By email (bc_102_15@legco.gov.hk) and by hand

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Hon. Kenneth Leung
Chairman,
Bills Committee on Inland Revenue (Amendment) (No.4) Bill 2015,
Legislative Council Complex,
1 Legislative Council Road,
Central, Hong Kong

Dear Mr. Leung,

Inland Revenue (Amendment) (No.4) Bill 2015

Tax concessions for corporate treasury centres

Thank you for inviting the views of the Hong Kong Institute of Certified Public Accountants ("the Institute") on the Inland Revenue (Amendment) (No.4) Bill 2015. The Institute's Taxation Faculty has considered the bill. We are in support of encouraging the development of corporate treasury centres ("CTCs") in Hong Kong and also clarifying the tax treatment of regulatory capital securities ("RCS") issued by banks in Hong Kong in compliance with their Basel III capital adequacy requirements.

In relation to the proposals on CTCs, while we support the principle, we also consider that the raft of accompanying anti-avoidance measures will potentially dilute the value of the incentives and add considerable, and in our view, unnecessary, complexity and also uncertainty to the Inland Revenue Ordinance ("IRO"). We suggest that many of these specific anti-avoidance provisions aimed apparently at addressing all conceivable ploys to circumvent the primary purpose of the legislation are unnecessary, because the general anti-avoidance provision in section 61A should be able to deal with clear cases of abuse. We refer to some examples below where we feel that the legislation has gone too far in restricting CTCs' and other parties' room to manoeuvre.

Operation test vs. provision of credit test

The proposed section 15(1)(ia) of the IRO deems as trading receipts "sums not otherwise chargeable to tax under this Part, received by or accrued to a corporation (other than a financial institution), by way of interest that arises through or from the carrying on in Hong Kong by the corporation of its intra-group financing business within the meaning of section 16(3), even if the moneys in respect of which the interest is received or accrues are made available outside Hong Kong".

This deeming provision brings in what is commonly known as the "operation test" and, while the aim of the bill may be to codify the case law position to ensure that interest on money lent or borrowed by a CTC is in principle taxable, regardless of whether the money was made available within or outside of Hong Kong, it could create uncertainty for enterprises engaged in certain intra-group financing activities (including those that do not qualify for, or seek to benefit from, the CTC concessions).

Currently, in order to determine the taxability of interest income of enterprises whose main object is not treasury-related activities, but which may conduct some incidental intra-group lending and borrowing, the test that is generally used is to ask "where the credit was provided to the borrower, i.e., the place where the funds from which the interest is derived were provided to the borrower, commonly known as the 'provision of credit' test" (Inland Revenue Department ("IRD"), Departmental Interpretation and Practice Notes ("DIPN") No. 13 (Revised), paragraph 2). However, if the bill is passed in its present form, the position is likely to become less clear and there may be considerable debate around the fringes of what amounts to carrying on intra-group financing business in Hong Kong. Businesses that have been used to being taxed on the basis of the provision of credit test may instead find their income assessed under the operation test, which could well be disadvantageous to them. The end result could be to cause some non-CTC enterprises not to undertake certain of their relevant intra-group financing activities in Hong Kong with a consequent loss of business.

In view of the above, if the bill is aiming to do no more than codify the case law position, then, were the deeming provision not to be included, it would seem to do no particular harm to the proposed CTC regime overall and there would be no increase in uncertainty. Alternatively, if the deeming provision is retained, it will be essential to provide further clarification on the meaning of "carrying on intra-group financing business", preferably with examples provided in a DIPN.

<u>Other anti-avoidance measures relating to deduction of interest</u>

Under the proposed section 16(2)(g) of the IRO, a CTC is allowed to deduct interest paid on money borrowed from a non-Hong Kong associated corporation. This would exclude any borrowing from associated companies in Hong Kong and from unrelated entities (where the sums payable by way of interest are not chargeable to tax under the IRO in the hands of the recipients). Where the lender is not subject to Hong Kong tax, the deduction will be disallowed if the lender is not subject to a similar tax (i.e., a tax on profits, as indicated in the proposed section 16(2I)(b) at a rate that is no lower than the equivalent in Hong Kong (e.g., 16.5% or 8.25%, as will be specified from year to year in Schedule 8). It will also be disallowed "if the Commissioner is satisfied that the main purpose or one of the main purposes, of the borrowing of the money is to utilise a loss, postpone or reduce a liability" of any party to profits tax under the IRO. These restrictions could potentially make it uncertain from year to year whether deductions of interest on money borrowed will be permitted. Where, for example, the profits tax payable by a non-Hong Kong associated lender on interest received from a Hong Kong CTC, which may be similar to the rate in Hong Kong one year, is subsequently reduced in the budget of the government of the relevant jurisdiction, the CTC may suddenly find that it is denied the deduction that it had previously enjoyed.

This all seems to be unnecessarily complicated and could result in the proposed concessions not achieving the desired effect of attracting new CTC business to Hong Kong. As indicated above, we suggest that the government consider simplifying the specific anti-avoidance provisions and relying more on the general provision in section 61A, which the IRD has used successfully on a number of occasions in the past.

Anti-avoidance measures relating to the reduced rate of profits tax

Although the proposed reduced rate of profit tax may not be the main attraction for setting up a CTC in Hong Kong, here also the anti-avoidance measures need not be as restrictive as proposed in our view. For profits of a CTC to qualify for the lower rate, the transactions will have to be provided to a non-Hong Kong associated corporation that does not carry on business in Hong Kong. This would appear to be to ensure that the receiving corporation would not at the same time be seeking a deduction of expenses in Hong Kong. As such, this restriction could be relaxed where, for example, a non-Hong Kong associated company covered by a tax treaty with Hong Kong is carrying on a business in Hong Kong other than through a permanent establishment.

While appreciating that there may be some potential tax leakages, we query why, by virtue of section 14D(8), it would appear that a CTC may not qualify for the concessionary tax rate if, for example, it receives a payment from a financial institution carrying on business in Hong Kong, even though there is no abuse of the non-synchronicity between deductions and the taxability of such payment.

In addition, it is unclear why in order to qualify for CTC status, the relevant activities must be conducted with a corporate entity only and not, say, with an associated trust or a limited liability partnership.

The proposed section 14D indicates that it is envisaged that a company's CTC status may, in practice, vary from year to year. Given that the reasons for this may not all be within in the control of the CTC and may be due, to a significant extent, to the restrictive nature of the qualifying conditions, this uncertainty may also call into question of the practical value and effectiveness of the proposed concessions.

Tax treatment of regulatory capital securities

We support the legislative proposal to allow distributions paid on RCS to be treated as tax deductible interest. However, we consider that the proposed new sections 17E to 17H of the IRO are problematic, not immediately necessary and should be removed.

Section 17F contains some complicated specific anti-avoidance provisions that may render this legislative proposal difficult to comply with in certain circumstances. As with the CTC proposals, it would be highly preferable to rely on the existing general anti-avoidance provisions of the IRO than on section 17F to deal with any abusive tax arrangements involving RCS. The RCS regimes in Singapore and the United Kingdom, for example, rely on their existing relevant general anti-avoidance legislation to deal with any abusive tax arrangements involving RCS.

Section 17G

The proposed section 17G could be interpreted in such a way that it would fundamentally change the source rules for the profits of a Hong Kong branch of a non-resident bank, leading to the undesirable result of having one set of statutory source rules for Hong Kong branches of non-resident banks, under section 17G, and a different set of case-law-based source rules for resident banks. If this is the intention, such a fundamental change to the basis of taxation for Hong Kong branches of non-resident banks warrants wider discussion. If it is not the intention, then further clarification is needed to remedy the apparent ambiguity in this provision.

Section 17G imports the authorised approach of the Organisation for Economic Cooperation and Development ("OECD") towards profit attribution to permanent establishments for all foreign banks in Hong Kong that have raised capital through the issue of RCS. It does this by determining the profits that the Hong Kong branch would have made were it a distinct and separate enterprise that engaged in the same or similar activities under the same or similar conditions, and dealt wholly independently of the non-resident financial institution (i.e., the foreign bank with its head office outside of Hong Kong).

The methodology for calculating the profits under this "separate enterprise" principle is complex for banks. The effect of this provision is that, instead of determining the assessable profits of a Hong Kong branch of a foreign bank based on the profits shown in its branch accounts, in accordance with Inland Revenue Rule 3, the profits of the branch are determined based on the separate enterprise principle outlined above.

In practice, a majority of foreign banks may already be applying arm's length principles in determining the income that is attributable to their Hong Kong branches as part of their global transfer pricing policies. This is consistent with the IRD's assessing practices regarding transfer pricing, as set out in DIPN No. 46. As a result, the impact of the introduction of section 17G will be mainly be in respect of the allocation of free capital to a Hong Kong branch and the impact on a branch's tax-deductible funding costs. However, this is a complex calculation that may involve preparation of a regulatory capital balance sheet (i.e., risk-weighted assets) for the branch or finding suitable local bank comparables, which will give rise to a significantly increased compliance burden for these branches.

For the majority of banks, this legislative amendment will result in additional equity capital being allocated to their Hong Kong branch, and displacing of debt capital and the associated tax-deductible funding costs. However, in some rare cases it may result in greater debt capital being allocated to the Hong Kong branch and an increase in associated tax-deductible funding costs (for example, where the head-office is largely equity funded or cannot issue tax-deductible regulatory capital in its home jurisdiction).

It is interesting to note that section 17G applies only to financial institutions that have raised capital through the issue of RCS. However, in practice this is likely to be almost all financial institutions with Hong Kong branches, as RCS include Basel III capital instruments issued abroad and most international banks will at least have some Tier 2 capital issuances.

The proposed section 17G is sandwiched between a number of anti-avoidance provisions dealing specifically with the taxation of RCS, when arguably section 17G is of greater interest and wider applicability than the rules it is buried within. In addition, the Legislative Council Brief on the bill gives little mention of the move to a separate enterprise principle for the taxation of Hong Kong branches of foreign banks, only briefly referring to it in the context of an anti-avoidance provision in respect of the rules on RCS.

The proposed sections 17E and 17H relate to the transfer pricing legislation for RCS transactions and to the possible extension of section 17G to other types of non-resident enterprises that are not banks. These provisions may have broad ramifications.

Section 17H

The proposed section 17H states that:

"Sections 17E and 17G do not prevent principles similar to those provided for in those sections from applying to a person, or in circumstances, other than the persons or circumstances mentioned in those sections."

Proposed section 17E introduces an arm's length principle for determining the profits of associates in connection with a RCS and the proposed section 17G is explained above. Some people have expressed concern that section 17H means that the arm's length and separate enterprise principles in section 17E and 17G, respectively, may also to be applied to non-financial institutions and that, in effect, transfer pricing and the authorised OECD approach to branch profit attribution will be brought into the IRO, generally, "through the back door."

However, one reading, and perhaps the natural reading, of section 17H is that it provides clarity that if a person does not fall within the specific requirements of section 17E or 17G it does not mean that they are excluded from any other instances of the arm's length or separate enterprise principles, where there are other such instances. At present there are no other instances of the arm's length principle or separate enterprise principle in the profits tax provisions of the IRO (although we note the IRD's assessing practice as discussed in DIPN 46).

While we do not think that section 17H intends to create rules applying the arm's length and separate enterprise principles to non-financial institutions, this needs to be clarified. Prima facie, it seems unlikely that such a fundamental change to the Hong Kong tax system would be introduced in this way. We would expect that, as a minimum, any fundamental changes would be clearly highlighted and discussed in the Legislative Council Brief and explanatory memorandum to the bill. Also, the government has previously indicated that it intends to consult on the adoption of the arm's length and separate enterprise principles into legislation in the future, so introducing such principles with general application into this legislation would fly in the face of that assurance.

For the above reasons, particularly given the ambiguity that they could create, we suggest that serious consideration be given to removing sections 17E, 17F, 17G and 17H from the current bill. Any proposals for fundamental change to the basis of taxation for Hong Kong branches of non-resident banks and the introduction of transfer pricing legislation generally may have broad ramifications and would require wider discussion. If after public consultation, legislation is found to be desirable in the wider context, it can be introduced later in a form and manner that is appropriate and acceptable to the stakeholders concerned.

If, however, the above provisions are retained notwithstanding these serious concerns, as a minimum, clarification needs to be provided as to the purpose and intent of section 17H to assure taxpayers that, at present, the arm's length and separate enterprise principles in sections 17E and 17G, respectively, are intended to apply only in the circumstances reflected in those sections and not more generally to all taxpayers.

Should you have any questions on our submission, I can be contacted at the Institute on 2287 7084 or by email at peter@hkicpa.org.hk .

Yours sincerely,

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