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Report of the Bills Committee on Inland Revenue (Amendment) (Miscellaneous Provisions) Bill 2021

Purpose

This paper reports the deliberations of the Bills Committee on Inland Revenue (Amendment) (Miscellaneous Provisions) Bill 2021 ("the Bills Committee").

Background

2. Division 3 of Part 13 of the Companies Ordinance (Cap. 622) ("CO"), which came into effect on 3 March 2014, provides for a set of court-free amalgamation procedures for wholly-owned intra-group companies incorporated in Hong Kong and limited by shares to amalgamate and continue as one company ("qualifying amalgamation"). At present, the Inland Revenue Department ("IRD") makes assessment on qualifying amalgamation cases in accordance with an assessment practice published on IRD's website. According to paragraph 5 of the relevant Legislative Council ("LegCo") Brief [1], while the interim administrative assessment practice has been implemented smoothly since its publication, it is necessary to introduce legislative amendments to codify the practice into the Inland Revenue Ordinance (Cap. 112) ("IRO") for clarity and certainty. The Inland Revenue (Amendment) (Miscellaneous Provisions) Bill 2021 ("the Bill") is thus introduced into LegCo to provide for tax treatment in relation to qualifying amalgamations. In addition, the Bill seeks to provide for the tax treatment in relation to the transfer or succession of certain capital assets without sale given that there is currently no provision under the IRO to deal with the transfer of assets without sale except for limited circumstances. The Bill also seeks to enhance the statutory framework for furnishing tax returns and foreign tax deduction.

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[1] File Ref.: TsyB R 183/700-6/12/0 (C) issued by the Financial Services and the Treasury Bureau in March 2021.

The Inland Revenue (Amendment) (Miscellaneous Provisions) Bill 2021

3. The Bill was gazetted on 19 March 2021 and received its First Reading in LegCo on 24 March 2021. The Bill seeks to amend IRO to –

(a) provide for tax treatment in relation to the amalgamation of companies under Division 3 of Part 13 of CO;

(b) provide for tax treatment in relation to the transfer or succession of certain capital assets under certain circumstances;

(c) enhance the mechanism for furnishing tax returns required under IRO;

(d) enhance the current provisions for deduction of foreign tax paid in respect of certain income, profits or gains; and

(e) provide for related matters.

4. The key features of the Bill are set out in paragraphs 6 to 19 of the LegCo Brief. The Bill, if passed, would come into operation on the day on which the enacted Amendment Ordinance is published in the Gazette. The amendments relating to foreign tax deduction apply only in relation to a year of assessment beginning on or after 1 April 2021.

The Bills Committee

5. At the House Committee meeting held on 26 March 2021, Members agreed to form a Bills Committee to scrutinize the Bill. Hon Holden CHOW Ho-ding was elected Chairman of the Bills Committee. The membership list of the Bills Committee is in **Appendix I**.

6. The Bills Committee has held two meetings with the Administration and invited written submissions from the public and relevant organizations. The Bills Committee has received six submissions. A list of the organizations which have provided written submissions to the Bills Committee is in **Appendix II**. The Administration has provided written responses[2] on the issues raised in the deputations' submissions.

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[2] LC Paper Nos. CB(1)856/20-21(03) and CB(1)923/20-21(02).

Deliberations of the Bills Committee

7. Members of the Bills Committee have not raised objection to the Bill. The Bills Committee's deliberations are set out in the ensuing paragraphs.

Conditions for setting-off pre-amalgamation losses

8. Members have examined the rationale for the restrictions on and conditions for the set-off of unutilized pre-amalgamation losses of the amalgamating company and amalgamated company against the assessable profits of the amalgamated company under the proposed special tax treatment.

The "good commercial reasons" condition

9. In relation to the treatment of pre-amalgamation losses of amalgamating companies and amalgamated companies, the proposed sections 24(5) and 26(3) of Schedule 17J to IRO provide that unless the Commissioner of Inland Revenue ("the Commissioner") is satisfied that (a) there are "good commercial reasons" for carrying out the qualifying amalgamation, and (b) avoidance of tax is not the main purpose or one of the main purposes of carrying out the qualifying amalgamation, the set-off of pre-amalgamation losses under specified circumstances will be disallowed. Members and the Legal Adviser to the Bills Committee have sought elaboration on the factors that the Commissioner will take into account when determining the conditions mentioned in (a) and (b) above. Members opined that the Administration should not disallow set-off of pre-amalgamation loss merely because the amalgamation results in a large tax benefit/saving but should also consider the commercial reasons of the amalgamation.

10. The Administration has advised that when determining whether the relevant companies have "good commercial reasons" for a qualifying amalgamation, the Commissioner will consider all relevant facts and circumstances, such as the reasons and circumstances for the amalgamation, what result the amalgamation is intended to achieve or has achieved, the non-tax purpose of the amalgamation, whether there are alternative ways to achieve the non-tax purpose, etc. As the facts of each case are different, the Commissioner will carefully consider all relevant facts and circumstances specific to the case. If tax benefit is only an incidental consequence of the qualifying amalgamation, the obtaining of tax benefit will not be considered a main purpose. The pre-amalgamation loss would be allowed for set-off

subject to the satisfaction of other conditions. On the other hand, if the tax benefit is achieved through deliberate arrangement, the pre-amalgamation loss would not be allowed for set-off.

The "same trade" condition

11. Under the same trade condition provided under the proposed section 25(3) of Schedule 17J, a pre-amalgamation loss of the amalgamated company can only be used to set off against the assessable profits of the amalgamated company derived from the same trade, profession or business that was carried on by the amalgamating company immediately before the date of amalgamation and that is succeeded from the amalgamating company, or to set off against the amalgamated company's share of assessable profits of a partnership through succession to the amalgamating company's interest in the partnership.

12. Members note the concern of some deputations that the same trade condition may be too restrictive. For example, a company operating a Japanese restaurant ("Company A") is making a loss before amalgamation. It amalgamates with another group company carrying on a catering business in order to improve synergy. If for commercial reason the amalgamated company's business is converted into operating an Italian restaurant, Company A would not be considered as carrying on the "same business" and the pre-amalgamation tax loss of Company A is unlikely to be able to be utilized upon the change of business model after amalgamation. The condition is thus unduly restrictive and hinders commercial practicality. Members have also pointed out that whether two trades are considered the same trade involves subjective judgment, and in this way, the same trade condition may give rise to uncertainties.

13. The Administration has advised that the same trade condition is to prevent the transfer of losses between group companies through amalgamation. An amalgamation is the combination of two or more companies into a larger single company, and the amalgamating company's business should be succeeded by the amalgamated company. In the absence of the same trade condition, an amalgamated company may avoid tax simply through making use of the loss of the amalgamating company by closing the business of the amalgamating company after amalgamation. Singapore also applies the same trade condition in similar situation. Whether two businesses are the same is a question of fact and reference can be made to the judgment of Walton J in *Rolls-Royce Motors Ltd v Bamford* [1976] STC 162.

The "financial resources" condition

14. Members have examined the financial resources condition for the set-off of pre-amalgamation loss as provided under the proposed section 26(2) of Schedule 17J, under which the amalgamated company must have adequate financial resources (excluding any loan from an associated corporation of the amalgamated company) immediately before the amalgamation to purchase, other than through amalgamation, the trade, profession or business carried on by the amalgamating company immediately before the date of amalgamation, and the amalgamating company's interest in any partnership in which the amalgamating company was a partner immediately before the date of amalgamation. Members note the concern of some deputations that from the perspective of commercial operation, the financial resources condition is unduly restrictive and may limit the deployment of financial resources within the group/a group of companies. Moreover, there is currently no similar provision in IRO preventing a loss company from obtaining financing from a group company to acquire a profitable business.

15. The Administration has explained that the purpose of the financial resources condition is to minimize the risk of achieving group tax loss relief through amalgamation. Under horizontal amalgamation, the group is free to choose any wholly-owned subsidiary as the amalgamated company. If the condition is removed or relaxed, an amalgamated company may make use of its losses to set off the profit of an amalgamating company to avoid tax even if the amalgamated company has no financial ability to carry on business. In applying the financial resources condition, IRD will consider whether the amalgamated company has sufficient capital, liquid assets or cash on the date of amalgamation to carry on business as well as its ability to raise funds from independent third parties having regard to its own credit rating status. Such condition has been included in IRD's interim administrative assessment practice since 2015 and it has been operating smoothly without any operational problems.

Merger of Hong Kong branches of two foreign companies

16. A merger of two companies (e.g. two foreign banks) under the merger law of a foreign country is not a "qualifying amalgamation" as defined in the Bill and as a result, the transfer or succession of assets between the Hong Kong branches of these two foreign companies pursuant to the merger will not qualify for the special tax treatments. On the other hand, based on the current definition of "specified event" in the Bill, the above transfer or succession of assets between the two Hong Kong branches will fall within the

scope of specified events, and as a result, the provisions on deemed disposal and purchase of specified assets in a specified event under the proposed new Part 6D of IRO would apply to a foreign merger but not a qualifying amalgamation in Hong Kong. Members note some deputations' view that from the tax policy perspective, there should not be any differences between the tax treatments of a qualifying amalgamation under CO in Hong Kong and a merger under the merger law of a foreign country if the latter is of substantially the same nature of the former. The special tax treatment under the proposed Schedule 17J should apply to the merger of Hong Kong branches of two foreign companies under the merger law of a foreign country (i.e. treating such merger a qualifying amalgamation by default), if an election for special tax treatment has been made under the proposed section 40AM(1).

17. On the above view regarding the merger of Hong Kong branches of two foreign companies, the Administration has explained that a branch is considered part of an entity and is not a separate legal entity. The merger of foreign entities is governed by the laws of the foreign jurisdictions which may be different in different jurisdictions. Some mergers may also involve companies which are not wholly-owned by the same group. As such, the Administration considers it not appropriate to cover the merger of Hong Kong branches of two foreign companies under the proposed legislation.

Role and liability of service provider in furnishing of tax returns

18. Under the proposed section 51AAD(1) a taxpayer may engage a service provider to furnish a return under section 51(1) of IRO for or on behalf of the taxpayer. Members note the concern raised by some deputations that the term "service provider" is unclear and should be more clearly defined as to whether it includes parties performing tasks in preparation for the furnishing of tax returns, e.g. preparing profits tax computations and other supporting documents, filling in the return forms, etc. Members and the deputations consider that the penalty provisions against service providers' failure to perform a statutory act should be considered only if the role of service providers is clearly defined.

19. The Administration has advised that section 51(1) of IRO imposes on a taxpayer the obligation to furnish tax returns within a stipulated time. It is understandable that preparatory work is involved before a taxpayer discharges its obligation to furnish tax returns. However, the obligation imposed on a taxpayer by section 51(1) does not concern how and by whom such preparatory work is to be performed. Even when such preparatory work is contracted out by taxpayers to other persons, the obligation to furnish tax

returns under section 51(1) remains with the taxpayer. The proposed section 51AAD(1) and (8) makes cross-reference to section 51(1). Specifically, the proposed section 51AAD(8) serves to define "service provider" to mean a person engaged to carry out a taxpayer's obligation to furnish returns under section 51(1). By defining the role of service provider as "furnishing returns", it is intended to refer only to the person who furnishes the tax return on behalf of the taxpayer (i.e. the one signing the return), irrespective of the way in which a return is furnished (i.e. paper, electronic or mixed). In other words, a person engaged by a taxpayer for undertaking only preparatory work such as preparing profits tax computations and other supporting documents, filling in the return form, etc. is not a service provider for the purpose of the proposed section 51AAD(8) unless he also furnishes the tax return on behalf of the taxpayer.

20. The Administration has further advised that the wording used in the definition of "service provider" in the proposed section 51AAD(8) and the proposed section 51AAD(1) for engagement of service provider is in line with the definitions of "service provider" under sections 50A(1) and 58B(2) of IRO and the provisions for engagement of service provider under sections 50H(1) and 58M(1). Since these enacted provisions have been operating smoothly for some years without any problem, the same wording should be adopted in the proposed section 51AAD(1) and (8) for the sake of consistency in the administration of IRO. However, in view of the members' concerns above, the Administration has undertaken to clarify the definition of service provider in the speech of the Secretary for Financial Services and the Treasury when the Second Reading debate on the Bill is resumed.

21. Regarding the concern on penalty against service providers, the Administration has advised that it is the taxpayer who has the primary responsibility for furnishing the tax return. Under normal circumstances, penal action would be taken against the taxpayer for failure to furnish the return or furnishing an incorrect return. A service provider under the proposed section 51AAD(8) is engaged by the taxpayer to perform a statutory act, i.e. to furnish the tax return for or on behalf of the taxpayer. If the service provider so engaged, without reasonable excuse, fails to do so, or does not do so in accordance with the information provided or instructions given by the taxpayer and the return so furnished is incorrect in a material particular, it is reasonable to impose penalty on the service provider to protect the interest of the taxpayer.

Circumstances for specifying by a gazette notice that a taxpayer may engage a service provider to furnish a return

22. Under the proposed new section 51AAD, the Commissioner may specify by notice published in the Gazette and by reference to a class or description of persons or returns that a taxpayer may engage a service provider to furnish a return for or on behalf of the taxpayer. Members and the Legal Adviser to the Bills Committee have sought clarification on the circumstances in which the Commissioner would do so; and why, insofar as a class or description of persons or returns may be affected, the Commissioner's notice is not proposed to be subsidiary legislation subject to scrutiny by LegCo.

23. The Administration has advised that its current plan is to allow taxpayers to engage service providers to furnish profits tax returns for or on their behalf irrespective of the mode in which a return is furnished (i.e. paper, electronic or mixed). As system enhancement is required, the gazette notice will be published as and when the enhanced system is ready for operation.

24. On the reason why the Commissioner's notice mentioned above is not proposed to be subsidiary legislation, the Administration has advised that under the existing section 51AA(5) and (6) of IRO, the Commissioner may specify by notice in the Gazette the types of tax returns which can be furnished electronically or using a telefiling system, the form and manner of furnishing electronic returns, and technical requirements in relation to an electronic record. Such notice is not subsidiary legislation under the existing section 51AA(8) given that these are operational matters and do not carry any significant policy implications. The notice to be made by the Commissioner under the proposed section 51AAD regarding the optional engagement of a service provider to furnish a tax return for or on behalf of a taxpayer is similar in nature to the notice to be made under the existing section 51AA(5) and (6) of IRO in that it is operational matter and does not carry any significant policy implications. Therefore, the Administration proposes that such notice to be made by the Commissioner is similarly not subsidiary legislation.

Mandatory e-filing of returns

25. According to the Administration, one of the purposes of the Bill is to provide legislative backing to IRD's plan to enable more businesses to voluntarily e-file profits tax returns including financial statements in 2023, with the ultimate goal of implementing e-filing of profits tax returns through the newly developed Business Tax Portal. The proposed section 51AAB of

IRO empowers the Commissioner to, through subsidiary legislation, specify the classes or descriptions of taxpayers who must furnish their tax returns by e-filing in a gazette notice. Members have enquired about the timetable for implementing mandatory e-filing and the types of businesses to which e-filing is applicable. As this may represent a major operational change to the process of furnishing tax returns, members called on the Administration to exercise prudence in implementing e-filing and allow businesses, in particular small and medium enterprises, to have sufficient time to understand and adapt to the new e-filing mechanism.

26. The Administration has advised that when setting the timetable for implementing mandatory e-filing, the Administration will consider the actual situation and feasibility, including whether taxpayers and tax practitioners have sufficient time to get familiar with the new e-filing mechanism. The preliminary thinking is, at appropriate time, to require large businesses (e.g. with turnover above a certain threshold) or businesses in certain sectors (e.g. financial institutions) to make their filings electronically first. It may be extended gradually to cover other classes of businesses or entities at a later stage. The Administration may also consider allowing micro enterprises (e.g. with turnover below a certain threshold) to continue filing profits tax returns in paper form. Before the implementation of mandatory e-filing, IRD will duly gauge views from stakeholders in preparation for the subsidiary legislation, which is subject to negative vetting by LegCo.

<u>Foreign tax deduction under specified circumstances</u>

27. For non-interest related income, e.g. royalties and technical service fees, to be deductible under the proposed new section 16(1)(ca) of IRO, the foreign taxes paid have to be a "specified tax". A component of the definition of "specified tax" is that it is a tax charged by a territory outside Hong Kong on a certain percentage of income received or receivable by the person from that territory without deduction for the outgoings and expenses (whether or not they were incurred in the production of the relevant income) when computing the amount of tax charged to the person in that territory. In this connection, members have sought clarification as to whether "specified tax" covers foreign taxes charged on deemed profit amount (based on a deemed profit rate) of income received without deduction of any actual outgoings and expenses.

28. The Administration has clarified that whether foreign taxes charged on deemed profit is deductible would depend on the basis of computation. Subject to other conditions, foreign taxes on deemed profit should be deductible if they are charged based on turnover.

Proposed amendment to the Bill

29. The Bills Committee and the Administration will not propose any amendment to the Bill.

Resumption of Second Reading debate

30. The Bills Committee raises no objection to the resumption of the Second Reading debate on the Bill at the Council meeting of 2 June 2021.

Follow-up action by the Administration

31. The Administration has undertaken to clarify the definition of "service provider" in the speech of the Secretary for Financial Services and the Treasury when the Second Reading debate on the Bill is resumed (see paragraphs 18 to 21 above).

Consultation with the House Committee

32. The Bills Committee reported its deliberations to the House Committee on 21 May 2021.

Council Business Division 1
Legislative Council Secretariat
27 May 2021

Appendix I

Bills Committee on Inland Revenue (Amendment) (Miscellaneous Provisions) Bill 2021

Membership List

Chairman	Hon Holden CHOW Ho-ding
Members	Hon WONG Ting-kwong, GBS, JP
	Hon Starry LEE Wai-king, SBS, JP
	Hon Wilson OR Chong-shing, MH
	(Total：4 members)
Clerk	Mr Derek LO
Legal Adviser	Miss Rachel DAI

Appendix II

Bills Committee on Inland Revenue (Amendment) (Miscellaneous Provisions) Bill 2021

List of organizations which have submitted views to the Bills Committee

1. Deloitte Advisory (Hong Kong) Limited
2. Hong Kong Institute of Certified Public Accountants
3. Joint Liaison Committee on Taxation
4. PricewaterhouseCoopers Limited
5. Taxation Institute of Hong Kong