For information
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Legislative Council Panel on Financial Affairs

**Legislative Proposal to
Enhance the Qualifying Debt Instrument Scheme**

PURPOSE

This paper sets out the legislative proposal to amend the Inland Revenue Ordinance ("IRO") (Cap. 112) for enhancing the qualifying debt instrument ("QDI") scheme, which has been announced in the Financial Secretary's Budget for 2010-11.

BACKGROUND

2. Interest income and trading profits of debt instruments issued and traded in Hong Kong are chargeable to profits tax under the IRO. In mid-1990s, Hong Kong introduced concessionary tax treatment in respect of interest income and trading profits derived from QDI with the policy objectives of attracting overseas issuers to Hong Kong, enlarging the debt market, and enhancing the competitiveness of Hong Kong vis-à-vis other financial centres in the region. The QDI scheme was refined subsequently in 1999 and 2003[1].

3. Currently, a 100% exemption from profits tax for interest income and trading profits arising from certain categories of debt instruments is granted under section 26A of the IRO. These debt instruments include government bond, Exchange Fund debt instrument, Hong Kong dollar denominated multilateral agency debt instrument, and long term debt instruments with an original maturity of seven years or longer.

4. Under section 14A of the IRO, a tax concession at 50% of the normal profits tax rate is applied to interest income and trading profits derived from a

[1] In 1999, the minimum denomination for debt instruments eligible for the 50% concessionary rate of profits tax was reduced from $500,000 to $50,000. In 2003, the 50% profits tax concession was extended for interest income and trading profits derived from QDIs with original maturity period of not less than five years to three years, and the profits tax concession was enhanced from 50% to 100% for interest income and trading profits arising from QDIs with an original maturity of at least seven years.

debt instrument that satisfies the relevant criteria, including those instruments which -

(a) are lodged with and cleared by the Central Moneymarket Unit operated by the Hong Kong Monetary Authority ("HKMA");

(b) have an original maturity of not less than three years but less than seven years;

(c) have a minimum denomination of HK$50,000 or its equivalent in a foreign currency;

(d) are issued to the public in Hong Kong; and

(e) are issued by a person and have at all relevant times a credit rating acceptable to the HKMA from a credit rating agency recognized by the HKMA (which is currently set at minimum BBB- from Standard and Poor's).

5. Although the refinements made to the QDI scheme in 1999 and 2003 have helped boost the number of debt instruments eligible for the QDI scheme and have increased the size of issuance of long-term debt instruments in Hong Kong, the percentage of QDI issuance in total issuance remained small. Only 4% (or about HK$42 billion) of Hong Kong's total debt issuance are QDI issuance since the last refinement in 2003. It shows that there is still room for improving Hong Kong's QDI scheme to enable it to better serve its policy objectives of enlarging the local debt market and enhancing the competitiveness of Hong Kong vis-à-vis other financial centres in the region.

6. We have conducted an internal review of Hong Kong's QDI scheme and identified several areas for improvement. First, the structure of the tax incentives offered under the QDI scheme does not match the landscape of Hong Kong's corporate bond market. While Hong Kong's corporate bond market is dominated by privately-placed short-term debt instruments with an original maturity of less than three years (46% of total issuance), the QDI scheme only offers tax incentives to debt instruments with an original maturity of three years or more and which are "issued to the public". Second, since the "issued to the public in Hong Kong" criterion is not clearly defined in the IRO, there are some uncertainties in the market about how such criterion should be interpreted in practice. In addition, the eligibility criteria of Hong Kong's QDI scheme appear to be more stringent than those of similar schemes used in other regional

financial centres[2].

7. Given the importance of an active and diverse debt market to the further development of Hong Kong as an international financial centre, we propose that improvements to Hong Kong's QDI scheme be made to help develop Hong Kong's debt market and enhance the competitiveness of Hong Kong's debt market vis-à-vis those of other regional financial centres.

LEGISLATIVE PROPOSAL

8. To address the issues mentioned in paragraph 6 above, we have included three major elements in our legislative proposal for enhancing the QDI scheme. We expect that these enhancements, which aim to strike a balance between meeting market development needs and minimising the risk of tax avoidance, would help further develop Hong Kong's debt market and put Hong Kong on a more equal footing with other regional financial centres in attracting debt market activities.

Extending tax concession to short-term debt instruments

9. First, we propose that the 50% tax concession currently granted under section 14A of the IRO be extended to interest income and trading profits derived from debt instruments with an original maturity of less than three years.

10. This proposed amendment aims to place short-term debt instruments on a level-playing field with longer-term debt instruments in respect of profits tax treatment. As an international financial centre, Hong Kong should aim at developing a debt market that is deep, active and diverse, and with a wide spectrum of participants (including issuers, investors and services providers) as well as issues. With this proposed amendment, we hope that it would help stimulate new demand for bond issuance activity.

Clarifying the "issued to the public" criterion

11. Second, to remove the uncertainties concerning what constitutes "issued to the public" as required under section 14A(4)(e) of the IRO, we propose to replace the "issued to the public" criterion by a new requirement along the line that, at the primary launch, the instrument is issued to -

[2] For example, under a similar scheme in Singapore, debt instruments only need to meet certain requirements on the issuer and the arranger and fulfil a clearly defined criterion on "issued to the public" to be eligible for tax concessions under the scheme. No maturity requirement is applied under the Singapore scheme.

(a) 10 persons or more; or

(b) if less than 10 persons, none of which is an associate of the issuer.

12. The "issued to the public" criterion was introduced to address potential tax avoidance through arranging as QDIs intra-group or inter-group debt issues that are otherwise not necessary so as to enjoy tax benefits. However, since the IRO does not specify what constitutes "issued to the public", the legal uncertainties involved have put many debt market participants off using Hong Kong's QDI scheme. The proposed amendment has been formulated taking into account the landscape of Hong Kong's debt market and its original intent of preventing tax avoidance. In drawing up the proposal, we have made reference to similar schemes overseas which are considered successful in using tax incentives to develop their debt markets[3].

13. We propose that the minimum number of persons a debt instrument has to be issued so that it would be eligible for Hong Kong's QDI scheme should be set at 10. To cater for the large amount of private-placement debt issues in Hong Kong that may be offered to a large number of potential investors but are usually only issued to less than 10 investors at the end, an alternative requirement is provided for debt instruments that are issued to less than 10 persons at primary launch. To fulfil this alternative requirement, none of the investors should be an associate of the issuer at the primary launch.

Further anti-avoidance provision

14. Third, to provide further safeguard against potential intra-group tax avoidance arrangements, we propose adding a new provision along the line that if any portion of a QDI is held by an associate of the issuer at any time during the life of the issue, the relevant profits tax concession offered under the QDI scheme will not apply to that portion of the issue. The rest of the issue will not be affected by this proposed provision.

[3] Under Singapore's scheme, debt securities would be deemed "issued to the public" if they are issued to four persons or more; or have less than 50% of the issue of debt securities being beneficially held or funded by related parties of the issuer of those debt securities at the time of primary launch. If, at any time during the life of an eligible debt issue, 50% or more of the issue is beneficially held or funded, directly or indirectly, by a related party of the issuer, the portion of the issue held by related parties will not be eligible for tax concessions under the scheme. Under Australia's scheme, issuers are only required to offer the issue to a specified minimum number of potential investors. No requirement is set on the number of investors to whom the debt securities are ultimately issued.

LEGISLATIVE TIMETABLE

15. Our target is to introduce the amendment bill into the Legislative Council in the next legislative session. We have sought initial views and input from market participants and the industry is generally supportive of the direction of our proposal. We will continue to engage the market players in preparing the proposed legislative amendments with a view to ensuring that they would address the relevant market views.

Financial Services Branch
Finance Services and the Treasury Bureau
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