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Bills Committee on Inland Revenue (Amendment) (No. 4) Bill 2015

Background brief

Purpose

This paper provides background information on the Inland Revenue (Amendment) (No. 4) Bill 2015 ("the Bill"). It also summarizes the relevant views and concerns expressed by members of the Panel on Financial Affairs ("FA Panel") during discussions on the legislative proposal to attract enterprises to establish corporate treasury centres ("CTCs") in Hong Kong and the implementation of the Basel III capital requirements in Hong Kong.

Proposed tax incentives for corporate treasury centres

Background

2. A CTC performs the role of an in-house bank of a multinational corporation providing treasury services for its group companies. Activities of a CTC usually involve (a) intra-group borrowing and lending of money; (b) optimizing multi-currency cash management and liquidity management; (c) central or regional processing of payments to vendors or suppliers for the corporate group; (d) conducting transactions for financial or treasury-related risk management; and (e) supporting the raising of capital by the group.

3. From the perspective of multinational corporations, centralizing treasury management can improve efficiency through achieving the economy of scale and standardization of procedures and processes. CTCs have to be strategically located to cater for business, cost and tax considerations, ideally in a financial centre which can provide corporate treasurers with excellent financial, banking and professional services, as well as deep capital markets for liquidity and portfolio management. According to the Government, more multinational corporations are looking to Asia to establish global or regional CTCs in recent years, given the expansion of their business in Asia as a key growth and revenue-generating market.

4. The Government considers that the establishment of more CTCs in Hong Kong will create demands for the financial and professional services sectors, and contribute to the development of headquarters economy in Hong Kong. Hong Kong enjoys advantages in attracting corporate treasury activities with its proximity to the Mainland, status as the premier offshore Renminbi centre, and low and simple taxation regime. However, Hong Kong's profits tax regime has yet to make provisions customized for CTC activities and operations. Some market players and corporate treasurers perceive that the interest deduction rules in the Inland Revenue Ordinance (Cap. 112) ("IRO") are relatively less favourable for multinational corporations to engage in intra-group borrowing and lending of funds through Hong Kong. These companies are locating their CTCs in other Asian jurisdictions which have introduced relevant tax incentives[1]. The Financial Secretary announced in the 2015-2016 Budget that, to attract multinational and Mainland enterprises to establish CTCs in Hong Kong to perform treasury services for their group companies, the Government would amend IRO to allow, under specified conditions, interest deductions under profits tax for CTCs, and to reduce the profits tax for specified treasury activities by 50%.

Revision of interest deduction rules

5. At present, under IRO, if a company obtains a loan from a non-financial institution ("non-FI"), the interest expense is tax deductible only if the interest expense is incurred for the production of chargeable profits by the company and the corresponding interest income of the non-FI is chargeable to Hong Kong profits tax. From the perspective of CTCs located in Hong Kong engaging in intra-group liquidity management, its interest expense payable to associated corporations outside Hong Kong (being non-FIs whose profits are not subject to Hong Kong tax) are not tax deductible, whereas the interest income arising from its lending of money to associated corporations in or outside Hong Kong is chargeable to profits tax.

6. To provide a more tax-friendly environment for CTC operations, the Government proposes amending IRO to the effect that a corporation which borrows from associated corporations outside Hong Kong in the ordinary course of an intra-group financing business be allowed deduction of the related interest expense, if the interest received by the associated corporation is subject to a similar tax in another jurisdiction at a rate not lower than Hong Kong's profits

[1] According to the Government, Singapore allows interest, qualifying trading gains and fee income received by an approved treasury centre to be taxed at a concessionary rate of 10% as compared to the normal corporate tax rate of 17%. In addition, it provides exemption from withholding tax on interest payments on borrowing by these treasury centres from overseas banks and approved institutions, provided that the funds raised are used for the conduct of qualifying treasury activities. Malaysia allows certain income derived by corporations with approved "treasury management centre" status to enjoy a 70% tax exemption for five years, giving rise to an effective tax rate of 7.5% in relation to corporate treasury activities.

tax rate. Correspondingly, it is proposed to make it clear in IRO that if a corporation (other than an FI[2]) lends money to a non-Hong Kong associated corporation in the course of its intra-group financing business carried on in Hong Kong, the relevant interest income is deemed trading receipts chargeable to profits tax, even though the loan is made available outside Hong Kong.

Introduction of a concessionary tax rate for qualifying corporate treasury centres

7. In order to enhance Hong Kong's competitiveness for CTC operations, the Government also proposes amending IRO so that the tax rate on qualifying profits of a qualifying CTC derived from specified lending transactions, corporate treasury services or corporate treasury transactions, is half of the profits tax rate for corporations (i.e. a concessionary rate of 8.25% as compared to the current profits tax rate of 16.5%). To prevent corporate taxpayers from shifting non-CTC incomes into the half-rate regime, it is proposed that group companies should be required to conduct the qualifying activities via a standalone entity (known as the entity-based approach)[3] in order to enjoy the concessionary tax rate, and the Commissioner of Inland Revenue should be empowered to determine that a corporation is a qualifying CTC.

Clarification of the tax treatment for regulatory capital securities

8. According to the Government, with the gradual implementation of Basel III capital adequacy requirements[4] in Hong Kong and other jurisdictions since 2013, FIs have been strengthening their capital base through, among other means, issuing regulatory capital securities ("RCSs") such as Additional Tier 1 and Tier 2 instruments. These Additional Tier 1 or Tier 2 instruments possess hybrid features of debt and equity but are not regarded as debt instruments under the current IRO provisions, and hence their distributions are not deductible for profits tax purposes. In order to help enhance the treasury operations within FIs and promote the stability and resilience of the banking sector, the Government proposes adding new provisions in IRO to treat RCSs as debt securities, so that distributions arising from RCSs will be treated as interest for both deduction and taxation purposes. With the proposed debt-like

[2] Under section 2(1) of IRO, a financial institution means an authorized institution (i.e. a licensed bank, a restricted licence bank, or a deposit-taking company) within the meaning of the Banking Ordinance (Cap. 155), or its relevant associated corporation.

[3] This proposed entity-based approach differs from an activity-based approach whereby the concessionary rate is applied to profits generated from qualifying corporate treasury activities within any company. The Administration considers that the entity-based approach will be tidier in terms of implementation, as the activity-based approach may require a regulatory framework for CTCs and separate audit and tax filing, so as to ensure that the company concerned is genuinely carrying a CTC business.

[4] The legal framework for the implementation of Basel III standards in Hong Kong is provided by the Banking (Amendment) Ordinance 2012 enacted in February 2012. The capital adequacy requirements are set out in the Banking (Capital) Rules (Cap. 155, sub. leg. L).

treatment of RCSs under IRO, amendments are proposed to the Stamp Duty Ordinance (Cap. 117) to give stamp duty relief to the transfer of RCSs, i.e. the same treatment for the transfer of other debts.

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

9. The Bill was published in the Gazette on 4 December 2015 and received its First Reading at the Legislative Council ("LegCo") meeting of 16 December 2015. The main provisions of the Bill are explained in paragraph 12 of the LegCo Brief (File Ref: B&M/2/1/66C) and paragraphs 6 to 10 of the Legal Service Division Report on the Bill (LC Paper No. LS19/15-16).

Major views and concerns expressed by Members

10. The Government consulted FA Panel on the proposal to attract enterprises to establish CTCs in Hong Kong at the meeting on 1 June 2015. The major views and concerns expressed by members are summarized in the ensuing paragraphs.

<u>Benefits of attracting establishment of corporate treasury centres in Hong Kong and the Government's promotional work</u>

11. Members supported in general the proposal to revise the tax rules to attract enterprises to establish CTCs in Hong Kong. Some members called on the Administration to step up its efforts in developing the headquarters economy in Hong Kong taking into account the relevant practices of other jurisdictions such as Singapore, which had adopted a proactive approach in promoting relevant tax incentives and measures for enterprises. Some members enquired about the number of enterprises expected to set up CTCs in Hong Kong and the anticipated benefits to Hong Kong. The Administration responded that more than 7 500 multinational corporations had set up regional headquarters, regional offices, or local offices in Hong Kong, and around 100 to 200 of them were engaging in corporate treasury activities. The proposal would attract more multinational corporations and Mainland enterprises to set up CTCs and regional headquarters in Hong Kong, which in turn would generate demand for financial and professional services, contribute to the development of headquarters economy in Hong Kong, and strengthen its position as the major platform for Mainland enterprises to "go global".

12. Members sought details on the promotional activities conducted by the Administration and its plans to attract enterprises to establish CTCs in Hong Kong and the results achieved. The Hong Kong Monetary Authority ("HKMA") advised that it had been promoting Hong Kong as a regional hub for CTCs.

Since the announcement of the proposal in the 2015-2016 Budget, the Administration and HKMA had engaged the industry and conducted meetings and various promotional activities in the Mainland, Asia and Europe. The results had been encouraging and the Administration and HKMA would continue to step up efforts in this regard.

Maintaining a simple taxation regime

13. Members stressed the need for the Government to maintain a simple taxation regime in Hong Kong and avoid complicating the provisions in IRO when working out the details of the Bill. The Administration responded that its policy was to maintain a simple taxation regime in Hong Kong. The Administration assured members that in drafting the Bill, it would make reference to similar measures introduced by comparable jurisdictions and the prevailing international practices, and would strike a balance between simplicity and operational needs.

Anti-avoidance provisions in relation to the tax incentives

14. Members called on the Administration to put in place measures to prevent possible abuse of the tax incentives in order to protect revenue income. The Administration advised that the Bill would include provisions to ensure that only enterprises which engaged in genuine corporate treasury activities could benefit from the proposal. In order to enjoy the proposed concessionary tax rate, a group company would have to set up a standalone corporate entity which should carry on the business of the borrowing of money from and lending of money to associated corporations, perform qualifying corporate treasury services or enter into qualifying corporate treasury transactions. The Bill would include definitions for terms such as "corporate treasury service" and "corporate treasury transaction". As for the proposed deduction of interest expense, the associated corporation of a CTC had to be subject to tax of substantially the same nature of profits tax in a foreign territory at a rate not lower than Hong Kong's profits tax rate. The Administration would review the proposed anti-avoidance measures in the light of operation of the proposed taxation regime.

Tax treatment for limited recourse long-term debt

15. During the briefing on the second-phase implementation of the Basel III requirements at the FA Panel meeting on 7 July 2014, members enquired about the classification of limited recourse long-term debt ("LRLD") issued by banks for complying with the capital adequacy requirements and the eligibility of the interest payable on LRLD for tax deduction purposes. There was a suggestion that the Administration should make reference to practices of overseas tax authorities in clarifying the tax treatment for LRLD. HKMA responded that it

was aware of the clarifications issued by the tax authorities of Singapore and the United Kingdom with respect to debt securities issued by banks for inclusion in their regulatory capitals. The Administration took note of members' views on the need to clarify the issue.

Latest development

16. At the House Committee meeting on 18 December 2015, Members agreed to form a Bills Committee to study the Bill.

Relevant papers

17. A list of relevant papers is in the **Appendix**.

Council Business Division 1
Legislative Council Secretariat
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Appendix

List of relevant papers

Date	Event	Paper/minutes of meeting
7 July 2014	The Panel on Financial Affairs ("FA Panel") discussed the proposed implementation of the second phase of Basel III requirements	Discussion paper (LC Paper No. CB(1))1668/13-14(03)) Minutes (LC Paper No. CB(1) 1998/13-14)
1 June 2015	FA Panel was brief on the Administration's proposal to attract enterprises to establish corporate treasury centres ("CTCs") in Hong Kong	Discussion paper (LC Paper No. CB(1)870/14-15(04)) Minutes (LC Paper No. CB(1)1190/14-15)
14 October 2015	The Research Office of the Legislative Council ("LegCo") Secretariat issued a briefing paper on CTCs	Essentials (ISE01/15-16)
16 December 2015	The Inland Revenue (Amendment) (No. 4) Bill 2015 was introduced into LegCo	The Bill Legislative Council Brief (File Ref: B&M/2/1/66C) Legal Service Division Report (LC Paper No. LS19/15-16)