

BRIEF FOR THE LEGISLATIVE COUNCIL

Inland Revenue Ordinance
(Chapter 112)

EXEMPTION FROM PROFITS TAX (INTEREST INCOME) ORDER

INTRODUCTION

Annex

At the meeting of the Executive Council held on 30 June 1998, the Chief Executive in Council made the Exemption from Profits Tax (Interest Income) Order at Annex (the Order) under section 87 of the Inland Revenue Ordinance (Cap. 112).

BACKGROUND AND ARGUMENT

2. On 22 June 1998, the Chief Executive announced a package of special relief measures addressing the present economic adjustment. One of the measures is to exempt from profits tax interest income accrued on or after 22 June 1998 from deposits placed locally with authorized institutions under the Banking Ordinance (Cap. 155) by corporations and individuals other than financial institutions. The measure aims to ease the current credit crunch. According to an analysis by the Hong Kong Monetary Authority (HKMA), the current round of credit crunch is rather severe as measured by marked slowdown or even contraction in Hong Kong dollar deposits and domestic lending, and rises in both nominal and real interest rates. The HKMA reviewed the situation with the local banks in mid-May. All of them emphasised that the current situation is affecting their profitability and the stability of the banking system.

3. According to HKMA's statistics, offshore Hong Kong dollar deposits (including swap deposits) amounted to HK\$162 billion as at end-April 1998, of which 80% (or HK\$130 billion) was estimated to be held by Hong Kong corporations. In addition, an informal survey suggests that roughly HK\$70 billion are placed offshore in the form of foreign currency deposits by Hong Kong corporations. It is believed that most of the HK dollar offshore deposits and a large part of the foreign currency offshore deposits are placed outside Hong Kong for tax reasons. Removing the tax disincentive would encourage corporations to repatriate these offshore deposits to Hong Kong, and would hence improve the liquidity and lending appetite of local banks.

4. We therefore propose to exempt from the payment of profits tax interest income received by all businesses, except financial institutions, as defined under the Inland Revenue Ordinance (Cap. 112) (the Ordinance), which are derived from deposits (including certificates of deposits) placed in Hong Kong with authorized institutions under the Banking Ordinance (Cap. 155), regardless of their currency denominations. The exemption would apply to the whole of the interest paid on all new deposits or renewals of existing deposits which were made on or after 22 June 1998. As for deposits which were placed or renewed before 22 June 1998, the exemption would apply to the whole of the interest accrued on or after such date until the deposits mature.

5. We also propose that under the circumstances where there are interest expenses incurred in the production of the interest income which is now exempt from the payment of tax, the amount of tax exempted should be calculated based on the interest received after deduction of all outgoings and expenses, including interest expenses, incurred in the production of such interest. Furthermore, we propose that the exemption should not apply to interest accrued to deposits which are used to secure or guarantee back to back loans while the interest expenses arising from such loans will continue to be deductible under sections 16(1)(a) and 16(2)(d) of the Ordinance.

THE ORDER

6. **Section 1** provides a definition to an authorized institution which is not defined under the Ordinance. **Section 2** specifies the persons eligible to the profits tax exemption in respect of interest income and the circumstances under which the exemption is applicable. **Section 3** provides that the exemption applies to deposits with an authorized institution in Hong Kong regardless of their currency denominations.

BILL OF RIGHTS IMPLICATIONS

7. The Department of Justice advises that the proposed profits tax exemption is consistent with the human rights provisions of the Basic Law.

PUBLIC CONSULTATION

8. The proposal has been well received by banks in Hong Kong and the business sector in general since its announcement.

FINANCIAL AND STAFFING IMPLICATIONS

9. The net revenue forgone is estimated to be about \$500 million annually from 1999-2000. There are no staffing implications arising from the proposal.

ECONOMIC IMPLICATIONS

10. We believe that the exemption would encourage corporations to repatriate their offshore deposits to Hong Kong and hence will improve the liquidity and lending appetite of banks in Hong Kong. The increased bank lending capacity thus entailed will be beneficial to the entire economy, especially if the funds thereby retained in Hong Kong are of longer maturities.

PUBLICITY

11. The Order will be gazetted on 3 July 1998 and tabled in the Legislative Council on 8 July 1998.

Finance Bureau

File Reference : FIN CR L/M 54/98

**EXEMPTION FROM PROFITS TAX
(INTEREST INCOME) ORDER**

(Made by the Chief Executive in Council under section 87
of the Inland Revenue Ordinance (Cap. 112))

1. Interpretation

In this Order -

“authorized institution” (認可機構) means an authorized institution within the meaning of section 2 of the Banking Ordinance (Cap. 155).

2. Exemption from profits tax

- (1) Subject to subsections (2) and (3), where any sum is received by or accrued to -
- (a) a corporation carrying on a trade, profession or business in Hong Kong;
 - or
 - (b) a person, other than a corporation, carrying on a trade, profession or business in Hong Kong, in respect of funds of the trade, profession or business,

which sum is by way of interest derived from any deposit placed in Hong Kong with an authorized institution, the corporation or person other than a corporation shall be exempt from the payment of profits tax chargeable under Part IV of the Ordinance in

respect of that interest, after deduction of all allowable outgoings and expenses under Part IV of the Ordinance incurred in producing such interest, and such exemption applies, in respect of -

- (i) a deposit placed or renewed prior to 22 June 1998, to the whole of the interest accrued on or after such date; and
- (ii) a new deposit placed or an existing deposit renewed on or after 22 June 1998, to the whole of the interest paid on such deposit.

(2) Subsection (1) shall not apply in the case of any deposit which is used to secure or guarantee money borrowed referred to in section 16(1)(a) of the Ordinance where the condition specified in section 16(2)(d) of the Ordinance is satisfied.

(3) This section does not apply to interest received by or accrued to a financial institution.

(4) The exemption under this section applies whether or not a deposit is evidenced by a certificate of deposit.

3. Exemption applies to all currencies

This Order applies to deposits with an authorized institution, regardless of the currency in which the deposit is denominated.

Clerk to the Executive Council

COUNCIL CHAMBER

30 June 1998

Explanatory Note

The purpose of this Order is to exempt certain persons from the payment of profits tax in respect of interest income chargeable under the Inland Revenue Ordinance (Cap. 112). However, the exemption does not apply to financial institutions as defined in section 2 of the Ordinance.