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**By email (dwylo@legco.gov.hk)**

31 December 2018

Ms Doris LO
Clerk to Bills Committee
Legislative Council Secretariat
1 Legislative Council Road
Central, Hong Kong

Dear Ms Lo,

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

Thank you for your email dated 18 December 2018 enclosing the list of follow-up actions arising from the 2nd Bills Committee meeting on 17 December 2018. Please find the Government's response to the written submissions received and views expressed by deputations at the meeting at **Annex**.

Yours sincerely,

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

c.c.

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| Commission of Inland Revenue | (Attn: | Mr KK CHIU) |
| Department of Justice | (Attn: | Miss Betty CHEUNG<br>Ms Carmen CHAN) |

**Annex**

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

## Government's Response to Written Submissions and Views Expressed by Deputations at the 2nd Bills Committee Meeting

| | Comments / Issues Raised | Organisations / Persons | Government's Response |
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| **A. Aligning the Tax Treatment of Financial Instruments with their Accounting Treatment** | | | |
| 1. | Generally welcome the introduction of the Bill to allow taxpayers to elect for financial instrument be taxed on fair value basis. | • The Association of Chartered Certified Accountants Hong Kong ("ACCA(HK)")<br>• The Hong Kong Association of Banks ("HKAB")<br>• Hong Kong Securities Professionals Association<br>• The Institute of Securities Dealers<br>• PricewaterhouseCoopers Limited ("PwC")<br>• Taxation Institute of Hong Kong ("TIHK")<br>• Dr. Agnes W.Y. LO and Dr. Raymond M.K. WONG | We are pleased to note the support. |

| | Comments / Issues Raised | Organisations / Persons | Government's Response |
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| 2. | An additional condition should be included in sections 18K(3)-(5) specifying that credit-impaired expected credit loss ("ECL") in respect of financial instruments valued at amortized cost or fair value through other comprehensive income ("FVOCI") which are acquired for trading purposes or are held on revenue account by a taxpayer will also qualify for tax deduction. | • ACCA(HK)<br>• HKAB<br>• PwC<br>• TIHK | In general, financial instruments acquired for trading purpose would be measured at fair value through profit or loss. Any expected credit loss would be reflected in the fair value changes and charged to the profit and loss account and therefore, no separate allowance for expected credit loss would be made. If a taxpayer classifies a financial instrument as measured at amortized cost or fair value through other comprehensive income but claims that it is acquired for trading purpose and the Assessor is satisfied that it is for trading purpose, adjustment can be made in tax computation. No amendments should be required for the proposed sections 18K(3)-(5). |

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| 3. | The Government should consider allowing tax deduction of non-credit-impaired ECL, particularly those incurred by financial institutions. | • HKAB<br>• Hong Kong Institute of Certified Public Accountants ("HKICPA")<br>• PwC<br>• TIHK | 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 Hong Kong Financial Reporting Standard 9 ("HKFRS 9"), we consider it prudent to maintain the status quo (i.e. no tax deduction for non-credit-impaired debts). Taxpayers have been allowed to claim bad debts under the Inland Revenue Ordinance ("IRO") and this remains available even if they have elected to be taxed on fair value basis for financial instruments. Taxpayers that have elected so could claim Stage 3 expected credit loss as loss under the proposed amendments.<br><br>We further noted that only a few jurisdictions have allowed tax deduction for all three stages of ECL with different approaches. Hence it is not a norm and not a must for jurisdictions to have tax treatment to tally entirely with accounting treatment. |

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| 4. | The Government should reconsider whether the proposed claw-back of tax deduction for ECL previously granted in the proposed scenario under sections 18K(6)-(8) is necessary and justifiable. | • HKAB<br>• PwC<br>• TIHK | Sections 18K(6)-(8) would be invoked only if the loss allowance in respect of the credit-impaired loan is transferred to the transferee together with the loan. In such case, there is no separate consideration for the transfer of the loan. The loan is not transferred by way of a sale and therefore, no gain or loss on the transfer would be recognized by the transferor. The loss allowance is not effectively written off but is transferred to the transferee.<br><br>In the example given by PwC, the loan of $100 was transferred by the financial institution at a consideration of $60. The transferee would recognize the loan as a purchased credit-impaired loan in accordance with HKFRS 9 and no loss allowance would be booked by the transferee. In such case, the loss allowance of $40 would not be transferred to the transferee and sections 18K(6)-(8) would not apply.<br><br>In the scenario where sections 18K(6)-(8) apply, as the loan is no longer held by the financial institution, the special deduction of impairment loss provided to financial institution should no longer apply. It is necessary to claw back the impairment loss which has been previously allowed. There are similar provisions in Singapore (section 34AA(5) of Singapore's Income Tax Act). |

<table>
<tr><th></th><th>Comments / Issues Raised</th><th>Organisations / Persons</th><th>Government's Response</th></tr>
<tr><td>5.</td><td>Given the proposed sections 18K(6)-(8), the Government should clarify the tax treatment for transfer of credit-impaired loan if the parties concerned are not financial institutions.</td><td>ACCA(HK)</td><td>If the transferor is not a financial institution, sections 18K(6)-(8) would not apply and no tax adjustment is required. In the case where the transferor is a financial institution, section 18K(7) applies if the transferee is a financial institution and section 18K(8) applies if the transferee is not a financial institution.</td></tr>
<tr><td>6.</td><td>No part of the amortization of the discount or premium of convertible debt securities should be attributable to the equity component of the convertible debt security and the proposed disallowance of part of the discount or premium under section 18L(6) is not justified.</td><td>• HKAB<br>• TIHK</td><td rowspan="2">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. Despite the accounting treatment, convertible bonds would be treated as debt. Therefore, any consideration the issuer received and any sums payable by the issuer should be in relation to the debt. In any event, the aggregate amount of interest/discount/premium paid by the issuer would be allowable for deduction. Only part of the interest/discount/premium computed at the effective interest rate which is attributable to the "equity component" would be disallowed for deduction. There is a similar legislative provision in Singapore (section 34AA(3)(l) of Singapore's Income Tax Act).<br><br>Under all three scenarios given by PwC, section 18L(6) applies only if according to the applicable accounting standards, the issuer of the convertible bond is required to split the bond into liability</td></tr>
<tr><td>7.</td><td>While noting the rationale of disallowing such discount or premium, it is suggested that more guidance be given to taxpayers on how such portion should be determined in different scenarios.</td><td>PwC</td></tr>
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| | | | component and equity component. If there is no equity component, no tax adjustment will be required. |
| 8. | The Government should note the potential impacts that could possibly arise from the election of the alignment of tax and accounting on firms' financial reporting practices and in particular, earnings management. It is suggested to add a clause in section 18H(1)(b) requiring the entity to indicate such election in the financial statements in order to protect shareholders. | Dr. Agnes W.Y. LO and Dr. Raymond M.K. WONG | The scope of the Inland Revenue Ordinance ("IRO") is to impose tax on property, earnings and profits while accounting standards are set by HKICPA. It is not appropriate to impose financial reporting requirements under the IRO. |
| 9. | The definition of "specified financial reporting standard" under the proposed section 18G should be expanded to include the accounting/financial reporting standards adopted by other overseas jurisdictions that are a local equivalent of International Financial Reporting Standard ("IFRS") 9. | PwC | The Government will propose Committee Stage Amendments to expand the definition of "specified financial reporting standard" to include local accounting/financial reporting standards adopted by other overseas jurisdictions which are equivalent of IFRS 9. |

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| 10. | The proposed sections 18K(2) and (3) should be reworded so that impairment loss may be deductible if the condition in section 16(1)(d) is met. | PwC | The proposed sections 18K(2) and (3) are in general in line with the requirement under section 16(1)(d). A financial asset is "credit-impaired" when one or more specified events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. In such case, it is likely that it can be "proved to the satisfaction of the Assessor to have become bad". On the other hand, it is unlikely that a financial asset which is not credit-impaired can satisfy the condition in section 16(1)(d). |
| 11. | It should be clarified in the Inland Revenue Department ("IRD")'s departmental interpretation and practice notes ("DIPN") or otherwise –<br>(a) that an impairment loss made under Stage 3 is deductible even if it may not satisfy the criteria under section 16(1)(d);<br>(b) the meaning of "credit-impaired" . | • ACCA(HK)<br>• HKAB | The deduction of impairment loss under Stage 3 (i.e. in respect of a credit-impaired financial instrument) is governed by section 18K(3) and is not subject to the criteria specified in section 16(1)(d). The term "credit-impaired" in respect of a financial instrument, which appears in the proposed sections 18K(2) and (3), has the same meaning as the term "credit-impaired financial asset" as defined in Appendix A to HKFRS 9.<br><br>IRD will take into account the suggestion when preparing the DIPN after the passage of the amendments. |

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| 12. | It should be made clear in the IRO that distributions from preference shares received by holder of preference share would be treated as non-taxable dividends. | PwC | Distributions from preference shares will be treated as dividends and the general principles will apply, including the provisions in section 26 of the IRO. In other words, distributions from preference shares are generally not chargeable to tax if the dividend is distributed from a corporation which is chargeable to tax. We consider that an additional provision is not necessary. |
| 13. | The Government should consider allowing taxpayers to spread the amount of the total adjustments on first adoption of HKFRS 9 over a few years, say 3 years, such that the cash flow impacts on the taxpayers could be reduced. | HKICPA | The experience at the time when Hong Kong Accounting Standard 39 was introduced suggests that spreading of the transitional adjustments over a few years is not necessary. It is expected that the impacts of the transitional adjustments on taxpayers should not be significant. |

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| 14. | It should be clarified whether –<br>(a) sections 18I(3) and 18I(4) set down rules that one should first consider the tax treatments and then compute the quantum with the exception of situations mentioned in section 18I(2); and<br>(b) the purpose of section 18I(3) is to allow application of the relevant tax treatments in the other Part 4 provisions despite the fact that certain wording in those sections, e.g. incurred, may not be in line with the logic of HKFRS 9. | HKICPA | Section 18I(3) and (4) set out the interaction of the sections 18J, 18K and 18L with the other Part 4 provisions.<br><br>The other Part 4 provisions include, for example –<br>(a) the rules that profits/losses which are offshore or capital in nature are not chargeable to tax or allowable for deduction;<br>(b) the deeming provisions and deduction rules.<br><br>In general, the other Part 4 provisions are not changed by the proposed new sections. However, to the extent that the other Part 4 provisions limit profits/loss to realized profits/loss or provide a different way for computing profits/loss (e.g., computing interest based on the contractual rate instead of the effective rate), sections 18J, 18K and 18L would apply despite the other Part 4 provisions. |
| 15. | It should be clarified whether the term "on capital account" in section 18L(10) means that the hedged item is capital in nature for profits tax purposes. | HKICPA | It is correct that the term "on capital account" in section 18L(10) means that the hedged item is capital in nature for profits tax purposes. |
| 16. | The Government should consider revising some Chinese terms of the Bill, namely "公平價值" to "公允價值", "減值損失" to "信貸聲譽受損而影響價值" and "信 | ACCA(HK) | HKFRS 9 is published in English only and there is no official Chinese translation for the terms. We have taken into account the common usage of those terms in the IRO as well as industry's practice when |

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| | 用減值" to "信貸減值". | | preparing the relevant Chinese terms in the Bill.<br><br>The Chinese equivalent of "fair value" is "公平價值" in the Bill. The same Chinese rendition is adopted in the IRO. Therefore, we consider appropriate that the same should be followed for consistency.<br><br>The Chinese equivalent of "impairment loss" is "減值損失" in the Bill and the term "impairment loss" is not found in the IRO. Therefore, when drafting the Chinese text, reference was made to the Banking (Capital) Rules (Cap. 155L), in which "減值損失" is prevalently found as the Chinese equivalent.<br><br>The Chinese equivalent of "credit-impaired" is "信用減值" in the Bill and the term "credit-impaired" is not found in the IRO. Yet, "credit" is rendered as "信用" in the recently enacted provisions of the IRO e.g. sections 17G and 50AAK, and therefore we have come up with "信用減值" in the Bill.<br><br>We consider that the relevant Chinese terms in the Bill are appropriate and no amendment is considered necessary. |

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| 17. | Tax payment on unrealised profit is not justified and it is not unusual for companies to prepare two sets of accounts. IRD may continue to use the existing practice of accepting taxpayers to include unrealised profits in the reported tax profits on a concessionary basis if it is applied consistently. If fair value accounting will be enacted in the tax legislation, the financial instruments that are qualified for fair value accounting should be listed in, for example, the Inland Revenue Rules. The tax authority should have evaluated whether it is appropriate to tax on the unrealised profits of that particular financial instrument. Also, the election should be revocable as there may be merger and acquisition and the new investors should be allowed to choose again. Further, taxation on fair value accounting on leasehold property and revaluation surplus on other assets should be discussed in one go. | Anonymous | The proposed amendments in Part 2 of the Bill seek to make express provisions to provide taxpayers an option which allows them to align the tax treatment of financial instruments with their accounting treatment so as to ease the practical difficulties encountered by taxpayers if their profits for taxation purposes are to be computed separately. For taxpayers who do not make such an election, they remain entitled to exclude any unrealized profits in their tax returns. Unless there is any special reason that a differential tax treatment is required, we consider that the same set of proposed tax treatment should be applicable to all types of financial instruments which are within the scope of HKFRS 9. An election under the proposed section 18H(2) is, in general, irrevocable. However, an "escape clause" is provided in the proposed section 18H(4) that an election may be revoked with the approval of the Commissioner of Inland Revenue ("Commissioner") if the person proves to the Commissioner's satisfaction that there are good commercial reasons for the revocation and the revocation is not for tax avoidance. In view of the industry's request and the practical difficulties faced by taxpayers in re-computing their profits from financial instruments on a realisation basis, we consider that there is an urgency to deal with the tax treatment of financial instruments in this Bill. |

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| **B.** | **Allowing the deduction of interest expenses payable to overseas export credit agencies** | | |
| 18. | The Government should clarify whether the interest expense paid to the Hong Kong Export Credit Insurance Corporation ("HKECIC") is tax deductible in the foreign jurisdictions. | Anonymous | As far as we understand, the HKECIC provides insurance protection against buyer and country risk instead of providing credit or loan directly to exporters. Further, whether a foreign jurisdiction allows the interest paid to an overseas export credit agency depends on the law of that jurisdiction. |
| **C.** | **Refining the provisions that implement the arrangement for automatic exchange of financial account information in tax matters ("AEOI")** | | |
| 19. | The Government should provide more information on similar legislations relating to the concept of "controlling person" and "investment entity" in other jurisdictions, and the existing definition of trusts and related terms are preferred. | Anonymous | As explained in paragraph 11 of the Legislative Council Brief on the Bill, the proposed amendments serve to better align the Hong Kong AEOI requirements with the requirements of the Common Reporting Standard ("CRS") promulgated by the Organisation for Economic Co-operation and Development ("OECD"). The CRS provides a standardised set of due diligence and reporting rules for financial institutions to follow to ensure consistency in the scope and quality of information exchanged. Around 150 jurisdictions have committed to implement the CRS. |

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| 20. | Guidelines on interpretation of IRD are already published by way of DIPN, and therefore it is not necessary to further empower the Commissioner to publish non-statutory guidelines on the interpretation of AEOI related provision under the new section 50L. | Anonymous | The guidelines to be published under the new section 50L are not subsidiary legislation, and are no different in content from the existing materials explaining the AEOI requirements (e.g. Guidance for Financial Institutions on the interpretation of AEOI related provisions). The empowering provision is needed in order to better align with the requirements of the OECD. |
| 21. | The Government should not remove Mandatory Provident Fund Schemes ("MPF Schemes") from the list of non-reporting financial institutions ("NRFIs"). | Anonymous | The proposed change to the list of NRFIs is essential for ensuring that Hong Kong's AEOI regime is consistent with the requirements of the CRS. The rationales for removing MPF Schemes from the list of NRFIs are set out in paragraph 13 of the Legislative Council Brief on the Bill. |

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| 22. | MPF Schemes with no voluntary contributions ("VCs") should remain in the list of NRFIs, or the Government should prohibit VCs or restrict the withdrawal of VCs so that MPF Schemes can remain in the list of NRFIs. | Anonymous | VCs are voluntary and flexible in nature so as to compensate for the rigidities in the design of mandatory contributions. It is the Government's policy to encourage employers and employees to strengthen retirement protection and savings through making VCs. The Government currently has no plan to prohibit or impose withdrawal restrictions on VCs in general as this would go against the policy intention. The Government had proactively pursued different solutions with the OECD; however, removing the NRFI status of MPF schemes is the only viable option acceptable to the OECD. |
| 23. | The Government should explore the possibility of imposing additional requirements on credit unions (e.g. restricting the participants to Hong Kong residents) to avoid the need of removing such from the list of NRFIs. | Anonymous | We had consulted the credit unions and relayed their views and suggestions on how they might remain on the list of NRFIs to the OECD. Nonetheless, the OECD maintains the view that credit unions need to be removed from the list of NRFIs if Hong Kong's AEOI regime is to be consistent with the requirements of the CRS. |

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| 24. | The inclusion of additional 51 jurisdictions in the list of reportable jurisdictions may be very costly, and should not be pursued. | Anonymous | As explained in paragraph 15 of the Legislative Council Brief on the Bill, the additional 51 jurisdictions are all Hong Kong's prospective AEOI partners. Since the reporting financial institutions have already set up systems to collect data relating to the 75 jurisdictions covered by the existing list of reportable jurisdictions, we anticipate that any additional costs involved in expanding the data collection in respect of more jurisdictions would not be significant. |
| 25. | The Government should clarify its plan, if any, to implement the Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures ("MDR") promulgated by the OECD, and include related OECD publications under the new section 50L. | Anonymous | The MDR is not part of the minimum standards mandated by the OECD at present. We have no plan at this stage to implement MDR in Hong Kong or include the related OECD publications under the new section 50L. |

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| 26. | The definition of "FATF Recommendations" should be removed since anti-money laundering requirement should not be dealt with in the IRO. | Anonymous | As explained in paragraph 11 of the Legislative Council Brief on the Bill, the proposed amendments serve to align with the requirements of the CRS promulgated by the OECD. The amendments are not meant to create a new anti-money laundering obligation, but seek to clarify that the term "investment entity" is to be interpreted in a manner consistent with the recommendations of the Financial Action Task Force. Such interpretation approach forms part of the requirements under the CRS. |
| 27. | The existing definition of "dormant account" under section 7 of Part 3 of Schedule 17C to the IRO is too restrictive. | Anonymous | We do not propose any amendment to the definition of "dormant account" in this Bill. The existing definition of "dormant account" in the IRO is consistent with the CRS promulgated by the OECD. |
| **D. Avoiding potential double non-taxation of income of visiting teachers and researchers** | | | |
| 28. | Support the amendment to avoid potential double non-taxation of income of visiting teachers and researchers. | Hong Kong Baptist University | We are pleased to note the support. |
| 29. | The amendment to section 8 on salary tax should be removed as the problem of taxing nowhere does not exist. | Anonymous | The potential problem of double non-taxation arising from the introduction of teachers and researchers article is explained in paragraphs 17 and 18 of the Legislative Council Brief on the Bill. |