



Inland Revenue Department  
Hong Kong

## **DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES**

**NO. 13A**

### **PROFITS TAX**

#### **DEDUCTIBILITY OF INTEREST EXPENSE**

These notes are issued for the information and guidance of taxpayers and their authorised representatives. They have no binding force and do not affect a person's right of objection and appeal to the Commissioner, the Board of Review or the Courts.

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Commissioner of Inland Revenue

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# DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

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## **INTRODUCTION**

Interest expense, insofar as it is incurred in the production of the chargeable profits of a person, is deductible from the assessable profits of the person. With the gradual removal of interest tax in the 1980's and the limitation in taxing offshore interest income earned by a person carrying on business in Hong Kong, the taxation scheme on interest receipts and interest payments have become asymmetrical, in that interest income is not taxable while interest expenses are tax deductible. Recognising the risk of revenue loss that might be caused by tax avoidance schemes that would take advantage of the lack of symmetry in tax treatment on interest, specific rules were introduced in 1984 and 1986 to restrict the deduction of interest under certain circumstances. The interest deduction scheme has been revamped substantially by the recent amendments introduced by the Inland Revenue (Amendment) Ordinance 2004 (the 2004 Amendment Ordinance), with a view to bolstering up the interest deduction rules. This Interpretation and Practice Note sets out the Department's views and practices on the interest deduction scheme that applies before and after the commencement of the 2004 Amendment Ordinance, which came into operation on 25 June 2004. *[The practices of the interest deduction scheme that applied before the commencement of 2004 Amendment Ordinance were previously included in the DIPN No. 13.]*

## **INTEREST DEDUCTION SCHEME BEFORE THE COMMENCEMENT OF THE 2004 AMENDMENT ORDINANCE**

2. Following the abolition of interest tax, anti-avoidance measures were enacted in relation to interest deductions under profits tax to protect the profits tax yield. In addition to the interest being incurred in the production of chargeable profits, specific conditions must also be satisfied before interest expenses could be allowed as deductions in computing assessable profits. In practice, these measures required all claims for deductions in respect of interest payable on moneys borrowed for the purpose of producing assessable profits to be supported by sufficient details and/or documentary evidence to satisfy at least one of the six prescribed conditions in section 16(2)(a) to (f). *[Sections of the Main Ordinance referred to in paragraphs 2 – 9 are those provisions*

that were in force before the commencement of the 2004 Amendment Ordinance.]

### ***Conditions for Deduction***

3. **Conditions (a) and (b)** were largely self-explanatory and referred to borrower taxpayers who were financial institutions or public utilities. All borrowings by a financial institution satisfied condition (a), while any borrowings by public utilities at a rate of interest not exceeding a specified rate satisfied condition (b).

4. **Condition (c)** applied to borrowings from persons other than financial institutions or overseas financial institutions. It would be satisfied by the borrower establishing that any interest payable on the loan was chargeable to profits tax under the Inland Revenue Ordinance (IRO). Where the money borrowed had been made available to the borrower in Hong Kong, it would generally be clear that any interest paid on the loan would be chargeable to profits tax in the hands of the lender who was carrying on a trade or business in Hong Kong, as the interest income was sourced in Hong Kong. In such cases, to demonstrate that condition (c) was satisfied, it would be sufficient to disclose the identity of the lender, the place of his business, and the place where the money borrowed was made available to the borrower, so as to establish that the interest paid was chargeable to profits tax. On the other hand, where the loan was made available to the borrower outside of Hong Kong as an offshore loan, there would be a prima facie presumption that any interest payable was not chargeable to profits tax (for being incurred outside Hong Kong) and that condition (c) was not satisfied. This presumption could, of course, be rebutted by the borrower demonstrating that notwithstanding the loan being offshore, the lender nevertheless carried on business in Hong Kong and was chargeable to profits tax on the interest received.

5. **Condition (d)** referred to moneys borrowed from financial institutions or overseas financial institutions. Its practical application was best explained by distinguishing such borrowings into those that satisfied the condition and those that did not. A loan from a financial institution (whether local or overseas) would satisfy condition (d) if –

- The loan was not secured or guaranteed by any deposit made with that or another financial institution; or
- The loan was secured or guaranteed against a deposit with that or another financial institution, by –
  - the borrower or on his behalf, or,
  - a person who was closely associated with the borrower (an associate as defined in section 16(3)),

and the interest received on the deposit was subject to profits tax.

Where a loan from a financial institution was secured or guaranteed against a deposit with that or another financial institution and the interest received on the deposit was not chargeable to tax in Hong Kong, condition (d) would not be satisfied.

The following examples illustrate the above situations –

**Example 1**

*Mr A carried on business as a plastics manufacturer. In order to obtain additional working capital, he borrowed from a local bank. This borrowing was secured by a mortgage over the factory premises owned by Mr A.*

Because the loan was not secured by a deposit, the borrowing clearly satisfied condition (d).

**Example 2**

*Mr B carried on an export/import business in Hong Kong. In order to obtain additional working capital, he borrowed from a local bank. The borrowing was secured by a fixed deposit with that same bank registered in the name of Mr B's wife, who carried on no business in Hong Kong.*

The interest received by Mrs B was not chargeable to tax in Hong Kong and as the relationship between Mr and Mrs B (as husband and wife) was one within the class of “associates” prescribed in section 16(3), the borrowing by Mr B did not satisfy condition (d).

### **Example 3**

*C Limited carried on business in Hong Kong as an electronics manufacturer. For the purpose of acquiring new factory premises, C Limited borrowed from a local bank. This borrowing was partly secured by a fixed deposit with the same bank registered in the name of D Limited, a wholly owned subsidiary of C Limited. D Ltd carried on business in Hong Kong.*

Although the borrowing was secured against a deposit owned by an “associated corporation”, condition (d) was satisfied because the interest on the deposit was chargeable to profits tax in the hands of D Limited.

### **Example 4**

*E Limited carried on business in Hong Kong as consultants. Mr E, who was the major shareholder and managing director of E Limited, received dividends and a salary from the company. For the purposes of expanding its business, E Limited borrowed from a local bank. This borrowing was secured by a fixed deposit in the name of Mr E with a Cayman Islands financial institution.*

Being both a shareholder and a director of E Limited, Mr E was related to E Limited as an associate within the terms of section 16(3). As Hong Kong tax was not chargeable on interest received by Mr E from the Cayman Islands deposit, the borrowing by E Limited did not satisfy condition (d).

6. In practice, the most appropriate way of establishing that condition (d) was satisfied was for the taxpayer to submit a statement with his return setting out details of both the borrowing and the security or guarantee provided for the loan. Where the security or guarantee took the form of a deposit

owned by a person other than the borrower, the relationship between that person and the borrower and whether that person carried on a business in Hong Kong should be clearly explained. Further, if the borrowing was from a financial institution which did not carry on business in Hong Kong, then sufficient details of that institution should be provided so as to enable the Commissioner to determine whether it was an overseas financial institution which could be recognized for the purposes of section 16(2), (3) and (4). To qualify as an overseas financial institution, the institution in question must be adequately supervised by a supervisory authority.

7. **Condition (e)** would be satisfied by the borrower establishing that –

- the money had been borrowed wholly and exclusively to finance capital expenditure on machinery and plant, or for the purchase of trading stock, for the purpose of producing chargeable profits; and
- the lender was not an associate of the borrower in terms of section 16(3).

8. Finally, **condition (f)** related to corporate borrowings by way of debentures or other “marketable instruments”. As regards the interest payable on debentures, the condition would be satisfied where such debentures were listed on a stock exchange in Hong Kong or any other stock exchange recognized by the Commissioner. Insofar as “marketable instruments” were concerned, the condition would be satisfied if the instruments were issued-

- bona fide and in the course of carrying on business and was marketable in Hong Kong or any other major financial centre approved by the Commissioner; or
- pursuant to the authorisation of the Securities and Futures Commission under section 105 of the Securities and Futures Ordinance [*under section 4(2)(g) of the Protection of Investors Ordinance before 1 April 2003.*].

9. Condition (f) would also be satisfied where the borrowing was from an associated corporation and the moneys borrowed in the hands of the associated corporation arose entirely from the proceeds of an issue of debentures or marketable instruments as described above. As for borrowings

from associated corporations, the deduction for interest paid by the borrowing corporation was restricted to the amount of interest paid by the associated corporation to the holders of its debentures or instruments.

## **INTEREST DEDUCTION SCHEME AFTER THE COMMENCEMENT OF THE 2004 AMENDMENT ORDINANCE**

10. The 2004 Amendment Ordinance has introduced substantial amendments to the interest deduction scheme. The conditions for interest deduction under section 16(2)(a) to (f) as regards the types of loans remain, in broad terms, the same as before. However, the condition under section 16(2)(d) on the loan not being secured or guaranteed by a deposit that can generate tax free interest has been removed to a new provision [section 16(2A)] which has a broader application. New provisions have also been added to restrict the deduction of interest despite the satisfaction of the respective conditions under section 16(2). The new scheme of interest deduction after the 2004 Amendment Ordinance is discussed below.

### ***Conditions for Deduction***

#### **Conditions (a) and (b) – borrowings by financial institutions and public utilities**

11. No amendment has been made to these two conditions. All borrowings by a financial institution and any borrowings by public utilities at a rate of interest not exceeding a specified rate will continue to satisfy conditions (a) and (b) respectively.

#### **Condition (c) – borrowings from persons other than financial institution**

12. The main part of this subsection remains unchanged. The comments in paragraph 4 above continue to apply. In addition, interest deduction on a loan satisfying this condition is also subject to the new restrictions under section 16(2A) and (2B).

**Condition (d) – borrowings from financial institutions or overseas financial institutions**

13. This condition will be satisfied if the loan is borrowed from a financial institution or an overseas financial institution. The requirement that the loan is not being secured by a deposit of the borrower or his associate that can generate tax free interest is removed from this condition, but a similar test is added as a criterion for restricting interest deduction under section 16(2A). On top of that, deduction of interest payable on this type of loan is further subject to the new restrictions under section (2B).

**Condition (e) – borrowings for specified purposes**

14. As before, this condition will be satisfied by the borrower establishing that –

- the money has been borrowed wholly and exclusively to finance capital expenditure on machinery and plant, or for the purchase of trading stock, for the purpose of producing chargeable profits; and
- the lender is not an associate of the borrower in terms of section 16(3).

Deduction of interest under this type of loan is subject to the new restrictions under section 16(2A) and (2B).

**Condition (f) – interest on debentures and debt instruments**

15. This condition continues to relate to corporate borrowings by way of debentures or other marketable debt instruments. For the interest payable on debentures, the condition will be satisfied where such debentures are listed on a stock exchange in Hong Kong or any other stock exchange recognized by the Commissioner. Insofar as debt instruments are concerned, the condition will be satisfied if the instruments are issued -

- (A) bona fide and in the course of carrying on business and is marketed in Hong Kong or any other major financial centre recognized by the Commissioner; or

- (B) pursuant to any agreement or arrangements, where the issue of an advertisement, invitation or document in respect of the agreement or arrangements to the public has been authorized by the Securities and Futures Commission under section 105 of the Securities and Futures Ordinance.

Marketed

16. The two conditions relating to the interest deduction on debt instruments resemble closely the corresponding provisions that prevailed immediately before the 2004 Amendment Ordinance. The only major difference is that debt instruments (other than those issued under an agreement or arrangement with the approval of the Securities and Futures Commission) that qualify for interest deduction have to be actually *marketed* in Hong Kong or in a major financial centre recognized by the Commissioner. This means that to satisfy the condition, not only should the instrument be marketable, there should also be some actual marketing activities conducted when, or shortly after, the instrument is issued.

17. Whether an instrument has been marketed is a matter of fact to be determined by reference to the common market practices. The followings are some of the conditions the existence of which may indicate that the instrument has been marketed –

- (i) road-shows or meetings with potential investors are conducted before the issue of the instrument;
- (ii) research reports on the issuer are published by major market participants;
- (iii) the instrument is rated by reputable credit rating agencies, e.g. Standard and Poor's, Moody's, Fitch IBCA, etc.;
- (iv) the instrument is cleared through one of the recognized clearing systems, e.g. the CMU (Central Moneymarkets Unit) of the Hong Kong Monetary Authority, Euroclear, Clearstream, etc.;
- (v) the description of the instrument is displayed on major real-time financial information networks, e.g. Reuters, Bloomberg, Telerate, etc.;

- (vi) one or more market participants agree to quote bid prices on the instrument under normal market conditions;
- (vii) evidence that shows the existence of trading of the instrument in the secondary markets, e.g. transaction records in the clearing systems.

*Issue of debentures or instruments through associated corporation*

18. As before, condition (f) will also be satisfied where the borrowing is from an associated corporation and the moneys borrowed in the hands of the associated corporation arose entirely from the proceeds of an issue of debentures or instruments as described above. As for borrowings from associated corporations, the deduction of interest paid by the borrowing corporation is restricted to the amount of interest paid by the associated corporation to the holders of its debentures or instruments.

19. Deduction of interest under this condition is subject to the new restriction under section 16(2C).

***Limitation of Deduction of Interest***

20. The 2004 Amendment Ordinance lays down restrictions on interest deduction under certain circumstances. Deduction of interest on loans borrowed from non-financial institutions (condition (c) loans), borrowed from financial institutions (condition (d) loans) or borrowed for specified purposes (condition (e) loans) will all be subject to two additional tests under section 16(2A) and (2B) –

Section 16(2A)

- (i) the loan is not secured by a deposit or loan made by the borrower or a person associated with the borrower with or to the lender, a financial institution, an overseas financial institution or an associate of any of these parties, where the interest generated by such deposit or loan is not taxable (i.e. the **secured-loan test**); and

## Section 16(2B)

- (ii) there is no arrangement in place such that the interest payment is ultimately paid back to the borrower or to a person connected with the borrower (i.e. the **interest flow-back test**).

21. As regards the deduction of interest on debentures or debt instruments, it will be subject to the same interest flow-back test (section 16(2C) as that mentioned in paragraph 20(ii) above). Nevertheless, failure to comply with these tests does not necessarily disqualify the interest expense in its entirety from a deduction claim. In the case of a partial failure, the restriction on interest deduction will only be confined to the portion of the interest relating to the portion of loan, debenture or debt instruments that failed the tests and the time in which the failure persisted.

22. Bankers may have the right to utilise balances in deposit accounts of a customer to set off the outstanding loan and interest payable by that customer in the case of default in repayment of the loan. Despite such right of the bankers, the balances in deposit accounts of a customer who also borrows money from the bank would not be taken as a security of the loan if the customer's right to withdraw the deposit is not restricted at any time before he defaults in repayment of the loan. Such deposit, which the depositor has unrestricted right to operate before the bank exercises the right of set-off, does not appear to be, by nature, a security for the loan.

### **Restriction under section 16(2A) [The secured-loan test]**

23. Restriction of deduction under section 16(2A) applies to interest deduction claims on loans satisfying the conditions under section 16(2)(c), (d) or (e). The provision is triggered when the following situation exists at any time during the basis period of the borrower in respect of which interest deduction is claimed –

- (i) the payment of any interest or the repayment of any principal of the loan in question is secured or guaranteed by a deposit (or a loan);
- (ii) the said deposit (or loan) is made by the borrower or an associate of his with (or to) a specified person;

- (iii) the specified person is either –
  - a. the lender or an associate of the lender;
  - b. a financial institution or an associate of a financial institution; or
  - c. an overseas financial institution or an associate of an overseas financial institution; and
- (iv) the deposit or loan generates interest income that is not chargeable to tax in Hong Kong.

The term “associate” has the same meaning before and after the 2004 Amendment Ordinance, as defined in section 16(3).

24. This section, when applicable, will reduce the interest deduction by an amount calculated on a basis as is most reasonable and appropriate in the circumstances of the case, having regard to the amount of interest income arising from deposit or loan in question. The following examples illustrate the Department’s practice.

**Example 5**

*Taxpayer F borrowed \$1M from Bank G at 5% interest rate p.a. The loan was secured by a fixed deposit of \$1M earning tax-free interest of 4% p.a. There was no other security. In the year of assessment, F earned interest of \$40,000 from the deposit and paid interest of \$50,000 on the loan.*

The amount of interest expenses allowable for deduction will be reduced by \$40,000, being the tax-free interest earned. In other words, the allowable interest is \$10,000.

**Example 6**

*The \$1M loan in Example 5 was secured by a deposit of \$500,000 and some shares which were also worth \$500,000. The deposit generated tax-free interest of \$20,000.*

The amount of interest expenses allowable for deduction will be reduced by the amount of tax-free interest (\$20,000) generated from the deposit. In other words, the allowable interest is \$30,000.

### **Example 7**

*The \$1M loan in Example 5 was secured by a deposit of \$2M that generated tax-free interest of \$80,000. There was no other security.*

The amount of interest expenses allowable for deduction will be reduced by \$40,000, which is calculated as follows –

$$\$80,000 \times \frac{\$1M \text{ (loan)}}{\$2M \text{ (deposit)}} = \$40,000$$

### **Example 8**

*The \$1M loan in Example 5 was secured by a deposit of \$1M (which generated tax-free deposit interest of \$40,000) and some shares valued at \$500,000.*

The amount of interest expenses allowable for deduction will be reduced by \$26,667, which is calculated as follows -

$$\$40,000 \times \frac{\$1M \text{ (deposit)}}{\$1.5M \text{ (deposit + shares)}} = \$26,667$$

The value of shares used as security may vary from time to time. For the purposes of this calculation, a reasonable basis of averaging, such as by reference to month end balances, will be accepted.

### **Example 9**

*A deposit of \$2M (generating tax-free interest of \$80,000) was used to secure a loan of \$1M used for financing onshore business activities and another loan of \$1.5M used for financing offshore businesses. Interest incurred on the onshore business loan was \$50,000 and that on the offshore business loan was \$80,000.*

In this example, the deposit was used to secure two loans. The amount of interest expenses allowable for deduction will be reduced by \$32,000, which is calculated as follows -

$$\$80,000 \times \frac{\$1M \text{ (onshore loan)}}{\$2.5M \text{ (onshore loan + offshore loan)}} = \$32,000$$

### **Example 10**

*The two loans in Example 9 were secured by a deposit of \$4M, which generated tax-free interest of \$160,000. There was no other security.*

In this example, the portion of deposit that was used to secure the two loans is \$2.5M / \$4M; and out of this portion, the part attributable to the onshore loan is \$1M / \$2.5M.

The amount of interest expenses allowable for deduction will be reduced by \$40,000, which is calculated as follows –

$$\$160,000 \times \frac{\$2.5M}{\$4M} \times \frac{\$1M}{\$2.5M} = \$40,000$$

### Trusts

25. In considering the relation between the borrower and the holder of the deposit or loan used as security, if a deposit or loan is made by a trustee of a trust or a corporation controlled by such a trustee, the deposit or loan shall be deemed to have been made by each of the trustee, the corporation and the beneficiary under the trust [section 16(2D)]. Section 16(3) contains a definition of “beneficiary under the trust”.

### **Restriction under section 16(2B) [The interest flow-back test]**

26. Deduction of interest on loans that satisfy the conditions under section 16(2)(c), (d) or (e) will be restricted if there is an arrangement under which the interest payable will be paid, directly or through an interposed person, back to the borrower or to a person connected with the borrower who is not an “excepted person” within the meaning of section 16(2E)(c). The

provision applies where the said arrangement exists at any time during the basis period of the borrower for the year of assessment in respect of which deduction is claimed for the interest on the respective loan. Any payment of interest to a trustee or a corporation controlled by the trustee is deemed to be a payment to each of the trustee, the corporation and the beneficiary under the trust [section 16(2E)(b)].

27. The term “arrangement” is defined in section 2. It includes –
- (a) any agreement, arrangement, understanding, promise or undertaking, whether expressed or implied, and whether or not enforceable or intended to be enforceable, by legal proceedings; and
  - (b) any scheme, plan, proposal, action or course of action or course of conduct.

The provision for restricting interest deduction will be invoked whenever arrangements are in place, irrespective of whether the passing of interest has actually occurred.

28. In this section, the reference to “any sum payable by way of interest on the loan borrowed” is expanded by section 16(2E)(a) to cover the payment of interest or principal in respect of any other loan, the repayment of which is secured by the payment of interest or repayment of principal of the loan in question (e.g. the second loan is advanced by way of sub-participating in the first loan borrowed by the borrower).

### **Example 11**

*Company H borrowed a loan of \$100M from Bank J. Bank J entered into a loan sub-participation arrangement with Company K, which is an associated company of Company H. Under the arrangement, Company K advanced a loan of \$100M to Bank J on the condition that the repayment of principal and interest of this loan by Bank J to Company K would only be made on the condition of the repayment of principal and interest of the bank loan by Company H to Bank J. In practical terms, Bank J is risk free.*

In this situation, the interest paid by Bank J to Company K is treated as if it were the interest on the loan borrowed by Company H from Bank J when the restriction of section 16(2B) is considered. As the interest was paid to an associated company of the borrower (Company H) of the loan, the interest deduction claim would be denied.

### Interest Apportionment

29. Triggering the application of section 16(2B) does not necessarily mean that the whole amount of interest incurred on a loan will be disqualified for deduction. Indeed the section allows for apportionment of interest expenses in two ways –

- The provision applies to arrangements that cover interest payable on a part of a loan, and this allows apportionment of interest in the case where only part of the loan in question is subject to an arrangement under which the interest payable will be reverted back to the borrower or his connected person.
- Where the arrangement is in place for only part of the basis period during which the loan interest is incurred, the interest expenses can be apportioned on a time basis. This means that only the portion of interest attributable to the period of time during which the arrangement is in place will be disallowed from deduction.

### **Example 12**

*Company L borrowed a loan of \$10M from Bank M at the interest rate of 10% p.a. At its inception, \$7M of the loan was sub-participated by Company N, an associate company of Company L. The repayment by Bank M to Company N of the principal and interest of the \$7M loan was made conditional to or secured by the repayment of principal and interest of the \$10M loan made by Company L to Bank M. In a year of assessment Company L paid interest of \$1M to Bank M, and correspondingly Bank M paid interest in the amount attributable to the \$7M loan to Company N.*

In this example only \$7M of the total loan was sub-participated by a person connected with the borrower (Company L). Thus only the interest attributable to the sub-participated portion, that is the amount of \$700,000 ( $\$1M \times 7/10$ ), is subject to the adjustment under section 16(2B). As this part of the loan was participated for the whole period during which interest was incurred, the full amount of the \$700,000 interest would be disallowed by section 16(2B). However, the interest on the remaining part of loan which was not sub-participated by the borrower or a person connected to him (in this case interest of \$300,000) would be allowable for deduction.

### Example 13

If in Example 12, the loan of \$7M (C) was sub-participated by Company N for only 6 months (A) during the basis period of the year of assessment (B) concerned, the operation of section 16(2B) will be as follows –

	(\$M)
Interest payable on the portion of loan which was sub-participated to Company N	0.7
Deduct: by the amount (A/B x C) (183days / 365 days x \$0.7M)	<u>0.35</u>
Interest on sub-participated loan deductible	0.35
Add: Interest on the portion of the loan that is not sub-participated ( $\$3M/\$10M \times \$1M$ )	<u>0.3</u>
Total interest deduction	<u>0.65</u>

Note that the amount of interest paid on the sub-participated loan (the loan advanced by Company N to Bank M), even if of different amount, is not relevant in the computation.

## **Restriction under section 16(2C) [Interest flow-back test on debt instruments]**

30. Like interest on ordinary loans, deduction of interest on debentures or debt instruments that satisfy the conditions under section 16(2)(f) will be restricted if there is an arrangement under which the interest payable will be paid, directly or through an interposed person, back to the borrower (the issuer) or to a person connected with the borrower who is not an “excepted person” within the meaning of section 16(2F)(c). The provision applies when the said arrangement exists at any time during the basis period of the borrower for the year of assessment in respect of which deduction is claimed for the interest on the respective loan. Any payment of interest to a trustee or a corporation controlled by the trustee is deemed to be a payment to each of the trustee, the corporation and the beneficiary under the trust [section 16(2F)(b)].

31. Again, the term “arrangement” has a wide coverage as defined in section 2 (see paragraph 27 above). The provision for restricting interest deduction will be invoked whenever arrangements are in place, irrespective of whether the passing of interest has actually occurred. Peculiar to the nature of debentures and debt instruments, the term includes the holding of debentures or debt instruments either directly or beneficially (i.e. holding any interest in debentures or debt instruments).

32. In this section, the reference to “any sum payable by way of interest on the debentures or instruments concerned” is expanded by section 16(2F)(a) to cover the payment of interest or principal in respect of any other loan the repayment of which is secured by the payment of interest or repayment of principal of the debentures or instruments concerned (see Example 11 above).

### *Interest Apportionment*

33. Section 16(2C) allows for apportionment of interest expenses in three ways –

- The provision applies to arrangements in relation to interest expenses payable on any debentures or instruments within an issue. This allows for apportionment of interest expenses when only some of the debentures or instruments issued are held by the borrower or a connected person of the borrower.

- The provision also applies to arrangements that cover interest expenses payable in the interest on any debentures or instrument concerned. This allows apportionment of interest expenses in the case where the beneficial interest in a debenture or an instrument is shared among a number of persons, and only some of such persons are connected with the issuer.
- Where the arrangement is in place for only part of the basis period of the issuer during which the loan interest claimed for deduction was incurred, the interest expenses can be apportioned on a time basis. This means that only the portion of interest expenses attributable to the period of time during which the arrangement was in place will be disallowed from deduction.

#### **Example 14**

*Corporation P issued debentures in amount of \$100M in a recognized overseas stock market. Out of the issue, an associated company of Corporation P subscribed \$80M and acquired the remaining \$20M debentures from the market in the middle of the year of assessment. During the year of assessment concerned total interest in the amount of \$10M was paid. Corporation P adopts a basis period that corresponds to a year of assessment (i.e. for year ended 31 March).*

The interest deduction calculation will be as follows –

	(\$M)
Interest on \$80M debentures subscribed by the associated company	8
Reduced by the amount attributable to the holding of the associated company	<u>8</u>
Balance deductible	<u>0</u>

Interest on the \$20M debentures acquired by the associated company in the middle of the year	2
Reduced by the amount attributable to the holding of the associated company (183 / 365 x \$2M)	<u>1</u>
Interest on this portion of debenture deductible	<u>1</u>
Total interest deduction (\$0M + \$1M)	<u><u>1</u></u>

***Persons Connected with the Borrower [Section 16(3B)]***

34. This is a new concept under the interest flow-back test. A person is regarded as being connected with the borrower if the person is –

- (a) an associated corporation of the borrower; or
- (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 is the borrower.

35. The term “associated corporation” is defined in section 16(3). This definition has not been changed by the 2004 Amendment Ordinance. The meaning of the term “control” [which is formerly defined in section 16(3)] is now provided under section 16(3A). So far as a corporation is concerned, the meaning of control has not been changed by the 2004 Amendment Ordinance. However, it has been expanded to cover the situation of controlling a person who is not a corporation.

***Excepted Persons***

36. This is another new concept under the interest flow-back test. Interest restriction under the test does not apply where under the arrangement

concerned, the interest flows to a connected person who is an “excepted person”. The definitions of excepted person under sections 16(2E)(c) and 16(2F)(c) are the same and cover the following categories –

- a person who is charged to tax in respect of the interest in question;
- a person acting as a bare trustee;
- a beneficiary of a unit trust to which section 26A(1A)(a)(i) or (ii) applies, where the interest payment is in respect of a specified investment scheme;
- a member of a recognized retirement scheme, or a similar scheme established outside Hong Kong accepted by the Commissioner;
- a public body (which is defined under section 3 of the Interpretation and General Clauses Ordinance, Cap 1, as including the Executive Council, the Legislative Council, and District Council, any other urban, rural or municipal council, any department of the Government, and any undertaking by or of the Government);
- a body corporate of which the Government owns more than half in nominal value of the issued share capital; or
- a financial institution or an overseas financial institution.

### ***Exemption for Market Makers of Debt Instruments***

37. Section 16(2G) provides for an exemption from the interest deduction restriction under section 16(2C) in respect of debentures or debt instruments. The restriction does not apply where under an arrangement interest on debentures or debt instruments is payable to a market maker who holds such debentures or instruments in the ordinary course of conduct of his trade, profession or business in respect of market making, notwithstanding that the market maker is a person connected with the issuer.

38. The purpose of holding the debentures or debt instruments must be for providing liquidity for such securities. Under normal circumstances, long-term or substantial holdings of the securities will not be considered as consistent with market making activities. For this purpose, a holding of over 5% of an issue for a period of over 3 months will not be taken as a holding of the securities in the ordinary course of conduct of market making activities, unless the Commissioner is satisfied that there are reasonable explanations for doing so.

39. To qualify for the exemption, the market maker must be a person who –

- is a licensed or registered dealer of securities under the Securities and Futures Ordinance (Cap. 571), or in a major financial centre outside Hong Kong recognized by the Commissioner;
- in the ordinary course of conduct of the market making business, holds himself out as being willing to buy and sell securities for his own account and on a regular basis; and
- is actively involved in market making in securities issued by a wide range of unrelated institutions.

#### **APPLICATION OF THE GENERAL ANTI-AVOIDANCE PROVISION (SECTION 61A)**

40. While the conditions and restrictions on interest expenses deduction under section 16 lay down specific rules governing the interest deduction scheme, compliance with such rules and conditions does not preclude the application of the general anti-avoidance provision under section 61A in cases that satisfy the conditions specified in section 61A. Support for this proposition can be found in the Privy Council decision of *CIR v. Challenge Corporation Limited*, [1986] STC 548, and the Court of Appeal decision of *Yick Fung Estates Ltd. v. CIR*, 5 HKTC 52.

## **GRANDFATHERING PROVISIONS**

41. The application of the new interest deduction provisions of the 2004 Amendment Ordinance is set out in section 16(5A). As a general rule, the new scheme will apply to interests incurred after the commencement of the 2004 Amendment Ordinance, that is, on or after 25 June 2004.

42. Nevertheless, interest incurred under a transaction which was the subject of an advance clearance, or under an arrangement which was the subject of an advance ruling given under section 88A, can be grandfathered from the application of the new scheme. To qualify for grandfathering, the advance clearance or the advance ruling must have been given by the Commissioner, before 25 June 2004, on the issue that the transaction or the arrangement, as the case may be, would not fall within the terms of section 61A. Deductions of interest expenses arising from these transactions or arrangements (incurred after 25 June 2004) are governed by the provisions that were in force before the amendments made by the 2004 Amendment Ordinance are effected [see paragraphs 2 – 9 above], as if the amendments of the 2004 Amendment Ordinance to section 16 had not taken effect.

## **DUTY OF THE TAXPAYER TO DISCLOSE DETAILS OF INTEREST DEDUCTION CLAIMS**

43. It is the duty of the taxpayer who makes a claim for interest deduction to disclose the full details of the facts that may affect the deductibility of the interest concerned. It is therefore necessary for him to ascertain and to disclose in the tax return whether there is any arrangement in place that may trigger the interest deduction restriction provisions under section 16(2A), (2B) or (2C).