香港會計師公會
HONG KONG SOCIETY OF ACCOUNTANTS
(Incorporated by the Professional Accountants Ordinance, Cap. 50)
香港金鐘道八十九號力寶中心二座四樓
4th Floor, Tower Two, Lippo Centre, 89 Queensway, Hong Kong.
Tel: 2287 7228 Fax: 2865 6603 / 2865 6776 Website: http://www.hksa.org.hk E-mail: hksa@hksa.org.hk

BY FAX AND BY POST
(2877 1082)

Our Ref.: C/TXP(2), M14456 18 September 2002

Mr. Tam Kuen-chong,
Deputy Commissioner of Inland Revenue,
Inland Revenue Department,
G.P.O. Box 132,
Hong Kong.

Dear Mr. Tam,

Inland Revenue (Amendment) Bill 2002

Thank you for your letter dated 9 July 2002 inviting the Society's comments on the proposed Committee Stage Amendments (CSAs) to the Inland Revenue (Amendment) Bill 2002 ("the Bill"). Our comments on the CSAs are as set out below. We would also refer you to our previous submissions on the Bill, dated 1 December 2000 and 7 June 2001 respectively.

As a general point, the Society has felt for some time that the Inland Revenue Ordinance (IRO) is in need of an overall revision to make it more simple and easy to understand. Amendments over the years have made it increasingly complex and obscure in terms of the drafting. The proposed CSAs, which contain complex cross-referencing and arguably some ambiguity, will exacerbate this problem and make the need for such a review exercise all the more urgent.

The Scope of the Committee Stage Amendments

Clause 5 (Section 15, IRO) of the Bill

We note from your letter and explanatory note that the purpose of the CSAs is to address the concerns raised over the provisions in Clause 6 of the Bill (covering sections 16(2)(d), (e) and (f) of the Inland Revenue Ordinance (IRO)), i.e. the anti-avoidance provisions relating to deduction of interest expenses. However, the concerns that we have previously raised over Clause 5 (covering section 15, IRO) of the Bill, that it appears to undermine the "source principle" under the Hong Kong tax regime, have not been addressed.

For the reasons given in our previous submissions, we remain unconvinced that the decision in CIR v Emerson Radio Corp. was incorrect or that it changed the position that had applied prior to the decision. On this and other grounds, we have also queried the figure quoted earlier by the Inland Revenue Department (IRD) as the potential loss of revenue that would arise from accepting the outcome of the Emerson Radio case. While we note the desire of the Commissioner to seek "symmetry" between deductibility of an expense by one entity and taxability of the receipts in the hands of recipient, we believe that to achieve it by taxing an entity which conducts no

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business and has no place of business in Hong Kong is inappropriate and contrary to the basic tenets of the Hong Kong tax system. Under the circumstances, we continue to oppose the introduction of the proposed section 15(1)(ba) under Clause 5 of the Bill.

Grandfather provision

Before turning to the details of the provisions now proposed under Clause 6 of the Bill, we note that they are very broad. It must be remembered, however, that the purpose of these provisions is to attack abusive arrangements aimed at avoiding the restrictions on interest deductibility. The IRD has previously accepted that the transactions against which the provisions are aimed are capable of being struck down under section 61A, but that a more targeted approach is appropriate to place the responsibility for the identification and disallowance calculation on taxpayers rather than the IRD.

While we understand the position taken by the IRD on this matter, it should be recognised that it is inevitable that the broad scope of the proposed provisions will result in unintended consequences. That is, it is inevitable that there will be cases of interest on loans which are not predominantly tax motivated and not of the abusive type targeted by the IRD, being rendered non-deductible by the proposed provisions.

Going forward, although it may be acceptable to put the onus on taxpayers to take care to ensure that transactions are not inadvertently caught by the provisions, it would be unreasonable to require taxpayers to restructure genuine commercial transactions that would otherwise be affected by the proposals.

Without wishing to diminish the generality of the above concerns, the situation would be even more unfair for those taxpayers who have entered into transactions (predominantly leveraged lease or other asset financing transactions) where advance rulings or clearances have already been obtained from the IRD, and which are commercially particularly difficult to restructure. Although the deductibility of interest may not have been a specific issue on which the ruling or clearance was obtained, the fact remains that all aspects of the transaction would have been made known to the IRD and by issuing a clearance or ruling the IRD would effectively have sanctioned the transaction as not involving any tax abuse.

In view of the above, the Society would like to propose some form of grandfather provision in relation to loans already entered into. In the simplest form, the legislative provisions could provide that the amendments have no application to transactions entered into prior to the proposed provisions passing into law (or perhaps some other specific future date). This would not prevent the IRD from using existing remedies (most notably section 61A) to attack what they perceive to be abusive transactions that would otherwise benefit from the proposed grandfathering.

Section 16(2)(c)

The further restrictions imposed on the deductibility of interest expenses by the Bill are extended by the proposed CSAs to apply to interest which is otherwise deductible pursuant to section 16(2)(c). However, section 16(2)(c) provides that, assuming a nexus to the earning of assessable profits exists, interest is deductible where the recipient of that interest is subject to Hong Kong tax thereon. This provision is at the core of the intended effect of the restrictions imposed by section 16(2) (i.e. to require symmetry in the Hong Kong tax treatment of interest, other than in specified circumstances). To impose further restrictions on the deductibility of interest which is assessable to Hong Kong tax in the hands of the recipient seems to be unnecessary and contrary to the spirit of s16(2). It is therefore difficult to see what tax leakage or mischief the Commissioner is seeking to remedy by including references to section 16(2)(c) in the additional anti-avoidance provisions in the proposed sections 16(2A) and 16(2B). We suggest therefore that references to section 16(2)(c) in these two sections should be deleted, unless the Commissioner is able to put forward a convincing justification as to need to extend the scope of the relevant provisions in this way.

Section 16(2)(d)

See our comments below in relation to s16(2A) under the heading *Borrowings secured pursuant to an executed instrument*. The same point applies to the proposed amended s16(2)(d).

Section 16(2)(e)

For the avoidance of any doubt, we recommend that s16(2)(e) be redrafted to expressly cover deduction of interest incurred either to finance or refinance expenditure on depreciable machinery or plant, or trading stock.

While s16(2)(e) allows a deduction for plant and machinery qualifying for depreciation allowances under Part VI of the IRO, it does not allow deduction of interest costs incurred in financing/refinancing expenditure on machinery or plant which is within the meaning of "prescribed fixed asset" in s16G. We therefore suggest that s16(2)(e) be further amended to cover the purchase of prescribed fixed assets.

Section 16(2A)

Borrowings secured pursuant to an executed instrument

The proposed s16(2A) is similar to the current s16(2)(d) in that it renders non-deductible interest on loans where the borrowing is secured by a loan or deposit of the borrower or an associate, and the interest on the loan or deposit is not subject to tax. However, s16(2)(d) currently requires that the borrowing be secured pursuant to an executed instrument, whereas the proposed provision contains no such requirement.

As a result, a bank's common law or statutory right of set-off of a loan or deposit would potentially render some interest expenses as non-deductible. This is unlikely to be the intention of the legislation; rather, the provisions are presumably aimed at countering contrived arrangements to avoid the interest deductibility rules by specific matching of loans and deposits. As such, maintaining the requirement that there be a security instrument executed would be more appropriate.

Secured or guaranteed by a deposit or loan made with or to any person

Currently, the deductibility of interest payable on money which has been borrowed from a financial institution or an overseas financial institution is not denied under section 16(2)(d), provided that the repayment of the principal or interest is not secured or guaranteed against a deposit made with a financial institution or overseas financial institution where any sums payable by way of interest on the deposit are not chargeable to tax under the IRO. Section 16(2A), on the other hand, now proposes to disallow deduction of interest payments in respect of a loan where repayment is secured or guaranteed by a deposit held with or a loan to any person, where the interest earned from such deposit or loan is not chargeable to tax under the IRO.

It seems possible that this could be interpreted to mean that a legitimate commercial arrangement where, for example, US Treasury Bills are pledged as a security or guarantee against borrowings, would in future fall within the proposed section 16(2A), as a result of which the pledgor would be denied a deduction of the loan interest. As the pledging of US Treasury Bills would not constitute deposits made with a financial institution or an overseas financial institution, such an arrangement would not currently fall within the anti-avoidance provisions in s16(2)(d). It is our understanding that the Bill is not intended to broaden the scope of s16(2) but rather to deal with situations of abuse. However, if situations of the type referred to in the above example are caught by the CSAs, then it would represent a significant extension of scope. If this is indeed the effect of the proposed provision, we believe that it is an unintended consequence of the drafting and, as such, it needs to be reviewed and potential abuses targeted more directly.

Section 16(2A) test of apportionment

The Society, in principle, welcomes the proposed amendments providing for apportionment under section 16(2A), where repayment of a loan is secured by a deposit held or loan made by the borrower in relation to which the interest is not chargeable to Hong Kong tax. As we have previously indicated, this should go some way to minimising the extent of any negative consequences of the legislation and limiting its application to cases of actual abuse. However, it is not immediately apparent why, what is to all intents and purposes, a discretionary test is adopted in the proposed s16(2A) whereas more specific formulae for disallowing deductions are adopted in the proposed ss16(2B) and (2C).

Although the apportionment provision may not strictly be a discretion granted to the Commissioner (given the references to what is "most reasonable and appropriate in

the circumstances”), in practice we believe that it is likely be viewed and treated as one by the IRD.

Any legislative provision which confers a discretionary power on the IRD, or introduces a test the application of which is which is to be determined primarily by the IRD is, in our view, not desirable because of the uncertainty that this would introduce, both in terms of the outcome and the filing position to be adopted. Given that the provision requires regard to be had to the amount of non-taxable interest income derived from the deposit or loan when determining the interest expense to be disallowed, it appears that in most instances it is the intention that the interest expense is to be reduced by the amount of that interest income. Accordingly, we recommend that the provision state this expressly. An exception to the general rule could be provided for in order to deal with the rare cases where, for example, a loan is over-collateralised.

Section 16(2B)

“Arrangements” / “... any sum payable by way of interest on the money borrowed or on any part of the money borrowed...”

We would suggests that the term “arrangements” be given some definition. It is not clear what degree of formality, if any, is intended to be covered by this term.

In order to avoid any possible ambiguity, we would suggest that the phrase, “any sum payable by way of interest on the money borrowed or on any part of the money borrowed” in the proposed section 16(2B)(b) be redrafted as “any sum payable by way of interest on (i) the money borrowed or (ii) any part of the money borrowed”.

Disallowance formula

Section 16(2B), as proposed, provides a formula for disallowing some or all of a interest expense where, during the basis period of the borrower for the year of assessment in which interest payment on the loan or any part thereof is claimed for deduction, there are arrangements in place such that the interest on the loan is payable directly or indirectly back to the borrower or to a person connected with the borrower.

Section 16(2E) meanwhile provides that the payment of interest through a sub-participated loan, which is secured or guaranteed by or conditional upon the repayment of the money borrowed by the borrower, will be treated as arrangements for the purposes of s16(2B).

We believe that the proportional disallowance of interest expenses under the formula in s16(2B) could in practice be complicated and time-consuming to operate in situations where, for example, the sub-participated amount fluctuates at different times of the year.

Section 16(2C)

"Arrangements"

See our comments in relation to s16(2B) above regarding the need for a definition of "arrangements". The same point would apply to the reference to "arrangements" in s16(2C)(b).

Scope of restrictions

The proposed s16(2C) deals with the disallowance of otherwise deductible interest on marketed securities where the relevant securities are held by the borrower or *"a person who is connected with the borrower"*. A *"person.....connected with the borrower"* is defined in s16(3B) very broadly and extends to, inter alia, a director, shadow director or the chief executive of an associated corporation. Given how broadly *"associated corporation"* is defined, it seems clear that in the case of a borrower which is part of a multinational group, it will be difficult for the borrowing corporation to ascertain whether, or the extent to which, the securities are held by associates. Moreover, it would be unreasonable to expect a multinational corporation to put in place systems to require disclosure of such information from all associates or connected persons. To properly comply with these provisions, a corporation would need to establish complex and possibly costly audit procedures. This could be the case particularly when there are non-Hong Kong listed companies involved where directors are not required to disclose connected party transactions.

Further, the schemes which it is understood the IRD is targeting with this legislation are typically those whereby a corporate group obtains a deduction for self-funded borrowings where the related interest income is derived by the group (in order that the whole transaction is off the consolidated accounts) but is not subject to tax under the IRO. Payments to a director of the borrower or a director of an associated corporation of the borrower, would not permit the desired result to be achieved. Moreover, we can see no reason why interest on a bona fide marketed security should not be deductible if paid to a director, in the same way as to any other investor. Accordingly, we recommend that the restrictions imposed by s16(2C) be limited to interest on securities held by an associated corporation.

Moreover, there will be many good reasons why an associate may wish to acquire securities issued by a borrower. For example, the issuing group may be a market maker or may wish to support the price of the securities. As such, we recommend that there be an exemption from the provision for transactions undertaken as part of a *bona fide* market-making operation, and a general *de minimis* exemption to cater for the situations where associates of a borrower hold no more than, say, 30% of an issue of securities.

Disallowance formula

Section 16(2F) provides that payment of the debenture interest, etc. to a related party of the issuer through a sub-participated loan, which is secured or guaranteed by or conditional upon the repayment of the loan under the debenture or instrument, will be treated as arrangements for the purposes of s16(2C).

Under s16(2C), where only part of a debenture issue is assigned or sub-participated by related parties, the part of interest payment attributable to holdings by unrelated parties will be allowed. The allowable portion will be calculated, in accordance with a formula specified in the provision.

We believe that formula in s16(2C) could in practice be cumbersome and time-consuming to operate in situations where, for example, the associates only hold part of the debenture issue for part of the year. It is not clear for example how parts of days during which the arrangements are in place, are to be calculated, although the drafting would suggest that it will be determined by the situation existing at the end of any given day. This point would also apply to the formula in the proposed s16(2B).

Section 16(7)

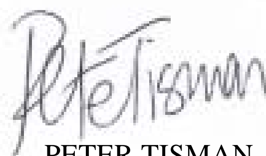
The proposed s16(7) provides that the other proposed amendments to s16 do not apply to interest expenses, etc. incurred before the provisions have come into effect. For the avoidance of doubt, we recommend that s16(7) be redrafted to clarify that the relevant provisions do not apply to loan transactions, etc. entered into, rather than the interest expenses incurred, before the provisions have come into effect.

Clause 23

In accordance with our views under s16(2)(c) above, we would suggest deleting the reference to this section in the proposed consequential amendment to the Exemption from Profits Tax (Interest Income) Order contained in this clause.

We trust that you find our comments to be constructive. If you have any questions or comments in respect of the above, please contact the undersigned at 2287 7084.

Yours sincerely,



PETER TISMAN
DEPUTY DIRECTOR
(BUSINESS & PRACTICE)

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