

II. REPORT

The date of First Reading of the Bill is 14 November 2018. Members may refer to the Legislative Council ("LegCo") Brief (File Ref.: TsyB R 00/800/24/0 (C)) issued by the Financial Services and the Treasury Bureau ("FSTB") on 31 October 2018 for further details.

Object of the Bill

2. The Bill seeks to amend the Inland Revenue Ordinance (Cap. 112):
 - (a) to align the tax treatment of financial instruments with their accounting treatment in certain circumstances;
 - (b) to provide for deduction of interest expenses payable to overseas export credit agencies ("OECAs");
 - (c) to refine the provisions that implement the arrangements for automatic exchange of financial account information in tax matters ("AEOI");
 - (d) to avoid potential double non-taxation of income of visiting teachers and researchers; and
 - (e) to revise the meaning of the sibling relationship.

Provisions of the Bill

3. The salient provisions of the Bill are summarized below.

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

4. In *Nice Cheer Investment Ltd v. Commissioner of Inland Revenue* ("CIR") (2013) 16 HKCFAR 813, the Court of Final Appeal 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 recomputed on a realization basis for that purpose. According to FSTB, this would cause financial institutions and securities dealers hitherto using the fair value basis to incur substantial costs for re-computation of their profits.

5. To address these concerns, clause 3 seeks to add new sections 18G to 18L to Part 4 (Profits Tax) of Cap. 112 to align the treatment of financial instruments for profits tax purposes with their accounting treatment. Under the proposed new

section 18H, a person who prepares financial statements in accordance with the Hong Kong Financial Reporting Standard 9 (Financial Instruments) ("HKFRS 9") or the International Financial Reporting Standard 9 (Financial Instruments) would be able to make an election (which would be irrevocable, except with CIR's approval, and have effect for the year of election and all subsequent years of assessment) to the effect that under Part 4 of Cap. 112:

- (a) the amount of any profit, gain, loss, income or expense computed for a financial instrument for profits tax purpose for a period would be the amount of such profit, gain, loss, income or expense recognized for the instrument for accounting purpose for the period, such that profits would include not only realized, received, accrued or paid profits, but also a change in fair value (albeit unrealized) of a financial instrument (the proposed sections 18I and 18J); and
- (b) special treatment would apply in certain circumstances to an impairment loss, an equity instrument or financial liability on revenue account, an embedded derivative, a preference share, a non-arm's length loan or debt security and a hedging instrument (the proposed sections 18K and 18L).

6. The tax treatment of financial instruments under the proposed sections 18G to 18L of Cap. 112 would apply in relation to a year of assessment for which the basis period¹ begins on or after 1 January 2018 (section 2, proposed Schedule 48).

Interest expense payable to OECA (clause 4)

7. 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. Under section 16(3) and (4), an OFI is currently defined as "a person carrying on the business of banking or deposit-taking outside Hong Kong other than a person whom" CIR determines shall not be so recognized on the basis that "that person's banking or deposit-taking business is not adequately supervised by a supervisory authority". According to paragraph 8 of the LegCo Brief, an OECA run as a public institution does not fall within this definition as it does not carry on banking or deposit-taking business, and is not regulated by an overseas authority as a banking or deposit-taking institution.

8. Clause 4 seeks to amend the definition of OFI in section 16 of Cap. 112 to include OECAs so that interest expenses payable to them would also be deductible for profits tax purposes. Under clause 4(2), OECA would be defined as "an organization that is owned by, or was established and is operated by, a governmental entity² of a jurisdiction outside Hong Kong for the purposes of carrying on export credit business", i.e. the business of supporting and developing international trade by

¹ Under section 2(1) of Cap. 112, "basis period" for any year of assessment means the period on the income or the profits of which tax for that year ultimately falls to be computed.

² "Governmental entity" would be defined to include the government, a political subdivision, an integral part, a controlled entity, or a wholly owned agency or instrumentality, of the jurisdiction.

providing financing support to exporters or investors of that jurisdiction. Under the proposed section 16(4) sought to be amended by clause 4(3), CIR may refuse to recognize an OECA as an OFI if CIR opines that its export credit business is not adequately monitored or regulated by the governmental entity which owns or established and operates the OECA.

9. If the Bill is passed by LegCo, the proposed amendments to section 16 would apply to interest accruing on or after the day on which the enacted Ordinance is published in the Gazette ("gazettal date") (sections 1 and 3, proposed Schedule 48).

Refinements to AEOI (clauses 5 to 9)

10. Clauses 5 to 9 seek to implement certain recommendations made by the Organization for Economic Co-operation and Development ("OECD") by refining the provisions for AEOI in Part 8A (Returns by Reporting Financial Institutions) of Cap. 112 so as to align with the requirements under the Common Reporting Standard ("CRS") promulgated by OECD in March 2017. Under the proposed amendments:

- (a) "controlling persons" (the proposed section 50A(1)):
 - (i) in relation to an entity (including a corporation, partnership, unincorporated body, trust or legal arrangement), would mean an individual who exercises control over the entity; and
 - (ii) in relation to a trust, or a functionally equivalent or similar entity, would include the settlor, trustee, protector, enforcer or beneficiary of the trust, or an individual in a similar position;
- (b) there would be residency rules for financial institutions (other than trusts) that do not have a tax residence (the proposed new section 50A(15)(d));
- (c) certain schemes, pooling agreements and approved pooled investment funds under the Mandatory Provident Fund Schemes Ordinance (Cap. 485) or the Occupational Retirement Schemes Ordinance (Cap. 426), and credit unions registered under the Credit Unions Ordinance (Cap. 119), would cease to be non-reporting financial institutions (clauses 5(5) and 7(2));
- (d) CIR would publish guidelines to ensure that the AEOI provisions in Part 8A are construed consistently with CRS, but the guidelines would not be subsidiary legislation or subject to scrutiny by LegCo (clause 6); and
- (e) 51 reportable jurisdictions would be added to Schedule 17E to Cap. 112 in view of the extension of the Convention on Mutual Administrative Assistance in Tax Matters to Hong Kong (clause 9).

Income of visiting teacher or researcher (clause 10)

11. According to paragraph 16 of the LegCo Brief, a Teachers and Researchers Article ("TRA") has been included in the Comprehensive Avoidance of Double Taxation Agreement ("CDTA") signed with Saudi Arabia³ to provide for tax exemption for visiting teachers and researchers in the jurisdiction visited for a period of time, and a TRA is planned to be added to the proposed CDTA with the Mainland.

12. As Hong Kong adopts a territorial basis of taxation, salaries tax is not, under section 8(1A)(b) of Cap. 112, chargeable to income derived from employment where the person renders all the services in connection with the employment outside Hong Kong. To avoid double non-taxation under the TRA, clause 10 seeks to amend section 8 of Cap. 112 so that a Hong Kong resident person's income derived as a visiting teacher or researcher in a territory outside Hong Kong to which a TRA applies would be exempted from salaries tax only if the person satisfies CIR that, despite the TRA, tax is paid or payable in that territory in respect of the income.

13. The proposed amendments to section 8 would apply in relation to a year of assessment beginning on or after 1 April 2019 (section 4, proposed Schedule 48).

Sibling relationship (clause 11)

14. 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") 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. The Administration replied that the proposed definition of "sibling" was modelled on the definition of "brother or sister or brother or sister of the spouse" under 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 2018⁴) to rectify the omission.

15. Clause 11 seeks to 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. Under the proposed new definition, "brother or sister" would include, among others, "a natural child of an adoptive parent of the person or the spouse" (if the person or the spouse is adopted). The expression "natural" sibling would also be changed to a sibling "of full or half blood".

³ See Article 21 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).

⁴ Published in the Gazette on 9 November 2018 as the Inland Revenue (Amendment) (No. 8) Ordinance 2018 (31 of 2018).

16. The proposed new definition would apply in relation to a year of assessment beginning on or after 1 April 2019 (section 5, proposed Schedule 48).

Use of notes

17. It is noted that clauses 3 and 5 include certain "notes without legislative effect" to explain the background, meaning and effect of the proposed amendments.⁵

Commencement

18. If passed, the proposed amendments relating to AEOI under Part 4 (i.e. clauses 5 to 9) of the Bill would come into operation on 1 January 2020, while the remainder of the enacted Ordinance would come into operation on its gazettal date.

Public Consultation

19. According to paragraphs 27 and 28 of the LegCo Brief, relevant stakeholders have been consulted on the proposed alignment of tax and accounting treatment of financial instruments, AEOI reporting requirements, and avoidance of double non-taxation of income of visiting teachers and researchers, and the Bill has incorporated the suggestions received on various technical matters as appropriate.

Consultation with LegCo Panel

20. As advised by the Clerk to the Panel on Financial Affairs, the Panel was briefed on 3 July 2018 on the proposals to allow the computation of assessable profits on financial instruments on a fair value basis, expand the definition of OFI to cover OECA for interest deduction, and align the relevant AEOI provisions with CRS. Members raised various enquiries such as whether a company would be able to elect realization accounting for tax computation on its financial instruments, how much tax revenue would be forgone under the proposed OECA interest deduction, and whether similar tax deductions would be offered to Hong Kong persons by other jurisdictions.

Conclusion

21. LSD's scrutiny of the Bill continues. In view of the enquiries raised at the Panel meeting, Members may consider forming a Bills Committee to study the Bill in detail.

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⁵ See paragraph 9.4.3 of *Drafting Legislation in Hong Kong – A Guide to Styles & Practices* published by the Department of Justice.