

Interest Deduction under Profits Tax



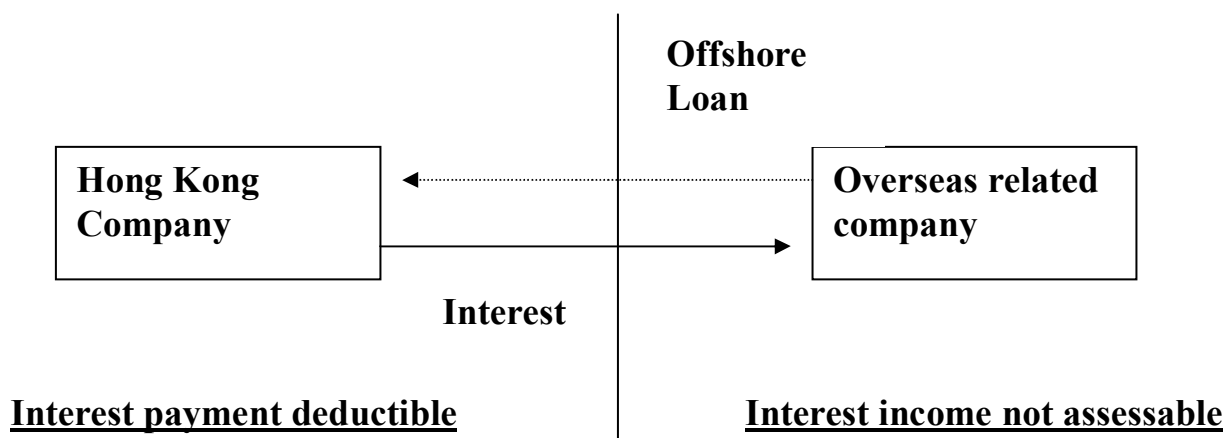
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Interest Deduction under Profits Tax

- Developments
 - Before early 1980's
 - Enhancements in 1984 and 1986
 - Further Amendments in 2004

Before the early 1980's

- Interest Deductible under section 16(1)(a) – interest is deductible to the extent that is incurred by the taxpayer for the production of chargeable profits. Apart from this, there are No Other Conditions.
- Interest on local loans are taxable by profits tax or interest tax. So, symmetry in taxation may to some extent exist because:
 - Interest is taxable in hands of recipient
 - Interest is deductible in hands of payer.
- But asymmetry in tax collection still occurs because:
 - On the source of interest principle, interest payable on loans borrowed overseas is not assessable.
 - Interest tax on deposits with financial institutions was gradually abolished in 1982 and 1983.
- Interest deduction is often abused by loans between related companies. Revenue loss became heavy, thus causing law amendment.
- Example of abuse



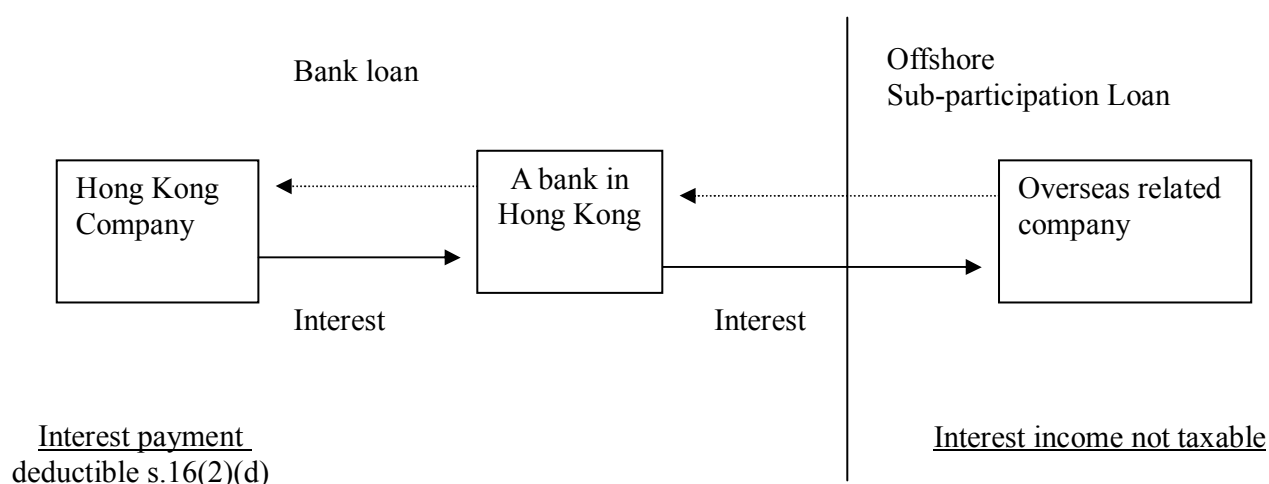
Law amendments in 1984-86

- Besides S.16(1)(a), interest payment must also satisfy one of the conditions under S.16(2).
- The further conditions under section 16(2)(a) to (f) are -
 - (a) interest paid by Financial Institutions (FI) – no other requirements
 - (b) interest paid by public utilities companies at specified interest rate
 - (c) interest on loan from non-FI and interest is taxable in hands of recipient
 - (d) interest on loan from FIs – the loans is not secured by tax-free deposit of the borrower or its associates
 - (e) for special purpose loans not borrowed from associates
 - (f) Special method of borrowings
 - Debentures – listed
 - Debt instruments –
 - Issued bona fide; marketable in HK or a major financial centre; or
 - Issued to the public with authorization of SFC.
 - Indirect issue through associated corporations.

Before the 2004 law amendment

- Conditions (a) and (b) concern special types of borrowers. They do not give tax collection problems.
- Conditions (c) aims at tax symmetry.
- Conditions (d), (e) and (f) allow for the relaxation of the tax symmetry rule under condition (c) in certain types of borrowing.
- The relaxation of the tax symmetry rule weakens the anti-avoidance objective of S.16(2).
- Each condition has its own requirements and works independent of the others. So, it can be easily circumvented by sophisticated multi-tier loan arrangements.

■ Example of abuse – sub-participation



■ Another example of abuse – debenture issue

Hong Kong company issues debentures listed in Luxemburg Stock Exchange. The debentures are subscribed by a related company. Interest payment is deductible because S.16(2)(f) is satisfied.

After the 2004 Amendment

Interest is deductible if

- it is incurred for the production of chargeable profits, vide S.16(1)(a)
- satisfy one of the conditions in S.16(2)(a) to (f)
- subject to the following restrictions:
 - For interest on loans under conditions (c), (d) or (e): by both the secured loan test - vide S.16(2A) and the interest flow-back test vide - S.16(2B);
 - For debenture/debt instrument interest under condition (f): by the interest flow-back test – vide S.16(2C).

Conditions for deduction

- Conditions under S.16 are largely the same as before, with the following adjustments:
 - Conditions (d): the requirement of “not secured by interest free loan” is converted to a restriction under s.16(2A) that is applicable to conditions (c), (d) and (e).
 - Condition (f): debt instrument without the approval of SFC must be marketed in Hong Kong or through a major financial centre recognized by CIR.
 - Whether an instrument has been “marketed” is a fact to be determined with reference to common market practices
 - The followings are indications of debt instruments being marketed:
 - road-shows or meetings with potential investors
 - research reports about the issuer
 - rated by credit rating agency
 - cleared through market clearing system
 - display on financial information network
 - market participants can quote bid
 - trading in secondary market

Section 16(2A) – secured loan test

- It is applicable to loans under conditions (c), (d) and (e).
- It is a similar test to that under S.16(2)(d).
- It is invoked when:
 - the loan is secured by a deposit or loan giving tax-free interest
 - the deposit is placed by the borrower or an associate with the lender, an FI or an overseas FI, or with an associate of these parties.
- Where applicable, interest deduction will be reduced by a reasonable and appropriate apportionment having regard to the interest income arising from the deposit (or loan).
- For apportionment of interest, see Examples 5 to 10 in DIPN13A.

Section 16(2A) Apportionment

- Interest deduction is reduced by the tax-free interest earned by the collateral deposit. See Examples 5 & 6 of DIPN 13A.
- Where the collateral value is greater than the loan, the reduced amount is apportioned by the ratio of loan: i.e. the collateral value. See Examples 7 & 8 of DIPN 13A.
- Where part of the loan secured by the collateral is not used for the production of chargeable profits (e.g. for offshore activities), the reduced amount is apportioned by the proportion of: Value of loans that is used for producing chargeable profit to the Value of total loans secured by the collateral. See Examples 9 & 10 of DIPN 13A.
- How is the value of collaterals measured? It is computed on a reasonable basis of averaging: such as by reference to month end balances. See Example 8.
- If 'personal guarantee' is used as part of collateral, how to value it? 'Personal guarantee' will normally be the last resort of security: it is treated as supplementing other collaterals, and so , it can be regarded as no value.

Section 16(2B): Interest flow-back test

- It is applicable to loans under conditions (c), (d) and (e).
- It is invoked when
 - Arrangement is done;
 - Interest payable is paid back, directly or through interposed person, to the borrower or to a person connected with the borrower; and
 - The borrower or his connected person is not an excepted person.
- "Arrangement" is defined in section 2 as including:
 - Any agreement, arrangement, understanding, promise or undertaking; and
 - Any scheme, plan, proposal, action or course of action or course of conduct.
- "Person connected with borrower" is defined in section 16(3B) as including
 - An associated corporation of borrower
 - A person who controls, is controlled by borrower, or under control of the same person as the borrower.
 - Narrower than the concept of "associate".
- "Excepted person" is defined in S.16(2E)(c) as:
 - A Person who pay tax on interest received;
 - A Bare trustee;
 - A Beneficiary of unit trust under s.26A(1A)(a);
 - A Member of recognized retirement scheme;
 - A Public body
 - A Government owned corporation; or
 - A FI and an overseas FI

Section 16(2E)(a)

Section 16(2E)(a) extends the application of the flow-back test through indirect means, such as loan sub-participation scheme. When considering interest flow-back to a related party, the interest paid under the sub-participated loan is treated as the “interest” on the original loan. See example 11 in DIPN 13A.

Apportionment are done in two ways:

- Where the arrangement only covers part of the loan
- Where the arrangement is in place for part of the basis period
See examples 12 and 13 in DIPN 13A

Section 16(2C): Interest flow-back test

- It is applicable to debenture and debt instruments.
- It is similar to s.16(2B).
- Apportionment are done in three ways:
 - Arrangement covers some debentures in one issue;
 - Arrangement covers beneficial interest on any debenture or debt instruments;
 - Arrangement covers part of the basis period.
 See example 14 in DIPN 13A.

Section 16(2G): Market Maker Exemption

- Section 16(2G)
 - S.16(2C) restriction does not apply to an arrangement under which a market maker holds interest in debenture or debt instrument in ordinary course of market making business for providing liquidity.
- Market maker must be:
 - A licensed or registered dealer under SFO, or in a major financial centre
 - Holds himself out as willing to buy and sell securities for own account on a regular basis
 - Actively involved in market making securities issued by unrelated institutions

Trusts

- S.16(2A): if a deposit is made by the trustee or a corporation controlled by the trustee, the deposit is deemed to have been made by each of the trustee, the corporation and the beneficiary of the trust. See S.16(2D)
- S.16(2B) and (2C): any interest payable to the trustee or a corporation controlled by the trustee is deemed to be payable to the trustee, the corporation and the beneficiary. See S.16(2E)(b) and (2F)(b)

General Anti-Avoidance Provisions in IRD

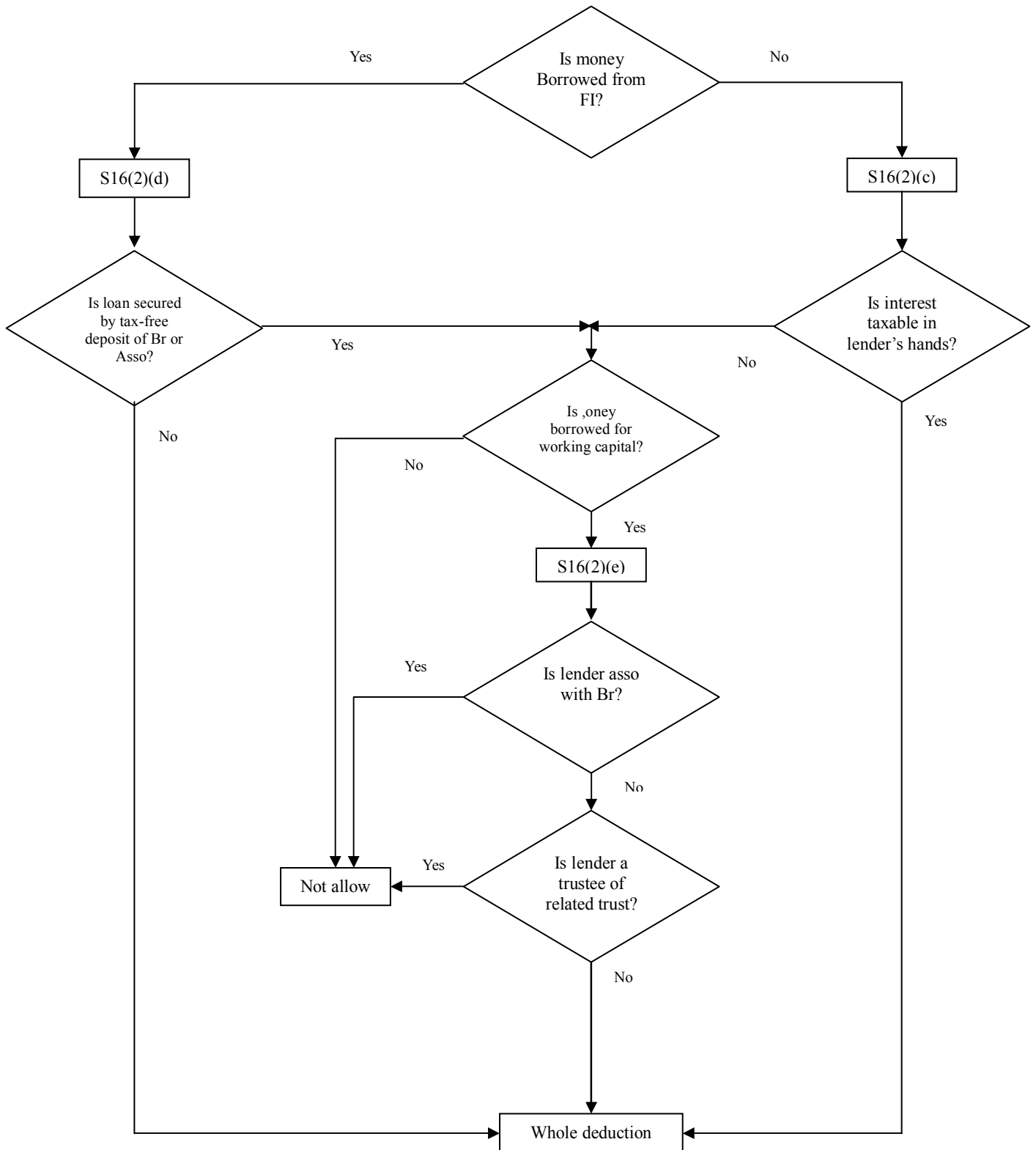
The S.16(2) provisions lay down the rules governing eligibility of interest deduction in the circumstances prescribed. If it cannot be effectively counteract the tax avoidance, the IRD may invoke the general anti-avoidance provisions, such as S.61A, as a last weapon. Based on the court cases, viz CIR v. Challenge Corporation Ltd. or Yick Fung Estates Ltd. V CIR, the IRD opines that the S.16(2) provisions do not preclude the Revenue from using the general anti-avoidance provisions.

Flow Chart for illustration of interest deduction

Abbreviations for the flowchart:

FI	- Financial institution
FC	- Financial Centre
SFC	- Securities and Future Commission
Br	- Borrower
Asso	- Associate of the borrower as defined in existing section 16(3).
CP	- Person connected with the borrower as defined in proposed section 16(3B).
EP	- Excepted person as defined in proposed section 16(2E)(c) in CSA.

Interest Deductions under sections 16(2)(c), (d) and (e) before 2004



Interest deduction under sections 16(2)(c), (d) and (e) after the 2004 Amendment:

Apportionment I - Disallowance of part or whole of the interest under section 16(2A)

Apportionment II - Disallowance of part or whole of the interest under section 16(2B)

