HONG KONG SOCIETY OF ACCOUNTANTS
(Incorporated by the Professional Accountants Ordinance, Cap. 50)

香港會計師公會

BY FAX AND BY POST
(2511 7414)

Our Ref.: C/TXP, M3895 7 June 2001

Mrs. Alice Lau,
Acting Commissioner of Inland Revenue,
Inland Revenue Department,
36/F, Revenue Tower,
5 Gloucester Road,
Wanchai, Hong Kong.

Dear Mrs. Lau,

Inland Revenue (Amendment) Bill 2000

I am writing to convey the Society's views on the proposals for amendments to the Inland Revenue (Amendment) Bill 2000 as outlined to representatives of the Society in a meeting with Mr. Elmo D'Souza and other members of the Inland Revenue Department (IRD) prior to Mr. D'Souza's retirement.

Firstly, we would like to thank the IRD for inviting us to hear and comment upon the outline proposals for changes to the Inland Revenue (Amendment) Bill 2000. We appreciate the efforts being made by the IRD to address the concerns raised and in general terms regard the outline proposals as a step forward. However, for reasons that we explain, the Society still has certain residual concerns about some of the provisions, and in relation to all of the changes we would be grateful for the opportunity to see the detailed drafting of the Committee Stage Amendments. Our comments are set out below.

Clause 5 (section 15, Inland Revenue Ordinance)

We understand that IRD is proposing now to delete the explicit references in clause 5 to the use of/right to use, etc. certain intellectual property outside of Hong Kong, because of the perception of that this is inconsistent with the source principle. At the same time, you are still proposing, where the company is trading in Hong Kong and paying a royalty, even where the goods concerned are manufactured overseas and intended for purely for export outside of Hong Kong, that the income to which the royalty relates will be deemed to have a Hong Kong source. In IRD's view, this would to return to the position that existed, and was fully understood and accepted by taxpayers, prior to the decision in CIR v Emerson Radio Corp. IRD's view appears to be that the court in the Emerson case gave a narrow and literal interpretation of the concept of "use of/right to use in Hong Kong" and if the judgment is accepted, then a considerable loss of revenue could result. It was also pointed out to us at the meeting with the then Acting Commissioner that various other jurisdictions, such as Singapore, Australia and the Mainland, impose a withholding tax in similar circumstances.

The Society nevertheless has some reservations regarding the proposal. Members of our Taxation Committee are not entirely convinced that the decision in Emerson has altered the position from the perspective of taxpayers or that legislation should be introduced to avoid the consequences of the judgment. They consider that in practice many taxpayers would have interpreted the legislation in the same way as the court has now done and, in similar circumstances, would simply not have regarded the royalty payments as assessable income in the hands of the recipient. In addition, the pre-Emerson position did not enshrine the principle of symmetry in the legislation and

we doubt whether it would be helpful now to make a necessary and explicit linkage between deductibility by the payer of the royalty and taxability in relation to the recipient. There are other situations in which this form of symmetry does not apply and it could therefore be confusing to entrench it as a statutory principle under section 15 of the Inland Revenue Ordinance (IRO).

As regards the comparison with the position in other jurisdictions, given that Hong Kong has a unique tax system, we feel that it would not necessarily be appropriate or advantageous for Hong Kong to follow the example of those jurisdictions that happen to operate a similar withholding tax regime.

Furthermore, we note that a figure of $HK200 million has been quoted as the loss of revenue arising from the Emerson decision. We find this figure to be high for at least two reasons. Firstly, because, as indicated above, we believe that the Emerson decision would not have altered the way in which many taxpayers already regarded certain royalty payments. Secondly, even assuming a complete loss of revenue from this source, the figure quoted would seem to imply an amount in excess of $HK10 billion in total income which, from their experience, members of our Taxation Committee find to be somewhat surprising.

Clause 6 (section 16(2)(d) and (e), IRO)

We note the IRD's view that section 61A, IRO is considered to be inadequate to deal with abuses under this sub-section of the IRO. We feel however that s61A should be sufficient to be able to deal with the more blatant and offensive forms of avoidance although this may require identification of the specific schemes involved. The concern that we have is that in trying to introduce more broad-brush preventative legislation, the Bill may have certain unintended adverse consequences and catch in its net small sub-participations and purely commercial arrangements in which, for example, the interest payments may be fully taxable overseas in the hands of the recipient.

In our annual submission to the Financial Secretary on the Budget, we have on several occasions drawn attention to the impediments under Hong Kong's tax regime to genuine intra-group funding. This already places Hong Kong at a disadvantage compared with other leading financial centres and we would again suggest that the Administration take the opportunity to review the whole situation. Under the circumstances, you will understand our concern about any new legislation that could have the effect of reinforcing or exacerbating this problem.

At the meeting with Mr. D'Souza, we were given to understand that the IRD is willing to grant apportionment on a case by case basis where the loan on which the taxpayer wishes to claim a deduction of interest is larger than the deposit/loan used to secure it. This may go some way to minimizing the extent of any negative consequences of the legislation and limiting its application to cases of actual abuse. However, the Society believes that in order to be effective, such apportionment needs to be provided for in the legislation. The detailed nature of the actual mechanism to be used to achieve this should not have to be spelled out in the Bill itself, which need only contain a simple enabling provision, such as a "to the extent" test.

The Society has made a similar point in the context of the Exemption from Profits Tax (Interest Income) Order and we should also like to take this opportunity to propose again that apportionment be provided for in the circumstances governed by the Order, as well as in relation to this part of the Bill. We note that the IRD has sought to justify the introduction of a restriction on "back to back" loans/deposits under section 16(2)(e) on the grounds of harmonization with section

16(2)(d). On the same basis, therefore, we would argue that it would be consistent to extend the possibility of apportionment to the situations covered by the Order.

Clause 6 (section 16(2)(f), IRO)

As we understand it, the IRD is now proposing that the criteria for a debenture-issuer to qualify for a deduction of interest under section 16(2)(f) of the IRO, should be based on a "control" test instead of a simple definition of "associate". Thus the deduction will only be denied where debentures are held by a "controlled" entity and only in proportion to the period that they are so held.

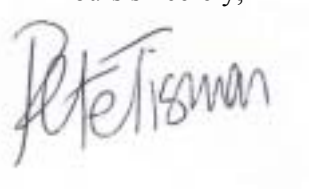
Prima facie this arrangement seems to be preferable to that currently reflected in the Bill. The feasibility and practicality of the proposal will however rest to a large extent on the detailed drafting and the definitions contained in any amendments. As indicated above, therefore, we would appreciate the opportunity to comment on the draft Committee Stage Amendments once they are available.

Clause 14 (section 68, IRO)

We understand that the IRD will bring to the attention of the Board of Review our concern regarding the need not to discourage applications to the Board by the imposition of potentially large costs. The Society welcomes this undertaking by the IRD.

We hope that you find the above comments to be helpful. We would be happy to discuss them with you further.

Yours sincerely,



PETER TISMAN
DEPUTY DIRECTOR
(PROFESSIONAL PRACTICES)
HONG KONG SOCIETY OF ACCOUNTANTS

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