liability is on revenue account of the taxpayer, all the gain / loss derived from the disposal, including the amount that has previously been recognized in other comprehensive income but is not "recycled" into the profit or loss, is chargeable / allowable for the year of disposal.	Section 18L(3) to (5)

	Views	Government's Response	Section in the Bill
10.	Special treatment of embedded derivative should not be included as it has been the practice of IRD to determine the nature and locality of profit and loss of a hybrid instrument on the basis that it is one single instrument.	For convertible bonds, we maintain the view that the issuer stands in the position of debtor of a money debt before the right to convert is exercised. Hong Kong Accounting Standard 32 requires the issuer of convertible debt securities (which provide an option to the holder of the debt securities to convert the securities into the issuer's own shares) to split the debt securities into liability components and equity components (i.e. the option rights) and present them separately in the balance sheet, under certain circumstances. At initial recognition, the issuer is required to measure the liability component at fair value as if there was no equity component, and the equity component will be the difference between the fair value of the convertible debt securities as a whole and the fair value of the liability component. Thereafter the issuer is required to amortize the "discount/premium", which is the difference between the redemption price and the debt liability component of the convertible debt securities initially recognized, to the profit or loss. We consider that part of the imputed "discount/premium" is attributable to the equity component of the convertible debt securities and is not tax deductible because it is capital in nature. The	Section 18L(6)

	Views	Government's Response	Section in the Bill
		following example illustrates the operation of section 18L(6) – Company A issues convertible bond at $10,000, redeemable at a premium of $1,000. Assuming the fair value of the liability component is $9,500 (i.e. the fair value of a similar bond without the option to convert into shares), the equity component will be $500 ($10,000 - $9,500). During the tenure of the convertible bond, the difference between the redemption price of $11,000 and the fair value of the liability component at initial recognition of $9,500 (i.e. in the amount of $1,500), will be amortised to the profit or loss in accordance with HKFRS 9. For accounting purpose, the imputed premium is $1,500. However, for tax purpose, only the actual premium of $1,000 (being the premium on redemption per contractual terms) is allowable as a deduction. The remaining $500 is attributable to the equity component and will not be allowed as a deduction.	
11.	Clarification as to whether any income (coupon or premium) received by the preference shareholder is a dividend and not taxable (regardless of the accounting classification of the preference share).	Distributions from preference shares will be treated as dividends and the general principles will apply, including the provisions in section 26 of the IRO.	Section 18L(7)

	Views	Government's Response	Section in the Bill
12.	Clarification as to the rationale behind the special treatment for the transfer of credit-impaired loan from a financial institution to another party who is not engaging in money lending business in Hong Kong.	The special treatment applies only if the credit-impaired loan is transferred to the transferee together with the loss allowance for an expected credit loss. That means, the transfer is not by way of a purchase and sale transaction. For a purchase and sale transaction, the purchaser will recognize the purchased loan at its fair value, instead of recognizing a loss allowance in its accounts. In the case where merger accounting is used, the credit-impaired loan will be recognized by the transferee at its carrying amount in the transferor's financial statements, i.e. both the carrying amount and loss allowance of the loan will be transferred from the transferor's to the transferee's accounts. In the case where the transferee is not in the business of money lending in Hong Kong, the transferee may not be eligible for deduction of impairment loss and any reversal of the impairment loss or recovery of the debt by the transferee may not be chargeable to tax. To protect the revenue, it is necessary to claw back the impairment loss which has been previously allowed to the transferor.	Section 18K(6) to 18K(8)

Annex B

Proposed Changes in Part 4 of the Bill and Corresponding Provisions in the Common Reporting Standard ("CRS")[1], Commentaries on CRS[2], CRS Implementation Handbook[3] and FATF Recommendations[4] ("Relevant Materials")

Item	Clause in the Bill	Reference in the Inland Revenue Ordinance	Provisions in the Relevant Materials	Reasons for the proposed changes
1.	5(1) 5(2)	Section 50A(1) Interpretation of the terms "controlling person" and "entity"	CRS – Paragraph E(3), Section VIII (page 60) Commentaries on CRS – Paragraphs 135 and 136, Section VIII (page 199) CRS Implementation Handbook – Paragraph 117 (page 57) FATF Recommendations –	To clarify that controlling persons will be identified, in relation to any legal person which is functionally equivalent or similar to a trust, in a way similar to the way in which controlling persons are identified in relation to a trust. The concept of "legal person", which is used in the CRS and the Commentaries on CRS, is defined in the FATF Recommendations to mean "an entity other than a natural person that can establish a permanent customer relationship with a financial institution or otherwise own property". The Bill incorporates the concept of "legal

1 It refers to the Common Reporting Standard contained in the Standard for Automatic Exchange of Financial Account Information in Tax Matters (Second Edition), published by the Organisation for Economic Co-operation and Development ("OECD") on 27 March 2017 (https://www.oecd-ilibrary.org/docserver/9789264267992-en.pdf?expires=1542623115&id=id&accname=guest&checksum=B25A6BCC1374E4AAC2340A880DD27578).

2 It refers to the Commentaries on the Common Reporting Standard contained in the Standard for Automatic Exchange of Financial Account Information in Tax Matters (Second Edition), published by the OECD on 27 March 2017 (https://www.oecd-ilibrary.org/docserver/9789264267992-en.pdf?expires=1542623115&id=id&accname=guest&checksum=B25A6BCC1374E4AAC2340A880DD27578).

3 It refers to the Standard for Automatic Exchange of Financial Information in Tax Matters-Implementation Handbook (Second Edition), published by the OECD in April 2018 (http://www.oecd.org/tax/exchange-of-tax-information/implementation-handbook-standard-for-automatic-exchange-of-financial-information-in-tax-matters.pdf).

4 It refers to the International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation-the FATF Recommendations, as adopted by the Financial Action Task Force Plenary in February 2012 incorporating updates made up to February 2018 (http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%202012.pdf).

			Definition of legal persons (page 120)	person" as defined in the FATF Recommendations into the definition of "entity".
2.	5(7) 5(8)	Section 50A(6)(c) Interpretation regarding the definition of "controlling person"	CRS – Paragraph D(6), Section VIII (page 57) Commentaries on CRS – Paragraph 134, Section VIII (page 198)	To clarify that the concept of "controlling person", in relation to a trust, covers trustees and beneficiaries.
3.	5(10)	Section 50A(13) Interpretation regarding the definition of "investment entity"	CRS – Paragraph 6(b), Section VIII (page 45) Commentaries on CRS – Paragraph 21, Section VIII (page 163)	To provide that paragraphs (d) and (e) of the definition of "investment entity" must be interpreted in a way consistent with the way in which similar provisions in the definition of ***financial institution*** in the FATF Recommendations are interpreted.
4.	5(11) 5(12) 5(13) 5(14) 5(15)	Section 50A(15) Interpretation regarding the definition of "reporting financial institution"	Commentaries on CRS – Paragraph 4, Section VIII (page 159) CRS Implementation Handbook – Paragraph 120 (page 58 - 59)	To incorporate the residency rules in relation to financial institutions (other than trusts) that do not have a residence for tax purposes.