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The Hon Kenneth LEUNG
Chairman of the Bills Committee on Inland Revenue (Amendment) (No. 4) Bill 2015
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong

Dear Hon Kenneth LEUNG,

Response to the Invitation for Submissions in respect of the Inland Revenue (Amendment) (No. 4) Bill 2015 ("the Bill")

We thank you for giving Ernst & Young Tax Services Limited ("EY") the opportunity to provide our comments on the Bill.

We appreciate and support the Government's initiative to amend the Inland Revenue Ordinance ("IRO") to enable Hong Kong to establish itself as a regional Corporate Treasury Centre ("CTC") hub. We believe this initiative will assist in the economic growth of Hong Kong, make Hong Kong more competitive regionally and support Hong Kong's position as a leading international financial centre thereby benefiting Hong Kong's financial and business sectors. We also support the proposals with regard to the tax treatment of securities issued for regulatory capital ("RCS") which will create a level playing field for Hong Kong Authorised Institutions when compared to financial institutions in other leading international financial centres, such as London and Singapore.

While we are supportive of the proposed amendments to the IRO, there are some areas where we believe amendments should be made to the Bill to ensure that the Government's objectives will be met through the Bill. We have restricted our comments to the areas we believe are most important.

The key areas where we believe amendments are required on Divisions 1 and 2 of Part 2 of the Bill, which contain profits tax concession for qualifying CTCs and provisions dealing with inter-company interest deduction, are as follows:

> The scope of the tax concession will exclude *bona fide* CTCs which are part of a Hong Kong global or regional holding company that are well capitalized and merely hold investments in subsidiaries. We recommend the definition of a qualifying CTC in the legislation be amended to cover a genuine CTC which also acts as a holding company. This could be achieved, for example, by excluding dividend income and investment in subsidiaries from the profits and asset tests, respectively.
>
> The provisions allowing a deduction on interest paid by a CTC to overseas group companies which are non-financial institutions ("non-FIs") as proposed are currently too restrictive. In this regard, the provisions may impose a significantly greater burden on a CTC in Hong Kong as compared to CTCs in other comparable and competing locations. Amongst others, the proposals contain a condition that profits tax or a similar tax "*has been paid or will be paid*" by the overseas recipient group companies. We recommend the condition be changed to a simple "subject to tax" requirement.

The proposed deeming provisions that deem certain interest income and profits on certificates of deposit or bills of exchange to be taxable are unnecessary. The operations test will apply to determine the source of interest or profits for a money-lending company according to established case law. As such, where the activities directly giving rise to the interest are carried out in Hong Kong, the interest income of the CTC will be taxable under existing law.

Our key comments where we believe amendments are required on Divisions 3 and 4 of Part 2 and all of Part 3, which contain the profits tax and stamp duty treatments in respect of qualifying RCS issued by financial institutions ("FIs") under the Banking (Capital) Rules (Cap. 155 sub. leg. L) ("BCR") or under the equivalent laws or regulatory requirements of another member jurisdiction of the Basel Committee, are as follows:

The Bill contains a provision which introduces the authorized OECD approach to determine the profits of a non-resident chargeable to tax in Hong Kong. This is a significant departure from the manner in which non-residents are taxed in Hong Kong and a move away from Hong Kong's sourced based approach to taxation. The proposed changes will result in an inconsistent treatment as regards Hong Kong incorporated taxpayers and non-resident taxpayers in ascertaining chargeable profits in Hong Kong. Any such proposals need to be comprehensive and tailored to Hong Kong's territorial tax system and should be subject to a separate and broader consultation process.

Certain provisions in the Bill seek to disallow payments made on the RCS where the funds are not specifically traceable to external issuance. While we understand the policy intent, these provisions are too restrictive and should be amended such that a tax deduction should be allowed to the extent that the amount of regulatory capital issued by an FI in Hong Kong to its associated corporations is less than that issued externally by the group holding entity. Alternatively, a proportional approach could be adopted to arrive at the disallowance.

Certain provisions in the Bill seek to disallow payments made on the RCS where these instruments are held by intra-group companies. There may be *bona fide* commercial reasons why these securities are held by related companies, and we recommend that certain exceptions be provided for and the disallowance proportionate to the holdings by related parties. Currently the Bill provides for a full disallowance.

Global regulators including the Hong Kong Monetary Authority are encouraging financial institutions to prepare themselves for orderly resolution including the issuance of regulatory capital by a non-bank holding company and not the banking entity itself. The proposed provisions should be amended to ensure that an "asymmetry issue" does not arise where such *bona fide* regulatory issuances are made out of a Hong Kong non-bank holding company. Currently, an "asymmetry issue" will arise under the Bill.

At different stages prior to the introduction of the Bill, EY through various industry bodies and associations, has provided more detailed comments and technical input to the administration in respect of the proposed changes contained in the Bill. For the purposes of the Bills Committee, given we are supportive of the overall direction and proposals in the Bill, we have limited our comments in this paper to the abovementioned key points and have respected the administration's position in respect of other previously debated aspects of the proposals. We do appreciate that these proposals are aimed at attracting more CTCs to Hong Kong and creating a level playing field for FIs, which should have a positive impact on Hong Kong's economic position.

Should you require us to provide further technical input or to participate in technical discussions on this matter, we will be glad to provide our services.

Our detailed views in regard to the Bill are included in the attached Appendices.

Yours sincerely,

For and on behalf of
Ernst & Young Tax Services Limited

Florence Chan
Partner

Attachment

Appendix A

Key Comments on Divisions 1 and 2 of Part 2 of the Bill

1.1 Request for proposed expansion of the provisions to cover group holding companies

The proposed Section 14D provides a 50% reduction in the profits tax rate applicable to a qualifying CTC subject to prescribed conditions being met. The definition of a qualifying CTC under Section 14D(2) provides that the corporation's business in Hong Kong must be limited to one or more of the following activities –

(i) qualifying lending transaction as defined in Section 14C(1)
(ii) qualifying corporate treasury service as defined in Section 14C(3)
(iii) qualifying corporate treasury transaction as defined in Section 14C(4)

As such, a CTC which also acts as a group holding company would not generally qualify for the 50% concessionary tax rate. In this regard, we suggest suitably amending the permitted scope of activities such that a group holding company that also acts as a CTC could also qualify as a qualifying CTC. One possible way to accommodate the situation may be that investment in subsidiary and associated companies and related dividend income from such investment made by such a CTC be excluded from the definition of the total assets and profits of the said CTC under the relevant safe-harbour rules of the Bill.

1.2 Request for relaxation of the prescribed condition for availing interest deduction

The proposed Section 16(2)(g) in the Bill is introduced with the view to addressing the tax asymmetry issue relating to intercompany interest expenses. It allows the deduction of interest payable by the borrower being a corporation carrying on an intra-group financing business in Hong Kong (defined in Section 14C) and sets out three conditions to be satisfied for claiming the interest deduction.

The condition of "subject to tax" proposed under Section 16(2I) is only met where the Commissioner is satisfied that profits tax or a similar tax "*has been paid or will be paid*" in respect of the interest income. This is a requirement of "tax being paid" rather than "subject to tax". Under the "tax being paid" requirement, interest paid by a CTC would not qualify for a tax deduction in Hong Kong if the recipient has tax losses such that no tax is paid overseas.

In our view, it should be sufficient to stipulate in the legislation that the gross interest income should be "subject to tax" at not lower than the applicable reference rate (i.e. 16.5% or 8.25% as the case may be), without requiring that tax being necessarily paid in all circumstances.

1.3 Request for due consideration of the deeming provisions

The deeming provisions proposed in the Bill seeks to tax certain interest and gains or profits from the sale, disposal or redemption of certificate of deposit or bill of exchange where the sale is effected outside Hong Kong.

The deeming provisions are unnecessary. The operations test will apply to determine the source of interest or profits for a money-lending company according to established case law. As such, where the activities directly giving rise to the interest or profits are carried out in Hong Kong, the interest income derived by the CTC will be taxable under existing law.

Appendix B

Key Comments on Divisions 3 and 4 of Part 2 and all of Part 3

2.1 Introduction

Division 3 of Part 2 of the Bill seeks to amend the IRO and the SDO to clarify the profits tax and stamp duty treatment of qualifying RCS issued by FIs under the BCR or under the equivalent laws or regulatory requirements of another member jurisdiction of the Basel Committee.

2.2 Section 17G proposes a significant change to the manner in which non-resident FIs are taxed in Hong Kong

The Legislative Council Brief on the Bill (File Ref: B&N/2/1/66C) states that, for anti-avoidance purposes, Section 17G (together with Section 17E) aims to specify the application of the arm's length and separate enterprise principles in ascertaining profits of non-resident FIs which have issued RCS.

In our view, Section 17G could however result in a significant departure from the manner in which non-resident FIs are currently taxed in Hong Kong, including potentially a change in the basis of taxation of non-residents from a territorial sourced based taxation system to a system that determines taxable profits based upon an approach similar to the approach authorized by the Organisation for Economic Co-operation and Development ("OECD"), hereinafter referred to as the "AOA" approach[1] which attributes profits to permanent establishments ("PEs").

Specifically, Section 17G(3), taken together with Section 17G(1), apparently provides that the taxable profits of the Hong Kong branch of a non-resident FI have to be ascertained taking into account "the functions performed, assets used and risks assumed by the non-resident financial institution (a) through the Hong Kong branch; and (b) through the other parts of the non-resident financial institution". However, this apparent proposed source rules of "the functions performed, assets used and risks assumed" may not necessarily align with the source principles and rules developed by the courts over the years.

As such, Section 17G could potentially lead to the situation where there is one set of statutory source rules for Hong Kong branch of non-resident FIs and a different set of case-law based source rules for resident FIs.

In our view, a broader industry consultation should be conducted for enactment of legislation with such wide implications.

2.3 Section 17H extends the AOA approach beyond the remit of the Bill

The proposed Section 17H in the Bill extends the introduction of the AOA to all non-resident taxpayers in Hong Kong.

In our view, the introduction of the AOA is a significant shift from Hong Kong's current territorial source principles (as governed by the general charging section, Section 14 of the IRO) in determining the profits of a non-resident chargeable to tax in Hong Kong.

Given that this is a significant departure and a move away from sourced based principles of taxation which will introduce an inconsistency between Hong Kong incorporated taxpayers and non-resident taxpayers, we strongly recommend that the Government consider removing Section 17H from the Bill.

The Government should only introduce the AOA and broad based transfer pricing provisions between related corporations after careful deliberation and consultation.

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[1] As explained in the OECD's final report on Attribution of Profits to Permanent Establishment published in July 2010.

2.4 Request for extending the tax deduction in respect of RCS to non-bank holding companies

The proposed Section 16(2AA) in the Bill restricts the application of debt categorization under Section 17B to FIs and hence the deduction to be allowed under Section 16(2AA) itself.

As per the currently drafted provisions, where RCS is issued by a "non-bank financial services holding company" ("Holding Company"), which then provides such capital to an intra-group bank, unless the Holding Company is included within the definition of FI, no deduction on RCS will be allowed to this entity. At the same time, any coupon payments by the bank may be taxable in the hands of the Holding Company. This may create an "asymmetrical tax outcome" for the Holding Company.

The Financial Institutions (Resolution) Bill, introduced into the Legislative Council in December 2015, recommended that under certain conditions resolution of a failing FI can only be achieved by taking resolution action at the level of a locally incorporated financial services holding company or a locally incorporated mixed activity holding company. Given this approach, the HKMA may request that AT1/T2 instruments be issued through non-bank financial services holding company.

In our view, it would be preferable to introduce into the Bill an additional sub-section covering RCS to be issued by Holding Companies to the extent that the provisions under the Financial Institutions (Resolution) Bill are applicable to FIs and their Holding Companies in Hong Kong. This should help provide a symmetrical tax treatment for RCS issued by these Holding Companies which may be encouraged/requested by regulators including the HKMA.

2.5 Request for amendments and guidance on the limitations on deduction placed under Section 17F(1)

It is provided under the proposed Section 17F(1) in the Bill that no deduction is to be allowed in respect of RCS if issued to, held by, or issued or held for the benefit of a specified connected person of the issuing FI, unless both of the following two conditions stated under Section 17F(2) are satisfied:

> The money paid by or on behalf of the specified connected person for the issuance has been entirely funded directly or indirectly by an external issuance; and
>
> The externally issued RCS is not held by or for the benefit of a specified connected person.

Under the first condition, FIs may encounter difficulties in tracing the flow of specific funds to demonstrate that the money paid by the connected person to the issuer was funded by the proceeds of an external issuance. Per the current drafting, an inability to trace back the flow of specific funds should lead to the disallowance of the entire sums paid in respect of the RCS.

In our view, certain stringent terms like "*entirely funded*" and "*held by or for the benefit of connected persons*" need to be suitably replaced such that RCS issued for *bona fide* commercial reasons are covered by the favourable tax treatment proposed by the Bill.

With regard to the second condition, there are *bona fide* commercial reasons why RCS may be held by related companies. Exceptions should be provided for to accommodate those cases. In addition, the extent of the disallowance should be proportionate to the holdings by related parties rather than a full disallowance.

Further, in order to ensure certainty to the taxpayers, practical guidance is required on the specific limitations that have been placed under this section. Guidance is particularly needed for situations where there is a time interval between the issuance of RCS by the FI in Hong Kong and the external issuance of the relevant RCS and other debt instruments by the connected person.

Appendix C

Other Comments on Divisions 3 and 4 of Part 2 and all of Part 3

3.1 Clarity on the scope of qualifying "RCS" under Sections 17A(2)(b), (c) and (3)

The proposed Sections 17A(2) and (3) in the Bill seek to impose certain limitations on a security eligible for debt categorization under the Section 17B. Section 17A(2) contains a definition of the term "security" and Section 17A(3) contains certain specific qualifying conditions in order not to fall within the exclusions to such definition. The effect of these sections is to define which securities are in-scope for the purposes of the Bill.

The limitations placed under this section may not fully align with the current market requirements imposed on issuers of RCS. In this regard, the contingent convertible features and discretion of the issuer to cancel distributions for AT1 capital instrument are within the qualifying criteria under Schedules 4B and/or 4C of the BCR or the equivalent law or regulatory requirements of other Basel committee member jurisdictions. Including such limitations under Section 17A(2) may create confusion or uncertainty as regards the application of the Bill and may cause AT1 and T2 capital instruments issued for *bona fide* regulatory reasons to fail to qualify as a RCS for the purposes of Section 17B in the Bill.

In order to provide clarity on the matter, given the Bill has already limited the application of the proposed Section 17B to "RCS" as defined under the proposed Section 17A(1) and related definitions proposed in (5), it would be preferable for the Bill to drop the limitations under the proposed Sections 17A(2)(b), (c) and (3).

3.2 Clarification that Section 17C in the Bill also covers relevant hedging transactions

The proposed Section 17C in the Bill seeks to ensure that, in ascertaining the profits of the issuer of the RCS, any mark-to-market adjustments in respect of the RCS as reflected in the accounts are not taxable/deductible to the issuing banks

It is common for banks to hedge their financial risks (e.g. interest rate and exchange rate risks) with respect to the RCS. For example, an FI with a functional currency of HKD may issue a RCS in USD and hedge the exchange rate risk by way of an exchange rate swap. Where there is a designated hedging transaction with respect to a RCS as such, fair value profit and losses may arise from both the security and the hedge.

In our view, to align with global best practice and to provide certainty to the issuers, a symmetrical tax outcome in respect of the RCS and its hedges is preferred.