Bills Committee on Inland Revenue (Amendment) (No. 4) Bill 2015
Legislative Council Secretariat
1 Legislative Council Road
Central
HONG KONG

21 January 2016

Dear Sirs,

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

The Asia Securities Industry & Financial Markets Association (**ASIFMA**[1]) welcomes the opportunity to make a submission to the Bills Committee in relation to the Inland Revenue (Amendment) (No. 4) Bill 2015 (**Bill**).

We have had the benefit of reading the submission prepared by the Capital Markets Tax Committee of Asia ("**CMTC**", 亞州資本市場稅務委員會) dated 20 January 2016 ("**CMTC Submission**") and concur with the views and concerns expressed in that submission.

Accordingly, with the approval of CMTC, we append the CMTC Submission as part of this letter and respectfully request that the Bills Committee consider the comments in that submission as also being the submission of ASIFMA. In particular, having regard to the concerns raised in the CMTC Submission, ASIFMA requests:

1) Section 17G to be extracted from the Bill for proper consultation with stakeholders;

2) Section 17H to be amended to clearly reflect the legislative intent that section 17E does not affect the application of the arm's length principle in other circumstances;

3) Section 17F to be amended to clarify that the deductibility of interest on regulatory capital securities (**RCS**) is only limited *to the extent* that it is not funded externally

[1] ASIFMA is an independent, regional trade association with over 90 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, professional service firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, competitive and efficient Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

and to allow RCS to be held by or for the benefit of specified connected persons for bona fide commercial reasons (e.g. where RCS is underwritten by a specified connected person);

4) Section 17A should be amended by permitting regulatory capital instruments containing compulsory "convertibility" and "discretionary" terms under Basel III standards to be qualified as RCS under the Bill;

5) Sections 15(1)(ia) and 15(1)(la) to be removed from the Bill in order not to contradict the good intention of promoting Hong Kong as a corporate treasury centre through offering half-tax rate incentives to corporate treasury centre activities and allowing deductions on intra-group group borrowings.

* * * * * *

If you would like to discuss anything contained in this submission, we would appreciate the opportunity to do so. Please do not hesitate to contact Patrick Pang, Managing Director and Head of Fixed Income & Compliance of ASIFMA, at ppang@asifma.org or +852 2531 6520.

Yours sincerely,

Mark Austen
Chief Executive Officer
ASIFMA

Enc.

Appendix: CMTC Submission dated 20 January 2016

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20 January 2016

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Legislative Council Secretariat
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Central
HONG KONG

Dear Sirs,

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

The Capital Markets Tax Committee of Asia ("**CMTC**", 亞州資本市場稅務委員會) appreciates the opportunity given by the Bills Committee to provide comments on the Inland Revenue (Amendment) (No. 4) Bill 2015 (**Bill**).

CMTC welcomes the Government's proactive efforts to enhance Hong Kong's competitiveness as a global financial centre. CMTC is therefore supportive of the following measures which seek to achieve the following:

- treating certain regulatory capital instruments issued by banks as debt instruments for tax purposes and recognising that the distributions associated with such instruments are interest expenses;
- introduction of a concessionary half-tax rate regime for qualifying corporate treasury centres; and
- allowing a tax deduction on interest expense on borrowings from non-Hong Kong associates in relation to intra-group borrowing and lending transactions.

Notwithstanding this, CMTC members have specific concerns about the Bill which are summarised below:

1) Regulatory Capital Securities (RCS) related provisions

A. The proposed section 17G introduce new complex principles to determine the taxable profits of a foreign bank with RCS and is not limited to determining the appropriate amount of interest on RCS that may be allocated by a foreign bank to its Hong Kong branch. This is a significant deviation from the current law and stakeholders have not been properly consulted in this respect.

   CMTC requests that section 17G is extracted from the Bill and deferred until there has been comprehensive consultation with stakeholders before its introduction. In particular, CMTC's immediate concerns are as follows:

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(i) Section 17G contains inherently complex principles, including the "separate entity principle", "profit attribution methodology" and "debt-to-equity" threshold, which have far-reaching implications beyond its intended scope of simply restricting the amount of interest expense on RCS that may be allocated to the Hong Kong branch of a foreign bank. CMTC is uncertain of how these complex principles will interact with the "source' principle that underlies the Hong Kong taxation system;

(ii) Section 17G will result in inequities amongst taxpayers where foreign banks that have issued RCS will be required to determine its chargeable profits based on the new complex principles under section 17G, whereas Hong Kong incorporated banks (irrespective of whether they have issued RCS) and those foreign banks without issued qualifying RCS (e.g. those that have issued preference shares) will not be required to adopt those principles;

(iii) Even if some of the principles are contained within Hong Kong's tax treaties, foreign banks have not required by the Inland Revenue Department (**IRD**) to adopt these principles in practice. Furthermore, Hong Kong does not have such bilateral agreements with all countries, including countries with major banking headquarters (e.g. United States and Australia). Hence, the principles, even if contained in certain tax treaties, are not currently applied to banks operating in Hong Kong;

(iv) The principles in section 17G contain profit attribution concepts introduced by the Organisation for Economic Co-operation and Development (**OECD**) which are discussed and agreed by OECD countries (not including Hong Kong) without any specific regard to Hong Kong's domestic circumstances. Therefore, in the absence of proper consultation, the introduction of principles of section 17G could have an adverse impact on the operation of foreign banks in Hong Kong.

CMTC believes that section 17G should be deferred for comprehensive consultation with stakeholders before its introduction as the principles contained within this section have far-reaching implications that is not limited to RCS. This recommendation should not impact the proper operation of sections 17A to 17F of the Bill as they relate to RCS (see our comments at **Section A** below).

B. Section 17H as currently drafted may be misleading and can be interpreted as codifying the application of the new complex principles in section 17G and "arm's length principle" in section 17E to all taxpayers (including non-financial institutions) whether or not RCS is relevant to them. This is surely outside the intended scope of the Bill designed to provide appropriate clarifications regarding the tax treatment of regulatory capital instruments for financial institutions.

We request that section 17H to be amended to clarify the legislative intent (see our comments at **Section B** below) and this amendment should not impact the proper operation of sections 17A to 17F of the Bill as they relate to RCS.

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C. Section 17F as currently drafted may give rise to an anomalous outcome between a RCS that is directly and indirectly issued to non-connected persons. Based on section 17F in its current form, if the RCS is directly issued (i.e. not issued through any interposed entities) by a financial institution, the interest on RCS is deductible to the extent it is issued to non-connected persons (e.g. the public). However, where the RCS is indirectly issued (i.e. issued through an interposed entity such as the group holding company), the interest on RCS can only be deducted if the interposed entity issues the instruments entirely to non-connected persons. This creates an unfair situation where there will be "zero" deduction on the RCS interest even if the interposed entity raised 99% of the funding from non-connected persons.

We request that section 17F is amended to remove this anomaly and to provide pro-rata deduction of interests on RCS indirectly issued to non-connected persons via an interposed entity.

(see our comments at **Section C** below)

D. Section 17A contains definitional provisions which exclude instruments containing key terms (including convertibility in the event of a non-viability event of a financial institution) which are required under the Basel III standards from qualifying as RCSs for the purposes of the Bill.

We request that section 17A is amended to align with the definition of regulatory capital instruments in compliance with Basel III global standards (and as implemented by the Hong Kong Monetary Authority (**HKMA**)) (see our comments at **Section D** below).

E. In addition, under new regulatory rules, a holding company of a bank may be required to issue RCS in certain circumstances and then provide support to the bank (e.g. through an interest-bearing loan). However, under the proposed Bill, only a bank should be entitled to treat the RCS as a debt instrument for tax purposes and therefore, the holding company would not be entitled to interest expense deductions on the RCS while the related gross interest income is subject to tax. We request that the Bill should also be changed to treat such a holding company as a "financial institution" (i.e. bank) in such circumstances and therefore entitled to treat RCS as a debt instrument for tax purposes.

2) Interest income deeming provisions

The proposed sections 15(1)(ia) and 15(1)(la) which deem interest income and gains on the disposal of certain money market assets as assessable are based on the "operations test" discussed by the Privy Council in *Orion Caribbean*.

The "operations test" applied in the *Orion Caribbean* case is based on the facts which are peculiar to that case. This case is not tax precedent that the "operations test" should have blanket application to all intra-group financing arrangements. In this regard, the Privy Council in the *Orion Caribbean* case have emphasised that source (of interest) is a "hard, practical matter of fact". Therefore, each case should be assessed on its own facts. In this regard, we note that even after the *Orion Caribbean* case in 1997, the IRD has stated in an article published in the Hong Kong Accountant (dated

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January/February 1998) to the effect that the "provision of credit" test "remains the basis of taxing interest in Hong Kong".

If it is the Government's intention to introduce provisions which provide symmetry between the assessability of interest income/gains and deductibility of interest expenses/losses, sections 15(1)(ia) and 15(1)(la) are not necessary. The existing deduction provisions contained in section 16(1) already necessitates that expenses are only deductible if *it is incurred in deriving assessable income*. In fact, if sections 15(1)(ia) and 15(1)(la) are introduced, a mismatch may arise which may deter multinational corporations with established central treasury functions to stay in Hong Kong. For example, in spite of the concessionary interest deduction provision (which are welcomed as part of the Bill), a company performing intra-group borrowing and lending functions could be subject to Hong Kong profits tax on the deemed interest income without an offsetting deduction for interest expense if the lender has not paid tax on the interest received at a rate that is not lower than the Hong Kong profits tax rate (i.e. currently 16.5%). This may very likely occur if the lender itself is in a tax loss position (i.e. tax will not be paid) or is resident in a jurisdiction also offering tax incentives (e.g. in Singapore, qualifying Finance and Treasury Centres are subject to a concessionary tax rate of only 10%).

Therefore, if these unnecessary provisions are introduced, multinational corporations with established central treasury functions in Hong Kong will be deterred from staying thereby rendering the well intentioned concessions in the Bill redundant.

We request that sections 15(1)(ia) and 15(1)(la) are removed from the Bill (see our comments at **Section E** below).

* * * * * *

If you would like to discuss anything contained in this submission, we would appreciate the opportunity to do so. Please do not hesitate to contact me on 2909-8112.

Yours sincerely,

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Enc.

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Section A: Section 17G contains complex principles which should be removed from the Bill for comprehensive consultation

Section 17G applies to ascertain the chargeable profits of a Hong Kong branch of a foreign bank if the foreign bank has issued RCS. Section 17G requires that such "chargeable profits" are to be determined on the basis that the Hong Kong branch is a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions, and dealt wholly independently of the foreign bank ("**separate entity principle**"), having regard to the following:

- the functions performed, assets used and risks assumed by the foreign bank through its Hong Kong branch and branches in other jurisdictions ("**profit attribution methodology**"); and
- assuming the Hong Kong branch has the same credit rating as the foreign bank and has equity and loan capital as it could reasonably be expected to have if it were a distinct and separate enterprise ("**debt-to-equity threshold**").

With the benefit of viewing the webcast of the first Bills Committee Meeting on 12 January 2016 ("**First Bills Committee Meeting**") and through previous correspondence between the Government and other interested parties, CMTC members understand that the legislative intent behind section 17G is to prevent foreign banks from allocating an unreasonable and disproportionate amount of the costs associated with RCS to Hong Kong branches, thereby eroding the tax base of Hong Kong.

CMTC appreciates that the Government should be entitled to introduce legislative provisions which promote Hong Kong as an attractive investment location without compromising its right to tax revenue. However, CMTC do not believe that section 17G is necessary and would not in fact allow the Government to achieve this balance. Our reasons are discussed further below.

1) *Section 17G has far wider implications beyond the appropriate allocation of interest on RCS to Hong Kong*

Pursuant to section 17G(1):

"This section applies in ***ascertaining profits*** *in respect of which a non-resident financial institution with capital raised through the issue of a regulatory capital security* ***is chargeable to tax*** *under this Part in relation to its Hong Kong branch."* (emphasis added)

Accordingly, while section 17G only applies in the event a foreign bank has issued RCS (as defined), its application is not limited to determining the appropriate amount of interest on RCS that may be allocated by a foreign bank to its Hong Kong branch. It has a far wider application which prescribes and replaces how such a Hong Kong branch would determine its chargeable profits, including how the Hong Kong branch should be allocated income in cross-border transactions (even if such allocated income is not relevant with RCS). The proposed 17G will also apply to determine the chargeable

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profits of a Hong Kong branch even if no interest on RCS is actually allocated by the foreign bank to Hong Kong.

2) ***Section 17G will result in Hong Kong branches of foreign banks with issued RCS being subject to different tax principles***

Section 17G should only apply to **a Hong Kong branch** of a foreign bank if the foreign bank has **issued Additional Tier 1 (AT1) and Tier 2 (T2) capital instruments that qualifies as RCS** (noting that, based on the Bill as currently drafted, not all AT1 and T2 capital instruments issued by a bank may qualify as RCS e.g. preference shares).

Accordingly, the following taxpayers would not be required to apply section 17G:

- Hong Kong banks with overseas branches
- Hong Kong branch of foreign banks without AT1 or T2 capital instruments that qualify as RCS
- Hong Kong branch of non-bank foreign companies

Since section 17G applies to determine *all* of the chargeable profits of a Hong Kong branch, CMTC members are concerned about the inevitable inequity that will arise from such application. By way of example, and without any implication that the principles in section 17G should be extended to other taxpayers, a Hong Kong branch of a foreign bank with RCS is required to apply section 17G to ascertain the chargeable profits of its Hong Kong business by applying a "profit attribution methodology" and "debt to equity threshold". However, the chargeable profits of a Hong Kong bank with overseas branches is not affected by section 17G and would continue to determine its profits from the Hong Kong business based on the general charging section (i.e. section 14(1)) which applies to all taxpayers. In this regard, chargeable profits determined based on section 14(1) (i.e. by applying the "source" principle) may not necessarily be the same as chargeable profits determined by adopting the "separate entity" principle and applying a "profit attribution methodology" and "debt to equity threshold".

This will create a different taxation basis for foreign banks with RCS carrying out business in Hong Kong and we recommend that section 17G is extracted from the Bill and deferred until proper consultation has taken place with stakeholders.

3) ***Section 17G contains complex tax principles that have not received proper consultation with stakeholders***

The Government has mentioned in the discussions at the First Bills Committee Meeting that the "separate enterprise" and "arm's length" principles are not new, and the "separate enterprise" principle is already prescribed by many Hong Kong tax treaties (referring then to Article 7 of tax

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treaties)[1]. However, it is important to firstly highlight that a tax treaty is a bilateral agreement made by two countries to resolve issues involving the double taxation of income. Therefore, by its very nature, in the absence an agreement between two countries and in the absence of double taxation, a taxpayer operating in a particular country is first and foremost governed by the domestic tax legislation and/or regulations operating in that jurisdiction.

In this regard, it is the industry's clear understanding and practice as condoned by the IRD that under the current domestic law of Hong Kong,[2] the certified financial accounts of a Hong Kong branch of a foreign bank is to be used for determining the "true profits" that should be chargeable to Hong Kong profits tax.

In addition, Hong Kong does not have tax treaties with a number of countries that have substantial banking operations, including the United States and Australia, and therefore Article 7 would not apply. Accordingly, the "separate enterprise" principle will be new law because this principle, at least, currently does not apply to all taxpayers.

If section 17G is to be implemented, the Hong Kong branches of foreign banks will be in a precarious position and CMTC is concerned Hong Kong's territorial basis of taxation (which has been the pillar of Hong Kong's tax system) will be eroded giving rise to further complexities requiring the "source" principle to be applied in some circumstances and principles in section 17G to be applied in others.

If the Government intends to introduce such new principles (to align to principles in the tax treaties), there must be a comprehensive consultation with stakeholders and allowing due process for stakeholders to assess the impact these new principles may have on their business and economy. For example, in late 2012 the Japanese Ministry of Finance (**MOF**) announced its intention to adopt the authorized OECD approach to the attribution of profit into the Japanese tax rules. Both before and following the announcement, the MOF expended considerable energy and resources to canvass taxpayer views on the proposed change. In particular, the MOF was interested to identify the key issues that most concern taxpayers in relation to the scope and application of any change in law. However, such due process and concern for the impact that new rules will have on the Hong Kong taxpayers is insufficient with the introduction of section 17G. In this regard, we understand these concerns were also raised in a submission made by the Joint Liaison Committee on Taxation (**JLCT**) dated 6 November 2015 in response to the draft Bill released by the Government and we are not aware that the Government has addressed these concerns.

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[1] Extract of paragraph 2 of Article 7 in the Hong Kong / United Kingdom tax treaty: *"Subject to the provisions of paragraph 3, where an enterprise of a Contracting Party carries on business in the other Contracting Party through a permanent establishment situated therein, there shall in each Contracting Party be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."*

[2] Through the application of Inland Revenue Rule 3: Method of ascertainment and determination of the profits of the Hong Kong branch of a bank whose head office is elsewhere than in Hong Kong.

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In the absence of proper consultation, we request that section 17G is extracted from the Bill and deferred until proper consultation has taken place with stakeholders.

4) *Comparison to other jurisdictions*

In recognition of the additional capital requirements of banks, Singapore introduced section 10O to its Income Tax Act containing only 2 subsections - an operative section 10O(1) and definition section 10O(2)). The operative section 10O(1) simply states the following:

> *"**Additional Tier 1 capital instruments**
> **10O.**
> —(1) Any distribution that is liable to be made in respect of an AT1 instrument in the basis period for the year of assessment 2015 or a subsequent year of assessment shall be deemed for the purposes of this Act, and for that year of assessment, as interest derived from a debt security."*

The Government must account for such simplicity in the introduction of the Bill in order to present Hong Kong on a level playing field. If the Government has introduced section 17G as an anti-avoidance mechanism, we do not believe such additional complexity is necessary as existing provisions within the Inland Revenue Ordinance (**IRO**) has sufficient safeguards. For example:

- pursuant to Section 16(1), interest on RCS would only be deductible to the extent that it is incurred in deriving profits that are assessable in Hong Kong. Therefore, a foreign bank may only allocate interest on RCS to its Hong Kong branch if it is doing so because the Hong Kong branch needs such funding to carrying on its business in Hong Kong.

- pursuant to section 61 and section 61A, artificial or fictitious transactions, or transactions entered into for the sole or dominant purpose of enabling an entity to obtain a tax benefit (e.g. claim a tax deduction) are denied and the Commissioner is empowered to apply the appropriate tax assessment in these cases. The inappropriate allocation of interest on RCS to a Hong Kong branch that the Government is preventing should fall within the ambit of sections 61 and 61A, and therefore the proposed section 17G should be rendered unnecessary.

Our recommendation:

We recommend that section 17G is extracted from the Bill and deferred until proper consultation has taken place with stakeholders which should not impact the proper operation of sections 17A to 17F of the Bill as they relate to RCS.

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Section B: Section 17H should be amended to clearly reflect the legislative intent that section 17E does not affect the application of the arm's length principle in other circumstances

Section 17H reads as follows:

> ***"Arm's length and separate enterprise principles not prevented from application in other circumstances***
>
> *Sections 17E and 17G do not prevent principles similar to those provided for in those sections from applying to a person, or in circumstances, other than the persons or circumstances mentioned in those sections."*

One interpretation of section 17H is that the principles in sections 17E and 17G may apply to all taxpayers (i.e. to non-financial institutions) whether or not RCS is relevant to them (which are the "circumstances" referred to in section 17E and 17G). We understand from the discussions in the First Bills Committee Meeting that this is not the intended interpretation by the Government.

We understand that section 17H should be interpreted to clarify that for the avoidance of any doubt, existing principles contained within the IRO and court cases are not prevented from applying in addition to sections 17E and 17G and should co-exist with these proposed sections.

Our recommendation

We recommend that section 17H is amended to clearly reflect the legislative intent as follows (on the basis that section 17G will be removed from the Bill for further consultation):

"17G: Section 17E does not affect the application of the arm's length principle in other circumstances

Nothing in section 17E has the effect of preventing principles provided for in existing sections of the Inland Revenue Ordinance from applying."

This should not impact the proper operation of sections 17A to 17F of the Bill as they relate to RCS

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Section C: Section 17F should be amended to clarify that the deductibility of interest on RCS is only limited *to the extent* it is not funded through an external issue

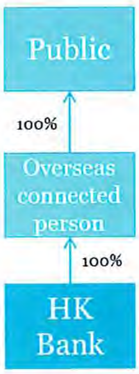
We understand that the intention of section 17F is to restrict the deductibility of interest on RCS to the extent that the RCS is issued to or funded by certain non-connected persons.

However, based on the current words of section 17F, anomalous outcomes may arise which requires RCS to be **entirely** funded by certain non-connected persons in an indirect issuance of RCS. The illustrations below demonstrate this:

1) Scenario 1: Direct issue of RCS partly to associates and partly to external issue

Under this scenario, where a Hong Kong bank issues RCS partly (e.g. 90%) to the public and partly (e.g. 10%) to an overseas connected person, only 90% of the interest on the RCS issued is deductible for tax purposes.

2) Scenario 2: Indirect issue of RCS to associates funded entirely by an external issue



Under this scenario, where a Hong Kong bank issues RCS entirely to an overseas connected person (e.g. group holding company) which is then entirely funded by issuing RCS, debenture or debt instrument to the public, *all* of the interest on the RCS issued is deductible for tax purposes.

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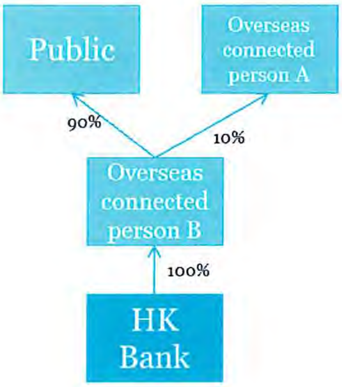
3) Scenario 3: Indirect issue of RCS to associates funded partly by an external issue



Under this scenario, where a Hong Kong bank issues RCS entirely to an overseas connected person which is then partly funded by issuing RCS, debenture or debt instrument to the public and partly funded by another overseas connected person, *none* of the interest on the RCS issued is deductible for tax purposes. This scenario is common in commercial practice as the RCS will often require its issuance and distribution to be underwritten by an overseas connected person in the overseas markets (e.g. part of the RCS issued is held by an overseas connected person on a transitional basis as a result of the underwriting activities).

Our recommendation

We recommend that section 17F is amended to allow deductions for interest on RCS on a pro-rata basis in an indirect issuance scenario as follows (amendments in strikethrough and/or bold):

> *"(2) Subsection (1) does not apply to a sum payable in respect of a regulatory capital security issued to or for the benefit of a specified connected person of the specified issuer* ~~***if***~~ ***to the extent that*** *both of the following conditions are met-*
>
> *(a) the money paid by or on behalf of the specified connected person for the issue of the security has been* ~~***entirely***~~ *funded, either directly or indirectly, by the proceeds of an external issue of a regulatory capital security or debenture or debt instrument by the specified connected person or an associated corporation of the specified issuer;*
>
> *(b) the externally issued regulatory capital security or debenture or debt instrument is not*~~***, at any time during the basis period of the specified issuer for the year of assessment concerned,***~~ *held* ~~***by or***~~ *for the benefit of a specified connected person of the specified issuer***.***"*

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Section D: Definitions contained within section 17A should be amended to align with the requirements to qualify as regulatory capital instrument in accordance with the regulatory rules

Section 17A specifies the regulatory capital instruments that are eligible under Division 3 to be treated as a debt instrument and therefore its distributions as interest which is deductible for tax purposes.

As a result of this section, regulatory capital instruments that would otherwise comply with the Basel III global standards are not eligible under Division 3 to be treated as a debt instrument.

Basel III contains global capital standards that banks must adopt. These standards are implemented and monitored by the bank regulators in each jurisdiction.

Broadly, under the Basel III standards, a bank's capital base comprises:

- Tier 1 Capital – further comprising:
    - Common Equity Tier 1 capital ("**CET1**") (which are essentially common shares and retained earnings); and
    - Additional Tier 1 capital ("**AT1**");
- Tier 2 Capital ("**T2**")

Unlike CET1 which are purely equity, AT1 and T2 instruments possess both equity and debt-like features. A key requirement introduced by the global Basel III standards is that AT1 and T2 instruments must contain a loss absorption mechanism that requires such instruments to either be written off or converted into an instrument that qualifies as CET1 at the option of the regulator if the bank becomes non-viable. In this regard, AT1 instruments must be perpetual and can take the form of perpetual notes / debt obligations or preference shares, whereas T2 instruments are generally fixed term notes / debt obligations.

Under the Bill, "Regulatory Capital Security" (**RCS**) comprises either i) AT1 capital instrument or ii) T2 capital instrument as prescribed under the Hong Kong or equivalent overseas banking rules. However, the following securities are excluded from the definition of RCS:

1. Shares;
2. Debt instruments which contains terms and conditions that allow for the bank (as issuer of the instrument) to **convert or an option to convert** the instrument to a CET1 after a period of time; or
3. Debt instruments that provides **discretion to the issuer** of the instrument to make a distribution or redemption payment depending on the business results of the bank (as the issuer), except under the situation where the results of the business of the issuer of the instrument worsen.

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CMTC is concerned that eligible Basel III compliance instruments containing key "convertibility" features or "discretion" of the issuer to make distributions would not qualify as RCS under the Bill.

Such distinctions may render the Bill ineffective.

Our recommendation

We recommend that sections 17A(2)(b), (c) and 17A(3) are deleted.

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Section E: The "operations test" is not the governing principle to determine the "source" of interest income in Hong Kong. Sections 15(1)(ia) and 15(1)(la) are unnecessary and should be removed

Profits are assessable in Hong Kong based on a territorial concept of taxation. This means, only profits which are "sourced" in Hong Kong should be subject to tax in Hong Kong. In this regard, there are two key cases heard by the Privy Council where it was held that the "source" of interest income may be determined in some circumstances based on the "provision of credit" test (refer to *Heng Seng Bank Limited* case) and in others, based on the "operations" tests (refer to *Orion Caribbean* case).

However, the Government has submitted that the "operations" test should be applied for all intra-group financing arrangements on the basis that the Privy Council decision in the *Orion Caribbean* case is binding case law that the IRD has applied over many years. As such, sections 15(1)(ia) and 15(1)(la) ("**deeming provisions**") simply codifies existing case law requiring interest and gains on the disposal of certain money market assets that a company derives from its intra-group financing business to be deemed as assessable for Hong Kong profits tax purposes. This is even if the funds are made available or the transaction to which the disposal relates has taken place outside of Hong Kong.

This is contrary to the "source" principle as stated above.

We respectfully submit that the "operations" test in the *Orion Caribbean* case is not binding case law that applies to all intra-group financing arrangements. The *Orion Caribbean* case involved specific facts as follows:

- In 1978, a new provision (section 15(1)(i)) was added to the IRO to bring to tax interest derived from outside Hong Kong by financial institutions carrying on business in Hong Kong;
- Certain banks responded by establishing Orion Caribbean Limited (**OCL**) in the Cayman Islands. OCL was in turn held by Orion Royal Pacific Ltd (**ORPL**), being a company incorporated in Hong Kong and owned by a consortium of 5 banks.
- OCL's function was to serve as a conduit for loans from ORPL to borrowers in the Asia-Pacific region, excluding Hong Kong. If ORPL had made loans directly to these borrowers, interest would be deemed subject to Hong Kong profits tax under the new section 15(1)(i) which applied to financial institutions.
- In accordance with this arrangement, some existing loans were transferred from ORPL to OCL and new loans were not made by ORPL but instead channelled through OCL.

In this case, although the Privy Council upheld the Commissioner's appeal in deciding that the profits on the loans were sourced in Hong Kong, such a decision was made based on the specific facts and circumstances applicable in that case. It is not without doubt that the tax avoidance efforts by the taxpayer placed some influence on the Lordships' decision. It is also important to note that the "operations test" is

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merely *orbita dicta* and not *ratio decendi* and therefore should not be used as the governing principle applicable to all cases. In this regard, we believe the Lordships recognised this by also emphasising the following in their judgement:

- Source is a "hard, practical matter of fact" – therefore a simple rule (such as the proposed interest deeming provision) is not helpful.
- The facts of the Orion Caribbean case are "far removed from the simple type of loan transaction contemplated by Lord Bridge in *Heng Seng Bank*" – the significance of this statement is a poignant reminder that judgements in precedent cases should not be read as if they were binding.

It is not true that a mismatch may arise in the absence of the deeming provisions giving rise to an erosion of tax revenue in Hong Kong because corporations would be entitled to treat interest on intra-group borrowings as deductible whereas interest income on intra-group lending would not. This is because existing safeguards under section 16(1) continue to apply even in the absence of the deeming provisions. Under section 16(1), interest expenses on intra-group borrowings are not deductible unless it is incurred in deriving assessable income.

The CMTC members are concerned that by legislating the deemed interest provision in its current form, multinational corporations who have already established central treasury functions in Hong Kong will be deterred to stay in Hong Kong and invest in other competitive jurisdictions. For example, although the Government has afforded a concession by allowing interest on intra-group borrowings to be deductible for tax purposes, such deductions are subject to specific requirements (e.g. the lender must have paid or will pay an amount of tax on the interest income at a rate that is not lower than the Hong Kong profits tax rate). This will give rise to an asymmetrical outcome whereby the entity undertaking the treasury function is deemed to be assessed on the interest income received (whether or not the loan has been made available in or outside of Hong Kong) without being eligible for a deduction (as was the intention of the Government) because its borrowings may have come from a Singapore group company qualifying as a Finance and Treasury Centre (being taxed at a lower tax rate).

Our recommendation

We recommend that sections 15(1)(ia) and section 15(1)(la) are removed as they are contrary to the good intention of the concessions offered to make Hong Kong an attractive treasury location for both new businesses and existing treasury centres in Hong Kong.