

Inland Revenue (Amendment) Ordinance 2004 – Deductibility of Interest Expenses

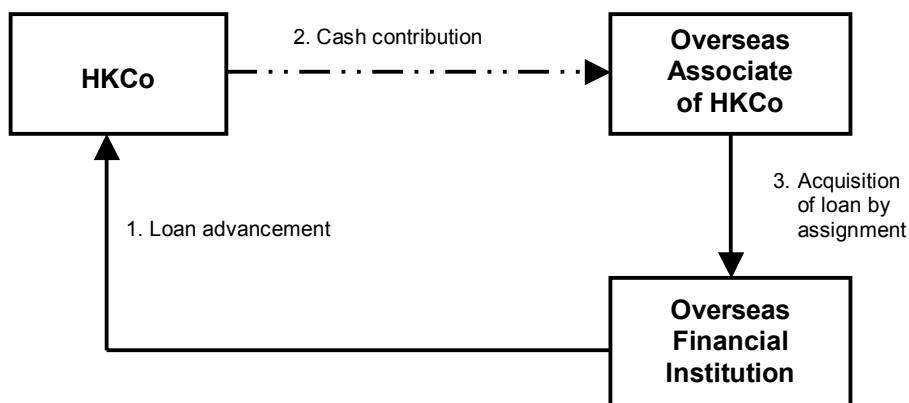
Clement Lam & Wallace Ng [December 2004]

The Inland Revenue (Amendment) Ordinance 2004 (“the Amendment Ordinance”) was enacted on 25 June 2004. One of the subjects it covered is the new condition governing the tax deduction of interest expenses under Section 16(1)(a) of the Inland Revenue Ordinance (“IRO”).

Deductibility of Interest Expenses Before the Amendments

Prior to the enactment of the Amendment Ordinance, interest expenses incurred by a taxpayer are allowed for tax deduction if it satisfies the conditions stipulated in Sections 16(1)(a) and 16(2) of the IRO. However, it has come to the IRD’s attention that there has been an increasing numbers of avoidance schemes (e.g. trust arrangement, loan and interest assignment, loan sub-participation arrangement etc.) which seeks to create tax deductible interest expenses for internal funded loans while the recipient, who are related party, is not chargeable to profits tax on the interest received. Some of the schemes commonly used by taxpayers are briefly explained in the following paragraphs.

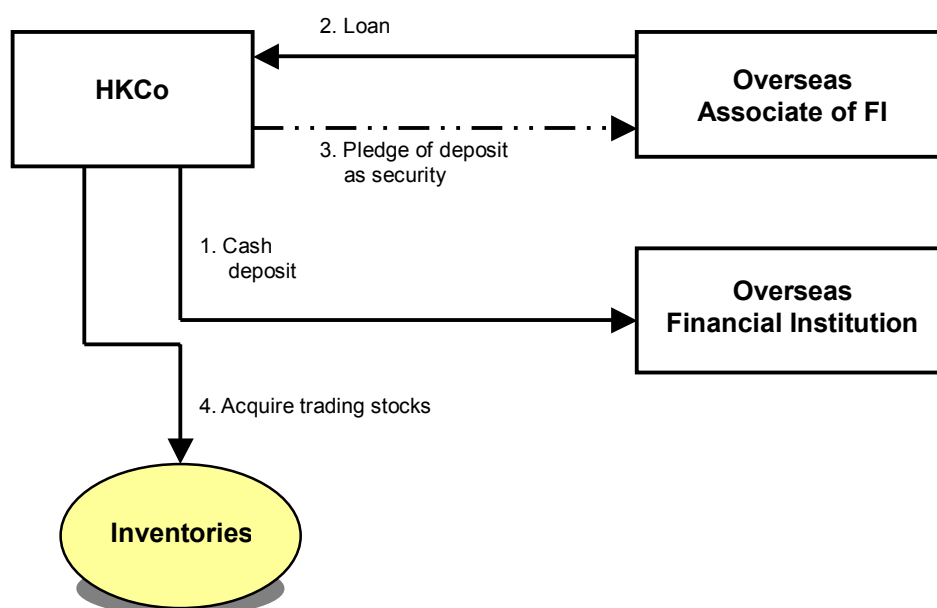
Scenario 1:



Under Section 16(2)(d) of the IRO, HKCo will be entitled to tax deduction of loan interest payable to a financial institution (local or overseas) if the loan is not secured or guaranteed (whether partly or wholly and whether directly or indirectly) by an instrument or undertaking given by the borrower or its associate against a cash deposit made with that or any other financial institution where the interest derived from that deposit is not chargeable to tax under the IRO.

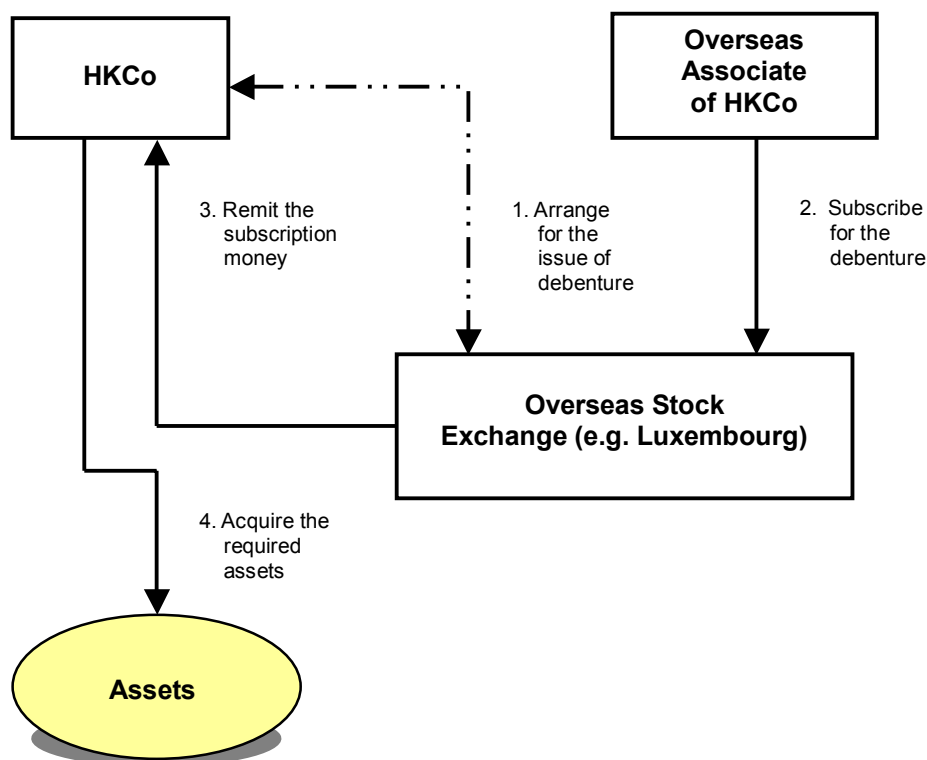
HKCo may therefore structure its loan borrowed from an overseas financial institution in such a way that the overseas financial institution can assign the loan receivable from HKCo to the latter company's overseas associate. Since the loan in question is neither secured nor guaranteed by a cash deposit placed with the overseas financial institution, HKCo is entitled to claim tax deduction on the interest expenses under Section 16(2)(d) of the IRO whereas the overseas associate of HKCo receives the interest income free of tax.

Scenario 2:



HKCo may enter into the above arrangement such that although the loan is secured by a cash deposit placed with overseas financial institution where the interest income derived from the deposit is not taxable in Hong Kong (hence, the conditions under Section 16(2)(d) of the IRO are not satisfied), HKCo still can claim tax deduction on the interest expenses under Section 16(2)(e) of the IRO because the borrowed funds are used wholly and exclusively to finance:-

- i. capital expenditure incurred for acquisition of plant and machinery which qualifies for a depreciation allowance; or
- ii. the purchase of trading stock for generating chargeable profits; and
- iii. the money lender is not an associate of the borrower.

Scenario 3:

In the above arrangement, HKCo may create interest deduction under Section 16(2)(f) of the IRO by issuing debentures or other forms of marketable debt instruments in an overseas stock exchange (e.g. Luxembourg). A majority or the whole of the debenture issued by HKCo is actually subscribed by its overseas associate and the interest income earned by this overseas associate is not taxable in Hong Kong.

Deductibility of Interest Expenses under the Amendment Ordinance

To close the above loopholes, new provisions governing the deduction of interest expenses are introduced in the Amendment Ordinance. Taxpayers are now required to pass two additional tests if they want to claim interest deduction on loans borrowed from other parties or on loans borrowed for specific purposes:

1. Secured-loan Test [Section 16(2A)]

The loan must not be secured by a deposit held by or a loan advanced by the borrower or its associate with or to the lender, a financial institution (local or overseas) or an associate of any of these parties, where the interest generated by such deposit or loan is not chargeable to tax in Hong Kong.

2. Interest Flow-back Test [Section 16(2B)]

There is no arrangement in place that the interest payment will be ultimately paid back to the borrower or to a person connected with the borrower ^{Note}.

Note: The term “a person connected with the borrower” is defined in new sections 16(3A) and 16(3B) as:-

- a. an associated corporation of the borrower. This means that a corporation over which the borrower has control or if the borrower is a corporation, then a corporation which has control over the borrower or a corporation which is under the control of the same person as the borrower.
- b. A person (other than a corporation):
 - i. who controls the borrower;
 - ii. who is controlled by the borrower; or
 - iii. who is under the control of the same person as the borrower.

It should be noted that the above definition is more restrictive than the definition of “associate” in the provisions prior to the amendments.

Please note that for deduction of interest on debentures or debt instruments under Section 16(2)(f), taxpayers are required only to meet the interest flow-back test.

Apportionment of Loan Interest

The following apportionment formula as described in Sections 16(2B) and 16(2C) will be applied when part of the relevant loan does not meet the conditions of the above-mentioned new tests or when the relevant loan does not meet the conditions of the new tests for part of the basis period of the taxpayer:-

<p>Total number of days during the basis period of which the loan/principal of debentures or instruments concerned is outstanding and the arrangement described in the interest flow-back test is in place</p> <hr/> <p>Total number of days during the basis period of which the loan/principal of debentures or instruments concerned is outstanding</p>	X	<p>Total amount of sums payable by borrower by way of interest on the money borrowed or on the relevant part of the money borrowed which, but for Sections 16(2A), 16(2B) and 16(2C), would have been deductible under Section 16(1)(a) for the year of assessment concerned.</p>
--	---	---

There are two situations in which the new provisions will not apply:-

- a. the interest is payable to “Excepted Persons” defined in Sections 16(2E)(c) and 16(2F) ^{Note} of the IRO; or
- b. the interest is payable to a market maker defined in Section 16(2H) of the IRO.

Note: "Excepted Persons" as defined in Sections 16(2E) and 16(2F) include those who are chargeable to tax on the interest income, a bare trustee, a beneficiary of a unit trust specified in Section 26(A)(1A)(a) of the Inland Revenue Ordinance, a member of a recognized retirement scheme, a public body, a government owned corporation and a financial institution (local or overseas).

The enclosed Appendix is a decision flowchart showing the deductibility of interest expenses under Sections 16(2)(c), (d) & (e) of the Amendment Ordinance.

Conclusion

The amendment has strengthened the conditions governing the deduction of interest expenses. It is specifically targeted to combat tax avoidance schemes in which multi-level borrowings have been used to create deductible interest expenses and non-taxable interest income through internal funded loans. The new provisions apply to interests incurred on or after 25 June 2004. ※

For any questions, please contact:

Clement Lam

PKF Hong Kong

Tel: +852 2806 3822

Fax: +852 2806 3712

E-mail: clementlam@pkf-hk.com

Bibliography:

1. Jimmy Chung, "*Perspective*", *Spring 2001*, p.25 - p.29, the Journal of ACCA Hong Kong.
2. Inland Revenue Department, "*The Hong Kong Accountant*", *September 2004*, p.92 - p.94, the Journal of Hong Kong Institute of Certified Public Accountants.
3. The Inland Revenue (Amendment) Ordinance No. 12 of 2004.

Deductibility of Interest Expenses under Sections 16(2)(c), (d) & (e)

