JOINT LIAISON COMMITTEE ON TAXATION

CONSTITUENT MEMBERS: **THE AMERICAN CHAMBER OF COMMERCE**
THE HONG KONG GENERAL CHAMBER OF COMMERCE
HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
THE INTERNATIONAL FISCAL ASSOCIATION - HONG KONG BRANCH
THE LAW SOCIETY OF HONG KONG
THE TAXATION INSTITUTE OF HONG KONG
FEDERATION OF HONG KONG INDUSTRIES
THE HONG KONG ASSOCIATION OF BANKS
CAPITAL MARKETS TAX COMMITTEE OF ASIA
14th Floor, One Taikoo Place, Quarry Bay, Hong Kong.
Telephone: (852) 2846 1089

29 April 2021

Clerk to Bills Committee on Inland Revenue
(Amendment) (Miscellaneous Provisions) Bill 2021
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong

Inland Revenue (Amendment) (Miscellaneous Provisions) Bill 2021 - proposed e-filing system / corporate amalgamations / succession to specified assets otherwise than by sale

By way of background, the Joint Liaison Committee on Taxation (JLCT) was established in 1984 and comprises representatives from the tax committees of the American Chamber of Commerce, Hong Kong General Chamber of Commerce, HKICPA, International Fiscal Association, Law Society, Taxation Institute of Hong Kong, Federation of Hong Kong Industries, Hong Kong Association of Banks and Capital Markets Tax Committee of Asia. We meet usually monthly with the Commissioner of Inland Revenue (CIR) and representatives of FSTB to discuss taxation proposals and developments. We have made submissions to both IRD and FSTB with respect to this Bill both before and after it was drafted for submission to the Legislative Council.

JLCT wishes to make some comments with respect to the Bill, particularly those provisions that relate to (1) electronic filing of tax returns, (2) corporate amalgamations and (3) succession to specified assets otherwise than by way of sale. We are grateful to the Bills Committee for giving us this opportunity to express our views.

We would say at the outset that JLCT generally supports the broad policies behind this Bill, but we do have some concerns about its provisions, as outlined below.

1. ELECTRONIC FILING OF TAX RETURNS

JLCT's earlier submissions to CIR were concerned with the practical operation of the proposed e-filing system, which is outside the scope of the Bill. We had encouraging dialogue with CIR about this.

Concerning the Bill itself, JLCT's concerns relate to the provisions that deal with service providers (SP). Our concerns are as follows.

a. Section 51AAD

This section introduces the concept of a SP who is defined as “a person engaged to carry out a taxpayer’s obligation” to "furnish" a tax return for or on behalf of the taxpayer pursuant to s.51(1) of the IRO. In this regard:

(i) It is not clear who is a SP for these purposes. The concept of "furnishing" a tax return in an e-filing context is markedly different from the concept under the current paper filing system. Filing electronically involves many discrete tasks, such as tagging and conversion of financial information data into the required computer software system, e-signing the return and transmitting the data to the IRD. In many cases, it is likely that these functions will be divided amongst a number of SPs. Larger corporations will likely perform some of these tasks themselves and outsource other tasks. In these situations, it is unclear whether a person who is engaged to perform only one of these tasks can be said to have been engaged to "furnish" the tax return. In our view, the definition of SP should be clear and unambiguous.

(ii) In our view, these provisions should only apply to e-filing. The current system of filing paper returns is well-established. We do not see a need to change it, nor are we aware that anyone is lobbying for changes.

(iii) We presume that the key role played by a SP will be to “e-sign and submit the return and supporting documents electronically”. By contrast, with the current paper filing system, an authorized representative may submit a tax return on behalf of a taxpayer but only the taxpayer may sign it.

It appears to us that penalizing a SP who has been engaged only to transmit the e-return to the IRD is similar to penalizing the Post Office for failing to deliver a posted paper return to the IRD. The SP in this case is only a messenger who transmits the return to the IRD.

The CIR explained to JLCT that, under the current paper filing regime, it is the taxpayer who signs its own return, and penalties apply to it as a signer. Under an e-filing regime, however, it is the SP who e-signs the e-return, and therefore it is appropriate that, as signer, the SP should be subject to the same penalties. In our view, this is a fallacious comparison. Despite the change in the identity of the signer, *in substance*, this remains the taxpayer's return regardless of who signs it. It is therefore the taxpayer, who has authorized the SP to e-sign the e-return on the taxpayer's behalf, who should, in our view, be liable for penalties should the return be incorrect.

JLCT therefore recommends that the definition of SP in 51AAD should be narrowed to a “person engaged to e-sign and submit a return and supporting documents electronically”. Other tasks such as off-line preparation or review of the return, and the tagging and conversion of the documents into the required computer software format, should not be considered to form part of the role of the SP (but, of course, the SP might in some case also provide these services). If this suggestion is accepted, there will need to be other consequential changes to the Bill, in particular to section 80K.

b. Section 80K

This section deals with offences that a SP may commit as follows:

(i) Failure to furnish the tax return without reasonable excuse;

(ii) Failure to obtain written confirmation from the taxpayer as previously explained and to retain it for 7 years without reasonable excuse;

(iii) Furnishing a materially incorrect return that is not in accordance with instructions or information given by the taxpayer without reasonable excuse.

In each case the SP would be liable to a fine of HK$10,000.

In our view, these provisions are reasonable and acceptable except for the first one, viz. failure to furnish a return. While it is reasonable to penalize a SP for acts of commission, we think it would be a waste of the IRD's time to pursue a SP for acts of omission. The IRD should take action against the taxpayer alone. Hence, we recommend that 80K(2) be deleted.

c. Section 80L

This states that a court may order a SP to furnish the return for which it was engaged or to obtain written confirmation and so on.

We suggest this procedure would be a waste of the court's precious time and that section 80L therefore be deleted. If a return has not been furnished, the sole remedy should lie against the taxpayer. We do not think it is appropriate to penalize the agent rather than the principal. Indeed, in some cases involving an difficult client, the SP might be unable to make the e-filing anyway (e.g. where the principal is facing business or financial problems, or fails to provide the necessary information to the SP).

d. Amendments to Section 82A

It is proposed that in certain cases engaging a SP would not "in itself constitute a reasonable excuse".

It is entirely a question of the relevant facts and circumstances as to what would and should constitute a reasonable excuse in any given case. It is wholly inappropriate to lay down statutory tests as to what is reasonable. Under the present system, it is for a taxpayer to defend itself and ultimately for the Board of Review or a court to decide whether the taxpayer has acted reasonably in the facts of each case. We believe a taxpayer should be entitled to rely on the services of a qualified expert in appropriate cases, and an impartial observer may consider such reliance to be entirely reasonable in such cases. We note that the Tax Tribunal in the UK has adopted a position in many cases whereby it has held that it was reasonable on the facts of those cases for the taxpayer to rely on its adviser (and on other facts it held that it was not reasonable for the taxpayer to do so). This requires a case-by-case analysis.

Hence, in JLCT's view, this and similar provisions should be deleted from the Bill.

2. CORPORATE AMALGAMATIONS

JLCT welcomes these amendments which are designed to clarify the tax consequences of voluntary corporate amalgamations made pursuant to the Companies Ordinance. This has been a source of disagreement between the tax profession and the IRD, and therefore the certainty that will be provided by the enactment of the Bill will be appreciated.

JLCT's main reservation concerns the restrictions on the use of tax losses of the two companies following an amalgamation. These restrictions appear to us to be excessive, especially considering that the IRO already contains a general anti-avoidance provision. Our concern is that, in the draftsperson's zeal to prevent tax avoidance, losses will be denied even in "innocent" circumstances. In our view, if tax avoidance is not the motive for conducting an amalgamation, then the general concept should continue to be that tax losses can be carried forward and used by the amalgamated company against its future taxable profits.

The two restrictions that cause us concern are the "post-entry" condition and the "financial resources" condition.

We understand that the proposed amendments are modelled on the corresponding legislation in the Singapore Income Tax Act. However, because of what appears to be excessive concern about abusing tax losses, the provisions in the Bill are materially more restrictive than in Singapore. The relevant Singapore provisions are in effect contained in a single section (s.34). By comparison, the Bill before you is long and is perhaps not as economical in its drafting as it could be. Further, the conditions attached to the on-going utilisation of pre-amalgamation losses in Singapore are more generous and, most importantly, more commercial compared with the Bill. JLCT therefore urges the Bills Committee to take into account the following issues.

We would again emphasise that the tax authorities in Singapore (IRAS) appear to consider its ‘light-touch’ loss carry-forward code for corporate amalgamations adequate for the preservation of the integrity of its tax laws and it is not clear to us why Hong Kong should follow a different approach in that regard.

a. "Post-entry" condition

There is no equivalent provision in the Singapore legislation and it is not clear to us why this is proposed to be introduced in Hong Kong.

FSTB's explanation for imposing this condition is to guard against taxpayers “*acquiring an unrelated or a non-wholly owned loss company to make use of the tax losses accumulated in that loss company before the acquisition so as to reduce the tax liabilities of the group through amalgamation*”.

We understand FSTB's valid concern, but in our view the post-entry condition is disproportionate. JLCT believes that general anti-avoidance provisions in ss.61 and 61B, and the specific anti-avoidance provisions contemplated in the Bill, are already more than sufficient to guard against aggressive tax planning in this regard. We therefore urge the Bills Committee to reconsider this condition. It is complicated, uncommercial, and will likely lead to amalgamating companies opting out of the discrete tax regime for amalgamated companies contained in the Bill.

b. Financial resources condition

The financial resources condition is also not contained in the Singapore legislation, and it appears excessive to apply this in Hong Kong.

The FSTB's explanation for imposing this condition is: "*[w]hether or not a company has financial ability to acquire the business of the amalgamating company is one of the indicators to infer whether there is an intention for tax avoidance. In the commercial world, if the amalgamated company has incurred substantial losses in the past, it is difficult for it to carry out amalgamation with a commercial purpose unless it has sufficient financial resources… Such test has been included in the IRD's interim assessment practice statement since 2015 and it has operated smoothly without any problems*".

In our view, the prevention of tax abuse for losses is already substantially addressed by the "good commercial reasons" test and the "main purpose" test contained in section 26(3) of the proposed new Schedule 17J to the IRO (and, of course, in the more general anti-avoidance provisions in ss.61 and 61B). To add an express "financial resources" test is unduly restrictive because it penalises capital rich but cash poor companies, and is in any event surplus to requirements. A 'one size fits all' financial resources condition is therefore in our view undesirable, and is likely to give rise to industry-specific imbalances in the application of the loss carry-forward regime.

Separately, it goes without saying that the fact that the "financial resources" condition was included in the IRD's interim published policy statement since 2015 (which of course has no legal authority) does not mean that this condition should be retained in the Bill.

In summary, JLCT urges that the post-entry condition and the financial resources condition be omitted from the Bill. It is not clear to us why it should be included, and we have noted that Singapore did not consider such conditions to be necessary. To restore Hong Kong as an international business bub, it is essential to provide a reasonable and practical legal framework to facilitate commercially-driven corporate activities, instead of imposing excessive restrictions to discourage such activities for the ease of tax administration.

3. SUCCESSION TO SPECIFIED ASSETS OTHERWISE THAN BY SALE

Paragraphs 8 and 9 of the Legislative Council Brief state that the purpose of the proposed amendments is to enable the claw-back of deductions or allowances granted with respect to specified assets, the ownership of which passes from the claimant to a successor without sale.

Specifically, footnote 9 refers to sections 16J(5B), 38(4) and 39D(4) as current instances of deemed disposal of assets at market value for tax purposes.

We understand that FSTB considers that such deeming provisions should, subject to two exceptions, be extended to cover all other transfer or succession of specified assets without sale. (The two exceptions are the succession of specified assets: (i) upon the death of a relevant person; and (ii) upon a qualifying amalgamation undertaken under the Companies Ordinance of Hong Kong where an election for the specified tax treatment under the proposed new Schedule 17J has been made.)

Under the proposed amendments, in all other situations referred to as "specified events", the specified assets will be deemed to have been sold by the transferor at market value (subject to capping the value at a certain amount), and purchased by the transferee at the same amount, under the proposed new sections 40AS, 40AT and 40AU of the IRO.

With respect, we have doubts about the rationale for applying these proposed deeming provisions, for the following reasons:

1. First, the existing deeming provisions contained in sections 16J(5B), 48(4) and 39D(4) all relate to an appropriation of assets for private or non-business use upon cessation of a business (i.e., they codify elements of the rule in the classic case of *Sharkey v Wernher*). In those circumstances, taxpayers could have sold the assets concerned but instead chose to appropriate the assets for their private or non-business use. There is an obvious policy basis in such cases to deem such taxpayers to have sold those assets at market value for tax purposes: it promotes tax symmetry.

2. Secondly, and more importantly, if the assets were subsequently actually sold within 12 months of the deemed disposal, taxpayers could apply to substitute the actual sale proceeds received for the market value of the assets previously adopted for tax purposes, and revise their previous tax assessment accordingly.

In other words, taxpayers in the above circumstances have a choice of either: (i) appropriating the assets for private or non-business use and being taxed based on a deemed sale of the assets at market value; or (ii) selling the assets within 12 months after the cessation of business and being taxed instead on their actual sale proceeds received.

Where, however, a succession of specified assets without sale is concerned, the taxpayers have not chosen to appropriate the assets for private or non-business use. Typically, such assets simply vest in the successors by operation of law. In such cases, (i) there is no appropriation of the assets by the taxpayers for private or non-business use; and (ii) no sale proceeds have been received by the taxpayers. It appears to us that the broad-brush default position of the proposed amendments (namely, deeming the specified assets as having been sold and purchased by the transferor and transferee concerned at market value in all situations where a specified event occurs) is excessive and not appropriate.

For example, structures comprising plant and machinery erected on land by a lessee would pass to the lessor upon the expiry of a land lease. (An example is an escalator that has been constructed by the lessee inside the leased premises.) Another example is the succession of specified assets where the Hong Kong branches of two foreign companies are merged under a foreign law.

In the first example, instead of the relevant assets being deemed to have been sold at market value, depending on the facts of each case, the lessee may in fact have a case to claim that the remaining unrelieved tax costs in respect of the assets could be granted balancing allowances, e.g., effectively as an additional occupancy cost of the lessee during the term of the lease. Conversely, it may also not achieve a desirable tax outcome by deeming the lessor to have purchased the relevant assets at market value.

In the second example, it does not seem to serve any policy objective to differentiate between the tax treatment for succession of specified assets without sale upon the amalgamation or

merger of the Hong Kong branches of two foreign companies under a foreign law, from that undertaken by two Hong Kong companies under the Companies Ordinance.

We therefore submit that the provisions in the Bill are excessive and unnecessary. Instead, a case-by-case approach should instead be adopted to cater for the different specified events as envisaged.

Finally, we suggest that the Government should consider extending the special tax treatment under the proposed new Schedule 17J to the IRO to cover the merger of the Hong Kong branches of two foreign companies under a foreign law, i.e., by default treat such a merger as also a qualifying amalgamation under the proposed amendments.

We hope you will find our comments helpful. If you have any question, we would be happy to provide further clarification or explanation.

Best regards,

Michael Olesnicky
Chairman
For and on behalf of
The Joint Liaison Committee on Taxation

cc Mr Ashley Tam Tai-pang, CIR
Mr Stephen Lo, FSTB