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

## The Government's Responses to Written Submissions

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| **(A) General comments** | | | |
| 1. | - | Respondents welcome and support the initiatives to introduce profits tax concession for qualifying corporate treasury centres ("CTCs"), allow interest deduction for the intra-group financing business of corporations, and treat regulatory capital securities ("RCSs") as debt securities. [HKACT, CKHHL, Deloitte, HKTI, HKICPA, PwC, EY, HKIoD, IACCT, CMTC, BAR] | • The support is noted. |
| 2. | - | Some respondents recommend that the Government should continue monitoring the development of financial markets and the tax regime for CTCs, and consider refining or | • The Bill seeks to, among others, resolve a perceived asymmetry in the current rules concerning interest income taxation and interest expense deduction under the Inland Revenue Ordinance (Cap. 112) ("IRO") in respect of CTCs functioning in Hong Kong, and introduce a concessionary profits tax rate for qualifying CTCs, with a |

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| | | broadening the current initiatives. The regime should be as straightforward, transparent, and easy to comply with as possible. [HKACT, CKHHL, Deloitte] | view to attracting more CTCs to operate in Hong Kong. It strikes a reasonable balance in introducing conducive tax measures for corporate treasury activities and mitigating risks of tax avoidance. We will keep in view the latest market developments so as to maintain a competitive tax regime.<br><br>• After the passage of the Bill, the Inland Revenue Department ("IRD") will explain the operation of the tax regime through Departmental Interpretation and Practice Notes ("DIPN") to facilitate compliance. |
| 3. | - | The banking industry welcomes the Bill as it achieves certainty on profits tax and stamp duty treatments in respect of RCSs. [HKAB, CMTC, BAR] | • The support is noted. |
| **(B) Profits Tax Concession for Qualifying CTCs – Division 1 of Part 2 of the Bill** | | | |
| 4. | - | A respondent considers that it is beneficial to offer incentives for companies from the Mainland and elsewhere to establish regional | • Enhancing Hong Kong's global competitiveness in attracting corporate treasury activities will help strengthen Hong Kong's position as a major platform for Mainland enterprises to go global and for multinational corporations to manage liquidity for operations |

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| | | treasury centres in Hong Kong, as this will deepen the markets for trading in Renminbi. [Deloitte] | on the Mainland and in the region. If more CTCs are established in Hong Kong, this will contribute to the development of headquarters economy, and the Belt-Road initiative by facilitating multinational or Mainland corporations to raise funds and manage financial resources and risks through Hong Kong. |
| 5. | - | A respondent suggests providing more guidance on how to segregate the profits and assets attributable to captive insurers and CTCs in order to benefit from the tax concession. [Deloitte] | • Section 2(7) of the Insurance Companies Ordinance (Cap. 41) provides that an authorized captive insurer can only carry on a captive insurance-related business. As it cannot carry on a CTC business at the same time, the segregation of profits and assets attributable to authorized captive insurers and CTCs is not necessary for the purposes of the profits tax concession. |
| 6. | Clause 3, Proposed sections 14C and 14D | A respondent is of the view that the scope of counterparties with which a qualifying CTC could conduct qualifying corporate treasury activities (the profits derived from which to be subject to the half-rate) should be expanded. [Deloitte] | • This proposed CTC regime is aimed to attract multinational and Mainland corporations to establish CTCs in Hong Kong, thereby generating incremental economic benefits for the financial markets and the professional services sectors and contributing to the development of headquarters economy in Hong Kong. Under the proposed section 14D(1), the half-rate concession will apply to assessable profits of a qualifying CTC derived from its "qualifying lending transaction", "qualifying corporate treasury service", or "qualifying corporate treasury transaction". The counterparty of the aforesaid transaction or service has to be a non-Hong Kong associated corporation which, by definition, is an associated |

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| | | | corporation that does not carry on any trade, profession or business in Hong Kong (see the proposed section 14C(1), (3) and (4)). If the half rate concession is extended to cover assessable profits of a corporation derived from the aforesaid transaction or service with its associated corporation in Hong Kong, this would create excessive tax avoidance risks for any corporation in Hong Kong to establish a subsidiary company in Hong Kong to arrange fictitious interest payments and service fees for tax avoidance, as the relevant profits of such intra-group transactions or services might be taxed at a half-rate in the hands of a qualifying CTC while the sums payable in respect of the transactions and services might be fully deducted by its associated corporation in Hong Kong. "Half taxation but full deduction" could cause significant fiscal losses. The same rule "no half taxation but full deduction" applies to the concessionary regimes in relation to the "offshore risk business" of authorized captive insurers and professional reinsurers (see section 14B). |
| 7. | Clause 3, Proposed sections 14C and 14E | A respondent agrees that the safe harbour provisions would give Hong Kong an edge over a similar regime in comparable jurisdictions, but is uncertain about how a multi-functional CTC would be able to meet the profits and asset tests, and | • The support for the safe harbour rule, which seeks to allow corporations having income and assets primarily for corporate treasury activities to be entitled to the half-rate concession, is noted.<br><br>• The terms "corporate treasury asset" and "corporate treasury profits" are defined in the proposed section 14C(1). The proposed section 14E(9) provides that, in computing the aggregate value of the |

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| | | which asset would be considered to be used in the carrying out of the qualifying corporate treasury activities. [Deloitte] | corporate treasury assets of a corporation, if a corporate treasury asset is used partly to carry out a corporate treasury activity and partly for another purpose, only the part of the value of the asset that is proportionate to the extent to which the asset is used to carry out a corporate treasury activity is to be taken into account. After the passage of the Bill, IRD will explain the operation of this provision through DIPN. |
| 8. | Clause 3, Proposed sections 14D and 14E | A few respondents consider that the Government should adopt an "activity-based" approach to grant the concessionary tax rate to qualifying CTCs, and lower the 75% safe harbour threshold. One respondent is uncertain why the half-rate should only apply to assessable profits derived from relevant transactions or services of a qualifying CTC with a corporate entity, but not, say, an associated trust or a limited liability partnership. [HKTI, HKICPA] | • In providing the profits tax concession, we are mindful of the need to ensure that any tax measures would meet the latest international standards to combat base erosion and profit shifting ("BEPS"), so as to avoid the occurrence of double non-taxation or the shifting of profits to low-tax regimes.<br><br>• It is necessary to require a qualifying CTC to be a standalone corporate entity, which is the most common legal form adopted by multinational corporations for undertaking business operations, including CTC operations, to address tax avoidance concerns. In particular, we need to guard against tax avoidance schemes which generate substantial losses from "financial transactions" being packaged as CTC transactions and utilised for reducing taxable profits accrued to a Hong Kong group company. The standalone CTC corporation requirement in the proposed section 14D(3) will help prevent a group company from shifting its non-CTC income |

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| | | | into the proposed half-rate regime. With this requirement and other safeguards contained in the Bill, we are satisfied that the proposed tax scheme for CTCs would not be labelled as harmful tax practices by the international community under the BEPS regime and action plans as promulgated by the Organisation for Economic Co-operation and Development in November 2015.<br><br>• In view of the possible abuse of the half-rate regime, the proposed profits tax concession will not apply to transactions or services with business structures other than an associated corporation. The avoidance risks concerning a limited liability partnership are that profits or losses may be allocated to the owners for taxation purposes and exploited for double deduction outcomes. Also, allowing tax concession for transactions and services with trusts which may receive different tax treatments in different jurisdictions may complicate our profits tax regime.<br><br>• In the proposed section 14E and Part 3 of the proposed Schedule 17B (Clause 6), we propose a safe harbour rule to allow corporations having 75% or more of the profits derived from, and 75% or more of the assets used to carry out, corporate treasury activities to be subject to the half-rate profits tax (in respect of the qualifying profits). We believe that this will help strike a reasonable balance to ensure that a CTC carrying out predominantly corporate treasury activities will |

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| | | | meet the proposed qualifying criteria. |
| 9. | Clause 3, Proposed section 14D(8) | While appreciating that there may be some potential tax leakages, a respondent queries why a CTC may not qualify for the concessionary tax rate if it receives a payment from a financial institution carrying on business in Hong Kong, even though there is no abuse of the non-synchronicity between deductions and the taxability of such payment. [HKICPA] | • The proposed section 14D(8) provides that, in computing the qualifying profits of a corporation for the profits tax concession under subsection (1), if any sum payable to the corporation by a person in respect of the transaction or service mentioned in subsection 1(a), (b) or (c) is deductible under Part 4 of the IRO, the amount of the qualifying profits attributable to that transaction or service is to be deducted by reference to the amount of that sum. Our intent is to avoid the half-rate regime being abused by a qualifying CTC having its qualifying profits taxed at the half-rate while a financial institution carrying on a business in Hong Kong claiming a tax deduction at full rate in respect of a sum payable on the relevant transactions. We therefore propose that the half-rate concession should only apply to qualifying profits of a qualifying CTC derived from corporate treasury transactions related to the business of non-Hong Kong associated corporations which will not claim deduction in Hong Kong in respect of sums payable to the qualifying CTC to avoid "half taxation but full deduction". |

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| **(C)** | **Interest in respect of Borrowing and Lending of Money with Associated Corporations – Division 2 of Part 2 of the Bill** | | |
| 10. | Clause 7, Proposed section 15(1)(ia) and (la) | A respondent considers that the deeming provisions contained in the proposed section 15(1)(ia) and (la) cannot be justified by the proposed relaxation of the interest deduction rules and should be removed. A respondent acknowledges that the operation test will apply to determine the source of interest or profits for a money-lending company according to the established case law. Some respondents suggest that it would seem to do no particular harm to exclude the aforesaid provisions which may be unnecessary. If the proposed deeming provisions are retained, it will be essential to provide further clarification on the meaning of "carrying on intra-group financing business", preferably with examples | • To maintain a symmetric tax treatment for interest income, the proposed section 15(1)(ia) and (la) seeks to stipulate clearly that the "operation test" applies in the determination of the source of interest income, as well as relevant gains or profits, arising from the carrying on in Hong Kong by a corporation (other than a financial institution) of its intra-group financing business. That is to say, if a corporation (other than a financial institution) 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 as trading receipts derived from Hong Kong, hence chargeable to profits tax, even though the loan is made available outside Hong Kong.<br><br>• To fall within the meaning of "carrying on an intra-group financing business", a corporation will have to borrow money from and lend money to its associated corporations routinely as a line of business with a view to earning a margin. In other words, section 15(1)(ia) and (la) will not apply to a corporation which borrows and lends money on a single transaction basis. Relevant factors (such as the frequency, repetitiveness and the amount of the borrowing and |

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| | | provided in DIPN. [HKTI, HKICPA, PwC, EY, CMTC] | lending of money at commercial rates of interest; whether there is borrowing from persons in addition to associated corporations of money at commercial rates of interest and the amount of such borrowing; whether there is a degree of system and continuity of laying out and getting back of the loan of money by way of interest and repayment of principal; the regularity and frequency of the payment of interest and repayment of principal; whether a profit is earned out of the interest differential between the borrowing and lending; and whether the interest charged on the borrowing and lending is on an arm's length basis) should be taken into consideration.<br><br>• After the passage of the Bill, IRD will explain the operation of this provision through DIPN. |
| 11. | Clause 8, Proposed section 16(2)(g) | A respondent agrees that this proposed section would help resolve the asymmetry issue, and notes that any corporation that carries on in Hong Kong a business of borrowing of money from and lending of money to associates (i.e. not only qualifying CTCs) would be able to benefit from | • The support is noted.<br><br>• The amendments to sections 15 and 16 of the IRO are to address the perceived asymmetry in the current rules concerning the taxation and deduction of interest in relation to a corporation carrying on an intra-group financing business in Hong Kong. Services fees to procure corporate treasury services or other expenses in relation to corporate treasury transactions, to the extent to which they are |

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| | | the interest deduction. This will certainly attract multinational companies to borrow from overseas associated corporations for their treasury operations. The Government should consider expanding section 16(2)(g) to include interest expense incurred by a qualifying CTC in the course of providing corporate treasury services and entering into corporate treasury transactions. [Deloitte, PwC] | incurred by a taxpayer in the production of profits in respect of which the taxpayer is chargeable to tax under Part 4 of the IRO, should continue to be deductible under the existing section 16(1). The interest expenses incurred for carrying out corporate treasury transactions or providing corporate treasury services may be deductible under other limbs in section 16(2) if the stipulated criteria are satisfied. |
| 12. | Clause 8, Proposed section 16(2)(g)(iii) | A respondent notes that the requirement that a lender should not be constrained by a contractual or legal obligation to pass interest received on to another person is in line with the "beneficial ownership" concepts in international tax law that seeks to prevent a conduit company from being interposed in a loan arrangement for treaty shopping purposes. New section 16(2CA) also | • The support is noted. |

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| | | contains an interest "flow-back" test, not dissimilar to current rules, whereby an interest deduction would be limited if arrangements are in place by which interest or principal of a loan obtained by a Hong Kong corporation is payable to a related person not subject to Hong Kong profits tax on the interest. [Deloitte] | |
| | | A respondent is uncertain about what constitutes "beneficial ownership" of an income (as it can be unclear and controversial in many circumstances) and is concerned about any onerous due diligence requirements. Another respondent suggests that these provisions seem to be unnecessarily complicated. The abusive arrangements envisaged by the proposed section 16(2)(g)(ii) and (iii) would likely be addressed by the application of the existing general anti-avoidance provisions contained in | • The proposed section 16(2)(g)(iii) seeks to prevent conduit arrangements, in particular back-to-back structures, assignments, defeasance arrangements, in which a lender is obliged to pass the interest to a third party upon receipt. This is in line with OECD's "beneficial ownership test", which is used to ascertain whether a party is a beneficial owner of an income. It helps prevent the siphoning of profits as interest to a low or no tax jurisdiction, whether directly or through conduits. If a lender does not have an obligation to pass the interest to a third party (i.e. the lender is a beneficial owner of the interest income), the deduction of interest expense will be allowed under section 16(2)(g) provided that other conditions are satisfied.<br><br>• In view of the nature of an intra-group financing business, it should |

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| | | section 61A and the proposed section 16(2CA). [HKTI, HKICPA] | not be difficult for a corporation to ascertain whether an associated corporation receiving the interest is a beneficial owner. In addition, the existing general provisions under sections 61 and 61A will continue to be invoked under any warranted circumstances. After the passage of the Bill, IRD will explain the operation of this provision in DIPN. |
| 13. | Clause 8, Proposed section 16(2CC) | A few respondents are concerned that the "one of the main purposes test" is more stringent than the "sole or dominant purpose test" under section 61A of IRO. Such formulation is not necessary. [Deloitte, PwC] | • The proposed section 16(2CC) provides that, in respect of a deduction claimed under subsection (1)(a) by virtue of subsection (2)(g), no deduction is to be allowed in respect of the interest if the Commissioner is satisfied that the main purpose, or one of the main purposes, of the borrowing of the money is to utilize a loss to avoid, postpone or reduce any liability to profits tax under the IRO.<br><br>• The "main purpose test" is increasingly found in overseas tax legislation and avoidance of double taxation agreements (including those signed by Hong Kong and our tax treaty partners and incorporated in the subsidiary legislation of the IRO – see, for example, Articles 10(6), 11(8) and 12(7) under the Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (Republic of South Africa) Order (Cap. 112CM))). To align with the latest international practices, the Government intends to adopt the "main purpose test" for section 16(2CC) to prevent tax avoidance schemes shifting losses to Hong Kong, though the "main purpose test" may be regarded as more |

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| | | | stringent (from some taxpayers' perspectives) than the "sole or dominant purpose test" under the existing section 61A. |
| 14. | Clause 8, Proposed section 16(2I) | A respondent agrees that the "subject to tax" requirement is in line with BEPS, but may discourage a Hong Kong corporation from undertaking *bona fide* borrowings from group companies. [Deloitte] | • We are mindful of the need to ensure that any tax measures would meet the latest international standards to combat BEPS. Under the proposed section 16(2)(g)(ii), the "subject to tax" requirement seeks to prevent avoidance opportunities in which a corporation arranges artificial loan transactions generating a huge interest expense (which will be deductible under the proposed section 16(2)(g)) with a lending associated corporation situated in a tax haven charging ultra-low or even zero rate for the profits derived from the interest income. In the absence of withholding tax and "thin capitalisation rules" in Hong Kong, the proposed requirement is necessary to ensure that the amendments to section 16 would not be seen by other tax jurisdictions as tax base erosion or as encouraging multinational companies to arrange cross-border transactions subject to "double non-taxation".<br><br>• The proposed amendments strike a reasonable balance in facilitating tax deduction by corporations and mitigating risks of tax avoidance. We believe that this requirement will not affect any genuine intra-group financing business. |

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| | | Some respondents consider that the "subject to tax" requirement should refer to the gross interest income being chargeable to tax outside Hong Kong at not less than the applicable reference rate, without requiring the tax being necessarily paid outside Hong Kong. Modifications are required so that the provision can be operative in practice and minimises potential tax disputes between taxpayers and IRD in respect of the deductibility of interest expenses to non-Hong Kong associated corporations, in particular with regard to the requirement of tax "paid" and the reference to the effective tax rate in jurisdictions outside Hong Kong. A respondent considers that the provisions seem to be unnecessarily complicated. [HKTI, EY, PwC, HKICPA] | • Under the proposed section 16(2I)(a), a person is, in respect of an interest, subject to tax at a certain rate in a territory if the Commissioner is satisfied that the tax (of a nature of the profits tax in Hong Kong) has been paid or will be paid, whether by deduction or otherwise, at that rate by that person in respect of the interest in that territory as required by the laws of that territory. Where a jurisdiction outside Hong Kong adopts a progressive tax system, it may be difficult to ascertain the tax rate which should be used to compare with the "reference rate" in Hong Kong (as defined in the proposed section 16(2I)(c)). In this regard, IRD will calculate the average rate at which tax is actually charged on the interest for the purpose of section 16(2)(g)(ii). This will avoid tax rate arbitrage in cases where the actual tax rate is much lower than Hong Kong tax rate, or where the jurisdiction outside Hong Kong offers other tax incentives (e.g. tax credit). After the passage of the Bill, IRD will explain the operation of this provision in DIPN.<br><br>• The proposed amendment strikes a reasonable balance in facilitating tax deduction by corporations and mitigating risks of tax avoidance. |

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| **(D) Tax Treatment of RCSs – Division 3 of Part 2 of the Bill** | | | |
| 15. | Clause 13, Proposed section 16 (2AA) | Some banks may issue RCSs through a non-bank holding company which may not fall within the definition of "financial institution" under the IRO. The distributions in respect of RCSs issued by a non-bank holding company should also be eligible for deduction. [HKAB, EY, CMTC, ASIFMA] | • If a holding company of an authorized institution ("AI") is incorporated in Hong Kong and is not itself an AI, the Hong Kong Monetary Authority ("HKMA") may extend the minimum capital requirements to cover the holding company through imposing conditions on the holding company as a controller of the AI under section 70(7) of the Banking Ordinance (Cap. 155). The sole purpose of such holding companies is to hold shares in the relevant AI (though the holding company may conduct other business activities for providing support to the business or activities of the AI concerned). At present, in most cases, the controllers of AIs are other banks or supervised financial institutions.<br><br>• Where a holding company of an AI is not itself an AI and is subject to the minimum capital requirements imposed by HKMA, IRD will consider treating the instruments issued by the aforesaid holding company as debt securities, providing that those instruments (a) are issued solely for the purposes of providing regulatory capital to the AI in strict compliance with the minimum capital requirements imposed on the holding company and the AI by HKMA and (b) would have qualified as Additional Tier 1 or Tier 2 capital instruments under the Banking (Capital) Rules (Cap. 155, sub. leg. L) if they had |

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| | | | been issued by an AI, thus within the definition of *regulatory capital security* in the proposed section 17A. However, section 16(2)(a) and the proposed section 16(2AA) shall not apply to the holding company since it is not an AI. Any distributions arising from such instruments issued by the holding company (to the extent that they are incurred by the holding company in the production of chargeable profits) may be eligible for deduction under section 16(1)(a) if any of the conditions under section 16(2)(b) to (f) or those under the proposed section 16(2)(g) is satisfied, subject to other requirements in the same section. The deduction of expenses in respect of such instruments issued by the holding company will also be subject to sections 61 and 61A of IRO. After the passage of the Bill, IRD is prepared to explain this in DIPN and consider any application for an advance ruling in respect of this type of claim. |
| 16. | Clause 14, Proposed section 17A | Some respondents are uncertain whether the scope of RCSs would cover instruments containing key convertibility features (in the event of non-viability or breaching of capital conservation buffer) for Basel III compliance purposes. [HKAB, EY, PwC] | • The definition of *regulatory capital security* contained in the proposed section 17A includes RCSs subject to the contingent conversion into a Common Equity Tier 1 ("CET1") capital instrument on the occurrence of a non-viability event or trigger event pursuant to Schedule 4B or 4C to the Banking (Capital) Rules (or under the equivalent laws or regulatory requirements of another member jurisdiction of the Basel Committee). It does not include instruments which provide for an issuer to convert, or an option to convert, into CET1 capital instruments after a certain period of time |

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| | | | (see the proposed section 17A(2)(b)). |
| | | Some respondents suggest that the proposed scope of RCS be amended to cover Additional Tier 1 ("AT1")/Tier 2 ("T2") instruments allowing an issuer of the instrument to convert the instrument after a period of time, or provides discretion to the issuer of the instrument to make a distribution or redemption payment based on the results of the business. They suggest that the proposed section 17A(2)(b), (2)(c) and (3) be removed from the Bill. [CMTC, ASIFMA, HKAB, EY, PwC] | • Relevant instruments with terms and conditions providing for write-down or conversion into ordinary shares to absorb losses in going concern (for AT1 instruments) or at the point of non-viability of the issuer (for both AT1 and T2 instruments) are RCSs under the proposed section 17A and will be given the proposed debt-like tax treatment. However, the debt-like tax treatment is not intended to cover RCSs with essentially equity-like features, even though they may be considered as *bona fide* regulatory capital or otherwise. Therefore, the proposed section 17A(2)(b), (2)(c) and (3) is necessary in order to exclude instruments with equity returns (i.e. distributions dependent to any extent on the results of the business of the issuer of the instruments), or those subject to contractual conversion into ordinary shares after a certain period of time at the issuer's option or otherwise. Those excluded instruments will not be treated as debt securities for both taxation and deduction purposes under the proposed section 17B(1)(a). |
| 17. | Clause 14, Proposed section 17C | Some respondents seek clarification on whether banks' hedging transactions with respect to RCSs would be covered by section 17C, which provides that fair value | • The proposed section 17C(2) provides that, in ascertaining profits of an issuer of a RCS, fair value accounting would be ignored for tax purposes in relation to the RCS. Therefore, any change in fair value of the RCS or any part of the RCS, and of any designated hedging instrument, will be disregarded for tax assessment purposes. |

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| | | accounting does not apply in relation to RCSs. [HKAB, EY] | Instead, any net payments made or received under the hedging transaction and its related costs will be brought into account for assessment purposes. The operation of this section will be explained further in DIPN. |
| 18. | Clause 14, proposed section 17F | In relation to RCSs issued to, held by or issued or held for the benefit of a *specified connected person* (as defined in proposed section 17D(5)), some respondents seek clarification on whether the deduction of interest on RCSs is only denied to the extent that the instruments are not funded through an external issue. [HKAB, EY, CMTC, ASIFMA, PwC] | • Interest deduction will be allowed to the extent to which the money paid by or on behalf of the specified connected person of the issuer for the issue of the RCSs is funded through an external issue of RCSs, debentures or debt instruments, where the externally issued instruments are not held by or for the benefit of a specified connected person of an issuer (see the proposed section 17F(2)). If a specified connected person of an issuer is using its own reserves to buy and hold a part of the RCSs issued by the issuer, the sum payable by the issuer in respect of that part of the RCSs not externally funded will not be eligible for deduction. That is to say, deduction will be proportionately allowed under section 16(1)(a), subject to the proposed section 17F. In addition, according to the proposed section 17D(6)(c), if an associated corporation of an issuer is a market maker who, in the ordinary course of conduct of the market maker's trade, profession or business in respect of market making, holds the security for the purpose of providing liquidity for the security, the associated corporation will not fall within the definition of *specified connected person* under the proposed section 17D(5) (when applied to section 17F), and as such will not be denied |

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| | | | deduction under section 17F. |
| | | It would be preferable to rely on the existing general anti-avoidance provisions of the IRO, rather than the proposed section 17F, against excessive interest deductions for Hong Kong profits tax purposes via down-streaming of RCSs by a banking group from outside Hong Kong. [HKTI, HKICPA] | • As we mentioned in LC Paper No. CB(4)534/15-16(01), the existing provisions under sections 61 and 61A of the IRO will continue to be invoked under any warranted circumstances.<br><br>• The proposed section 17F serves as a targeted anti-avoidance provision providing clarity to circumstances in which deductions for distributions in relation to RCSs will or will not be allowed. |
| 19. | Clause 14, Proposed section 17G | Some respondents ask whether the separate enterprise principle in the proposed section 17G will change the territorial source principle of taxation adopted by Hong Kong and is limited to determining the appropriate amount of interest on RCS that may be allocated by a foreign bank to its Hong Kong branch. [HKAB, EY, CMTC, ASIFMA, HKTI, HKICPA, PwC] | • The proposed section 17G does not change the territorial basis of taxation in section 14 of the IRO. The separate enterprise principle under section 17G will apply to attributing the profits that accrue to the Hong Kong branch of a non-resident financial institution ***with capital raised through the issue of a RCS***. Then the territorial source principle will apply to ascertaining the extent of attributable profits that are chargeable to Hong Kong profits tax. |

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| | | It is necessary to safeguard against possible abuse of the Hong Kong tax system. However, section 17G contains complex principles for the Hong Kong branch of a non-resident bank in ascertaining profits, thereby potentially affecting the level playing field among non-resident banks and Hong Kong banks, or among Hong Kong branches of non-resident banks which have issued RCSs and those which have not. Some respondents suggest that section 17G should be removed from the Bill, subject to further consultation. [HKAB, EY, CMTC, ASIFMA, HKTI, HKICPA, PwC] | • The proposed tax treatment of RCSs applies to AIs incorporated in Hong Kong and non-resident banks operating in Hong Kong through a branch. Section 17G is to treat a non-resident bank's branch in Hong Kong as a distinct and separate enterprise so as to prevent excessive booking of RCSs in the Hong Kong branch. The chargeable profits and the deduction for distributions made under RCSs by the Hong Kong branch of a non-resident bank are to be determined on the same basis with its comparable Hong Kong-incorporated counterparts subject to similar regulatory capital ratios. In applying section 17G, if excessive payments in respect of RCSs are allocated to the Hong Kong branch of the non-resident bank for profits tax deduction, an adjustment of such deduction may be required under section 17G(6).<br><br>• As we explained in LC Paper No. CB(4)534/15-16(01), the separate enterprise principle is currently enshrined in Article 7 of the avoidance of double taxation agreements concluded by Hong Kong with a number of tax jurisdictions. These agreements have been implemented by Orders made under section 49 of the IRO. At present, any attribution of profits to a Hong Kong branch of a non-resident bank will be assessed in accordance with the separate enterprise principle set out in the relevant agreement concluded with the tax jurisdiction in which the non-resident bank resides. Therefore, the application of the separate enterprise principle should |

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| | | | not affect the level playing field among Hong Kong branches of non-resident banks which have issued RCSs and those which have not. |
| 20. | Clause 14, Proposed section 17H | Further clarification is needed on the proposed section 17H as some readers may possibly interpret it as extending the arm's length and separate enterprise principles to other persons or circumstances. [HKAB, EY, CMTC, ASIFMA, HKTI, HKICPA, PwC] | • As we mentioned in LC Paper No. CB(4)534/15-16(01), the proposed section 17H should not be read, on proper interpretation, as importing the arm's length and separate enterprise principles to other areas outside the context of regulatory capital securities. Having regard to the views of the Bills Committee and some respondents, the Government would consider proposing committee stage amendments to remove section 17H, and all references to that section, from the Bill. After the passage of the Bill, the IRD will issueDIPN to explain that sections 17E and 17G are additional to and do not derogate from any other laws on the arm's length and separate enterprise principles (such as relevant case law and Articles 7 and 9 of avoidance of double taxation agreements between Hong Kong and various tax jurisdictions implemented by orders made under section 49 of the IRO). |

## References

| | Name of deputations | Submissions |
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| HKACT | The Hong Kong Association of Corporate Treasurers | LC Paper No. CB(4)516/15-16(01) |
| Deloitte | Deloitte Touche Tohmatsu | LC Paper No. CB(4)516/15-16(02) |
| IACCT | The International Association of CFOs and Corporate Treasurers (China) Limited | LC Paper No. CB(4)516/15-16(03) |
| CMTC | Capital Markets Tax Committee of Asia | LC Paper No. CB(4)516/15-16(04) |
| HKAB | The Hong Kong Association of Banks | LC Paper No. CB(4)516/15-16(09) |
| EY | Ernst & Young Tax Services Limited | LC Paper No. CB(4)516/15-16(10) |
| ASIFMA | Asia Securities Industry & Financial Markets Association | LC Paper No. CB(4)516/15-16(05) |
| HKTI | The Taxation Institute of Hong Kong | LC Paper No. CB(4)516/15-16(06) |
| HKICPA | Hong Kong Institute of Certified Public Accountants | LC Paper No. CB(4)516/15-16(07) |
| PwC | PricewaterhouseCoopers Limited | LC Paper No. CB(4)516/15-16(08) |
| BAR | Hong Kong Bar Association | LC Paper No. CB(4)628/15-16(01) |

**Financial Services and the Treasury Bureau**
**Inland Revenue Department**
**Hong Kong Monetary Authority**
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